THE
LONDON
COMPANY

October 5, 2015

To clients and friends of The London Company:

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"

– Lewis Carroll, *Alice's Adventures in Wonderland & Through the Looking-Glass*

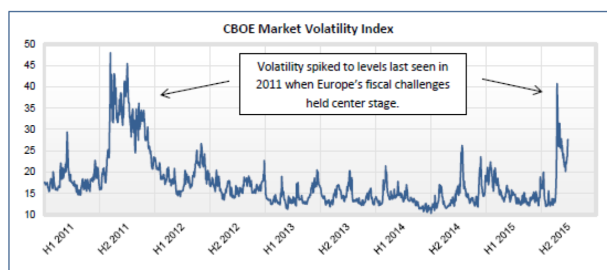
Seemingly the world is becoming more bizarre and things aren't always what they appear to be. Donald Trump and Bernie Sanders are currently the leading presidential candidates, Jared Fogle and Caitlyn Jenner are not who we thought (for dramatically different reasons), the Mets, Cubs, Astros and Blue Jays all made the playoffs, and Apple's next new hit product could be a minivan. It all makes perfect sense, doesn't it? While financial markets are considered conventionally mundane, there appears to be growing similarities between their inner workings and Alice's fictional Wonderland. What should be a rational and functioning marketplace often is not in the short term. And as nonsensical as it may sound, simple buying and selling of assets can be affected by this reality.

Market exchanges were formed to allow burgeoning enterprises access to capital and afford intrepid investors the opportunity to earn a satisfactory return for a commensurate level of risk. However, they are increasingly serving additional participants with alternative agendas. Specifically, the proliferation and use of exchange traded funds (ETFs) by hedge funds (particularly the risk-parity type) and high frequency traders to manage volatility are too often distorting prices and liquidity. As a result, trading volume is consolidating into large blocks thus increasing correlations and occasionally causing unforeseen dislocations. It is a 21st century tea party except these Mad Hatters have replaced the tea with computer models and algorithms. This has caused the volatility of volatility to increase as volume and technology advance, especially in down markets like this most recent quarter. Managing through these periods is at times frustrating for long-term fundamental investors like ourselves, yet we know they eventually pass.

For the third quarter the equity markets got roughed up, painfully returning -6.4% for the S&P 500 and -11.9% for the Russell 2000 Small Cap index. The pain spiked in late August, originating thousands of miles away in China where a massive market downdraft prompted a currency devaluation to help plug the bloodbath. The global selloff was powerful enough to push our domestic markets into correction territory after a long, prosperous streak. Precisely, it was 1,421 days without a 10% correction in the S&P 500 before quickly happening in six short days. That

804.775.0317 TEL 804.649.9447 FAX www.tlcadvisory.com 1800 Bayberry Court, Suite 301, Richmond, Virginia 23226

bridge was crossed on August 24th, the same day we saw massive liquidity disruptions from ETFs. The aforementioned algorithms have garnered most of the blame that caused 20% or more intraday swings on a number of stocks, ranging from small caps to blue chips. During the heart of the correction all asset classes suffered, with small, mid and large cap stocks falling between 10% and 11% in that short window. In effect, there was nowhere to hide. As seen in the charts below, volatility and correlations spiked this quarter.



Source: Factset

Source: Strategas

The London Company felt the brunt of this and didn't perform as well in this environment as we would have liked. While our returns didn't deviate much from the indices, it is typically in these periods where our portfolios excel by holding up better than the market. This was true four years ago in 2011 during the last correction, when all our strategies performed relatively well. Yet, our participation in this down quarter was greater than expected. Generally speaking, the dynamics of this down market worked against us as did our own stock selection. Our overall results were mixed this quarter with our small cap, mid cap and large cap portfolios lagging their respective benchmarks and our small-mid cap (smid), income equity and concentrated portfolios outpacing their respective indices. The full year results are still favorable with all strategies ahead of their benchmarks except mid and large cap.

As previously mentioned, correlations were high and returns were concentrated. What did work this quarter was growth and momentum. Our relative returns were negatively impacted as growth outperformed value by nearly 6% (S&P growth versus value indexes) and high price momentum stocks outpaced low momentum stocks by 8% *(Source: Strategas)*. It is not unusual to see investors (and/or hedge funds) gravitate towards these few positions, regardless of valuation, when organic growth remains scarce. To illustrate, there are only 20 stocks in the S&P this year that are up at least 25% while there are over 80 stocks that are down 25% or more. Additionally, the average drawdown in the S&P is roughly 16% and over half of the index constituents are now 20% below their 52-week highs. These numbers are even greater for small cap stocks. The resiliency of growth stocks during this correction is very different than the environment from 2011 and more closely resembles the concentration of returns in 2007. Our portfolios are more value oriented and traditionally void of high flyers, a definite disadvantage this quarter. Favorably, lower beta and higher quality companies outperformed this period which helped partially offset this headwind. Additional factors affecting performance this quarter included large caps outpacing small caps, defensive sectors bettering cyclical ones, and domestic-oriented companies remaining more buoyant than global-oriented companies. These last few factors had mixed results for our portfolios.

Beyond the rising growth names that we don't own, our own health care, technology and cyclically exposed names were common detractors for the smaller and mid cap strategies. In

large cap, our discretionary and industrial names subtracted value. Furthermore, not all of our recent additions have panned out so we are truncating smaller, weaker positions and reallocating to higher conviction ideas. The benefit of high correlation down markets is that there are many names that are being unfairly punished. To pay homage to the recently deceased Yogi Berra, you can observe a lot by just watching. So as we watch what doesn't make sense, we will try to take advantage of opportunities that come our way. Our discipline is as sharp as ever, and we will stay true to our process even if the landscape doesn't cooperate for the time being.

When adding it all up, our portfolios were greatly impacted by the above-mentioned market dynamics and less so by the fundamental characteristics of our specific companies. As fear ramps and uncertainty climbs, market volatility pushes all asset classes in whatever direction the mood of the day dictates. Beyond future growth ambiguity in China and other emerging economies, the markets had to confront a backpedaling Federal Reserve that paused again on raising interest rates. After foreshadowing their first hike in nearly a decade, Fed Chair Janet Yellen gave everyone the Heisman, reversing course by stating that market conditions warranted further prolonging. This announcement should have been viewed positively but was immediately frowned upon in both bond and equity markets. At its core, the Fed's credibility is being questioned as its internal inflation targets are repeatedly missed. The lack of inflation despite better employment is a reflection of our transition to a more service-oriented economy and the automation of many manufacturing plants. Wage pressure is slow to evolve which is helping companies retain above average profitability. Combining low inflation with slow GDP growth has the Fed hamstrung on how to react.

Uncertainty is nothing new and not knowing where the markets are going is expected from most participants. However, when the objectives of some extend beyond price discovery and enter into managing risk or volatility, then unfortunate situations can arise. For example, the handful of flash crashes over the past few years may portend a larger structural threat. The total ETF market has doubled in size over the last five years and now stands at $2 trillion in assets. Their impact on markets is enormous and growing quickly. With larger volumes and more frequent trades, especially when markets are down like this quarter, the timing of when those trades get inputted is also becoming important. Since index funds aim to mimic their underlying assets, then, all things being considered, they would like to trade at either the beginning or near the end of the day. This in theory would best align the index to the true price of the underlying assets. Unfortunately, this enhanced volume begets more volume to where nearly 1 in 6 trades for S&P 500 stocks are now conducted in the last 30 minutes of the session. The 3:30 to 4:00 window is crunch time for many traders, accelerating into the last five minutes where a third of late day trades are finalized. Counterintuitively, the more ETFs dominate trading the less liquidity there is for rest of the day. As a result, everyday buying and selling becomes more costly for retail and other institutional investors. It is the exact opposite of what an efficient, functional marketplace should be.

Looking ahead, these realities might not change. Higher volatility and correlations can be expected until confidence is renewed that our economy can sustain a certain modicum of growth. From our view, the domestic landscape is "okay", that's a technical term for it could be better or it could be worse. Consumer data has been fairly positive with confidence and personal income spending reporting solid numbers. Housing, auto sales and employment figures are also decent. That said, we are still at the mercy of a global marketplace that is not as sound and a Federal

Reserve anxious to call an end to our overly accommodative monetary party. This last point has caused credit spreads to widen across all asset classes and send the computer algorithms into overdrive. The seven-year bull market is technically still intact, but valuations cannot be labeled cheap even if they are reasonable. Fortunately for us, there are always a few names moving away from the herd that may fit our profile and be added to the portfolios.

To conclude with another *Alice in Wonderland* parody, here is a perfectly sound rationale for being optimistic heading into the fourth quarter. As if it were sourced from the rabbit hole by Tweedledee and Tweedledum directly, the market must go up because it always does on years that end in the number '5'. Seems logical, right? Well, this calendar year anomaly is currently true and has been since 1875. After 140 years and 13 consecutive times the year ended in '5', the market finished the twelve month period in positive territory. So even in this world of nonsense, the potential of it holding true again this year should make everyone feel a little bit better.

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

Important Disclosures:
*Past performance is no guarantee of future results. This report is for informational purposes only. The statements contained herein are solely based upon the opinions of The London Company and the data available at the time of publication of this report, and there is no assurance that any predicted results will actually occur. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell any specific securities and should not be considered investment advice of any kind. In making an investment decision individuals should utilize other information sources and the advice of their investment advisor.

The London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies and objectives, are fully described in the firm's Form ADV Part 2, which is available by calling (804) 775-0317, or can be found by visiting www.TLCadvisory.com.