

THE LONDON COMPANY

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To the clients and friends of The London Company:

Onward and upward! To Narnia and the North! C. S. Lewis was one of the most creative and imaginative writers of the 20th century, yet it's doubtful that he ever expected this quote could one day reference the equity markets. Nevertheless, his words are apt in describing year-to-date stock returns, especially after the S&P 500 posted its best first-half since the heyday of 1998. While second quarter returns slowed from the blistering pace at the start of the year, it was respectfully positive nonetheless. The S&P 500 returned 2.9% for the second quarter and is up 13.8% for the first six months. The Russell 2000 Small Cap Index returned 3.1% this quarter and is up 15.9% through June.*

The London Company strategies are keeping pace with their respective benchmarks and our small to mid cap portfolios have exceeded their indices for the first six months.* Our second quarter returns, while all positive, were somewhat mixed from a relative perspective. Sector allocation was a headwind in small cap but stock selection has been positive in large cap. High quality stocks (defined by return-on-capital) did well in April and June but low quality stocks led in May. In summary, second quarter results varied but were within the realm of the indices to keep full year returns in-line or ahead for all of our products.

Looking across the spectrum, small cap stocks have outperformed large cap stocks and defensive sectors have bettered cyclical ones. For the S&P 500, the top sectors during the quarter were financials, consumer discretionary, and health care. Stable companies with strong free cash flow generation were rewarded this quarter, particularly those that are reallocating capital back to shareholders. The bottom three sectors in the S&P were utilities, materials, and energy. Commodity-oriented stocks suffered from slowing emerging market growth and high yielding stocks, such as utilities, continue to underperform.

The Russell 2000 small cap universe was similar with consumer discretionary, consumer staples, and telecom leading the way and materials, energy, and utilities lagging. During the quarter, the dispersion of returns increased, between both the sectors and amid the market cap ranges within the index. The smaller market cap names performed better and created a headwind for our small cap strategy since it tends to be on the high side of the

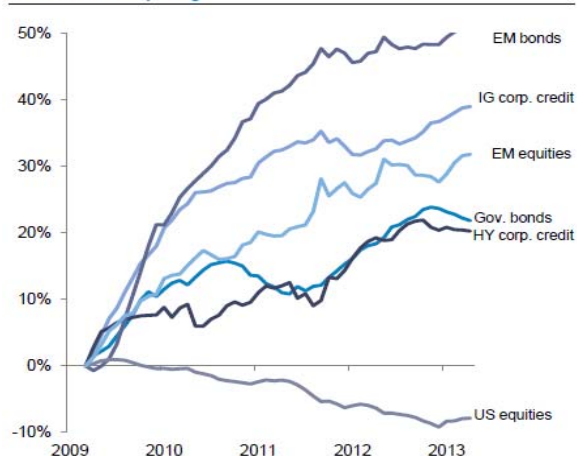
market cap spectrum. We have historically found opportunities in more established companies and expect that to continue.

As the stock market marches north we often get questioned about its sustainability and if we are due for a correction. Unfortunately, we don't know the answer to that question and if we ever thought we had a clear view into the market's future course, it would be as much by chance as by acumen. What we do see though is economic data that is improving and investor sentiment that is recovering. Whether that path gets us to Narnia, or any other magical place, is still to be determined.

Fortunately, we view our path as a domestic equity manager favorably when compared to other asset classes. U.S. stocks have been tremendously resilient, and that was on display again this quarter when volatility struck a number of other markets. The big news during the quarter was the announcement by our benevolent Federal Reserve Chairman, Ben Bernanke, when he hinted that easy monetary policy may not last forever. The news that the Fed may consider 'tapering' or simply reducing the liquidity being pumped into the system sent an immediate shock to the bond market, commodity complex and emerging markets.

While stocks turned negative for a week or two, the real excitement was seen in other asset classes. After the Fed's comments in May, the 10-year Treasury saw the largest weekly increase in yields in over a decade and may be on pace to have the worst one-year return in a century (*reminder for non-bond investors: increases in bond yields equal decreases in bond prices*). The 10-year ended the quarter with a 2.48% yield, a 33% increase from the first quarter and a 50% increase from this time last year. Quickly, bond investors began to pull funds out of these investments as prices fell. In just the first three weeks of June, nearly \$30bn has been liquidated from bond mutual funds, already making it one the largest monthly withdrawals on record. Commodities experienced similar pain and liquidations. Gold was down 23% this quarter resulting in its worst decline since 1920. Since Ben Bernanke's comments in May, emerging markets have fallen double-digits across the board. Domestic equities, on the other hand, have been isolated from the fray and are holding up well.

Cumulative net inflows into mutual funds (2008-April 2013): EM assets, credit and government bonds saw the largest inflows and are most at risk of repricing



Source: ICI, Deutsche Bank Research

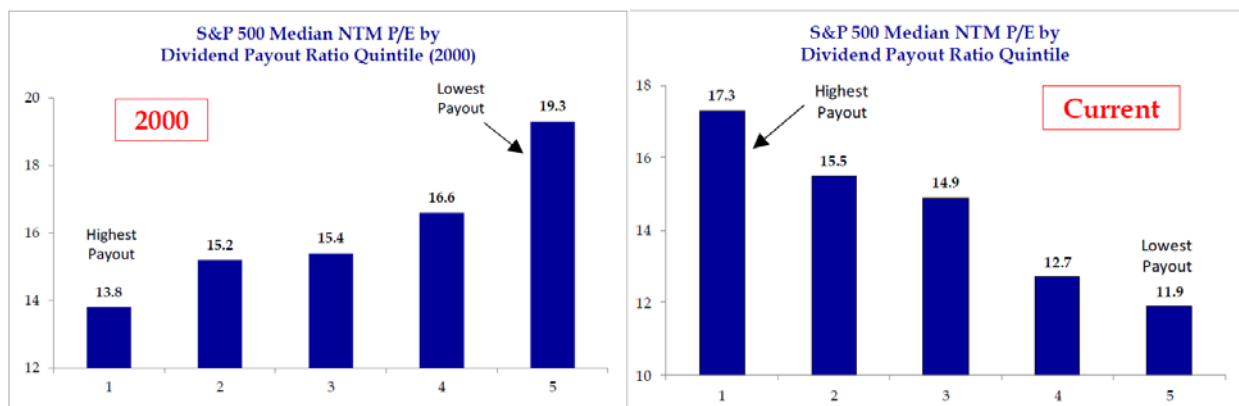
As seen in the chart on the left, the trends witnessed recently could continue for some time. Since 2009, fund flows to bonds and emerging markets have significantly outpaced domestic equities. Even when accounting for indexed ETF's, the directional flows remain the same. Simple reversion to the mean would provide a tailwind for U.S. stocks. But more importantly and longer lasting would be the real yields investors could achieve through equities. This potential should draw fund flows back in their favor. The reason equities have remained resilient is because of their real earnings yields and discounted valuations.

We have spoken a great deal in these letters about the historically high equity risk premium (spread between S&P earnings yield and the 10-Year Treasury bond) and how it would eventually normalize. The two scenarios called for equities to rise and bonds to fall, or both to happen simultaneously. While it is too early to signal a shift in the wind, the reaction to a less accommodative Fed indicates that both scenarios are possible.

It was just weeks ago when bond investors were still accepting negative real returns on their investment. Until recently, the 10-year yield failed to cover expected inflation. It was also less than the dividend rate for nearly half of the constituents of the S&P. The recent spike in yield reduces these extreme levels but falls well short of historical norms, and the \$30bn in liquidations this month doesn't scratch the surface on the \$1.3TRILLION in assets that have left stock funds for bond funds over the past four and half years. Considering the real earnings yield in equities and attractive valuations compared to bonds, we still believe equities offer the greatest risk/reward profile for investors seeking income and capital appreciation.

When we look at the economic data we are encouraged. The housing market has turned, consumer confidence is growing and negative effects from increased taxes or the soon-to-be implemented sequester appear mild. Economic and job growth remain meek, but Corporate America has excelled in maximizing productivity per worker and thus increasing profitability margins. The stock market has reacted positively to these results as well as the removal of many uncertainties and other worst-case scenarios (i.e., taxes, fiscal cliff, European collapse, China hard landing, etc...). Skeptics point to the rising stock market, up 135% since the 2009 low, and the high correlation it has to the actions of the Fed's quantitative easing programs. We too have voiced concerns about the effects of excess liquidity, but in the background, quietly overcoming obstacles has been our domestic economy. The stock market is a reflection of its resiliency.

Our focus always starts at the company level, but we share a macro view that organic growth is scarce. This belief has concentrated our focus on the companies generating high returns on capital, high free cash flow, and increasingly returning excess capital back to shareholders. In a low growth world where margins have already expanded, the allocation of capital is critical to maximizing wealth. Management teams without attractive investment opportunities are better served to buy back stock or increase the dividend. Fortunately, as seen in the charts below, investors are rewarding this behavior.



Source: Strategas

In a complete reversal from the tech bubble in 2000, companies today with the highest dividend payout ratio are apparently receiving the highest multiple. What was once scorned as being passé is now in vogue. That said, we are always cautious of crowds and already mentioned how high dividend paying stocks are beginning to underperform. Corporate cash remains abundant, so payout ratios could increase for quite awhile. The key, as always, is valuation.

Our margin of safety is determined by the tangible assets on the balance sheet and the free cash flows of the business. Ideally, we can identify investment opportunities that are trading at low valuations, or even close to book value, but have excess capital to return to shareholders. Many of our current holdings do have free cash flow yields greater than 8%, an attractive spread over the 10-year Treasury yield of 2.5%, despite its rapid increase. By avoiding speculation on growth and margins and having a tangible sense of real downside risk, we remain optimistic in our ability to earn above average returns.

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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Important Disclosures:

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