THE LONDON COMPANY OF VIRGINIA, LLC

Telephone: 804-775-0317
Facsimile: 804-649-9447

1801 Bayberry Court, Suite 301
Richmond, Virginia 23226

July 3, 2014

To clients and friends of The London Company:

"Those who have knowledge, don't predict. Those who predict, don't have knowledge."

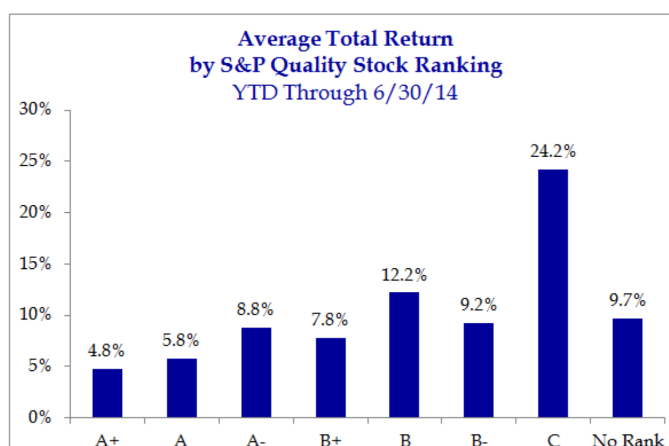
--Lao Tzu, 6th Century BC Chinese Poet

The words above are as wise today as they were centuries ago. Forecasting is fraught with failure — this is confirmed every day with real life samples from economists, to actuaries, to weathermen, and even horse handicappers placing odds on the favorite to win that elusive Triple Crown. In an uncertain world, nothing is guaranteed. Money managers are reminded of this reality all the time, as decisions are made on imperfect information and variables often beyond our control. Investing client assets based on assumptions and estimates of the future, while upholding the objective of preserving wealth, is not a long-term recipe for success. To stack the odds in our favor, The London Company reduces speculation and focuses on the tangible assets on hand. We predict little in an industry known for predictions. And although we don't presume to have excess knowledge, we believe so strongly in reducing forecast risk that it is a core tenet of our philosophy and a differentiating aspect in how we value businesses and protect wealth from unforeseen events.

The market today seems to be forecasting smooth sailing, as it has been for some time. Following an incredibly strong 2013, equity markets are still advancing on prospects of better growth ahead. Volatility remains low and returns have been more than adequate, with the S&P 500 advancing 5.2% in the second quarter and the Russell 2000 Small Cap Index increasing 2.0%. Universally, our strategies kept pace this quarter finishing inline to slightly behind their respective indices. Year-to-date, the S&P 500 is up 7.1% and the Russell 2000 is up 3.2%. Over this time period our Large Cap and Income Equity portfolios are ahead of their benchmarks while our small, mid, and concentrated strategies are behind.

Equity returns have shown a positive bias towards larger capitalized companies and issues offering above average yields. The more bond-like a stock, meaning the more attractive and consistently increasing its dividend, the better it has generally performed. Thus, it is no surprise that the dividend rich Utilities sector has been leading the way for the S&P 500, up 7% this quarter and 18% this year, over 1,000bps ahead of the index. The search for yield is also prevalent in the small cap world, as the Utilities sector is up 16% this year in the Russell 2000, only trailing the 18% advance in Energy names. For both the large and small

cap indexes, Energy and Health Care holdings have outpaced the market in 2014, due to the rise in oil prices and the financial deal makings amongst pharma and medical device companies. Consumer Discretionary stocks have lagged, creating a headwind for our smaller cap strategies that are typically overweight this sector. Another trend with long legs is the outperformance by lower quality companies over higher quality ones, a consistent headwind for our strategies the last few years. As seen in the chart to the right, the lowest quality names in the S&P have been the best performing year-to-date, and it really isn't even close. This phenomenon is a product of increased risk tolerance, but is not sustainable long-term.



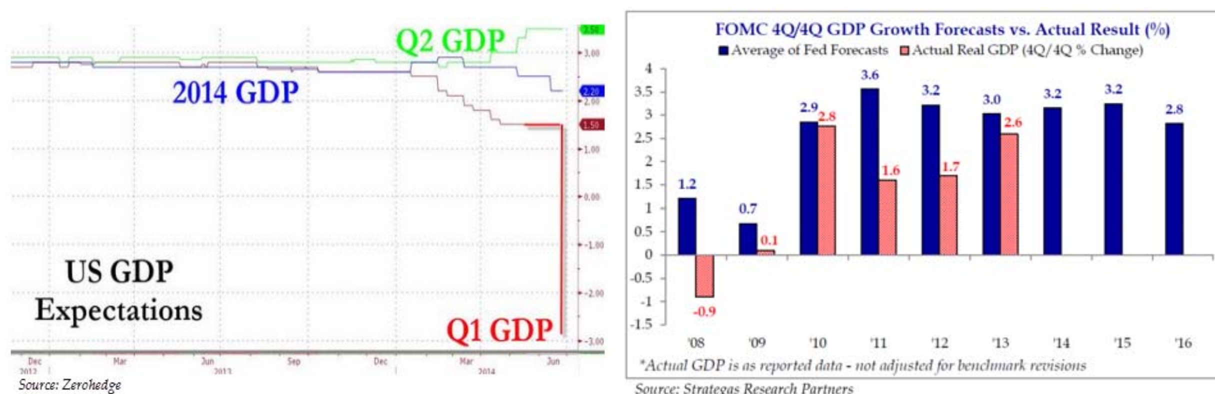
Source: Strategas Research Partners

The appetite for risk is often influenced by perceived changes to the status quo and the attractiveness of alternative investment opportunities. Despite a more talkative Federal Reserve, their actions haven't changed meaningfully, so the landscape remains dovish despite the slow tapering of their quantitative easing program. Bond yields today are surprisingly lower than they were at the start of the year, so the most common alternative investment option (bonds) remains unattractive, especially for those seeking income.

In yet another example of predictions proving false, interest rates have declined despite a near-consensus outcry that they must go up. The 10-year Treasury ended the quarter at 2.5%, a full percent below where expectations had the forecasted yield at the beginning of the year. The 50bps decline in rates this year is *unexpected* and helps explain the draw to Utilities and other bond-like stocks. It also supports the lack of volatility present in the equity markets. It has been over three years since the stock market has had a 10% correction, the sixth longest streak on record for an occurrence that happens every two years on average. *(Don't worry; we are not predicting a correction. We couldn't write about the perils of forecasting and then offer one up…we fully expect the market to do what it intends to do).*

The lack of volatility is also an acknowledgement that much of the market's discounting of distress has passed. The often discussed 'wall of worry' has been breached, if not surmounted completely. This is not only evident in our domestic equity returns and interest rates, but those that were at the epicenter of the crises a few short years ago. It is beyond astounding that French, Spanish, and Italian 10-year bonds are yielding rates as low today as any point in history. To put this into perspective, we must go back to the 18th Century to find a competing rate for French and Spanish debt, 1746 and 1789 to be exact. All faith and trust is in the hands of central bankers and maybe none more so than European Central Bank President Mario Draghi. Sub 2% and 3% borrowing rates for these countries suggest that his promise of doing "whatever it takes" has never been so believed.

Unfortunately, not all goes as planned. If the debt is manageable and the problems are indeed over… *great*; but if inflation accelerates, growth takes longer to form and/or the exit of easy monetary policy by central bankers is cumbersome, then the path going forward may not be as smooth. The hopeful answer is that a fast growing global economy will solve all ills and lift all boats, but those predictions have been slow to develop and difficult to time. Look no further than the recent GDP revision to Q1'14 and what our own Fed has expected GDP to grow since 2008. The chart on the left illustrates the dramatic miss by consensus expectations for GDP growth in Q1. The negative 2.9% rewrite is a reminder that being wrong can be trumped by being incredibly wrong to a large degree. The chart on the right highlights the FOMC's own error prone ability to forecast growth. The entity that is making policy choices based on their ability to interpret data and estimate growth has a tough time of getting it right, as can be seen with real GDP growth (in red) not catching up to expected growth (in blue).



The market generally ignored the big revision to Q1 growth, the largest since 1976 by the way. This is considered mostly 'old news' and there was very poor weather to blame as well as government accruals to healthcare spending (Obamacare) that did not take place. Not to fear though, next quarter the experts are certain to do better and we will be humming along with growth above 3.5%, if the seers are now to be believed.

To our eyes, we see mixed developments of an economy muddling along. Fortunately, we don't have to forecast macro events nor predict growth in our analysis of companies. The prospects to create value from strong balance sheets and cheap financing still coexist. We speak often about the spread between the cost of debt and equity, and the recent decline in rates only sustains this advantage. Through higher activism and simple crowd following, management teams are well aware of this opportunity and are taking action. Stock buybacks are nearing record highs for S&P 500 companies — $164bn in Q1 and on pace for another $200bn in Q2 — and the dollar value of dividends paid has never been higher.

Returning capital to shareholders is the top play for most companies that are hesitant to invest and fund capital projects. This cycle will eventually turn as confidence builds and growth surfaces. Obviously, we have no insight as to when this might occur, and since we don't do predictions, we will have to simply let events play out. In the meantime, we will stick with the mindset of our 6th Century BC Chinese poet friend, and build portfolios based

on tangible assets under management's control and not on assumptions about future growth or expected returns. We are strong believers that equity markets are much less efficient at assessing risk than reward; as a result, we are better suited at preventing strikeouts as opposed to predicting homeruns.

Looking around us, the investment universe remains relatively ample across the capitalization spectrum, as we strive to find businesses with increasing intrinsic values and reasonable valuations. The pool of candidates may not be as vast today as it was in years past, but by constructing our portfolios with just 30 to 40 stocks, only a handful are needed to have a meaningful impact on returns.

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