THE
LONDON
COMPANY

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To clients and friends of The London Company:

> "The pendulum of the mind alternates between sense and nonsense,
> not between right or wrong"
> - Carl Jung

The Swiss psychiatrist and psychoanalyst Carl Jung spent his life trying to understand people, the innate characteristics we possess, and how our conscious and unconscious states coexist. He founded analytical psychology, or individuation, which reflects a willingness to have a greater awareness to the factors that affect our total psyche. His work is insightful in appreciating how perception and judgment can vary from person to person based on certain distinctive personality traits. His discoveries became the founding force behind the Myers-Briggs personality test we know today. How we interact with the world and others is based on how we perceive it, and it is intuitive to think the more we know about ourselves the better we can understand others. In our world of investing, behavioral finance studies have shown similar effects with self-reflection and even-temperament being advantageous to long-term success.

The quote above relates to the alternating thoughts in the mind that arise from opposite forces. Carl Jung was instrumental in analyzing how we react to the problem of opposites - good and evil, love and hate, hope and despair, etc. Thoughts in our mind are neither right nor wrong, just rational or irrational. We find this view very applicable to how investors should treat financial markets, particularly in times of heightened volatility. The movements of securities are a reflection of our collective perception of the future and how secure we believe it to be. Greed and fear push and pull and markets sway. Sentiment isn't right or wrong, it simply swings and at times falls over the line of what is reasonable and towards extreme, giving us the notorious bull and bear markets we love and loathe. While there are factors that can distort or exaggerate these swings, we agree with Carl Jung's conclusion that they are self-regulating and that eventually, the psyche will in fact find balance.

As we reflect on the most recent quarter and first half of 2019, we find the market psyche today is mostly alternating between optimism and pessimism on trade tariffs and interest rates. These issues are dominating the headlines but their direction has been prone to sudden changes, sometimes casually from the President's twitter account and sometimes more formally from the Federal Reserve. The market volatility we experienced in the quarter, down 6.4% in May to up 7.1% in June, was due to anxiety transforming into renewed optimism on both fronts. Investors are focused on these items as they provide insight to the bigger conundrum, will the economy continue to expand or are we finally headed towards a recession? As you can see in the charts

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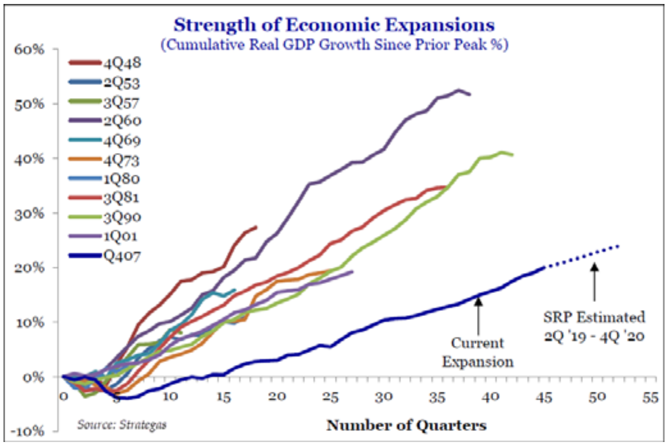
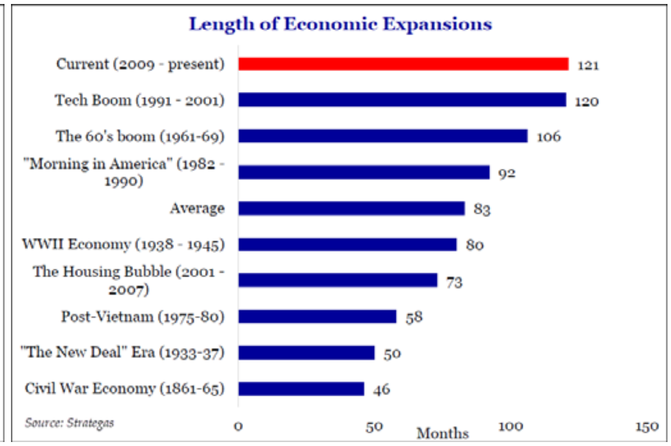
below, we are now technically in the longest, but slowest economic expansion ever, just surpassing the tech boom in the late 90's. Although the duration has surpassed other expansions, the pace





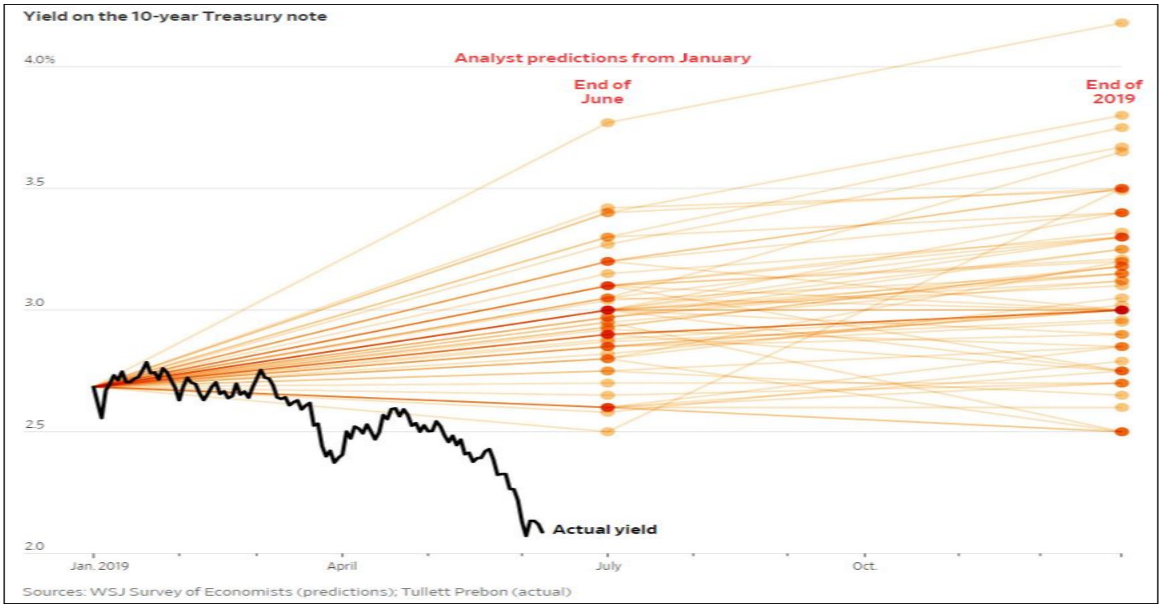
has lacked the same intensity. This has caused most of the angst over its sustainability. The 'wall of worries' has ebbed and flowed over the past decade, but its omnipresence has likely aided this streak. Looking ahead, the biggest debate revolves around the fact that the equity markets are making record highs and employment is strong, but inflation is low, and the yield curve is inverted. The latter two items suggest a slowing economy, thus giving the Fed real reasons to consider cutting short term rates. Unfortunately, each time rates have been reduced while unemployment was below 4%, a recession began soon after. The fact that the market is suggesting both outcomes reminds us of another quote from F. Scott Fitzgerald, "the test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function." Like Carl Jung, Mr. Fitzgerald knew the difficulty of dealing with uncertainty and how opposite forces affected our psyche. We claim no superior intelligence, but we are smart enough to know that we can't predict the future. We function by sticking to our discipline and staying prepared for times of distress. As we search for sensible and sound investments, we will use the rest of this letter to highlight some of the sensible and nonsensical realities of the current environment.

First, let's review the period. The market rally in June, which was that month's best return for the S&P 500 since 1955, allowed the second quarter to finish in positive territory. The S&P 500 Index increased 4.3% and the Russell 2000 Small Cap Index increased 2.1%. For the first six months, these indices ended up 18.5% and 17.0% respectively, capping off the best six-month start in over 20 years. For both the quarter and half-year, the market was led by large cap securities with growth continuing to outpace value. Quality did well but so did momentum, yet defensive sectors lagged while cyclical stocks led. This pattern of market leadership is not normal and is further evidence of an anomalous market.

The London Company portfolios did well, meeting our expectations. Our Income Equity and Large Cap portfolios participated in the upswing (not to the same degree of the market rally) but still finished the six-month period up roughly mid-double digits. Technology companies are leading the large cap universe with the bigger market cap securities doing the best. The market remains tilted towards growth over value, a streak now 12 years in the making. Given our more defensive posturing and those pockets of the market underperforming, we are content with our performance. Our Small Cap, SMID and Mid Cap strategies have fared better, outpacing their respective indices this quarter and for the year through June, an unexpected result given the strength of the market. Stock selection in these strategies has been positive, especially amongst our consumer discretionary and industrial holdings. We have been fortunate to minimize mistakes and have found attractive new ideas to populate the portfolios.

Generally speaking, larger cap companies continue to do well with narrow market participation. New market highs are had with fewer companies surpassing their 200-day moving averages. This means the more expensive names are performing well and continuing to get more expensive. According to Bernstein research, the valuation gap between growth and value is the largest it has been in 70 years, and nearly all of the multiple expansion is taking place in the already expensive pockets of the market. We have commented before that growth does best when it's scarce and we are seeing that in full effect today. Beyond the valuation levels of some of the fastest growing companies, the so called 'unicorns' in the IPO market are also showing some signs of irrational exuberance. For the first time since the tech bubble, 80% of companies coming to market are profitless. Unlike that time period, many of these companies have been in private hands for years (i.e., Uber, Lyft, Pinterest) but still generate negative earnings. For investors like us that focus on cash flows, this is not a market we participate in but one we watch for risk tolerance. Perhaps the biggest signal of greed and momentum was the issuance of Beyond Meat, a veggie-burger startup that increased 400+% in its first month of trading, becoming one of the hottest IPO's ever. Despite the lack of financial credibility or market acceptance, the byproduct of low rates and cheap capital is increased risk tolerance for these types of investments. This phenomenon was seen last year with cryptocurrencies and cannabis companies. We always steer clear of things we don't understand, but knowing the interest is there because growth is scarce elsewhere is a noteworthy concern.

Another sign of nonsense is in the credit markets and the roughly $13 trillion in negative yielding sovereign debt. This makes zero sense and relies on global central banks to constantly provide a backstop to all credit risk. Global central banks have become more transparent and have verbally confirmed to do "whatever it takes", but paying money to hold government debt is insanity. Money has proven to have no boundaries, so foreign debt holders starving for yield have come onshore to our domestic markets to fund that desire. The 10-year Treasury has fallen much more than forecasted partly due to this demand. Again, in the arena of nonsensical market folly, the challenge of predicting where the yield curve will sit six months to a year from now is a losing game. Just look at the forecasts from the beginning of this year to confirm. Not one estimate was remotely close to reality.



This is another concrete example why we try to reduce speculation in all aspects as much as possible. The bond rally (higher prices and lower yields for longer dated bonds) has coincided with record stock prices. In fact, after the Fed gave its dovish comments, every asset class that Deutsche Bank tracks, all 32 of them, were positive in June. This has only happened one other month since 2007, which occurred this past January after Steven Mnuchin formed the Plunge Protection Team following the tumultuous market in December. If the Fed does decide to cut rates, there will be debate of its independence and it is too beholden to the markets. In its defense, however, it is tough carrying that torch while the President continually derides its actions. Regardless, enhanced transparency has allowed the markets to position ahead of its moves and if things change, volatility will ensue.

As we look forward, we expect more of the same with volatility continuing to be a constant. The movements of securities are always quick, but the ever-increasing influence of passive vehicles keeps accelerating those actions. J.P. Morgan now estimates nearly 80% of the equity markets are passively controlled, with 60% in ETFs and another 20% dictated by quant funds and algorithms. Active mutual funds continue to lose assets to passive funds, so we don't expect that pendulum to swing back soon. We think it will take a real correction or an unwarranted dislocation of prices to stem the flow towards passive. Longer-term we think both will coexist and there will be a healthy balance between the two. In the meantime, we will remain opportunistic for when the passive influence becomes excessively penal in down-markets or underappreciates great businesses in up-markets. When the market is on autopilot, not only does it aid the weak companies it also can constrain the successful ones.

From our viewpoint today, we are content with our portfolio positioning as we remain concentrated on high return on capital companies with strong balance sheets. These businesses continue to grow, generate cash, and allocate that cash in sensible ways to the long term benefit of shareholders. We expect the sentiment on the economic backdrop to oscillate, whether the Fed intervenes or not. The best case scenario could be for the current countering views to continue, providing a healthy struggle where volatility is present but no major moves are sustained in either direction. This would allow corporate earnings to expand and perhaps reduce the valuation gap between growth and value. Reducing instabilities in the market would be a positive outcome and reduce risk of a larger, more painful correction if they were to continue to balloon.

The London Company remains focused only on the things we can control while staying disciplined to our process. We will steer clear of the occasional nonsense but highlight its risks. Neil deGrasse Tyson said the universe has no obligation to make sense to you, and that is how we think about the markets. We can only observe and control how we react to the swinging sentiment of the market, knowing any excess will eventually balance out. We recognize the markets aren't always rational, so we are happy to just acknowledge that chaos can exist without attempting to always understand it.

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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