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To clients and friends of The London Company:

"Over time, the skill with which a company's managers allocate capital has an enormous impact on the enterprise's value. Almost by definition, a really good business generates far more money (at least after its early years) than it can use internally. The company could, of course, distribute the money to shareholders by way of dividends or share repurchases. But often the CEO asks a strategic planning staff, consultants or investment banker whether an acquisition or two might make sense. That's like asking your interior decorator whether you need a $50,000 rug."

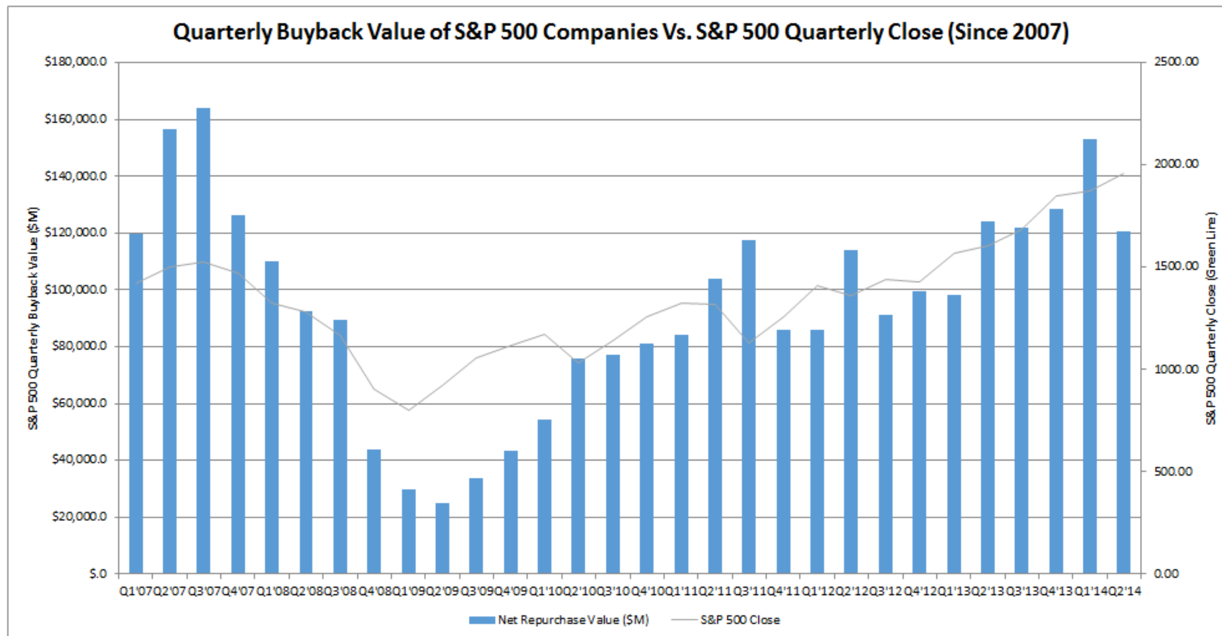
--Warren Buffett

During the latest quarter, investors showed increasing signs of fatigue from their long climb up the market's proverbial "wall of worry" and into uncharted territories. Meanwhile, corporate America exhibited an acquisitive vim and vigor, ordering up more and more of Buffett's metaphorical $50,000 rugs. We will address both developments in this quarter's letter. Beginning with our customary review of the investment landscape, the US economy performed better than did the markets during the third quarter. While the S&P500 eked out a 1.1% return and larger capitalization stocks were able to gain ground, returns became progressively more negative moving down the capitalization spectrum, with the Russell 2000 posting a broad-based (7.4%) drop. Every sector in the Russell 2000 declined over the period, so there weren't a lot of places to hide. Along with size working against stocks, lower quality but also lower beta, cyclicality, and value-oriented style all were negative attributes influencing quarterly returns. The revival of global geopolitical tensions, emerging market growth concerns, and another dose of "Fedaphobia"- investor's recurring, hair-trigger fear that Federal Reserve actions ultimately will cause interest rates to surge - all conspired to bring a sense of fatigue to the markets. Paradoxically, this bout of market exhaustion unfolded against a slew of positive domestic economic revisions, particularly across capital investment, an improving labor market, and a generally still-benign interest rate and inflation outlook.

Given the negatively-framed backdrop that we've just described, it should not be surprising that we performed comparatively well in the quarter, with our strategies out-performing the benchmarks other than in concentrated. It is particularly gratifying to report that quarterly relative performance was strongest in small cap, where absolute benchmark performance was the most negative. Although we don't assign much weight of evidence to short term results, protecting downside in periods of declining markets has been the

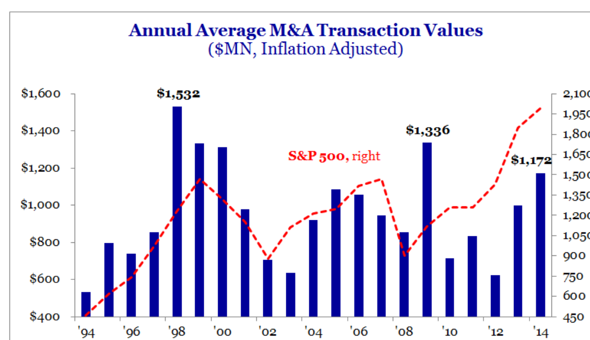
hallmark of our firm and what we expect to deliver to our clients over full market cycles. Looking at the nine month picture, 2014 thus far has been good for larger cap equities, with the S&P500 gaining 8.4% and establishing 34 separate all-time closing highs along the way. Impressively, 2014 already ranks as the 15th best year since 1928 for high water marks being set by the S&P Index (Source: Strategas Research Partners). Smaller caps have not fared nearly as well, underperforming larger caps both in 2q and 3q to fall behind by over 1200 basis points and putting a sizeable dent in the previous 5 year run of relative outperformance. We do not try to predict or time the likelihood of such outcomes, but would observe that the recent reversal of fortune is likely a confluence of factors including the narrowing of valuation differentials between small and large cap stocks, superior incremental profit margin improvement within the large cap constituency, and normal mean reversion. Regardless of precise root cause, this dramatic swing certainly has been reflected in our small cap strategy, which has moved ahead of its benchmark at this point in the year. Along with the snapback in small cap, our smid, large cap, and income equity strategies all are now ahead of benchmark YTD, while mid cap and concentrated remain behind. Because markets always will make dramatic and unexpected moves over the short term, we will always eschew the dismal science of forecasting and adhere to the principles of sound, long-term investing while maintaining the mindset of being an owner in the businesses of the companies in which we place client funds.

Now, regarding the matter of the $50,000 rugs, there is little doubt that one of the more noteworthy evolutions within the marketplace over the past few quarters has been the shift in capital allocation policies by public corporations. How corporate stewards allocate firm capital to create shareholder value remains a key focus here at The London Company so we monitor these actions closely. Over time, we have used these quarterly letters to chronicle how the unprecedented rebound in corporate profitability within a low growth economy has resulted in an excessive buildup in cash on balance sheets, which in turn has facilitated a virtuous cycle of its return to shareholders via dividends (including special dividends) and share repurchases. Corporate "cash hoarding" also has engendered an explosion of activist investors whose brazen assaults upon the piggy bank have greatly altered the capital allocation agenda at many public companies. But with the passage of time, behaviors and priorities begin to change, and we are seeing increasing evidence that both capital spending and M&A activity are supplanting the previous levels of commitment to dividends and share repurchases. For example looking at the quarterly data on S&P500 share repurchases, one can see that the low in activity coincided with the market low during 1q 2009. From that point, increasing repurchase activity supported the market recovery, but appears to have peaked at the end of 2013 and has started to recede from that run rate. The 1q 2014 jump included an $18B impact from the outsized share repurchases by Apple and IBM which were not repeated in subsequent quarters, so excluding that impact incremental activity is losing steam and no longer keeping pace with cash generation. Announced gross share buyback activity is down 30% YTD over 2013. As an interesting sidebar note, repurchase activity is actually continuing to increase at Russell 2000 companies, perhaps in part in response to the sharp downdraft in share prices (Sources: InsiderScore.com, JP Morgan).

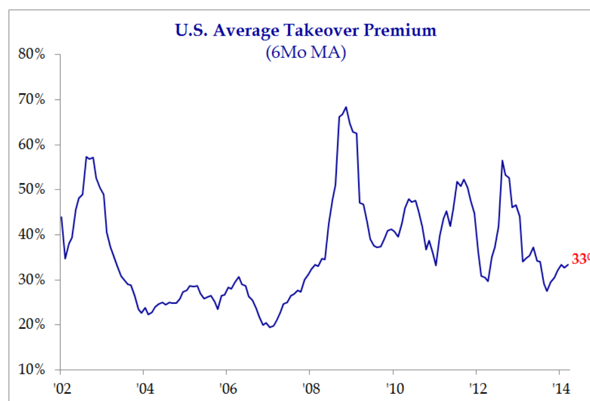


Source: InsiderScore.com

So with corporations continuing to gush cash, how are managements putting that money to work? While dividends and share repurchases remain a big part of the equation, dressing up the business profile with a $50,000 rug or two also is a growing part of the solution. According to JP Morgan, global M&A activity is running 50% over 2013 levels, while in developed markets the dollar value of deals through the first nine months of 2014 is up 127% over full year 2013. As shown to the right, deal levels are moving toward the previous highs seen in 1998 and 2009, but the premiums being paid for these acquisitions are lower than in past cycles. Exercising some degree of restraint in the prices being paid is a historical anomaly for management behavior, but one that is prudent in the context of the current environment, and has resulted in atypical investor response as well. Unlike past cycles, where merger announcements routinely triggered negative share price reactions in the acquirer's stock, investors have tended to view deals in a much more positive light thus far in this cycle. The chart below, which captures the ratio of positive reactions vs. negative reactions to merger announcements, clearly shows the accelerating approval of deal-making. In a slow growth, low- financing cost world, more transactions have made better economic sense and actually



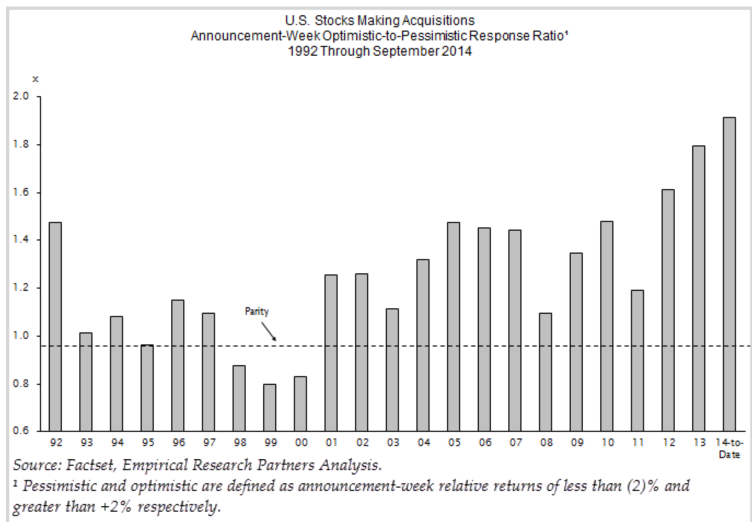
Source: Strategas Research Partners



Source: Strategas Research Partners

have been able to deliver accretion to more of the merged entity's results. And, positive response by the market only validates the strategy where transactions begat more transactions, providing a powerful corporate impetus to jump on the bandwagon.

While there is action occurring across the board, activity has clustered in those industries with some shared traits of maturing business models generating high free cash-flow but with diminishing growth prospects in the global economy. A secondary clustering has centered around opportunities to pursue inversion transactions, wherein a US-based company merges with a non-US based company in a lower tax rate country and re-incorporates the combined entity in that country to curtail US tax rates. As the transaction sizes have grown significantly larger and opposition hue and cry has become louder, inversions have become a hot potato political issue, and at some point will be addressed. In the interim, the window of opportunity remains open and more such transactions likely will be announced. Certainly we have seen this wave of M&A activity wash across our strategies, where at the present time we have nine separate positions that are engaged in one side or the other in a merger transaction. With our private equity-like approach, we would expect to participate in our share of deals as we have in past cycles, and also would expect to see additional involvement going forward, especially given the elements driving this vigorous burst of activity.



Source: Factset, Empirical Research Partners Analysis.
¹ Pessimistic and optimistic are defined as announcement-week relative returns of less than (2)% and greater than +2% respectively.

We remain mindful that historically, the M&A cycle ultimately becomes extended and destroys shareholder value, as managements lose discipline and continue to "ante up", buying $75,000, $100,000, $200,000 rugs. While we will continue to monitor price tag levels and management actions, here at The London Company our focus will remain consistent as we look for and invest in those companies that create value through balanced capital allocation. We also will not attempt to predict when current trends nor the market itself will hit a zenith, since anticipating future based outcomes is a skill that falls outside of our bailiwick.

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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