THE
LONDON
COMPANY

October 4, 2016

To clients and friends of The London Company:

"Not every day is a sunny day. Sometimes you're the pigeon, sometimes you're the statue."

- Claude Chabrol

For the third quarter, The London Company clearly was the statue. While the equity markets rallied ahead our portfolios were more or less anchored in stone. Collectively, The London Company strategies did not keep pace with their respective benchmarks this period. This was particularly true for our smaller capitalization portfolios where we, figuratively and literally, took an uncharacteristic number of unpleasant hits. Investing for the long run can occasionally cause short-term performance to suffer. Constructing portfolios to be substantially different from the index – a trusted core tenant we adhere to - can temporarily exacerbate that reality. So while no one ever wants to be the statue, over the investment cycle it's an unwelcome inevitability. We accept this harsh truth despite best efforts to prevent it. And while we wish it were otherwise, we have experienced these spells before but know they pass. It also provides opportunities to act and adjust, unlike that symbolic slab of marble, to continuously position ourselves for brighter days ahead.

The equity markets have been robust since mid-February, but especially so since the surprising Brexit vote in late June and the short-lived panic that ensued. For the third quarter, the S&P 500 increased 3.9% and the Russell 2000 Small Cap Index surged 9.0%. Year-to-date returns through September for these two indices are now 7.8% and 11.5%, respectively. It has been an impressive reversal from the double-digit negative returns the markets experienced at the start of the year. While not much has tangibly changed from then, sentiment has improved and fears have temporarily abated. It seems long ago since concerns about a strong US dollar or a China slowdown made front page news. The same can be said of the global debt burden facing most sovereign nations and central banks. None of these issues have been resolved but a level of confidence has emerged following the subdued fallout from Brexit. For the time being, the markets have become largely de-sensitized to these known risks.

The irony here is that no one seems happy with the results, or convinced they're sustainable. As equity benchmarks threaten to make new highs again, the current eight year bull market remains the most hated in history. The consensus view is commonly negative and has been so for quite some time. Research provider Strategas Partners recently conducted a large survey and found nearly 50% of their clients (fund managers, CIO's and other financial sorts) were just neutral on stocks, a historically high percentage from a traditionally bullish set. Furthermore, a full 70%

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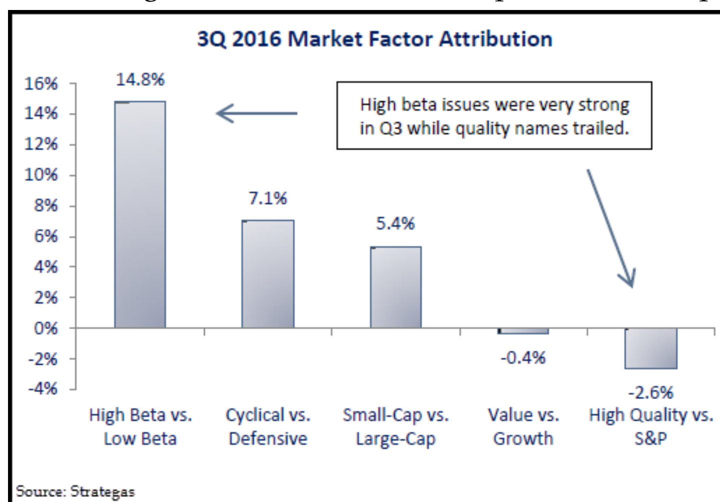
expected fourth quarter returns to be below average. While we acknowledge it is much easier to be cautious on the economic landscape and current market valuations, the natural contrarianism in us wants to question the crowd. We don't have the answer to what's around the corner, but we do believe it's an advantage that our investment decisions are based on tangible, company-specific factors rather than macroeconomic predictions.

So, if the market is appreciating despite universal skepticism, what is going on? Perhaps the simplest explanation is to cite the historically low interest rates (or the negative ones in Japan and most of Europe) and the lack of better investment options. From a macro perspective, it's more of the same – scarce global growth, low inflation and accommodative central banks. The Federal Reserve has so far delayed a 2016 rate hike which has contributed to a tightening of credit spreads and a less risk-averse market. In a world of low yields, investors have sought the one asset class that seems to provide both income and capital appreciation - equities.

While year-to-date returns have been positive the market leadership has not been steady. The first half of the year was dominated by the higher yielding, quasi 'bond-like' sectors. This third quarter was different (see chart to the right). Q3 was a full 'risk-on' rally, led by the following factors: high beta beating low beta, cyclicals crushing their defensive counterparts, small caps surpassing large caps, and growth over value. Specifically, the best performing sectors were Technology, Financials, Materials and Industrials. Lagging behind were Utilities, Telecom and Consumer Staples. This development was consistent up and down the capitalization spectrum. The only exception was the positive contribution from the Health Care names in the small cap index, a sector filled with unprofitable companies. The impact that loss-making companies have had on small cap returns is an important topic we will discuss here shortly.



Generally speaking, these cumulative influences were formidable headwinds for all our portfolios. Our process gravitates towards companies with sound balance sheets and predictable cash flows. We invest with a value bias and typically seek more conservative, lower beta and less cyclical issues. Thus, the sector allocation for our portfolios was unfavorable this quarter. This dynamic was noticeable in our large cap portfolio where we lagged the benchmark for not only what we own but also for what we did not own. The drastic change in market leadership during the year has also made the large cap indices tough to beat. Our approach is long-term and espouses patience, and historically has been rewarded when returns are more muted, as witnessed earlier in the year. Our Income Equity portfolio had a similar outcome, as its conservative, lower volatility profile did not keep pace this period. The Mid Cap portfolio was our best offering in Q3 and due to strong stock selection remains slightly ahead of its index on a year-to-date basis.

For our Small Cap and Small-Mid Cap portfolios, the story is less favorable. They both posted one of their worst quarters on record from a relative performance basis. The 90 days seemed like a bad Hitchcock movie with a suffocating flock of pigeons dropping an inexhaustible supply of negative news and disappointments. The relative performance gains built earlier in the year were quickly clawed backed, leaving our Small Cap portfolio behind its benchmark for the full year and our SMID portfolio just in line with its index. While some of this undoing was market related, much of it was frankly self-inflicted as well. When parsing through the results we were unfortunate to have a handful of larger weighted positions self-correct at the same time. A number of our recent top performers had disparate one-time issues that caused them to fall. For example, one particular holding was blindsided by a governmental change that will likely alter the course of its business going forward, which caused us to change our opinion of the investment thesis. Besides this instance, we have not lost faith with the positions that have recently stumbled. Yet, that also doesn't mean that further judgement and additional future actions may not transpire as we assess our holdings.

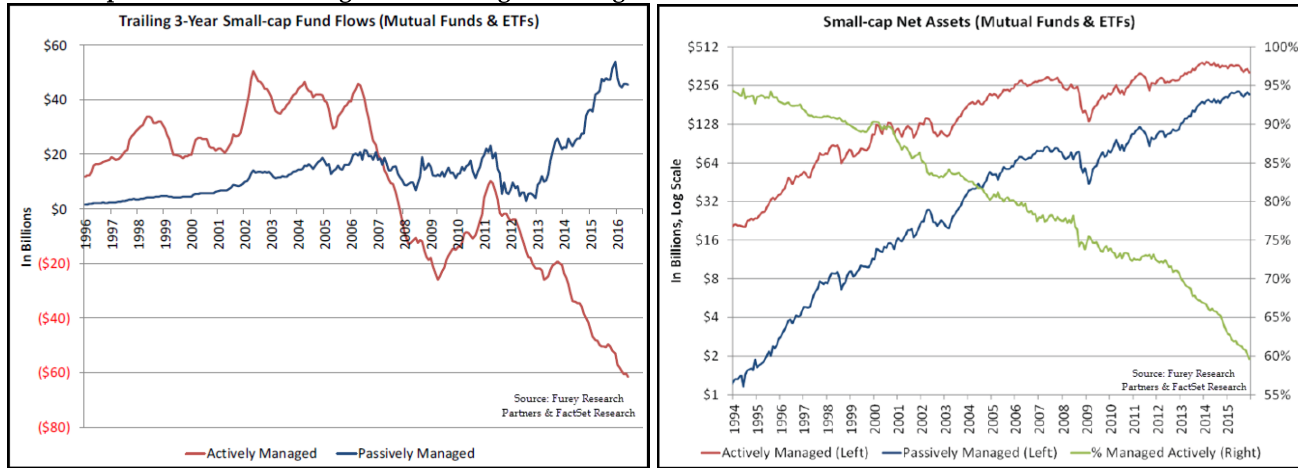
A positive consequence of feeling like the statue, besides the sheer humbling, is that it spawns self-reflection and a chance to re-challenge our beliefs. One takeaway this quarter is the realization that we likely overstayed our welcome on a couple of holdings. Despite a tendency to be patient and allow our top contributors to appreciate, we do understand not every name should be held indefinitely nor will they all mature into that coveted 10-bagger. Sometimes the investment thesis works more quickly than that, or not at all, and the tenure of the name needs to be truncated. Following this quarter, we are taking a more aggressive stance on challenging a company's capacity to compound its intrinsic value over time, particularly for our larger more successful positions. We are making no change to our essential process or discipline but just reinforcing our critique on the risk/reward profile of these positions.

Fortunately, a quarter is one short measurement period and we know over time the markets will both giveth and taketh away. Performance can change quickly and we never get to stop the clock. Although the past three years have been less than desirable for our Small Cap portfolio, we are steadfast in our conviction. The volatility in that strategy has been abnormally elevated and we have been undermined by just one bad quarter in each of the last three calendar years. It was the last quarter of the year in both 2014 and 2015 that derailed returns: the former due to exposure in our sporting goods holdings which quickly reversed, and the latter due to the performance of growth and momentum stocks which did not hold. The most recent quarter was a negative combination of macro headwinds and stock gut punches that hurt. Whether these setbacks quickly revert, which we believe will be the case, is still to be determined.

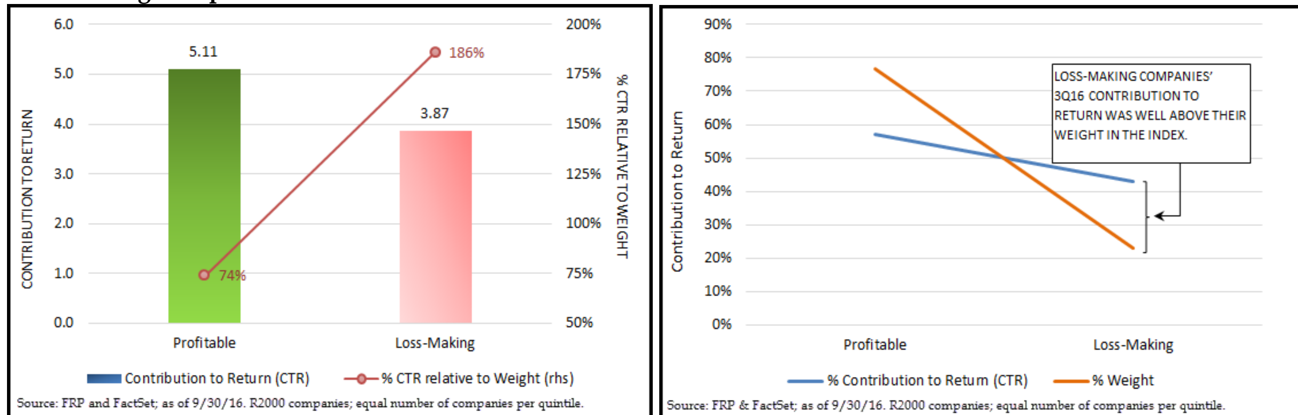
As we examined results in closer detail we came across an interesting undertow ongoing in the small cap universe. It is no secret that active managers have struggled to outperform the last few years, and a potential cause could be the rise in passive alternatives. Analogous to a self-fulfilling prophecy, it appears more investors are switching to index funds and that those asset flows are helping the performance of said index. According to Furey Research Partners, there has been a negative correlation to asset growth in the iShares Russell 2000 Index ETF (IWM) and active management performance. Their data highlights the rapid accumulation of flows into passive vehicles and the contribution to returns that the unprofitable companies held within the index are having on total returns. Specifically, the percentage of returns from unprofitable companies continues to increase with asset flows. These companies are now out-contributing their relative

weight in the index (see charts below). Said more simply, index funds must hold all stocks at once so even the riskiest businesses (think biotech) get a boost from new money coming in.

Small Cap Asset Flows Leaving Active Management to go Passive



Loss-Making Companies Contribution to Return



These trends are increasing. The percentage of loss-making small cap companies in the Russell 2000 Index is now over 25%. It is unlikely that this subset of unprofitable companies will ever become part of our portfolio or purchased by any other higher quality active manager. According to Furey, the dismal returns for small cap core managers during the third quarter reflect the above narrative, with only 17% of active managers outperforming. In Q3, they found that loss-making companies contributed 186% of their relative weight and that the 2nd lowest return on capital quintile performed the best. We are not quick to join crowds or make excuses, but it's worth noting that the risk is clear. Many investors in the index ETF don't really know what they hold. When looking at profitability or valuation metrics compared to our portfolio, it is a stark reminder that the index is currently less attractive and more expensive. So, for those questioning why not just go passive, one needs to consider what happens when the trends revert or the market corrects. If history is a guide, our downside focus, high conviction, high active share philosophy should bode well and protect client assets when that occurs.

So, when will we see a correction? We have no earthly idea! Nor do we have the audacity to predict one. Volatility was pretty calm for most of the quarter and only spiked in mid-September. That inflection is likely due to the one major topic we have so far avoided: the upcoming Presidential election. We have no comment on the candidates, only to observe that we

should have given ourselves better choices. The election appears to be a microcosm of a bifurcated country, and that is not a positive backdrop for progress. If we ever needed a unifying leader now is the time. The state of our economy typically decides if the incumbent party holds office or if the challenger prevails. Given the split view on the issue nationally, this election could be close till the end. Regardless of who wins, let's hope they are more proactive with fiscal solutions to our economic malaise. Monetary solutions are spent and further actions will likely create more harm.

In summary, this quarter wasn't much fun. Investing in stocks means you occasionally stub your toe and at times it can be exasperating (we are looking at you small caps). Although it doesn't happen often, we have experienced these periods before. We are focused on the same dynamics today and are still finding attractive investment candidates. We are consistent in our approach and know the process has yielded success over time. We are also grateful to have a long-term client base that understands this discipline. On the bright side, we are naturally optimistic after a period of rough performance. It is the equivalent of recognizing that the weather is usually best after a storm.

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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