THE LONDON COMPANY

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To the clients and friends of The London Company:

The more things change, the more they stay the same. Equity markets go up and go down, and when they go down too much our monetary leaders provide temporary relief. For the third straight year this pattern has repeated. In what feels like a six-month version of the movie *Groundhog Day*, investor confidence so strongly on display through March quickly turns into distrust by summer due to the unrelenting economic woes still present both domestically and abroad. First quarter returns for the S&P 500 and Russell 2000 Small Cap Index have averaged 8.0% and 9.7% over the past three years, versus -4.7% and -5.0% during the second quarter. For 2012, second quarter returns were in-line with this trend at -2.8% and -3.5% respectively.

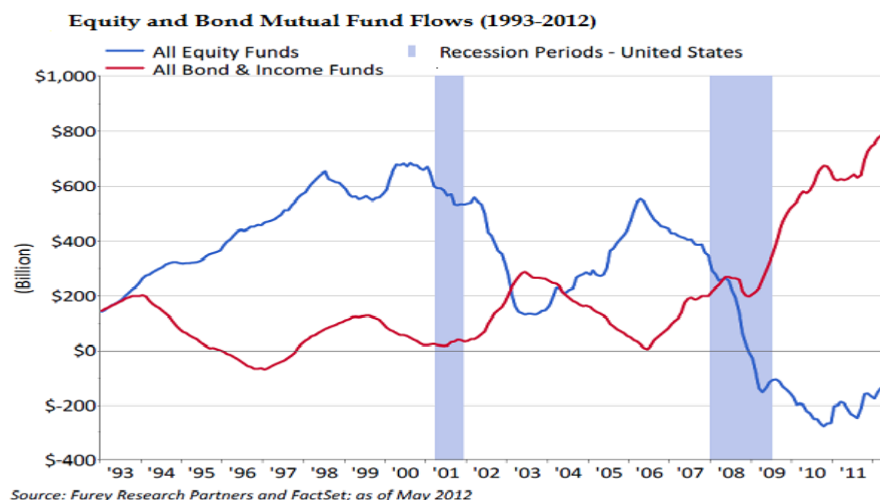
Fortunately, as we expect, our conservative, lower-beta portfolios did well during the market's downturn and outpaced their respective indices. Stock selection continued to add value during the quarter. Volatility picked up and companies that reported less than stellar earnings were often taken to the woodshed. Interestingly, lower quality stocks, as defined by Return on Capital (ROC), actually did better than higher ROC companies this quarter. The performance spread wasn't extreme, but it was an unusual divergence and an absent tailwind that our portfolios typically receive during down markets. In general, the more defensive sectors (Utilities, Consumer Staples, and HealthCare) outperformed and led returns. The more cyclical sectors (Energy, Technology, and Materials) lost ground and lagged the index. Year-to-date, equity returns for the S&P 500 and Russell 2000 Index are still respectable at 9.5% and 8.5%.

It is eerie how similar recent equity returns have been. As seen in the chart to the right, the pattern has followed a common theme – market resiliency at the start followed by fear and uncertainty shortly thereafter. Even a late June rally has repeated the past two years, both based on hope that European technocrats have improved a

Source: Strategas

seemingly hopeless situation. One year ago in this same letter we wrote how a repeat of the previous summer swoon was apt to recur. That forecast unfortunately proved true and lasted until our white knight, the Federal Reserve's Ben Bernanke, wielded his powers to temporarily forestall the ongoing concerns. The Fed's "quantitative easing" programs, when actively underway, have increased liquidity, lowered interest rates, and promoted rising stock prices. We illustrated the very strong correlation between QE and high stock returns in our letter last quarter. This annual backstop has been approved late in the summer the past three years, providing a welcome windfall for stockholders. A fourth round of easing, on top of the recently announced lengthening of *Operation Twist* could be this year's latest sugar boost.

Unfortunately, this up and down, risk-on, risk-off nonsense addresses none of the structural issues we face and continuously runs the risk of further alienating investors who are sick of the tumultuous volatility. This reality helps explain the $1 trillion outflow from equity funds into bond funds over the past three years despite record low interest rates *(see chart below).* Investors are speaking with their money when they indicate that public equities are not an attractive asset class, and until bondholders begin to lose principal this view may not change. As contrarians this is a positive, but more on that later.



Compounding the apprehension towards stocks are the worsening economic conditions being reported on a global basis. Manufacturing has universally turned negative, prices of commodities have fallen, and central banks around the world are lowering already low interest rates to help spur growth. Evidence suggests a further slowing of global GDP. Despite the efforts of central banks, global deleveraging is proving to be an extremely difficult issue to combat. After their 19th summit, European leaders have *again* theoretically reached a resolution to recapitalize the banks, back their bonds, and alleviate sovereign debt risk. This accord was reached late in the day and made clear in a 1 ½ page memorandum. Hence, it is safe to say the devil is in the details…most importantly where the money to save the banks will come from? If we have learned anything over the past four years, it is that short-term solutions to long-term problems don't solve anything, only delay the inevitable. Biding time offers hope and appeases voters, but real reform and structural changes will be needed for a sustainable recovery to take hold.

Beyond Europe, where a number of countries are already in recession, slowing growth in China, Brazil, and other corners of the world is further dampening investor sentiment. In the U.S., employment doesn't appear to be improving and housing is at best forming a bottom. The upcoming political election could be a binary event with a number of uncertainties hanging in the balance. Looking forward, the pending fiscal "cliff", including the expiration of payroll tax cuts, Bush Tax cuts, AMT, and the $1 trillion sequestration comes into effect at the end of the year. The chance of Congress removing these uncertainties before the election is slim to none.

As we have stated in the past, we focus on the things we can control and worry less about the things we cannot. Despite a relatively bleak macro environment, equity valuations are attractive and likely discounting much of the aforementioned concerns. Demand for income is as high as ever, but with fewer and fewer options to obtain it. It is amazing that over half of the companies in the S&P 500 pay a dividend yield greater than the current 10-year Treasury bond. Investors are getting a 2.0% yield from the S&P versus the record low 1.6% from the 10-year[1]. A lengthy stay at these levels should help reverse the fund flows chart on the previous page.

Our approach of utilizing the balance sheet to create a healthy margin of safety works great in this low rate environment. We are finding compelling investment candidates and are encouraged by the level of insider buying at many of our companies. Cash levels on corporate balance sheets remain elevated and payout ratios are at 60-year lows. Deploying this capital through increased dividends, stock buybacks, and M&A transactions should increase as we gain clarity on tax and regulatory reforms.

If we were to speculate on what disruptive force could ease the pain in a slower growth world, it would have to be our domestic energy discovery boom. It is worth mentioning that after a 40-year decline in production, a trend that was thought to be terminal, advances in drilling technology have turned the U.S. energy outlook on its ear. The technological advancements in 'fracking' have given us the ability to explore shale rock domestically, and thus enabled North Dakota to pass Alaska in terms of oil production. This has also caused natural gas prices to drop 75% in 5 years and prompt utilities and factories to convert and drastically reduce their input costs. Incredibly, the U.S. will import less oil every year going forward and within 10 years may be a net energy exporter. The implications could mean the disappearance of the trade deficit, lower input costs for businesses and consumers, and the possibility of a manufacturing rebirth due to low cost energy. The most desirable economic outcome for the U.S. is to transform from a credit funded, consumer spending dependent economy to an investment based, corporate led expansion that adds significant numbers of quality manufacturing jobs.

In doing our research, we are working to gain an understanding of management's strategic goals and plans to achieve them for each company that we investigate. Management does make a difference and with a major, long term economic transformation upon us, good management will make nearly all the difference.

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

Best regards,

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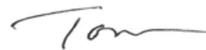

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[1] Past performance is not an indicator of future results.

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