THE
LONDON
COMPANY

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To clients and friends of The London Company:

> ***Kramer:*** *You know you're not supposed to brush your teeth for 24 hours before you go to the dentist.*
>
> ***Jerry:*** *I think you're thinking of 'You're not supposed to eat 24 hours before surgery'.*
>
> ***Kramer:*** *Oh, you gotta eat before surgery. You need your strength.*
>
> -***Seinfeld*** **S6E105**

The London Company is blessed to have an office full of *Seinfeld* aficionados. The famous 'show about nothing' is an in-house favorite and an oft-quoted source since it is actually relatable to almost everything. Our frequent referencing of the show even led to the discovery of an online quiz that helps determine which character you best resemble. Predictably, the most common result amongst our team was Jerry. Our lot did not cast a Kramer, but the quiz incredibly found both a Puddy and a Frank Costanza to provide contrast within our halls. Rarities for sure…and another reason to celebrate Festivus!

The exchange with Jerry in the above scene was classic Kramer, and it worked so well due to his equal level of conviction and ignorance. Kramer's observation is inherently funny but also instinctive and genuinely well-intended. To us, it's a glaring reminder that things aren't always as they appear and that simple logic, like Kramer's dental and health advice, can be seriously flawed. It is a truth as old as time and an integral part of human nature. Regrettably, this reality is becoming more prevalent given the proliferation of opinion and misinformation on social media. We are quick to jump to conclusions because it's easier to cling to what we want to believe than to discern and contemplate what may challenge our core views. This is particularly true in politics, where both sides of the aisle dwell in twin towers of partisan babble, making it almost impossible to know what is real and whom to trust.

The financial markets aren't nearly as sinister, but similarly prone to false narratives and misguided conclusions. History is littered with examples of overconfident crowds and poorly timed predictions. There is a reason why consensus views rarely endure, and that the most successful investors tend to be contrarian in nature. Over time, the stock market can act as a master manipulator lulling you into believing something that isn't true. It is how we got the infamous 1973 *BusinessWeek* cover, "The Death of Equities" or why *Barron's* questioned the ways of Buffet in

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its article, "What's Wrong, Warren" at the height of the tech bubble. It is how a journalist at the *Washington Examiner* this January advised millennials to save in Bitcoin, and why, according to *Fortune* just last week reported that 1 in 5 college students are now using their federal loan money to purchase said cryptocurrencies, which seems like a really bad idea.

The London Company isn't immune to bad outcomes with seemingly good ideas, as we have had our fair share of them too. Given enough time and experience, we know this business will at some point humble us all. The humbling headlines above were extreme examples where greed and groupthink helped form asset bubbles, but misconceptions to prevailing beliefs are also present on a smaller scale. A current example and outgrowth of this past quarter is that market volatility is abnormal or that it should be a cause for concern. This is a relatively new consensus view and a function of recent experience. As we turned the calendar into 2018, we exited a period of extreme calm and record low volatility. Nearly every measure of market stability was broken in 2017, as the S&P 500 positively advanced each month for the first time in its history without the scantiest of pullbacks. The trend continued in January as stock prices raced upward on a fast and linear path. The broader market was up over 5% with volatility still nonexistent. That "new normal" abruptly changed in February when inflation fears returned, credit spreads widened and protectionism surged. The market finally began to show some cracks, quickly falling 10% from its peak, and suggesting that all was not okay. To put it in perspective, the market had 23 daily moves, up or down, of at least 1% this quarter compared to just 8 in all of 2017. Simply put, volatility re-emerged as the "old normal".

At the end of the first quarter, the S&P 500 declined -0.8% and the Russell 2000 Small Cap Index returned -0.1%. On the surface these returns look benign. It would be easy to assume not much happened but we now know that wasn't the case. Late last year Chris Cole from Artemis Capital told *The New York Times*, "Volatility is an instrument of truth, and the more you deny the truth, the more the truth will find you through volatility." His observation was an accurate warning that the market had lulled us into a false sense of security, that things weren't as stable as they appeared, and risk was being mispriced. Today, with the benefit of hindsight, we can see the carnage. If volatility is truth, it spoke loudest to the riskiest of assets, cryptocurrencies - Bitcoin and its brethren - as they dropped 60% from peak (likely angering many college students along the way). Perversely, it also smashed low-volatility (low-vol) ETF funds, forcing some funds to shut down after parabolic spikes in the VIX (volatility index). In comparison, a roughly 10% equity correction seemed tame. The drawdown wasn't extreme but definitely a changing of the guard. So, it makes sense to see some consternation over the recent gyrations in the market. Fortunately, history tells us that the return of volatility was not only inevitable, but that it is actually normal and arguably even healthy.

The London Company has commented on the unintended consequences of a low volatility world, so we are encouraged to see recent price fluctuations. Our portfolios have traditionally done well in these periods. It opens up attractive buying opportunities, lets company fundamentals impact price, and most importantly, allows our more conservative approach to capture less of the downside. Preserving wealth is our number one priority and history has shown us to excel when markets are their weakest. This most recent period was the first time since 2009 that the market ended its first calendar quarter in negative territory, however slight at less than 1%. That means it is technically a rare down quarter, but not all down markets are created equal, so we need to assess what really drove returns before jumping to any false conclusions. We will spend the remainder of this letter discussing what worked and what didn't, and what we could expect going forward.

Before we peel back the onion, we will first report on our performance. As a whole, our lineup of products were mixed but within our expectations. The small cap, smid cap, mid cap and all cap strategies outperformed (gross of fees) their respective benchmarks for the quarter. As anticipated, the relative gains came in February and March when markets were stressed. Stock selection for all four of these products contributed over 100% of our relative outperformance as sector allocation was a drag, particularly for our small cap and smid portfolios. The best three performing sectors in those respective benchmarks were technology, health care and financials where we are significantly underweight. With the help from a couple of buyouts in small and smid, strong stock selection added enough value to offset that headwind. Our mid cap strategy has a more representative weighting to the same leading sectors and was able to outpace the index due to strong relative performance from our stocks in the industrials, financials and materials sectors. Our all cap product suffered more from its technology underweight and poor performance from some discretionary positions but still squeaked out a relative gain for the quarter.

Turning to our large cap, income equity, and concentrated strategies, they did not outperform their benchmarks for the period. The large cap portfolio finished near the Russell 1000 Index return of -0.7% but fell slightly short due to the poor relative performance of our consumer discretionary positions. Similarly in income equity, our underweight to growth generally and to technology specifically, coupled with an overweight to the poorly performing consumer staples sector – a traditional safe haven in down markets - prevented us from outpacing the S&P 500. Income equity did, however, end the quarter in line with its primary benchmark, the Russell 1000 Value Index, which returned -2.8%. The biggest driver between the two benchmarks was the continuing domination of growth over value, which anomalously occurred both during the up market in January and the down market in February. This long tailed growth and momentum trend was particularly evident early in the year, driven again by strong performance from the often discussed FAANG stocks. These companies continue to concentrate returns and narrow the market leadership, and were primarily responsible for the positive returns of the technology and consumer discretionary sectors, the only two sectors within the large cap indices to post gains for the quarter. Despite the pronounced intra-quarter volatility, growth enjoyed a 400bp advantage for the period to supplement the 1700bps spread in 2017.

Like the last few years, performance has been equally impacted by the companies you don't own versus the ones you do. For example, Amazon, a holding we don't own, increased 23% this quarter and was independently responsible for the positive return of the consumer discretionary sector. Its impact on the S&P 500 was five times its weight in the index and more than double the next largest contributor. It is hard to outpace any index when a single position, particularly one that doesn't fit our process, has such an outsized influence over the benchmark. This isn't excuse making but actual observations of what is driving returns.

Over our 24-year history, The London Company has been able to withstand many market environments, both good and bad, in addition to our own gaffes. We have built a process that has proven to mitigate downside capture and outperform over full market cycles. We believe part of the reason stems from two of our core tenets: having a long-term time horizon and being different than the index. Time provides perspective. It is like looking at a Monet painting from a foot away instead from across the room. What appears murky today eventually becomes clearer, and it is why we don't overreact to shorter-term results. For example, our income equity strategy has outpaced the S&P 500 in 18 of the past 22 down quarters, since its inception in 1999. This most recent quarter marks only the fourth such occasion it has not. While we would like to outperform

in every down period we know that's not possible. Like this past quarter, there may be transient factors influencing returns that are not obvious on the surface that eventually become known. Being different means we can distinguish ourselves from the benchmark and have positions that can meaningfully contribute to returns. More importantly, it means we don't generally capture 100% of the down market during corrections. Unlike passive vehicles, where you get the market return no matter what, we can avoid positions in the indexes you wouldn't want to own. It requires staying true to your core even when the world around you disagrees. Being significantly different than the index can be painful at times, but it is key to long-term success.

Looking ahead, we are optimistic about the markets and our portfolios. Economic conditions are adequate, and despite recent increases, interest rates and inflation levels remain historically low. Future spending should be fueled by a strong labor market, wage growth, solid housing, and lower tax rates for individuals and corporations. That doesn't mean equity markets are valued at overly attractive levels, nor susceptible to further weakness. A big reason we are now 109 months deep into the second greatest bull market ever, in both duration and return, is due to the accommodative Federal Reserve and its past quantitative easing programs. The low interest rate environment allowed significant financial engineering, boosting U.S. companies to repurchase roughly $4 trillion in stock since 2009. These buybacks have accounted for a substantial portion of the earnings growth in that time and the majority of it in recent years. As the Fed normalizes its past accommodative monetary policy, it will need to be replaced with fiscal stimulus. So far that seems possible, as tax reform will enable domestic companies to repatriate up to $700bn in overseas cash. This has led 2018 share repurchase announcements to already double last year's level.

As interest rates slowly rise, it is our estimation that dividends will become a larger percentage of the total return going forward. One of the aspects from tax reform is accelerated depreciation, which may encourage less financial engineering and more capital spending. This could have the effect of less available capital to offset any market dips, creating more variability in returns in the years ahead. We believe that could still be good for the markets longer term. We like where we are positioned because each of our portfolios are populated with businesses that have higher returns on capital and healthier balance sheets than the indices. We can avoid companies with credit risk, over-burdened debt, higher inflation costs, or poor capital allocators. We intend to stay within our circle of competence and avoid Kramer's toxic cocktail of conviction and ignorance. Our strategy is straightforward, but it requires a disciplined and repeatable process with the occasional reminder from Mark Twain, who famously said, "What gets us into trouble is not what we don't know. It's what we know for sure that just ain't so."

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

The London Company

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