April 8, 2019

To clients and friends of The London Company:

"You can't judge a book by its cover."
- Various Attributions

This very simple quote has been oft-invoked and proven applicable to describing a broad array of topics and situations. While having the sound of one of those timeless nuggets, its origin actually comes either from the mid-19th or 20th centuries, depending on which version and source of attribution one chooses to believe. It may have sprung from the pen of George Eliot's *The Mill on the Floss* in 1860, or the pages of newspapers *Piqua Democrat* in 1867 or *American Speech* in 1944, or even part of a 1946 murder mystery *Murder in the Glass Room*. It also became the title of a 1960 Bo Diddley song, but clearly he was late to the book party.

What prompts us to open this letter highlighting the differences of substance found between the bindings of a book's title is not to launch into a literary review, but rather to segue into a financial commentary of equity book value - one of the classic barometers of a company's worth - and how much the utility of that metric has devolved over time. Simply put, book value is the total value that shareholders theoretically could receive if the assets of a company were liquidated. Ben Graham, the father of fundamental analysis and value investing, employed book value as one of his key criteria in determining investment opportunity. Graham believed that stock prices that traded at or below the book value of a company's net assets provided an important margin of safety for investors. During the 1920's when Graham wrote of book value in *The Intelligent Investor*, evaluating a stock's price in relation to assets was a relevant exercise and the results tended to be largely as advertised. Of course, Graham's investment landscape also was dominated by manufacturing, transportation, commodity, and industrial companies with real assets chiefly comprised of land, plant and equipment, all of which lent themselves to Graham's fundamental methodology.

Over the ensuing decades, Graham has attracted a legion of investment disciples and many "intelligent investors", among whom Warren Buffett can be counted. Buffett has proven highly adept at discerning the intrinsic value of businesses and investing in them for long term success. Buffett's annual shareholder letters can be equated to annual installment chapters that build on Graham's body of work, so it is particularly noteworthy that he began this year's letter in the following manner: "For nearly three decades, the initial paragraph featured the percentage change in Berkshire's per-share book value. It's now time to abandon that practice. The fact is that the annual change in Berkshire's book value - which makes its farewell appearance on page 2 - is a metric that has lost the relevance it once had." For Buffett, the conventions of generally accepted accounting principles (GAAP) required to be used by

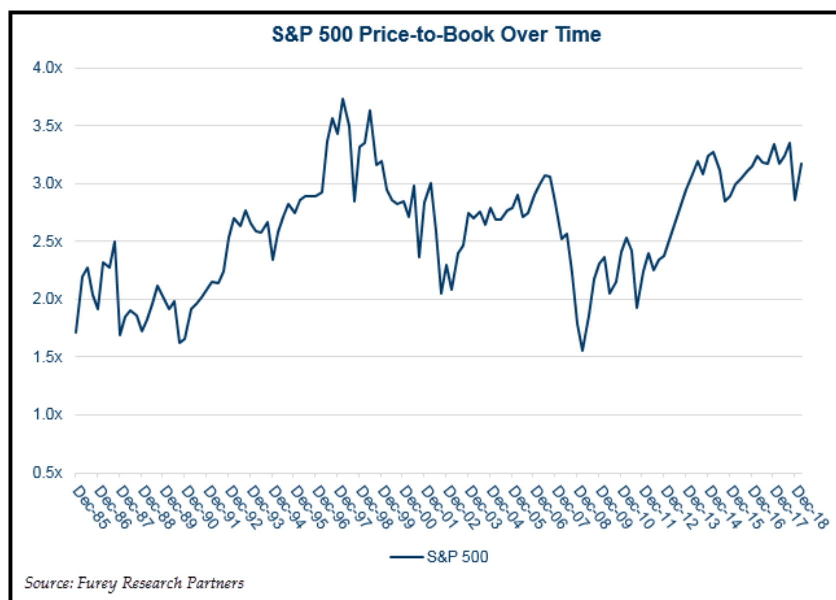
publicly traded companies have caused "…the book-value scorecard to become increasingly out of touch with economic reality."

In the case of Berkshire Hathaway, the economic disconnect revolves around Berkshire's significant and increasing investment in operating businesses in preference to making equity investments, which has resulted in an accounting problem wherein company book carrying value based on original cost fails to reflect the capital appreciation of those businesses over time. Buffett believes that the intrinsic value of these investments are hugely understated on Berkshire's balance sheet based on GAAP accounting. This disconnect has become further amplified as Berkshire uses its recurring gusher of free cash flow to opportunistically repurchase its shares. Repurchasing shares below intrinsic value (which is an accretive use of capital) but above the stated book value of the company, again required by GAAP accounting convention, has resulted in a mathematical dilution to the remaining book value. The reduction to stated book value caused by share repurchase, even as company intrinsic value continues to appreciate, will result in an ever-widening gap between the two measures and provide decreasingly useful analytical value to investors.

Berkshire is not unique in this quandary. As America and developing world economies have transitioned from a production-based, asset-intensive business core to a service-based, asset-light core, the challenges and problems of accounting for and valuing these assets only continue to grow. Intangible assets are greatly mistreated in conventional accounting. In the consumer space, brand building is expensive but also an expensed accounting cost, thus the intangible value of that brand is not captured as an asset. The advancements in healthcare and information technology have brought with them enormous investments in research and development and the creation of vast pools of patents and intellectual property, but neither of these translate into book asset values. Finally, in an era where merger and acquisition activity remains robust, the value of acquired assets is systematically depreciated from cost without provision for the appreciation of those assets over time. As the lifecycle of publicly traded companies continues to compress, we should expect the accounting mismatch to expand at an accelerating rate. A recent study by consulting firm Innosight showed that the average age of a company in the S&P 500 has shortened from 33 years in 1964 to 24 years in 2016 and forecast to become only 12 years by 2027. The market is and will continue to be incredibly dynamic, which underscores the challenges of using book value and indeed why we cannot fully judge that value by its cover.

All of this is highly critical to us here at The London Company where we have always focused on a company's balance sheet to guide our assessment of the long term intrinsic value of the businesses in which we invest. We appreciate and agree with Buffett's view that traditional, Graham and Dodd type analysis has complications and some limitations in today's world and requires more rigorous analysis of what does and does not exist within the balance sheets of our current and potential future investments. We understand and are comfortable with the fact that we can have portfolio price to book values above our benchmarks, an attribute about which we have been questioned. We do not see a more elevated price to book metric as inconsistent or incompatible with an intrinsic value approach to investing. A quick look at historical price to book value trends confirms that due to innovation, evolution and index

composition changes, especially within the S&P 500, there has been an expansion in the ratio of price to book value (P/B) over the past 30 plus years:



Source: Furey Research Partners

Pivoting from this longer expansive view to the more temporal perspectives on the quarter just ended, the equity markets enjoyed a powerful rebound during the first quarter, with the S&P 500 posting its best quarter in over a decade and best first quarter for a year in over two decades. Certainly part of the snapback can be attributed to a performance reversion from the dismal final quarter of 2018. Equities across the market capitalization spectrum participated, with the benchmarks clustered around a mid-teens percentage total return for the quarter. Smaller and mid-cap stocks did slightly better than large cap stocks, and stylistically growth outperformed value. While the S&P 500 largely recouped its losses from the prior quarter's swoon, the Russell 2000 did not, reclaiming only a 14.6% gain after declining 20.2% in 4q 2018.

In reassessing some of the biggest concerns previously weighing on the market, investors executed a nimble Texas two-step regarding the Fed. Prior to the Fed's abrupt policy shift announced on Christmas Eve, there was a uniformly pessimistic view of the Federal Reserve's expected 2019-2020 policy path with respect to further raising short term interest rates. That downbeat appraisal glided into a universally sanguine view that the Fed pivot clearly had signaled an end to rate increases for the foreseeable future. While investors also became progressively more optimistic about the prospects for resolution to the US-China trade disputes, this optimism was tempered by the present reality of a 10th consecutive monthly decline in the global PMI and measurable deceleration across domestic economic indicators. A dour international backdrop, downticks in consumer and investor sentiment, inclement weather and the government shutdown all influenced activity in the past few months, leading to a reduction in near term growth prospects and negative revisions to corporate earnings and earnings forecasts. Unlike most of 2018 when the market benefitted

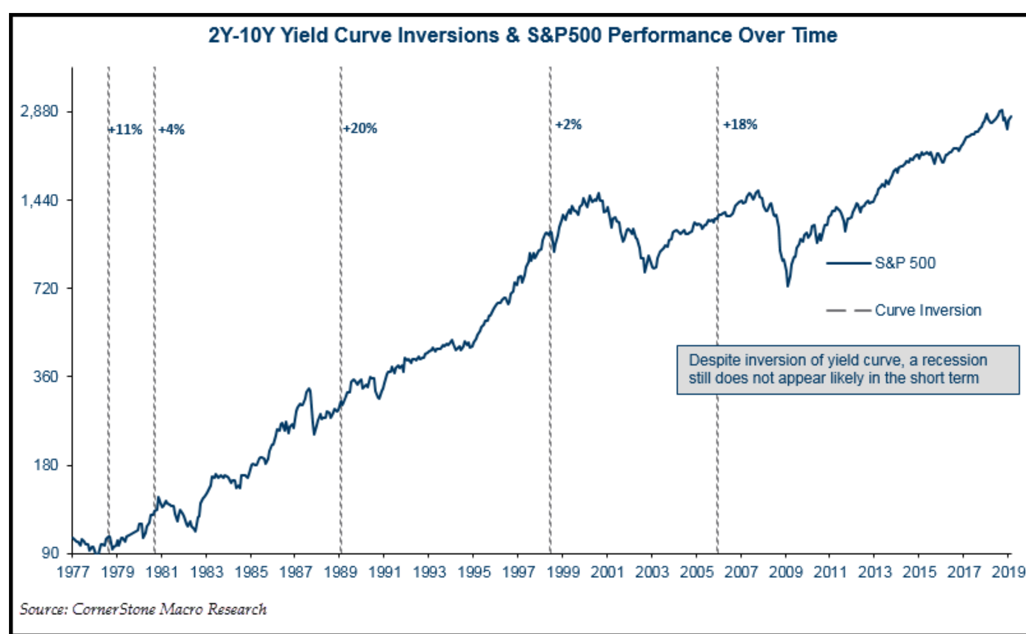
from a vigorous earnings tailwind, 2019 has been propelled by an expansion of price/earnings (P/E) multiples that have more than offset a decay in the earnings outlook. Historically, multiple expansion has been a higher octane fuel for the market than has earnings expansion.

Boomerang quarters like the one just ended typically do not make for great comparative marking periods for our portfolios. Given the market's strength and tilt towards growth, we were pleased with the performance across our strategies. Leading the way was our Small Cap portfolio, which overcame some familiar benchmark headwinds (top contributions from healthcare, technology, unprofitable companies, and lowest returns on invested capital) to outperform the Russell 2000. Stock selection really boosted returns in the quarter. On the other end of the capitalization spectrum our Income Equity portfolio outperformed the Russell 1000 Value benchmark while essentially matching the S&P 500's return. In between those bookends, our other strategies delivered over 90% upside capture in Mid Cap, and over 80% in SMID, Large Cap and Concentrated versus respective benchmarks. Those upside capture ratios are in line with to better than we would have expected given the environment and have given us a positive start to the year.

Like the bumper cars knocking around the track at Six Flags, the markets continue to be steered by the constant collision of macroeconomic, geopolitical, and momentum factors strewn across the path forward. For long term, fundamental investors such as ourselves, navigation through the vagaries of this short term news flow can be challenging and occasionally jarring, but we strive to maintain focus at the company level and not let transient events become a distraction. To us, trying to anticipate and position our portfolios for all of these bumps in the road is the kind of distraction we will leave for others better versed in forecasting. For most of the quarter, the storyline for investors centered on the Fed's policy pause, and different implications were reached in the bond and equity markets. Equity investors took the optimistic side that this pause would revive a still-healthy domestic economy, reflected by the expansion in P/E multiples. Bond investors veered toward the side that pause was evidence of weak or weakening global economic growth, concluding that the Fed's next move ultimately would be to reduce short term interest rates. This outlook was reflected in the flattening of the yield curve (most commonly viewed as the level of interest rate spread between three month and ten year US Treasury paper) , which succumbed to an inversion late in the quarter. With inversion, the ten year Treasury note falls to a yield level below the three month Treasury bill. This development seized the torch from the Fed pause narrative as the new market beacon leading investors into the second quarter.

Despite the media hoopla and reactionary outcry that an inverting yield curve flashed the definitive signal of approaching economic cycle Armageddon, we would not rush to judgment on where the next chapters on the market might take us based on this overhyped cover story. It is worth pointing out that the research done upon inversion effects concluded

that a full quarter of inversion, and not a handful of days, was a precondition for the signal's efficacy. Also, while we acknowledge that yield curve inversions historically have preceded recessions and then an end to bull market cycles, the time intervals between these events and the intervening market opportunities suggest that we not yet close the book on what has become the most durable bull market in index history:



For The London Company, our story remains the same. We seek to protect our clients against the full brunt of market downside and participate in the lion's share of the market upside over complete market cycles. We do so by investing in financially strong businesses buffered by a discount to our assessment of intrinsic value. While our approach doesn't always keep up with the pack over near term horizons, we believe that over the long term we can continue to deliver upon our value proposition and separate ourselves from that pack. If we are successful in doing so, we hope to become that book that our investors can judge by its cover.

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

Important Disclosures:
Past performance is no guarantee of future results. This report is for informational purposes only. The statements contained herein are solely based upon the opinions of The London Company and the data available at the time of publication of this report, and there is no assurance that any predicted results will actually occur. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell any specific securities and should not be considered investment advice of any kind. In making an investment decision, individuals should utilize other information sources and the advice of their investment advisor.

The performance is GROSS of investment advisory fees and includes the reinvestment of all income. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. For example, a 0.50% annual fee deducted quarterly (0.125%) from an account with a ten-year annualized growth rate of 5% will produce a net result of 4.4%. Actual performance results will vary from this example.

The London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies and objectives, are fully described in the firm's Form ADV Part 2, which is available by calling (804) 775-0317, or can be found by visiting www.tlcadvisory.com.

LCO-19-100