April 13, 2020

To clients and friends of The London Company:

"Life is true to form; records are meant to be broken"

- Mark Spitz

In acknowledgement that the 2020 Summer Olympics have been postponed amidst the global COVID-19 pandemic, we look to Olympian record-setting swim champion Mark Spitz as the inspiration for this quarter's letter. At the 1972 games in Munich, Spitz accomplished the unimaginable, winning seven gold medals. His feat stood the long test of time until finally being broken by fellow American champion Michael Phelps, who at the 2008 games won eight gold medals. When asked to comment in the aftermath of Phelps' record-shattering performance, Spitz responded with the above quote.

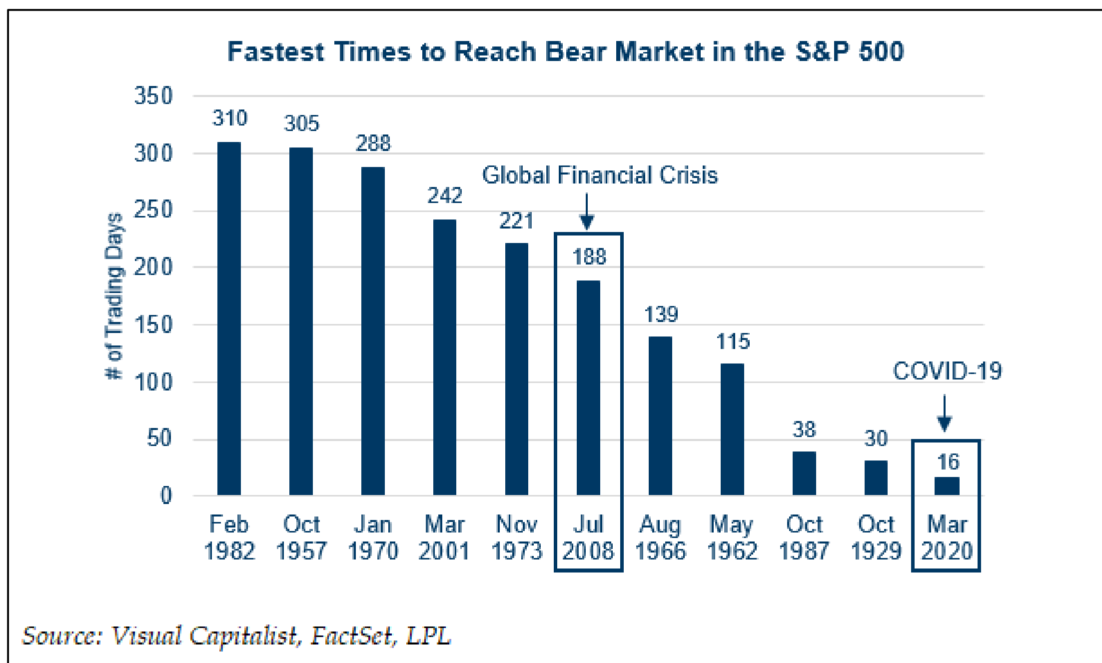
In thinking about the period just ended, so much has occurred so quickly, as we abruptly pivoted intra-quarter from the longest running bull market in history to the outbreak of twin global and financial market panics and the fastest bear market in history, all fed by the virus pandemic. While our mantra is to protect against the permanent loss of capital in client portfolios, we are equally concerned about the health and well-being of our clients and partners, their families, and our own colleagues and families. It is our hope that everyone is coping with all the ways this crisis is touching and disrupting our daily lives.

Black Swan events have been pondered and predicted for many years; there is little dispute that we are experiencing one right now. In the wake of its human and financial devastation, this Black Swan is breaking more records than any of us care to count, and with turbulence far beyond what Spitz or Phelps created in an Olympic pool in their record-setting performances. There is nothing true to form here, and no cheering or celebrating for the records that are being set or likely to be set. Rather, we are blanketed with a still-unfolding fog of fear and uncertainty and navigating what can only be considered unchartered waters. At The London Company we have always eschewed the dismal science of forecasting and focused on balance sheet strength and a long term investment horizon to drive value creation. As we review and discuss this record-breaking quarter, we want to make clear at the outset that we do so through the lens of viewing this crisis as ultimately solvable, and the massive dislocations being created producing opportunities for patient, disciplined investors such as ourselves.

In retrospect, the year started on a positive note both for the economy and the markets. While early reports of a virus outbreak in a remote province in China began in December, it had little impact as the S&P 500 was able to gain around 5% and the Russell 2000 Index around

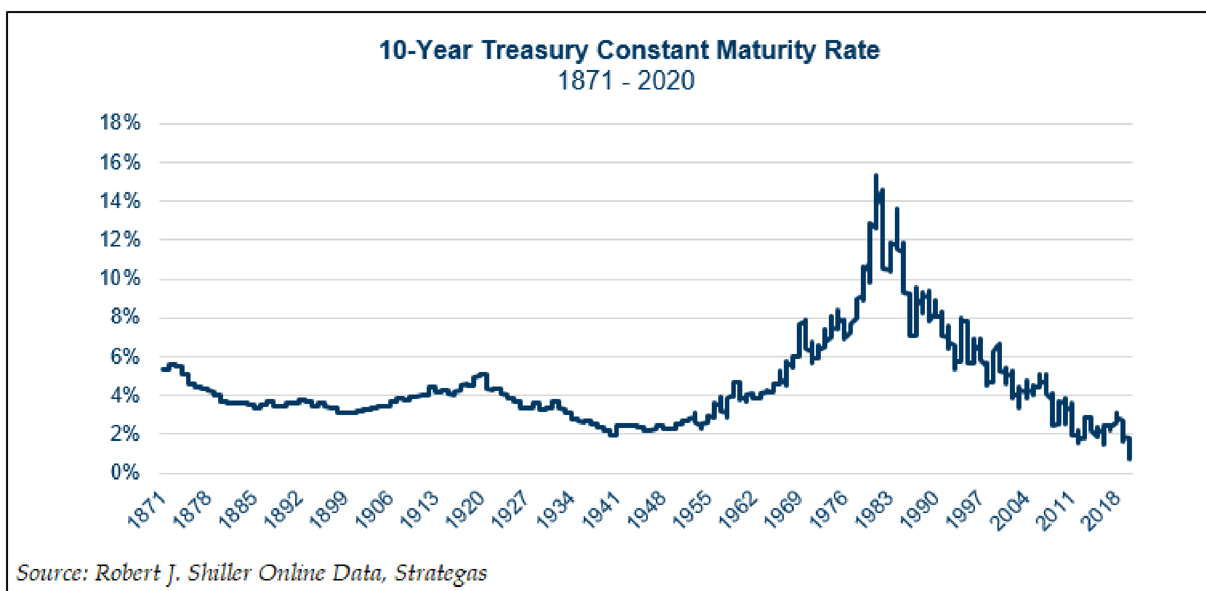
1.5% as the markets extended the longest bull market on record into all-time highs on February 19th. By then, it had become apparent that the virus was spiraling globally out of control and was poised to strike the United States with a force surpassing anything we have experienced in multiple generations. What has transpired since that peak has been simply unprecedented in the speed at which panic and the response to it have escalated. As covid-19 news flow continued to build like the monster waves off Peahi in Hawaii, investors fled from its path en masse in waves of terror-stricken selling. In the initial stages of the panic, the selling was totally indiscriminate and highly correlated leaving little differentiation between sectors or even market capitalizations of stocks. The environment truly was one where there was "no place to hide", exacerbated by mass liquidations of algorithmic and other program driven participants.

In a span of five days the market declined over 10%, putting stocks in correction. As investor fear continued to build, news flow further compounded these fears in early March as Russia and Saudi Arabia cooperation on oil production and prices broke down, touching off a ferocious price war that imploded the global energy markets literally overnight. The toxic combination of covid-19 and energy collapse destabilization ratcheted up panic even higher and equity markets lower, with the Russell 2000 nosediving into bear market territory (20% decline) in 12 trading days, while taking only 16 trading days for the larger capitalization S&P 500 to join it. We transitioned from the longest bull market to the fastest bear market in history:



Source: Visual Capitalist, FactSet, LPL

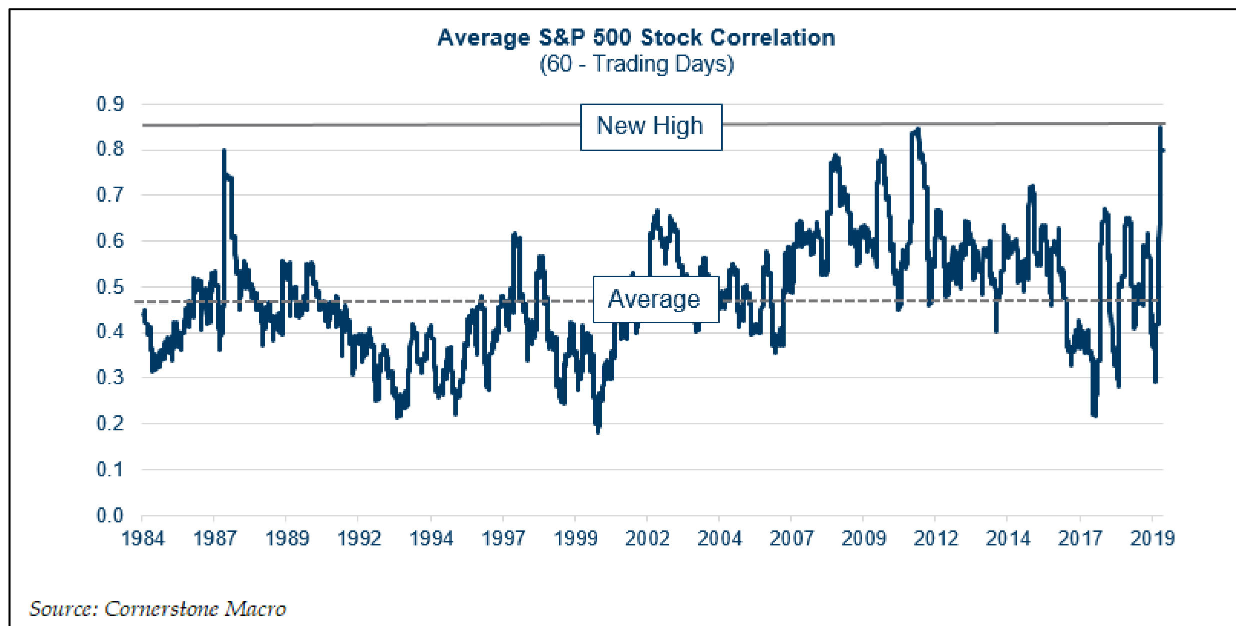
Simultaneously the frantic scramble for refuge outside the equity markets channeled investors into safe haven assets like gold and US Treasuries. Another striking visual is the concurrent plummet in 10 year government bond yields to 150 year lows while 3 month Treasury bill rates have reached negative levels:



After an initial shell-shocked pause, the Federal Reserve and administration both jumped into emergency triage mode, unleashing monetary and fiscal relief programs of staggering proportions. The Fed cut the funds rate to 0%, and within days and weeks offered a package of financial backstops and liquidity measures that collectively far exceed what took months to enact during the Great Financial crisis of 2008-2009. In broad terms, the Fed has effectively shifted from lender of last resort for banks to a commercial banker of last resort for the broader economy. On the fiscal side, once President Trump declared a state of emergency, the governing parties managed to overcome the yawning political divide to rush forward with multiple phases of far reaching stimuli that will exceed $2trillion. These steps prompted a brief but powerful reflex market rally approximating 15% off the March 23 lows. Despite a recovery in some of the losses, this was the worst first quarter for the S&P500 and Dow in history, and closed with the virus news worsening and a pervasive national economic lock down casting an ominous shadow over the future of the US and the rest of the world.

With the trailblazing speed, severity, and complexity of what has occurred over the past six weeks continuing to rewrite history even as we compose this letter, we want to offer commentary on how our strategies performed during the first quarter. For the record, four out of our five major strategies outperformed their primary benchmarks. Small Cap, SMID, MidCap, and Income Equity all finished ahead, although Income Equity did modestly trail the S&P 500 as did Large Cap. It is important to point out that for the first half of the quarter, the market was rising, and with leadership still residing on the growth side while value continued to lag. We saw this impact more in the large cap space especially in the S&P 500, which after gaining over 30% in 2019 had been rising at a 40% annualized pace at the point of the market's February 19th peak, a velocity we don't expect to match. These headwinds down the market capitalization spectrum in small caps proved not as strong, although growth and money-losing companies again did not favor our approach. Even with these cross currents, stock selection was particularly sharp in SMID and MidCap, and we were outperforming in those spaces into the peak.

The balance of the quarter, as we outlined above, was a perilous travail dominated by an onslaught of short term aberrations. As we already noted, during the initial leg down in the markets, stocks behaved like a single entity, all riding together in the same free falling elevator car. The distress was high, volatility surged, and stock correlations spiked to levels previously seen in the financial crisis of 2008-2009 and the market crash of 1987:



Source: Cornerstone Macro

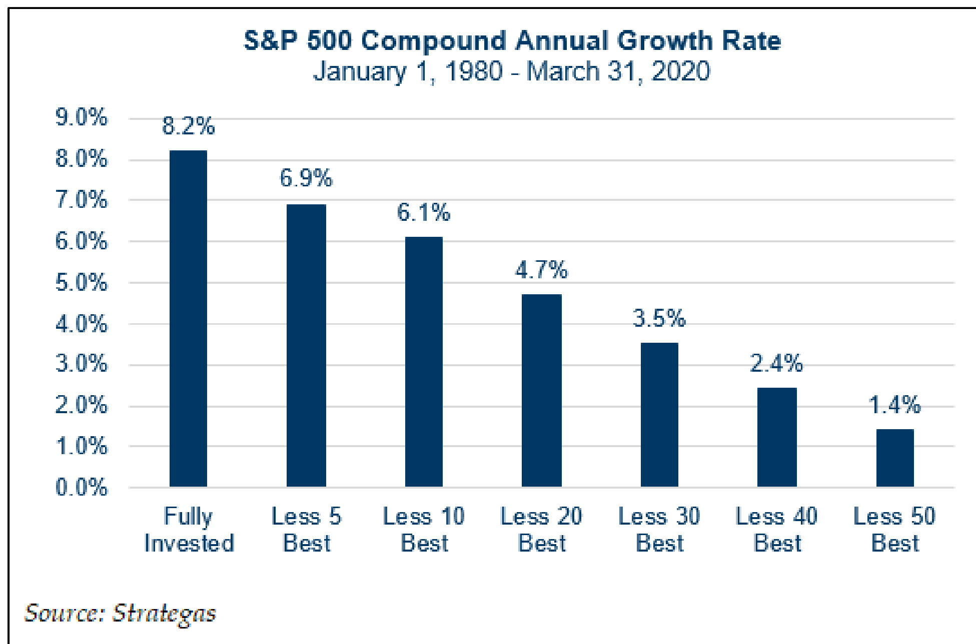
As a reminder the higher the correlation, the more highly similar is the performance of stocks. Beyond this first wave, correlations remained abnormally elevated, but some divergences did start to appear. Stylistically, growth resumed leadership over value by a staggering margin, accruing over 1200 basis points of differential within the quarter. This in part reflected the enormous dislocations occurring within energy, transportation, and venue-based consumer services, all of which collided with the epicenter of the virus and energy shocks. The capitalization weighted vs. the average weighted S&P 500 similarly diverged by over 600 basis points, which helped to explain what benefited that index given its bias to larger capitalization and growth companies. During the short-lived reflex rally, growth and unprofitable small cap companies, dominant in the healthcare and technology sectors, gave the Russell 2000 an unexpected boost as well. Despite these anomalies, all of our strategies declined less than their benchmarks during the bear market phase of the quarter.

Overall, our downside capture was good in the quarter, but we certainly recognize that for some of our strategies, our downside capture was higher than we expect to deliver. There are a few factors at work here that we want to highlight. First, the timeframe of comparison is incredibly short term; we are measuring a six week period, not even a full quarter or more. We have always taken a long term perspective in our approach, and while it has served us and our clients well over time it unfortunately has not and cannot offer a constant level of downside protection in such compressed and cataclysmic time increments. Secondly this period has been unfolding amidst a financial panic and global pandemic, an unprecedented combination that we and others understand to be unchartered waters. In the heat of the

moment, fear of the unknown has gained the upper hand and is being translated through the extraordinary spike in stock correlations, leaving equity investors without temporary sanctuary. Volatility too is the barometer of fear, with March daily price movements averaging 4.8%, well beyond the frenzies of the financial crisis or both market crashes in 1987 and 1929. When we look back to the worst days of the financial crisis in late 2008 and early 2009, or to the popping of the internet bubble as we entered the 2000's, we experienced downside capture similar to what we saw over the last 40 days. Simply put, our focus on balance sheet strength, business quality, and long term fundamentals lose relevancy to other investors during these episodes. As these episodes subside, volatility diminishes, and correlations recede, relevance re-emerges. So while downside capture in our larger cap strategies mostly met our expectations, given the abnormal factors at work and aforementioned drivers of returns, the outcome is like past periods. This should recalibrate back to fundamentals going forward.

Entering the second quarter and trying to look ahead, we and everyone else remain fogbound in many ways. With respect to the virus, we know that the worst still appears to be in front of us and tragically more lives will be lost. Society is locked down and the economy has effectively been shut down with an impact akin to hitting a brick wall at 100mph. Because of the lags in gathering the data, the full magnitude of these actions will become more apparent in the weeks and months ahead. Expectations among forecasters are deteriorating in real time, as job losses, business losses, and overall GDP slide into formerly unimaginably negative numbers. We acknowledge that all signs point to a period of horrific economic performance that also will exact a huge human toll. Efforts to contain the spread of the virus and "flatten the curve" in the US and globally is the most critical trend with which to contend. Turning to the equity markets, the depth, breadth, and length of all these unknowns will try to be discounted, along with attempts to identify the biggest winners and biggest losers. The market discounting mechanism generally keys upon the second differential in news and measurement, or the change in the rate of change. Whenever it is in time that investors start to detect second differential inflections, we likely will find greater stabilization, less volatility, and "green shoots" of optimism.

With so much that is unknown today, we want to impart a few things that we do know and can speak about confidently. While one could look to all the negatives that exist and all the uncertainty and significant draw down in equity prices and debate the merits of staying the course, we are staying the course. We have constructed our portfolios from a bottom up process that relies upon the financial strength of our concentrated holdings and the ability to use that strength to compound value while protecting downside over full market cycles. Market timing can undo all the good that a proven investment discipline creates. We have shared the following chart in the past, but it seems timely to share it once again in support of our unwavering focus on the long term:



We are not prescient enough to know when to substitute high levels of cash for the strong businesses that we own, and it seems reckless to jeopardize missing so much of the market's return over the past 40 years that occurred in a handful of days.

The environment is dynamic and we are monitoring events and remain in constant dialogue across the team as to the implications for the companies we own. We have been stress-testing balance sheets and talking with management teams to understand how they are adapting to the challenges they face. In the process we are reaffirming our conviction in our portfolio companies, but also in a few instances concluding that more durable impairments have occurred, necessitating the sale of the position. We are investigating new ideas where broad-based dislocations may be creating fresh opportunities. In a period of record volatility, sporadic liquidity, and frequent short term market whipsaws, the cost of transacting has soared so we are being careful about when we choose to go to market. We feel intellectually energized not paralyzed even though the team and the firm all have adapted to a work from home response to this crisis.

To reiterate what we said at the outset, while we cannot articulate the path nor the timeframe of how the pandemic is resolved and the economic devastation and bear market reversed, ultimately there will come resolution and the cycles will start anew. We make that observation cognizant that the worst may yet be before and not behind us, and that there are more dubious records left to be broken. Financially vital companies and sound balance sheets have enduring relevancy in the market, and if history is any guide, our portfolios remain well positioned over this cycle to protect against the permanent loss of capital and to perform strongly well into the future. We believe our discipline could benefit relative to our benchmarks over the long term, given the highly correlated and indiscriminate selling with this recent downturn. Due to current markets being dominated by passive and quant investors, with volatility and correlations heightened by algorithmic/high frequency traders,

market dislocation has led to extreme valuation discrepancies, comparable to the March 2000 sudden style reversal, where the tech bubble came to an abrupt end. This event led to our core/value quality discipline outperforming over the next decade. The current attractive valuations of the majority of our holdings could generate solid returns going forward (even with flat to moderate GDP growth), especially if interest rates remain low.

We know that much likely will have changed in the short time period between the writing of this letter and your receipt of it, but rest assured that our focus on you, our clients, will remain intact. These are incredibly stressful times across America and the globe, but together we will get through this gut-wrenching period. 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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