THE
LONDON
COMPANY

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To clients and friends of The London Company:

"In the eye of a hurricane
There is quiet
For just a moment
A yellow sky"

- *Hamilton* by Lin Manuel Miranda

Lin Manuel Miranda brilliantly crafted the Broadway hit *Hamilton* after reading Ron Chernow's biography of the founding father. The story begins in 1772 with a hurricane destroying Alexander Hamilton's home island of St. Croix. It tells how a young scholar survived the carnage, and subsequently wrote about it. He wrote about the damage he saw and did it so eloquently that the town took notice, to the point that total strangers raised funds to send the 17-year-old to New York to pursue a better education. Miranda meticulously worded this history in the song "Hurricane" from the musical. It not only shares how Hamilton wrote his way out of a wrecked island, but how he handled a personal storm brewing on his horizon years later. The eye of the hurricane, where there is quiet, was the brief moment Hamilton realized he needed to again write his way out of an upcoming revelation that was about to destroy his personal and political life. Honestly sharing his misdeeds (a character trait often nonexistent in today's politicians) didn't save his presidential ambitions, but it did protect his legacy.

In *Hamilton*, Miranda weaved the literal and figurative use of hurricanes to tell his story. The metaphor was appropriate for Hamilton's whirlwind life. Unfortunately, the destruction and despair that hurricanes brought our shores this summer were all too real. As we watched Harvey, Irma, Jose and Maria deliver unimaginable damage to the people of Texas, Florida and the Caribbean, it was hard not to feel helpless. The devastation was extreme and like nothing ever seen. Miranda's native homeland of Puerto Rico was particularly ravished by Maria and, at the time of this writing, is in great need of humanitarian aid and logistical assistance. While government backing can be arduous, we are encouraged by the uplifting stories of support and fundraising being done in communities across the country. It is not too dissimilar to strangers helping Hamilton get to America, and a positive reflection on the human spirit. The London Company sends our thoughts and prayers to all those impacted by these disasters and hope they can quickly recover.

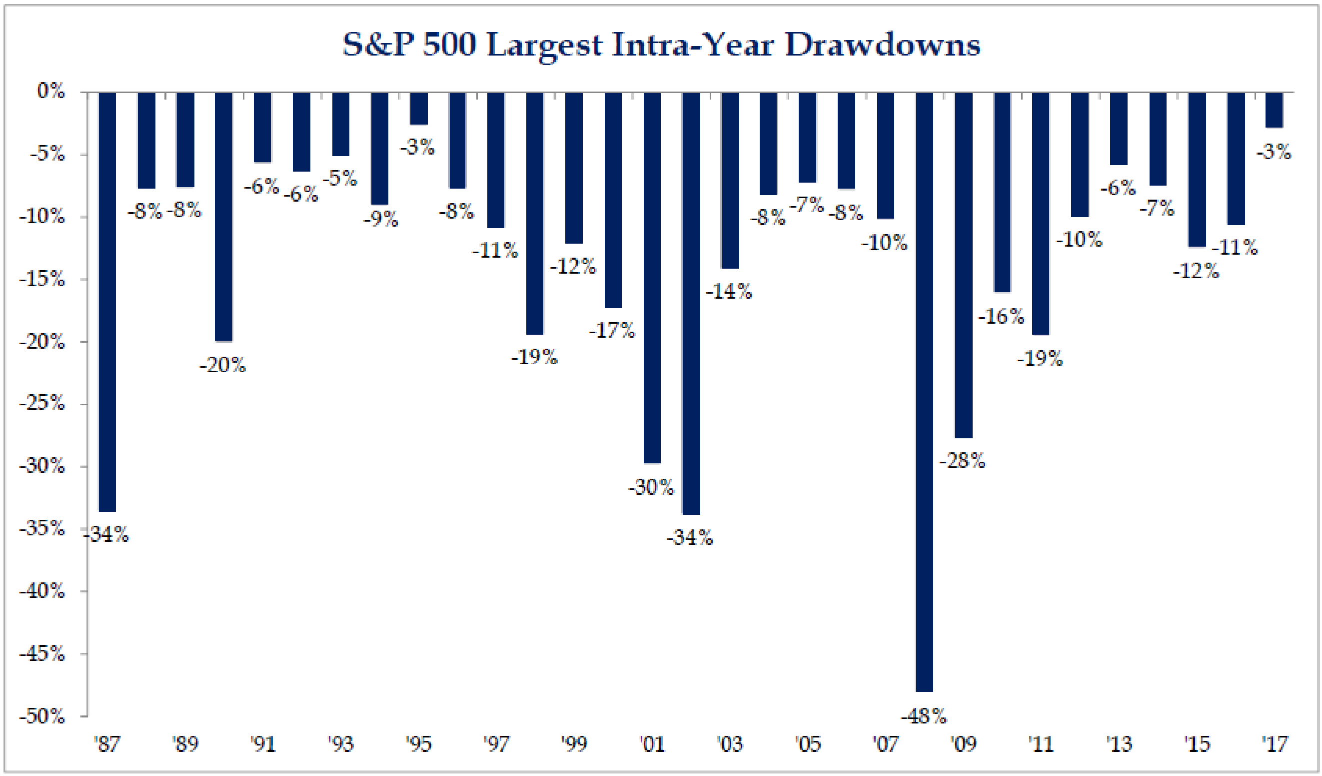
Given the prevalence of hurricanes this quarter, we were reminded of Miranda's words. The juxtaposition of a calm center eye being surrounded by chaos and violence is both mystifying and terrifying at the same time. The contrast in imagery is stark, and although it may be a stretch to compare hurricanes to the financial world, their composition is relatively descriptive of the current state of the equity markets. The stable rise of equity returns this year with little disruption is historically distinctive. It is as if the markets are protected and isolated from the swirling chaos all around. Neither hurricanes, earthquakes, wildfires, global terrorist attacks, domestic political ineffectiveness, ever-increasing global debt levels, impulsive and confounding Presidential tweets, threats of nuclear Armageddon nor senseless acts of violence could derail the markets. This quarter marks another period of positive gains and little volatility despite all the noise.

The London Company generally excels in periods of distress, meaning when markets are volatile and weak we have traditionally done well. In periods like today, we aim to keep up. For the third quarter, we mostly achieved our objective. Stocks were strong across the board this period, with the S&P 500 increasing 4.5% and the Russell 2000 Small Cap Index growing 5.7%. A late September rally pushed small caps ahead of their large cap peers for the quarter, although they still trail for the full year. Other factors include growth-oriented stocks outpacing value stocks and cyclical holdings over defensive ones. Across the market capitalization spectrum, the Technology and Health Care sectors continue to lead while the Energy and Consumer Staples sectors lag. There has been greater dispersion this year in sector returns but stock correlations within those sectors remains high, one of many odd anomalies in this market that we will address later. Interest rates are still low and inflation tepid, creating a favorable backdrop for credit access and corporate profits. In summary, not much has changed from the previous two quarters and the steady ship sails on.

As mentioned above, our portfolios performed mostly as expected this period. The Large Cap strategy has captured most of the upside this quarter and year-to-date. Our Mid Cap fund is doing particularly well for both periods and is ahead of its benchmark. Our Income Equity strategy has not kept pace this quarter, or year, and trails the S&P 500 composite, but remains in-line with the large cap value index. That product is temporarily lagging its core benchmark more due to positions it doesn't own rather than to the ones it does. The concentration of returns this year is another one of those market anomalies we will soon discuss. Lastly, our Small Cap and SMID Cap portfolios performed as expected this quarter, slightly trailing their indices in a robust return environment. These products continue to face style headwinds as growth and momentum outperform.

A core belief at The London Company is that the market is less efficient at assessing risk than reward. We attempt to exploit this belief by investing with a process designed to reduce volatility and increase our margin of safety. Since inception, we have done that fairly well. We historically capture less of the market downswings and enough of the upside to post attractive long-term risk-adjusted returns. We don't necessarily need large down markets to do our job well, but they invariably help. As you know, there have been very few down markets the last few years. In fact, the S&P 500 hasn't had a 15% pullback since 2011, the second longest streak on record. The markets have been rising so steadily that it's been over 300 plus days since we have had just a 5% pullback for any major US index, a 30 year record.

Market volatility can be cyclical and trend lower for extended periods, but these extreme low levels are unusual. As proof, the average daily percentage change for the S&P 500 this year is just plus or minus 0.3%, the lowest reading since 1964 and second lowest ever. The chart below shows the intra-year drawdowns for the S&P Index. Over the past 30 years, only 1995 has matched this year's stoic environment, falling just 3%. In our last letter, we discussed the "VIX" index, a popular measurement of short term market volatility and angst. It too broke numerous low records this past month. If records are meant to be broken, both hurricanes and low volatility measures did their job this quarter. Altogether, this signals that fear has subsided and a vast calm reigns over investors today, but similar to an eye of a hurricane, it could be providing a false sense of security.



Source: Strategas

Our interest isn't just reporting on this phenomenon, but understanding why it is occurring and what it may mean going forward. Is the calm warranted or should we be more convicted in our core belief that the market assesses risk poorly? The London Company naturally errs on the side of caution, and as we look across the landscape we are skeptical of many market irregularities. For example, how can sector returns diverge but stock correlations rise? Why is the market breadth declining while the stock indices are setting new highs? And why are traditionally more volatile growth stocks rising but the VIX falling? Do we truly believe expensive stocks are now safer than cheap stocks? This is the market environment today. While there are tangible reasons for optimism, including incredibly low interest rates, strong corporate profits, and the prospect of significant tax reform, we do question if these market abnormalities are sustainable long term. We also believe these distortions, which are partly driven from passive vehicles and sector ETFs, could be surprisingly disruptive when they ultimately revert.

We have previously addressed the influence of passive investing, and its particular impact on small cap stocks that don't make money. While that dynamic continues, there are also visible signs of sway in large cap stocks as well. This year, the largest positions in the large cap indices are having an outsized impact on returns. As passive funds take share from active mutual funds, the same stocks are bought and sold in the same allocations over and over again regardless of company fundamentals. The larger positions grow simply due to their size as passive funds increase. Our friends at Cornerstone Macro recently stated that the S&P 500 capitalization-weighted index is outperforming its equal-weighted construct by the biggest margin in 20 years. This highlights the pull of larger names, and explains how just the top ten stocks in the S&P 500 Index are accounting for nearly 30% of the return this year. This concentration of returns is partly due to the success of the much discussed FAANG stocks but also to a systematic structural change in how markets work.

Bernstein Research estimates by early next year, nearly 50% of all assets under management will be passive in nature. As active market participants, The London Company is increasingly becoming aware of the ownership levels of our companies by passive and active funds, and what unintended consequences may arise when times aren't as peaceful as they are today. For example, should Exxon Mobil (XOM) be both a momentum tilt stock and a low volatility stock? *(Thanks to Steve Bergman from Horizon Kinetics for pointing this out last year at a Grant's conference).* This is one of many odd examples and another byproduct of a world where there are more index funds than actual stocks.

To make matters worse, the market is becoming more and more dominated by quant funds and algorithmic traders who primarily buy and sell based on price action and recent muted volatility. JP Morgan estimates that quant funds and passive investors account for 60% of equity assets and the majority of trading volume. They suggest fundamental discretionary owners, like us, are now only 10% of daily trading, down significantly from a decade ago. Furthermore, it is estimated that there are hundreds of billions of dollars in risk-parity products and low volatility funds. Many of these funds use leverage which can increase when volatility declines. Jim Mooney from Baupost quoted, "The lower the volatility, the more risk investors are willing to or, in some cases, required to incur." The reality is that these vehicles can be self-fulfilling, creating a virtuous cycle of lower volatility yet more inherent risk. The offset should be the active manger that helps set prices, but that influence is being marginalized as passive funds grow. Few trends last forever, so a rise in the VIX could trigger a sell cascade, possibly creating a vicious cycle in the opposite direction.

The challenge is no one really knows when or what could cause the tide to turn. The London Company doesn't necessarily ascribe to valuing businesses with P/E ratios, but Robert Schiller's Cyclically Adjusted P/E Ratio (CAPE) is widely respected and a fair barometer for broad market valuations, so it is worth noting that his metric has only been higher twice, in 1929 and 2000. This metric has not proven to be very effective in the short-term but pretty accurate at predicting longer-term returns going forward. Yet, the problem with this metric today and other historic yardsticks, is the incredibly low interest rate environment and accommodative global central banks. As long as the credit markets remain calm and equities are de-risked, this low volatility, concentrated return environment can march on. We accept that possibility but are reminded of the late economist Hyman Minsky, who advised, "The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits."

Looking forward, we remain optimistic despite the current market headwinds. Our portfolios, in aggregate, are filled with businesses that produce higher returns on capital, have less financial leverage, and trade at sizeable discounts to the indices. We believe over time that markets find ways to self-correct, moderating the extremes, and that our process will perform well over that cycle. As always, we will focus on the items we can control and construct portfolios within our discipline. Even more than ever, we appreciate being very different from the benchmarks. We will not peer past today's eye of the hurricane and speculate on chaos hitting, but we will be prepared for that day when it inevitably comes.

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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