THE
LONDON
COMPANY

October 10, 2019

To clients and friends of The London Company:

> "When I use the four corners and win, I'm a genius. When I use it and we lose, I'm all wrong"
>
> - Dean Smith

Here at The London Company, we are fond of employing sports-themed analogies in our quarterly market letters, given the competitive similarities between sports and investing that help frame the dynamics and landscape. In particular, college basketball has a rich history of hotly-contested rivalries, including big games between our neighboring University of North Carolina (UNC) and our hometown favored sons from the University of Virginia (UVA). Perhaps the most fabled of these clashes occurred in the 1982 ACC title game. With UNC clinging to a one-point lead and over seven minutes remaining in the game, Carolina's legendary coach Dean Smith, from whom we have taken the introductory quote to this letter, instructed his team to execute its trademark "four corner stall." In an era before college basketball utilized a shot clock to maintain the pace of play, this strategy consisted of methodical passing of the ball back and forth while time ticked off the clock. As the minutes wound down, the crowd joined in being ticked off at witnessing limited action with no progress, as Virginia refused to challenge Carolina until the final seconds when it was forced to commit fouls. Those fouls were converted into Carolina free-throws, which sealed the victory for UNC, showcased Smith's "genius", and ignited national indignation among non-Carolina fans. Ultimately, the outcome of that game paved the way for the introduction of a shot clock in college basketball beginning in 1985, thereby retiring the effectiveness of the "four corner stall."

We have taken some pains to describe this moment in history for those readers who do not remember a game from nearly 40 years ago, and for those of you who do not follow basketball nor are familiar with the "four corner stall" tactic. There are clear parallels here in today's financial markets, where team USA and team China are embroiled in a political four corner stall on trade and tariffs that has been playing with a lot of movement but scant progress since January of 2018. Much like the UNC-UVA clash for basketball supremacy, the US and China have been vying for a much higher-stakes supremacy in the global arenas of economy and trade. Time has been ticking along, but similarly without the benefit of a political shot clock to engage the contestants into actionable endgame, time could continue to grind along given the absence of a finite or defined end point. Neither country wants to lose with the stall strategy, as Dean Smith reminds us, and be "all wrong." As a result, the two superpowers continue to spar with a strategy of avoiding forced error as they seek to position for and outwait the other party for victory.

Meanwhile the spectators, in this case billions strong worldwide with financial market investors packed into the premium seats, are fidgeting from mounting fatigue and impatience with the spectacle that plays on and on. So far, there have been 13 high-level meetings and conversations between the US and China on matters related to trade and tariffs, and countless tweets, reports, and other communiques that have wavered between acrimonious accusations and conciliatory gestures. A 14th meeting has been announced for October and market participants remain hopeful that a breakthrough will occur at some point, especially given the impossibility of instituting a political shot clock or time remaining for this contest to end.

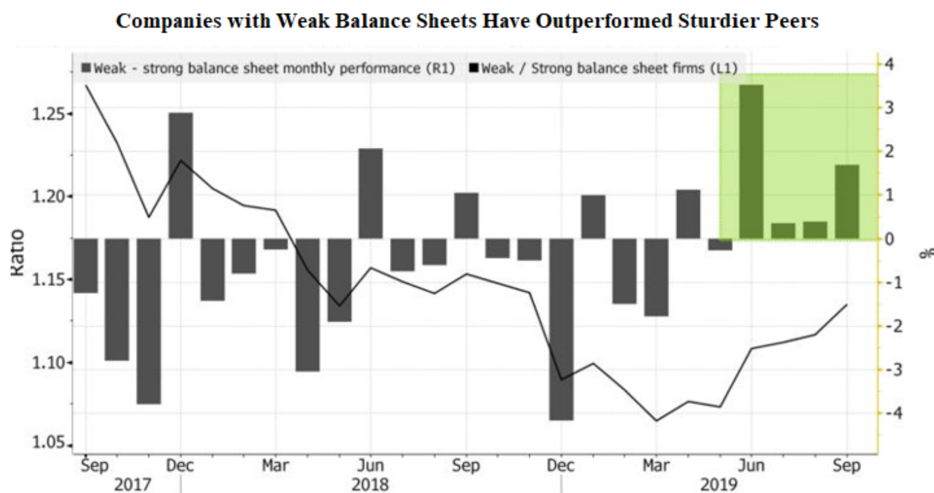
Getting to a breakthrough and a viable path to resolution really are central issues for the markets as we head into the final quarter of 2019. The imposition of tariffs, real and threatened, and the defense of trade policy have increasingly weighed upon global economic growth and business/investor sentiment. We wrote at length about sentiment and its role in the markets in last quarter's letter, and how the ping-ponging between investor fear and greed in an era of non-stop headlines and informational overload and overreaction was inflicting volatility and confusion into the markets. During the third quarter, the pace of this ping-ponging surged into overdrive on a day to day basis, although with less measurable market impact on a full quarter point to point basis.

For the record, the third quarter *appeared to be* benign, with the large cap Russell 1000 edging up 1.4% while the smaller cap Russell 2000 declined a modest (2.4%). This registered more like a mild aftershock following the seismic activity of the first half, which generated the best first half for equities in over 20 years. Stocks uniformly moved up a smidge in July, down a little in August, and back up during September. There were some points of distinction behind the data, with large cap outperforming small cap, particularly during the down month in August, leaving the large indices in the black and the small cap ones in the red over the three months. It is unusual to have small cap stocks decline in a quarter where large caps advance. While large cap growth and value performed comparably for the quarter, small cap value diverged sharply from growth, declining only (0.6%) vs (4.2%) as measured by Russell. Once again defensive sectors such as utilities, real estate and consumer staples did well, while energy suffered another difficult quarter and healthcare, materials, consumer discretionary and industrials lagged.

These trends are reflected in our results, although we tread lightly inferring that there are logical trends occurring against the backdrop of macro- economic and geo-political events. All of our strategies outperformed respective benchmarks gross of fees in the quarter, some by a small amount as in our Large Cap and Income Equity products, with others by a very wide margin as in our Mid Cap, Smid, and Small Cap products. Stock selection was the differentiator across the board. Given the market strength year to date - Russell 1000 +20.5%, Russell Mid Cap +21.9%, and Russell 2000 +14.2% - and leadership that for the most part has favored growth and momentum - we are satisfied with where we stand in our larger strategies and extremely pleased at how well our mid and smaller strategies have performed. Through the first nine months, Income equity is ahead of the value index and has captured approximately 90% of the core index upside. Large Cap has captured approximately 90% of

the value index and 80% of the core index upside. Meanwhile, our Mid, Smid, and Small Cap strategies all have captured well in excess of 100% of the benchmark upside on the contribution from very robust stock selection. A more pronounced shift from growth to value, and a preference for larger market capitalizations and higher return on invested capital (ROIC) companies also worked to our advantage.

Trying to fashion a cogent narrative around the recent investment environment and putting our results in that context, we would attribute adherence to our process and long-term orientation and not succumbing to the futile exercise of trying to decipher, act upon or predict short term market cause and effects. Certainly, impact from the already-highlighted trade war and tactical weaponry of tariffs and currency devaluation have radiated back from outside our borders to within, reflected by weakening US manufacturing data, moderating business capital investment plans, declining confidence, and an uptick in disappointing earnings reports and outlooks. The yield curve inverted yet the Federal Reserve enacted two rate cuts in the quarter even with long rates near record lows - an unprecedented event. And despite the growing economic uncertainty, the consumer and employment both have remained resilient, credit spreads have narrowed in the lower quality realm of the bond market, and more highly-levered equities have been outperforming:

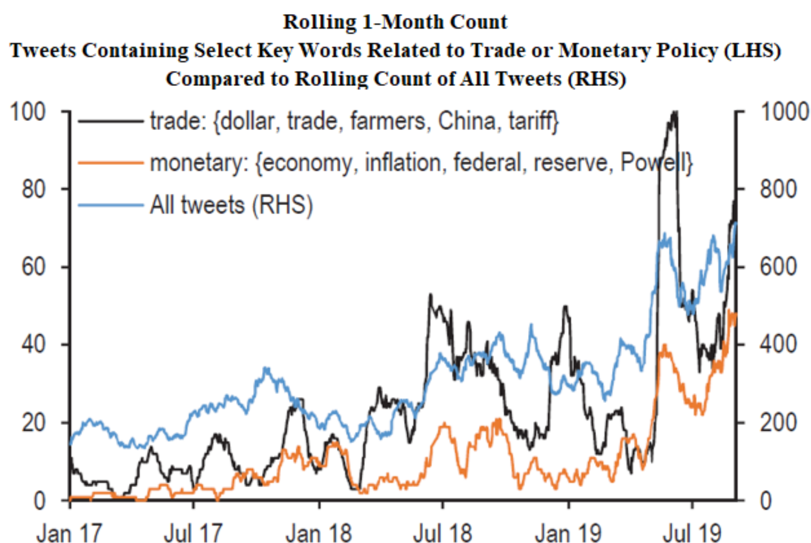


Source: Goldman Sachs, Bloomberg

The economic landscape is littered with a grab bag of anomalies, helping to burnish its moniker of "the dismal science" as infamously coined by mid-19th Century Historian Thomas Carlyle. Though Carlyle's original intent behind his remark was topically quite different from today's reality, it still seems quite appropriate for the times. Trying to frame the *science* behind today's economic picture is captured well in science fiction writer R.A. Rafferty's quip, "every science is made up entirely of anomalies rearranged to fit."

Turning to the geopolitical theater, one wonders if this global drama is non-fiction, science fiction, or perhaps the theater of the absurd. Domestically, political decorum continued to devolve between the governing parties, with Federal Reserve Chairman Powell enduring a public haranguing early in the quarter, and President Trump facing the prospect of a

Democratic-driven impeachment proceeding to close the quarter. Between these bookends were a barrage of tweets, bleats, and other headline-grabbing soundbites that proved to be market moving on a day to day basis. President Trump has taken the art of communications to new levels, now having sent over 10,000 tweets since taking office. This prodigious body of work and the market reactions it has produced inspired JP Morgan to research quantification through its creation of its "Volfefe Index." This indicator is a measure of tweet messaging impact on the fixed income markets, with the name a sly reference to one of President Trump's more controversial 2017 tweets that included the inscrutable term "covfefe." As is easily seen in the chart below, the focus on China and trade-related issues spiked during the quarter, coinciding with increased market whipsawing response that we will address later in this letter:



There were no offsetting calming influences from abroad during the quarter. In the UK, Prime Minister Johnson, noisily battled his own Parliament over Brexit, losing a Supreme Court ruling that he had unlawfully suspended Parliament in an awkward move to gain the political upper hand. In the Middle East, Saudi oil infrastructure was attacked by drones and temporarily taken off-line by interests widely tied to Iran. While briefly destabilizing the markets, this attack failed to reverse the ongoing slide in the energy markets or energy-related equities. Shifting over to the Far East, in China Premier Xi not only continues to strategize China's game plan in the four corner stall against the US, he is laboring to engineer a revival of China's economy while quelling growing civil unrest in Hong Kong.

With muddled economic and geo-political pictures, it is illogically consistent that the markets have followed a similar course of rearranging the anomalies to fit its path back to the cusp of all-time highs. Returning to the matter of the market whipsawing, the S&P500 weathered 14 trading days during the quarter in which it closed up or down greater than 1%; 9 days to the upside and 5 to the downside. While unsettling, that pattern historically is fairly normal. Less normal, as the Wall Street Journal noted, were the 11 daily occurrences in which every sector

of the market had moved together either up or down just during August. More anomalously, a generally uncorrelated grouping of US equities, international equities, bond yields, and oil prices all traded in the same direction 7 times during the same month. Having reached 70 year extremes in the relative valuation gap between growth and value stocks (which we pointed out in last quarter's letter), value enjoyed what Bank of America Merrill Lynch observed as a five standard deviation reversal during early September, the largest such performance divergence in over a decade. Not to be outdone, staid 10 year Treasury yields swooned nearly 16% in a two week period during August, only to ricochet back 27% in a comparable period during September, both among the largest directional two week moves tracked by Cornerstone Macro Research in 100 years of recorded history.

Our takeaway from these various data points is further evidence that short term instability favors the long term investor. In our judgment it is a loser's game trying to position against transient "crowded trades" or non-fundamentally driven trading strategies that account for the bulk of daily activity. Rather, buying financially strong, highly profitable, well-managed businesses and holding them for as long as it makes good sense to do so is a more comprehensible and successful way to protect downside and compound wealth. As an ironic footnote to a quarter in which active small cap managers actually performed relatively well vs benchmarks and active large cap managers performed much better than quantitative approaches, the total dollars invested in passive equity vehicles finally surpassed the total amount of money being actively managed during August. Whether or not this cross-over eventually is viewed as some kind of tipping point remains to be seen, but it is very clear to us that not very much is clear in these markets! To those who ask us "what to do now" in the current setting, we invoke the sage advice of Mark Twain, who mused "if you don't like the weather in New England now, just wait a few minutes." That said, we are investors, not meteorologists, and our best advice, as always, is to stay the course and not to be swayed by short term and oft-times conflicting data. We do not have any unique insights as to whether or not the longest economic recovery on record is finally sliding toward recession, who will score the final points and when the four corner stall will end, nor how the markets will react to tomorrow's soundbite headline.

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 performance is GROSS of investment advisory fees and includes the reinvestment of all income. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. For example, a 0.50% annual fee deducted quarterly (0.125%) from an account with a ten-year annualized growth rate of 5% will produce a net result of 4.4%. Actual performance results will vary from this example.

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.

LCO-19-300