THE
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To clients and friends of The London Company:

The second quarter of 2021 was a noisy one, but equity markets continued their grind higher, undeterred. From concerns over inflation, the Fed, and talks of tax hikes, there was no shortage of distractions for investors during the period. Nevertheless, it wasn't a 'sell in May and go away' kind of Spring. The continued strength of the economic recovery and robust earnings landscape helped lift equities higher, with the major indices posting mid-single digit gains.

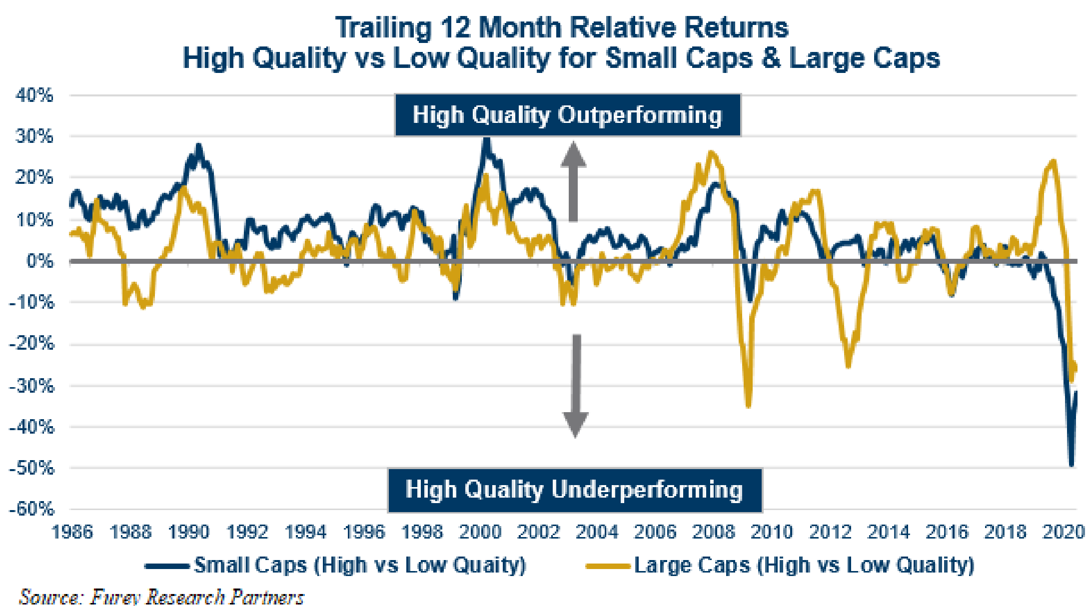
The nation is quickly reopening and the economic recovery is beginning to normalize, but the process of catching up and digesting the associated crosscurrents has produced some indigestion. Economic data released during the quarter was quite strong, and nearly half of our population is now fully vaccinated. Consumer spending is up, unemployment is trending lower, and the manufacturing and services segments of our economy are firmly in expansionary territory. Corporate America is in fantastic shape—setting records and rising to meet demand. Concerns over inflation are the counterbalance to much of this good news. We've lapped the very weak levels of the pandemic-driven 2020 inflation, making for distorted comparables. Further, there are major imbalances in the system where stimulus-boosted demand is currently outpacing supply. That said, the general narrative that has shaped markets hasn't changed much this year—it is still optimistic.

The broader market, as measured by the Russell 3000 index, rose by 8.2% during the second quarter, finishing up 15.1% for the first half of the year. Though last year's recession and recovery have been very unique, we've observed leadership transitions akin to the roadmap of prior recoveries. The conditions supporting growth's grip on leadership—high uncertainty and scarcity of growth—abruptly crumbled following the Q4'20 vaccine news and stimulus announcements. What followed was a historic risk-on rally. Initially, the most beaten down, lower quality stocks ricocheted off depressed lows, then cyclically sensitive equities with the highest beta quickly followed suit. Amidst this backdrop, value finally assumed the mantle of leadership—at least for two quarters. This quarter, growth actually outperformed value, largely due to a pickup in volatility following the Fed's meeting in June. While the cyclical tailwinds for value's leadership remain intact, value stocks are much more elastic to economic prospects than growth, so any hint of changes in trend can be met with leadership volatility. June's countertrend notwithstanding, breadth in cyclical leadership remains strong. While we've recently seen the rotation move up the quality spectrum to cyclical stocks with stronger fundamentals, profitability and quality factors have largely been out of favor in this recovery.

The performance and maturation of the recovery has been quite different for Large and Small Cap stocks. During the quarter, Large Cap shares had the edge with an 8.5% increase in the S&P 500 compared to the 4.3% return for Small Caps, as measured by the Russell 2000. But over the past three quarters, Small Caps have trounced Large Caps, 54.4% vs 29.3%, respectively. Among the reasons for this dispersion, we note index composition, diversification and the influence of exaggerated risk-taking. One big reason why the Russell 2000 has performed so well is due to its heavy tilt toward value. The traditional value sectors, like Energy, Financials, Industrials and Materials comprise 58% of the Russell 2000, but only constitute

26% of the S&P 500. Not only is the S&P 500 index more growth oriented by comparison, it is significantly more top-heavy. The top five holdings make up roughly 21% of the S&P 500, compared to only 2% for the Russell 2000's top names. As such, the Russell 2000 is much more diverse and not beholden to its top five stocks. This diversity of influence has served the Russell 2000 very well in this broad market rally. Finally, excessive risk-taking and speculation continue to thrive amid Small Caps. The performance leadership of lower quality factors (i.e. high beta, high volatility and negative earnings) for Large Cap stocks peaked back in March. Within Small Caps, these factors continue to lead the index. Examples of this dynamic include GameStop (GME) and AMC Entertainment (AMC). These beleaguered companies were left for dead before an army of retail day traders resurrected their shares through targeted short-squeeze trading. This year, GME and AMC saw their market capitalizations rise ~1,200% and ~5,300% respectively, and their contribution to the return for the Russell 2000 was over 10x their index weight—remarkable but not sustainable.

As a quality-oriented manager, we know that patience is rewarded in the long run, but it can require the ability to endure periods of challenging relative performance. To that point, our friends at Furey recently shared the following illustration that puts this notion in stark relief.



Turns out, the pandemic market was actually one of the worst periods ever for quality—a six standard deviation event for Small Caps! Though that context is illuminating, we know that extreme outliers can become more extreme and can remain so longer than many expect. And while we like to think quality should rebound similarly to what value recently experienced, we're mindful that you can't schedule mean reversion. We know the keys to long-term success require protection of capital when it matters most. Accordingly, we remain committed to patience and sourcing sensible investments that can help us deliver on our aim to capture 85-90% of the market's upside but only 75% of the downside over full market cycles.

Generally speaking, the cumulative effects of the dynamics described above presented headwinds for our portfolios, which delivered mixed results for the period. Given the robust return environment, our larger cap strategies performed as we would expect. The Large Cap strategy lagged the Russell 1000 in Q2, but is outperforming for the year. Our Income Equity strategy split its benchmarks in Q2—outperforming the Russell 1000 Value while finishing behind the S&P 500. For the year, it is slightly

behind both but within our expectations. Moving down the market cap spectrum, the results for our Mid Cap, SMID and Small Cap strategies were less favorable. All three have trailed their benchmarks this quarter and year-to-date, which isn't surprising given the environment. We did have a couple holdings stumble during the quarter, which detracted from short-term performance, but nearly all of the recent performance shortfall across these strategies can be attributed to what we don't own versus what we do.

So, what happens next? As long time readers know, we're loath to make any forecasts or dabble in speculation, but we can recap some of the noise we've outlined above. Among the conditions facing markets include an optimistic narrative, excessive risk taking, inflation concerns and potential tax hikes. Equity markets have been on an unprecedented run since the March'20 lows and valuations are still rich. If history is any guide, year two returns in bull markets are more challenging. Lastly, the Fed pivoted recently and is now saying they will allow the economy to run hot and inflation to exceed 2% for some time before taking any action. In the past, Fed actions were more preemptive. Now, the Fed seems to be moving to a more reactive response, which does carry risk. In general, it's best not to view individual macro risks in a vacuum and we actually believe fundamental conditions remain positive. But as we look to the second half of 2021, we note a confluence of these dynamics could lead to increased volatility as equities navigate an ongoing wall of worry.

We propose, without predicting, that quality factors more broadly appear poised for relative strength, especially if volatility levels increase. As we highlighted earlier, quality's recent stretch of underperformance has been an extreme outlier, but as a result, quality now trades at its biggest discount the broader market since the Tech Bubble. If this market continues to evolve like the roadmap of prior recoveries, we can expect investors to become increasingly more selective, leading market breadth to continue narrowing. As we look at the characteristics of our portfolios today, the positioning is the best it's been in a number of years. Returns on capital and balance sheet strength continue to be very healthy. Given the level of quality, it is abnormal to see our portfolios trade at such attractive valuations relative to the respective benchmarks. We believe this will serve us well for both near-term volatility and long-term durability.

As always, we appreciate and value highly the trust you have placed in us.

Best regards,

The London Company

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