THE LONDON COMPANY

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To the clients and friends of The London Company:

The financial markets were heavily influenced this past quarter by the actions of the Federal Reserve and European Central Bank (ECB). The most recent announcement, QE3, is an open-ended $500 billion a year program to last as long as needed to stimulate employment. While efficacy will take some time to judge, the secondary goal of propping up equity prices is working.

Equity returns for the third quarter were very strong. Stock prices foreshadowed a benevolent Fed and ascended to new cyclical highs. The S&P 500 came close to its 2007 peak, and the smaller cap indices of the Russell 2000 and Russell Mid Cap hit new record highs midway through September. The S&P 500 ended up 6.4% for the quarter and 16.5% for the year-to-date. The Russell 2000 trailed slightly, appreciating 5.3% for the quarter and 14.2% for the year-to-date. During the quarter, the more cyclical sectors (Energy, Consumer Discretionary, and Telecom) led and the more steady sectors (Consumer Staples, Health Care, and Utilities) lagged.

The London Company portfolios showed mixed results. The small cap strategy performed well and handily outpaced its benchmark. Stock selection was positive with our top holdings contributing meaningfully to returns. The Large Cap and Income Equity strategies trailed their respective benchmarks this quarter. Our focus remains on much longer-term time horizons, so we expect quarter-to-quarter fluctuations, particularly in periods of artificial stimulation by the Fed. During high beta market rallies, it is common for us to trail the index, but as we have shown consistently for the past 18 years, we significantly outperform during down markets resulting in top quartile performance over three to five year periods.

The strong correlation between QE programs and stock prices is undeniable and the stocks that benefit the most are typically the more volatile, less stable ones we specifically try to avoid. The Chairman is on record stating that "…higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending." Inflating asset prices to spur economic growth seems plausible, and the stock market has appreciated, albeit with less enthusiasm to each subsequent announcement. Unfortunately, higher equity prices have not yet translated into job creation and higher GDP. The diminishing effects of past QE programs bring into question what the Fed can really do to jumpstart growth.

Additionally, extending near zero interest rates through 2015 does not incent borrowers to invest in capital expenditures and hire people today. Management teams are in no hurry to borrow if they know they can get historically low interest rates for the foreseeable future. Instead, CFOs can borrow cheaply to refinance debt, repurchase shares or increase the dividend. This policy has helped current investors but, apparently, has not created new ones. Given tepid consumer demand and uncertainty about taxes, regulation, and health care costs, it is natural for companies to delay capital projects.

An indirect benefit, however, is that the lack of investment has strengthened current industry leaders to grow market share and increase profit margins. The lack of capital expenditures by weaker players to increase capacity and the dearth of new competition has grown the true intrinsic value of many of our portfolio companies. For the past few years, corporate profits have been a source of strength to the market and after-tax profit margins continue to make all-time highs. We are optimistic this dynamic will not change anytime soon due to past consolidation and the void of recent new capacity.

While this upcoming earnings season could challenge our recent Fed-induced surge, we are confident in our process and company-specific holdings to protect us on the downside if volatility increases. Earnings preannouncements are running 4-to-1 negative for the September quarter – the widest margin in 11 years. Profit warnings from high quality companies with broad global exposure to the economy such as FedEx, Caterpillar, Intel, and Norfolk Southern suggest some deceleration in the pace of activity. In normal circumstances, negative preannouncements can be a bullish signal for the markets, as information is already discounted and reflected in prices. This earnings season may be different given the non-fundamental, QE impact.

As prudent managers of capital, we focus on fundamental facts and guard against speculation. While there are many headline concerns and fears – elections, fiscal cliffs, slowing GDP growth, European sovereign debt, and Middle East angst – they are already well known. It is the out-of-left-field events that usually catch the markets off guard. Positive attributes in the market include visible progress in housing and services, underleveraged corporate balance sheets, attractive valuations, and healthy merger premiums. We expect dividend growth, stock buybacks, and premiums from acquisitions to lead equity returns over other asset classes. Free cash flow yields of many stocks that we follow are 10% and above. The spread to 10-year Treasuries, which yield 1.6%, is breathtaking. Equity risk premiums have rarely been greater, cause and effect of the continuing outflow from stock funds to bond funds and the low allocation to U.S. equities by investors of all stripes.

Looking forward, it is our view that confidence, not credit, is what needs to be increased. Confidence comes from having stable and transparent tax policy and regulatory rules. With policy certainty, corporations would part with their excess cash to hire and expand. Bull markets always begin with maximum fear and uncertainty, and this year appears to be no different with the broad markets up 15% so far. Equity returns should continue to outpace inflation and the returns of other mainstream, liquid asset classes given reasonable valuations and investor demand for income and, more importantly, growth in income. Dividends continue to grow and will remain, we believe, a key determinant of outperformance in a low interest rate world.

The London Company is fortunate and grateful to have wonderful partners and clients. We would like to share our success as we reach new milestones in terms of assets and employees. We are pleased to announce the addition of John Lombardo as an Equity Trader, effective September 10, 2012. John brings over 18 years of financial experience, most recently from Mizuho Securities in New York. We also announce that Wade Stinnette has left The London Company effective September 26, 2012 to pursue other opportunities. We appreciate Wade's valuable contributions and wish him well in his future endeavors.

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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