THE
LONDON
COMPANY

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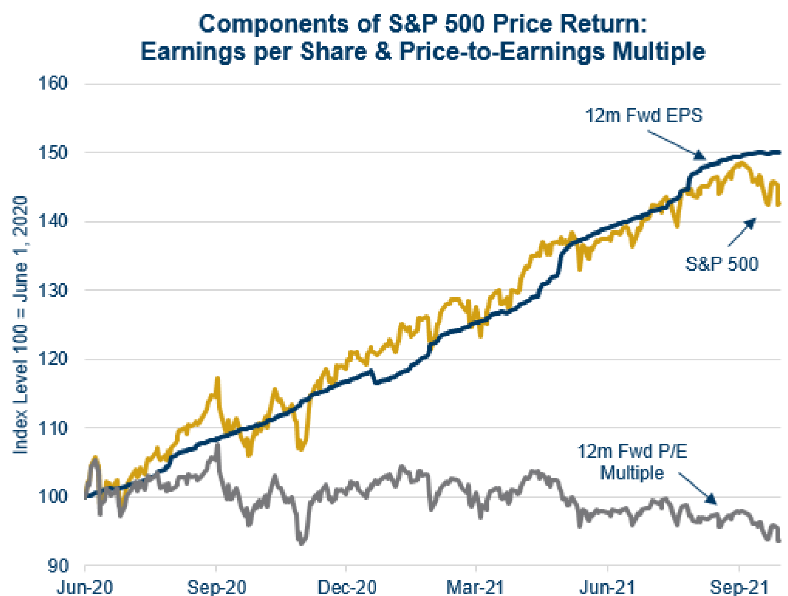
To clients and friends of The London Company:

Like a duck on a pond, the point-to-point third quarter return for the broader equity market seemed fairly ordinary and calm on the surface, but there was a flurry of activity and churning beneath the water as it progressed through the summer months. The rather mundane -0.1% return for the Russell 3000 in Q3 doesn't tell the full story. The quarter began with the upsurge of the Covid-19 Delta variant only to be bookended with a September to remember. Last month, a more hawkish Federal Reserve signaled that it would begin tapering its quantitative easing program. Additionally, debt crisis concerns erupted out of China, as one of its largest property development companies, Evergrande, collapsed over insolvency fears. Finally, political brinkmanship escalated down the stretch as lawmakers sparred over policy and deadlines. While the S&P 500 has been remarkably resilient, the quarter ended on a sour note as the cumulative effect of these headwinds led to the index's first 5% pullback since October 2020.

At the start of the year, the consensus outlook called for strong GDP growth, rising rates and elevated inflation. With that, we saw Value styles lead Growth, cyclical sectors lead defensive, and Small Cap stocks lead Large Caps through May. However, as the Delta variant spread over the summer months, the growth outlook was repriced and the market shifted to a narrative of peaking inflation fears, slowing growth, and falling yields. Like a tug of war, the leadership pendulum swung back in the opposite direction, as it has so many times in this seemingly binary market landscape. Growth styles and defensive sectors rebounded among Large Caps, but results were more nuanced down the market cap spectrum. Meanwhile, Large Cap shares outperformed Small Cap in Q3 with the S&P 500 posting a 0.6% return compared to a -4.4% decline for the Russell 2000.



Source: Cornerstone Macro, Bloomberg & Bernstein Analysis

Here at The London Company, we don't submit to narratives and we eschew consensus thinking, but we were encouraged to see signs of the market rewarding company fundamentals and becoming less macro dominated. If you break down the returns for the S&P 500 this year into its components, earnings per share and price/earnings multiple, you see returns for the market have been entirely driven by earnings—opposite of 2020 and 2019. More specifically, earnings revisions and rising expectations have been the primary driver of market upside. This is common after recessions. Overly skeptical analysts' forecasts typically set a low bar for recovering companies to surpass. As companies surprise on the upside, analysts

play catch up and often get too optimistic with their forecasts. Thus far in 2021, the market has rewarded companies with some of the largest earnings revisions. While this dynamic worked to the benefit of higher quality companies in Q3, many of these cyclical companies with the largest revisions are still getting back to normal. Across our portfolios, you won't find examples of such boom-bust companies. We like earnings stability and predictability of cash flows, and we don't put much weight into forecasts or estimates. As we think about this current backdrop, however, we wonder if the market has gotten ahead of itself with some of its earnings expectations.

Before we turn to our performance, we want to acknowledge the resiliency of this market while also pointing out the degree of dispersion beneath the surface. As we noted earlier, the S&P 500 experienced its first 5% pull back since October 2020, but historically we've averaged three such pullbacks per year, going back to the 1950s. In fact, the S&P 500 has nearly doubled since the March 2020 lows without a 10% correction—which is also very rare. The markets that did go beyond a doubling without a correction ended badly (1932, 1987 & 1997). On the dispersion front, the top-heavy S&P 500 index masked what's happened within and across the market. Away from the mega-cap names, the market consolidated under the surface. Rising uncertainty pushed market breadth to near one-year lows. The market's more cyclical corners and riskier pockets have experienced corrections for months now (e.g. cyclicals sectors, small cap stocks, Meme stocks, etc.). The Top 5 holdings for the S&P 500 represent roughly 23% of the index, but they contributed over 3x their index weight to the Q3 return. This abnormally high contribution to return helped prop up the index and stave off a more severe pullback. As we said at the outset, the Q3 index level performance doesn't tell the full story, and the concentration of returns was a major reason why.

The unique crosscurrents and index inconsistencies in Q3 translated into mixed results for our portfolios. As we noted in our Q2 letter, quality investing was coming off one of its worst stretches for relative performance in history. In Q3, quality turned the corner, but the move was most pronounced in the Small Cap space and masked at the Large Cape level. Accordingly, our Small and SMID strategies outperformed their respective benchmarks in Q3 as they were able to protect on the downside. The aforementioned concentration of returns for the large cap core indexes set a high bar. Our Large Cap strategy lagged the Russell 1000; meanwhile, our Income Equity strategy trailed both the Russell 1000 Value and S&P 500. Unfortunately, our Mid Cap strategy continued to trail its benchmark. Parsing through its results, a combination of factors worked against us. Several names posted negative returns in a strong up market, and some of our larger holdings that drove Mid Cap's outperformance in recent years have taken a breather so far in 2021. Across Mid Cap and other portfolios, we've had a handful of names fall short of the Street's lofty earnings expectations this year. It wasn't for lack of demand, pricing power or operating leverage. Many companies elected to absorb higher input pressures and maintain pricing as part of a longer-term strategy to gain share. We seek out such companies that have that margin of safety in their fundamentals and the discipline to delay gratification. While this can lead to some short-term pain, we'd rather our companies miss one quarter's earnings estimate and reinvest in the business at higher rates of return in order to achieve longer-term gains. For the full year, all of our strategies trailed their benchmarks, but most are within the zone of expectations. We know successful long-term investing is not a straight-line journey, and it's not uncommon for our concentrated portfolios to be out of sync with the market over short periods of time.

As we look ahead, even though the economy isn't living up to its full potential, we believe we're much closer to the start of this economic expansion than the end. That said, the risk side of the risk/reward equation has grown substantially over the past several months and could disrupt the equity market's historic advance. We're coming off of potentially peak margins and peak rate-of-change in domestic growth. This is occurring at a time where it's likely we'll see higher taxes, higher levels of inflation and tapering from the Fed. The Delta variant remains a big unknown and on-going supply chain frictions

could weigh on demand. China's Evergrande predicament could get resolved or it could turn out to be a canary in the coalmine. Moreover, China's ongoing crackdown on corruption has become a crackdown on capitalism. Its heavy-handed government intervention and inward pivot is concerning. The ripple effects down the road could be vast and significant for the global economy. These dynamics are at play when US equity market valuations are near historic extremes and 2021 inflows into passive equity ETFs are on pace to break records—adding to the growing list of parallels to the Dot.com bubble. As we noted earlier, the driver of the market's upside this year has been earnings revisions, but extrapolating too much optimism into the future can be problematic. When earnings revisions inevitably roll over, it's historically not the death knell for the market. However, it is typically accompanied by more volatility, slower growth and weaker returns. Net net, this should be good for active managers and a positive for strong companies with solid fundamentals.

We often are asked the question, 'What keeps you up at night?' The risks outlined above certainly bear monitoring, and there's always the chance for a policy misstep or an exogenous event (e.g. COVID-19). Fortunately, we're able to sleep well, knowing that our process prioritizes risk mitigation and protecting our clients' capital when it matters most. The macro landscape is often overwhelming and complicated. This quarter is a reminder that the consensus outlook often turns out to be wrong or things don't always go according to plan. We don't overreact to the macro and remain focused only on the things we can control. Even amidst this expensive market backdrop, we're still finding high quality companies at attractive prices that we believe can buttress that downside protection objective. Interestingly, there's no pattern to the names we've acquired this year. From a leading boat manufacturer, to insurance companies, to a water treatment company, to an aircraft lessor, and even an elevator company, we've managed to find high quality businesses with great fundamentals across the investment universe.

In closing, we'll leave you with a few excerpts from Lawrence A. Cunningham's excellent book, *Quality Investing: Owning the Best Companies for the Long Term*. Cunningham is an author for whom we have great respect. In his book, he addresses short-term underperformance struggles that quality investing inevitably encounters, but he reminds us to remain focused on the long-term. Relevant to this recovery, he explains that lower quality companies often benefit "when markets trade certainty for hope." However, over the long-term and especially during periods of distress, "the relative certainty provided by higher margins, strong returns, greater stability and more robust balance sheets becomes disproportionately valuable." These same principals inform our investment decision making, because one never knows when that duck on a pond turns into a black swan. And black swans have been known to keep investors up at night.

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

Best Regards,

The London Company

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