October 5, 2018

To clients and friends of The London Company:

"All things come to him who waits- provided he knows what he is waiting for."

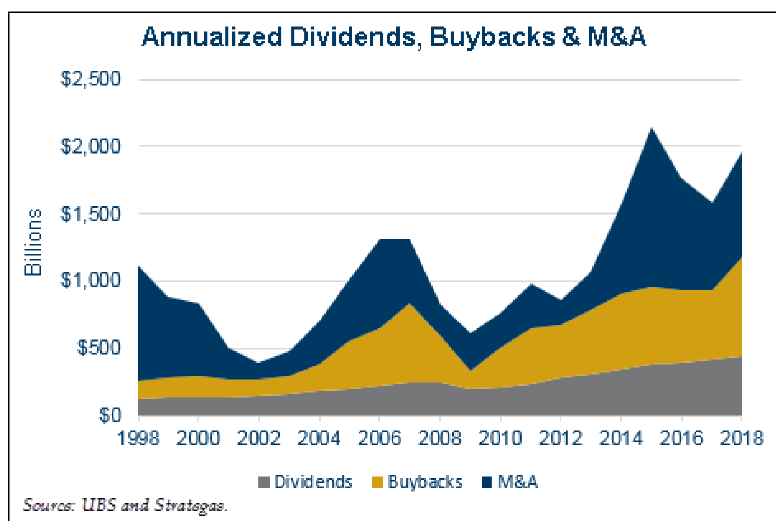
- Woodrow T Wilson

Native Virginian Woodrow Wilson served two terms as our 28th President of the United States and is remembered as an academic, a statesman, and a proponent of progressive legislation during the World War I era. Among the accomplishments under his administration were the establishment of the Federal Reserve System and Federal Trade Commission, negotiation of the Treaty of Versailles - leading to the creation of the League of Nations - and legislation to impose federal income taxes while lowering tariffs on imports. These aspects of Wilson's record stand out as a contra-point to what has been unfolding over the past few years where taxes have been lowered, tariffs raised, world trade and political cooperation challenged, and the autonomy both of the Federal Reserve and Federal Trade Commission questioned.

Wilson's quote, a favorite of his that he recycled with variation multiple times in his public remarks, originally referred to leadership and how it can be recognized. Repurposed, his words serve our quarterly letter as an appropriate departure point given today's investment backdrop of a political climate defined by little demonstrated patience or willingness to wait, while investors grapple to understand the potential market consequences that await them because of carpe diem agendas.

In our second quarter letter, we discussed the economic chess game between the US and China, and the uncertain endgame of that match. As we end the third quarter, the trade gamesmanship has accelerated and escalated, but until tariffs actually take effect and possibly alter the trajectory of growth, investors have been able to take a wait and see posture while riding the robust economic momentum of the US economy. Undeniably, the US economy is leading at a time when emerging markets, China, and the Eurozone all are decelerating. Our labor market is strong, with an unemployment rate the lowest since 1969. Outside of autos and housing, consumption continues to expand, fueled by high levels of consumer confidence that have kept most Americans in a spending frame of mind. Corporate America has matched those high confidence readings, evidenced by actions of still-rising dividend payouts, a surge in capital spending and a reacceleration both in share buybacks

and mergers and acquisition activity. As the chart below depicts, optimism and above 20% profit growth are being translated into more aggressive capital allocation decisions, particularly in the area of deal-making where US-based activity was reported to be up 18% year over year in the quarter and on track to eclipse 2016's record year:



Source: UBS and Strategas.

At the same time, we would make one cynical observation that the selling of personal stock holdings by these same optimistic corporate insiders has risen to levels last seen a decade ago, which slightly tempers the positive message being sent to investors.

Nevertheless, investors seemed to be feeling very good about the state of the markets, with the S&P 500 posting its best quarter since late 2013. In a reversal from the second quarter, larger capitalization stocks outperformed smaller ones in Q3, as domestic prosperity "trumped" trade tension and other global uncertainties. Overall it was another quarter where Russell growth benchmarks handily outperformed value ones across the market cap spectrum, pushing further into the future the validation of value investors who are waiting for that performance tide to turn in their favor. Although our clear orientation here at The London Company is to embrace more conservatism and intrinsic value, the performance in our large cap and income equity portfolios benefited from a snapback in quality and defensive vs cyclical factors and a healthy tailwind from stock selection. Both strategies were able to overcome the growth headwind, outperforming the benchmarks. Our concentrated strategy performed basically in-line, while we lagged in midcap, small-midcap, small cap, and all cap. Two consistent themes running through our results in these strategies were the negative contribution from stock selection in the quarter, and the continued positive contribution by healthcare and technology stocks where we have little to no exposure. We have discussed this allocation dynamic on several occasions in past letters, and little has changed to alter the mismatch between the opportunity set of names in many smaller cap tech and healthcare companies and the financial profiles of those names not meeting our investment criteria. As many of our readers know, we are not benchmark huggers and remain unwilling to compromise our process to chase this type of performance. From developments

in the market, it is possible that this mismatch could linger before reaching a tipping point of eventual reversion. A recent CNBC story reported that of the companies coming public thus far in 2018, over 80% had been unprofitable in the past 12 months, which is the highest percentage of initial public offerings (IPOs) since 1980. CNBC further cited an academic study that tracked the historical returns of unprofitable company vs. profitable company IPOs, and while unprofitable companies can perform well in the short term, they have chronically underperformed profitable companies by a wide margin in a three year and longer holding period, not only in this decade, but also in the 1980's and the 1990's. As Wilson inferred about leadership, we know what we are looking for in this market and are willing to wait until opportunities come to us to act upon. The good news here is that with the passage of time into what has now become the longest equity bull market in history, our patience is being rewarded with some names coming into our opportunity set.

Another noteworthy market development finally transpiring right at quarter's end was the long-anticipated changes to the S&P Dow Jones and MSCI indices in response to structural revisions to the Global Industry Classification Standard (GICS). First announced in November of 2017, the GICS reclassifications have transformed the moribund and less impactful telecommunications sector - which has long been dominated by AT&T and Verizon - into the immediately relevant and more significant communication services sector. The large cap benchmarks will reflect greater redistribution of weightings at the sector levels than will the smaller cap benchmarks, as this new sector will constitute over 9% of the Russell 1000 and S&P 500 benchmarks and between 3-4% of the mid and smaller cap benchmarks. FAANG names such as Alphabet, Facebook, and Netflix, along with media giant Disney have been culled from media and internet classifications and moved into the large cap communications sector. Both the information technology and consumer discretionary sectors will comprise lower weightings in the indices. The overall composition of the indices do not change, but the fundamental attributes and performance impact at the sector level certainly will change. This change in benchmarking has no impact on how we view or construct our portfolios, as we continue to focus on bottom up stock selection without suasion from sector considerations. A few of our names will be reclassified, thus how we report and discuss future performance relative to these benchmarks will incorporate the GICS revisions.

Heading into the final months of the year, the equity market uptrend appears intact with a vibrant economy and widespread confidence and optimism in the sustainability of the economy propelling the large cap indices to record levels. We would observe that indices descending down the capitalization chain are not participating in these fresh highs, albeit not far off the high water marks reached in late summer either. Even with an uptick in animal spirits, there is a sufficient laundry list of risk factors firmly in place that could help contain a potential wave of "irrational exuberance" akin to what former Federal Reserve Chairman Greenspan called out in the late dot.com era, or the bad behavior in the credit markets preceding the Great Recession. There are no glaring excesses across the economy and markets today, but investors should keep alert both to how the upcoming midterm elections unfold

and the evolution of Federal Reserve actions as it seeks to restore normalized monetary policy.

On the political front, which soon will take center stage as we move closer to the November elections, the consensus expectation has been that the Democrats would regain control of the House while the Republicans struggle but retain control of the Senate. The question to be determined by these elections is where the majority of voting Americans fall in endorsing or rejecting the agenda and record of the incumbent administration. President Trump has called the election a referendum on his presidency. Economic vigor and reform are clear bright spots, but have come with fractious and at times unsavory displays of partisan governance that have further divided and alienated broad swaths of the voting public. Some of the early polling suggests that the Democratic Party could capitalize upon this discord and surprise the consensus experts with a sweep of the House and Senate. Of course polling also has proven to be a far from reliable prognostication tool. Historically, control split between the parties has forged a more neutral policy somewhere between compromise and gridlock, whereas single party control has facilitated the incumbent party's agenda. A Democratic sweep, were it to occur, would send a loud renunciation of the political status quo that could redirect or thwart elements of the current agenda. As with the China tariff tiff situation, it is unclear what the forward repercussions might be, both for the markets and for the economy.

The Fed has embarked upon a path toward restoration of a more normalized monetary policy, having raised short term interest rates eight times since December of 2015, including the latest 25bp increase in September to 2.25%. The Fed envisions another 25bp rate increase in December, with four additional 25bp increases over 2019-2020 that would leave the fed funds rate at 3.5%. The debate here is whether a 3.5% short rate can be absorbed as long term rates continue to rise in tandem or will that rate level derail the mighty economic expansion. Long term interest rates again have breached the 3% level, but with the yield curve flattening instead of steepening, investors are left to wait and fret over this movement portending an eventual inversion of the yield curve. Historically, yield curve inversion has been recognized as a key clue to forecasting the future demise of the economic cycle.

In the category of Wilson's "all things come", there will be an end both to the current economic expansion and equity bull market. We strive to recognize what we and other investors are waiting for, but are not equipped to forecast when and how this inevitability will unfold. Bull markets tend to end from events and forces outside the equity market itself, and typically in ways that consensus forecasters do not correctly anticipate. We like to remind our readers each quarter that our watchword is to protect investor capital in all market environments, and to act decisively as opportunities come to us. This discipline has served us and our clients very well over the long term, and we believe that the rewards from maintaining a downside protection mindset can persist well beyond tomorrow's horizon.

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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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.

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