October 13, 2020

To clients and friends of The London Company:

"If the bubbles contain a misconception, as they always do, then it can't be maintained forever"
– George Soros

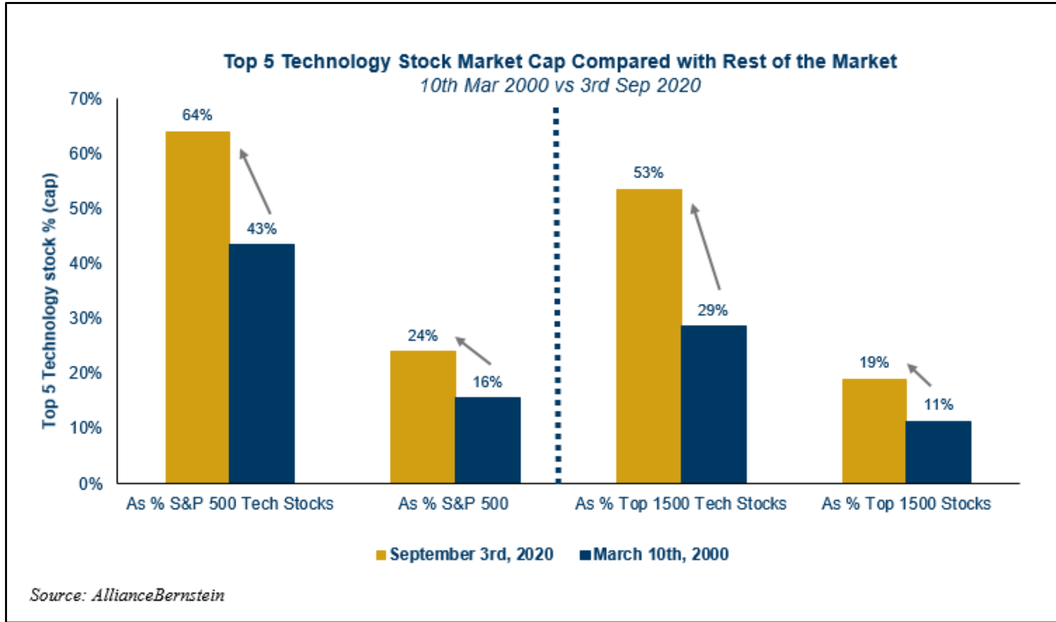
George Soros, legendary nonagenarian investor and philanthropist, has periodically addressed the presence of market "bubbles" in the context of his theory of reflexivity. While we don't subscribe to many of his controversial views, we do respect his market acumen. According to his reasoning, individual biases routinely enter markets, potentially changing fundamentals and creating a tendency to overshoot or undershoot. Soros believes that "financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times, it is quite pronounced. When there is a significant divergence between market prices and the underlying reality, there is a lack of equilibrium conditions." Bubbles occur because "... positive feedback develops between the trend and the misconception, setting a boom-bust process in motion. Eventually, market expectations become so far removed from reality it forces people to recognize that a misconception is involved."

We have chosen bubbles as our jump off point this quarter as we observe them to be omnipresent both in the ongoing equity market commentary and in the societal response to the COVID pandemic. Of course, there are stark differences between these two types of bubbles. Where the market bubble is viewed as speculative and ominous as described by Soros, the societal bubble is an active response to create a protective shield around families, groups, athletic teams, schools, localities, and various other institutions trying to function without furthering the spread of contagion. If there is a "misconception" about the societal bubbles that have formed, it rests in the flawed and complex premise that all members of the group accept what is required and can uniformly remain within the sphere of restriction for an extended period of time. As we have seen repeatedly, this premise is easier said than done, resulting in the piercing of many bubbles and the frustrating inability to arrest the spread of the virus.

The current market landscape is equally complex and the subject of spirited debate between investors who see an overly extended part of the market with parallels to the internet bubble, and those investors who see a long-running trend favoring mega-cap growth stocks with durable ingredients and tailwinds that differentiate today from the internet bubble period. It remains to be seen whose beliefs will ultimately prove to be far removed from reality. But it

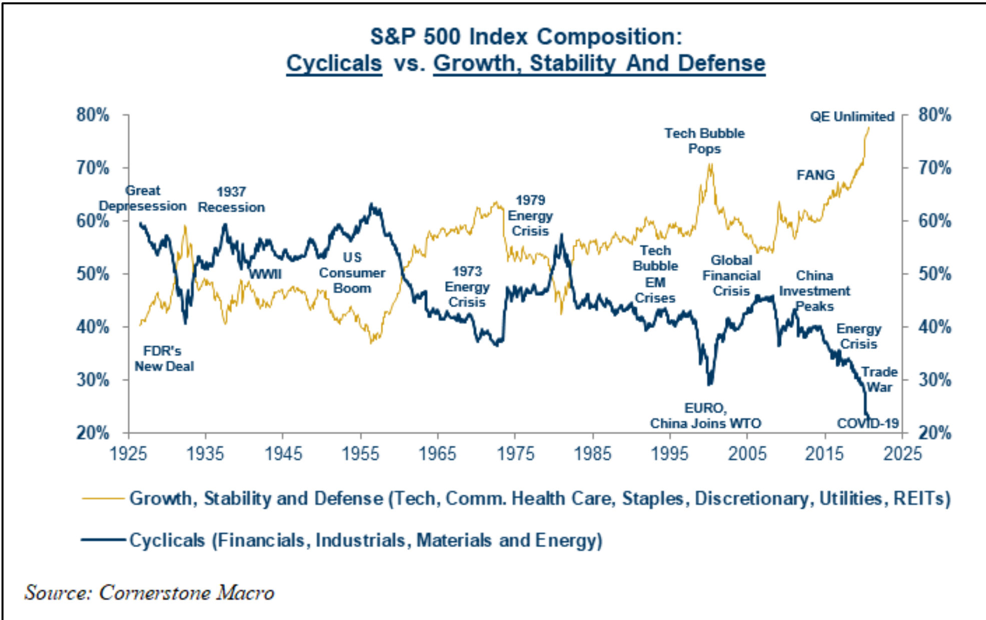
is hard to broach a review of this latest quarter without acknowledging the possibility that the market could be evolving along the continuum of misconception, although not yet at a tipping point. Rather, for much of the third quarter, we saw a replay of what has transpired previously. Thanks to the impact of record fiscal and monetary stimulus, the economy continued to bounce back, tracing out the early signs of a "V-shaped" recovery that was deemed unlikely during the depths of the crisis meltdown period. Outside of the most distressed industries, employment data so far has been encouraging, and consumer spending has reflected the flow-through of the multi-pronged stimulus support packages that have been put into place. Economic thaw has led to recovery in industrial production and inventory rebuild, leading to an uptick in business confidence and capital spending. With the Federal Reserve clearly putting a safety net under the markets and providing abundant liquidity for the foreseeable future, interest rates hover at nominal levels, spurring the release of pent up demand first for autos and now for housing. While we remain well below the pace of activity that preceded the pandemic outbreak, it appears that we are climbing out of the ditch and getting back on a track. This track is not without some weak rails though, and there is fragility to the recovery that argues for additional economic stimulus and meaningful progress toward commercialization of an effective COVID vaccine.

The markets responded enthusiastically to this backdrop, and despite a down month in September, posted strong returns for the third quarter. Large cap indexes remain the performance leaders, with the S&P 500 up nearly 9% for the quarter and now up over 5% for the year. From the market lows in March, the S&P 500 has staged the greatest and fastest rebound in history. Meanwhile, the small cap benchmark Russell 2000 gained just under 5% in Q3, and is still mired almost 9% in the red year to date. As Furey Research Partners have cited, it is rare for the S&P 500 to be positive with the Russell 2000 negative this far into the year and by this degree of spread, having occurred only in three other instances, the last being in 2014. With a more sanguine macro picture, some of the more cyclical areas of the market enjoyed the strongest performance in the latest quarter, notably consumer spending, materials, and industrials, along with technology. The investor love song for technology, and notably the mega-cap technology stocks, continues to play on with only sporadic interruption, having the earmarks of a single tune box set. We have spoken to this dynamic in past letters but want to return to this discussion as the highly concentrated handful of the very largest technology issues have generated staggering returns and in so doing have skewed benchmark composition to extremes that invite internet bubble comparisons. While technology's performance has been dominant, much of that sector performance has been driven by just a few of the most heavily weighted names. Here is a telling visual representation of the top-heavy nature of this market, which in fact is more concentrated than what we experienced at the top of the internet bubble period:



Source: AllianceBernstein

Certainly there are non-fundamental factors at work here related to fund flows driven by the relentless adoption of ETF's and other passive investment vehicles, and the concurrent influence of quantitative, momentum-based trading strategies, neither of which are guided by fundamental or valuation considerations. Technology valuations have expanded and are stretched relative to the rest of the market and particularly so compared to the traditional value areas of the market. Although technology does not represent the entirety of growth investing, it has become the "face" of growth and one of the primary drivers in the now long term style outperformance of growth sectors vs. value sectors within the S&P 500. Again with the benefit of a picture being worth 1,000 words, the extremes to which growth has diverged from value could not be more apparent:



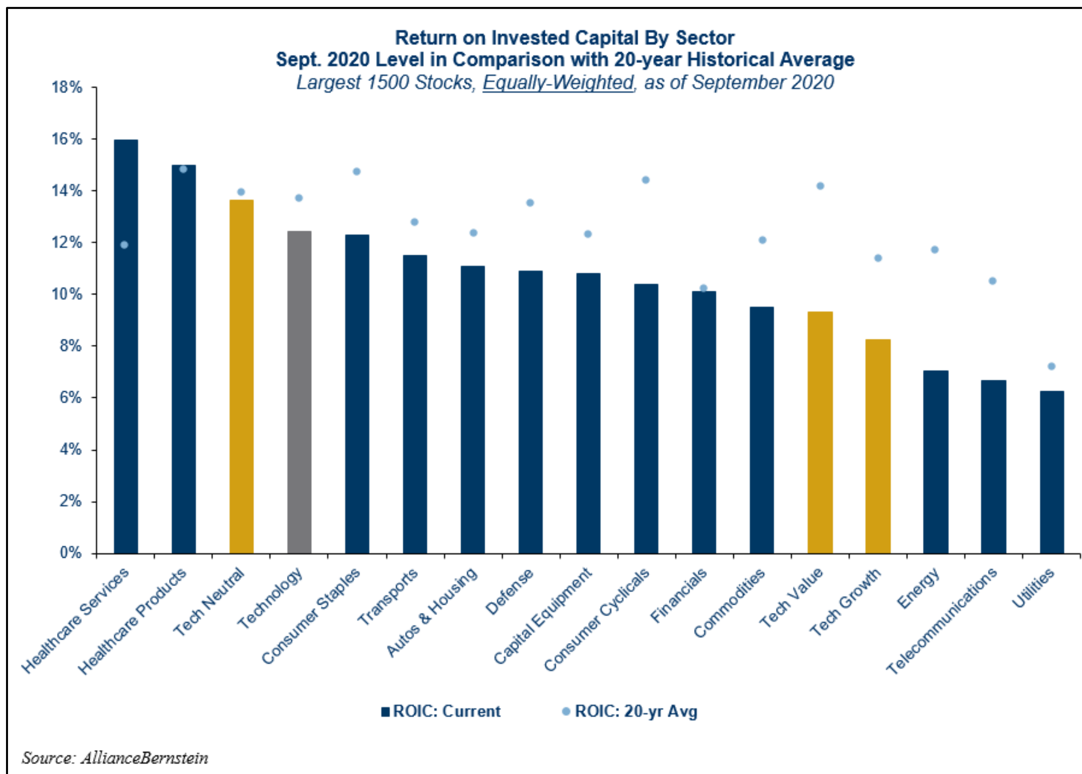
Source: Cornerstone Macro

Stretched valuations and unprecedented stylistic divergence have invited the comparison to the internet bubble period and fueled the debate that a new bubble has formed. We do not believe that today's market resembles the previous bubble in several key ways. This economic cycle has been characterized by lower nominal and real growth with attendant record low interest rates. There has been a surfeit of capital to invest, but a scarcity of growth opportunities in which to invest, and technology has been one pocket that has spearheaded and thrived in the world of disruption. As a consequence of the secular evaporation in the number of publicly traded companies available to own, there is an intertwined scarcity of growth and growth investments. And while the fundamental attributes of these growth companies remain predominantly unattractive to us in the smaller cap issues, in the mega-cap realm the profitability and financial strength metrics are superior to and quite unlike the internet bubble period. Furthermore, given the environment of much lower growth and interest rates, valuations are better supported today and do not rival the extremes of the last technology bubble. As previously illustrated, the "crowding effect" into these names is higher today than previously, and crowded trades have been and will continue to be vulnerable to setbacks amidst calls for stylistic convergence from today's extreme measures. Cornerstone Macro has identified 7 growth/value reversals so far in 2020 where value has enjoyed respites of outperformance. So far each has been a transient event before reverting to the trend in force. Stronger, more broad-based global economic growth, rising interest rates and inflation, and the sheer enormity of the style divergence all could foster a more durable reversal at some point, but that is a forecast among many forecasts we are unwilling to make in our portfolio construction.

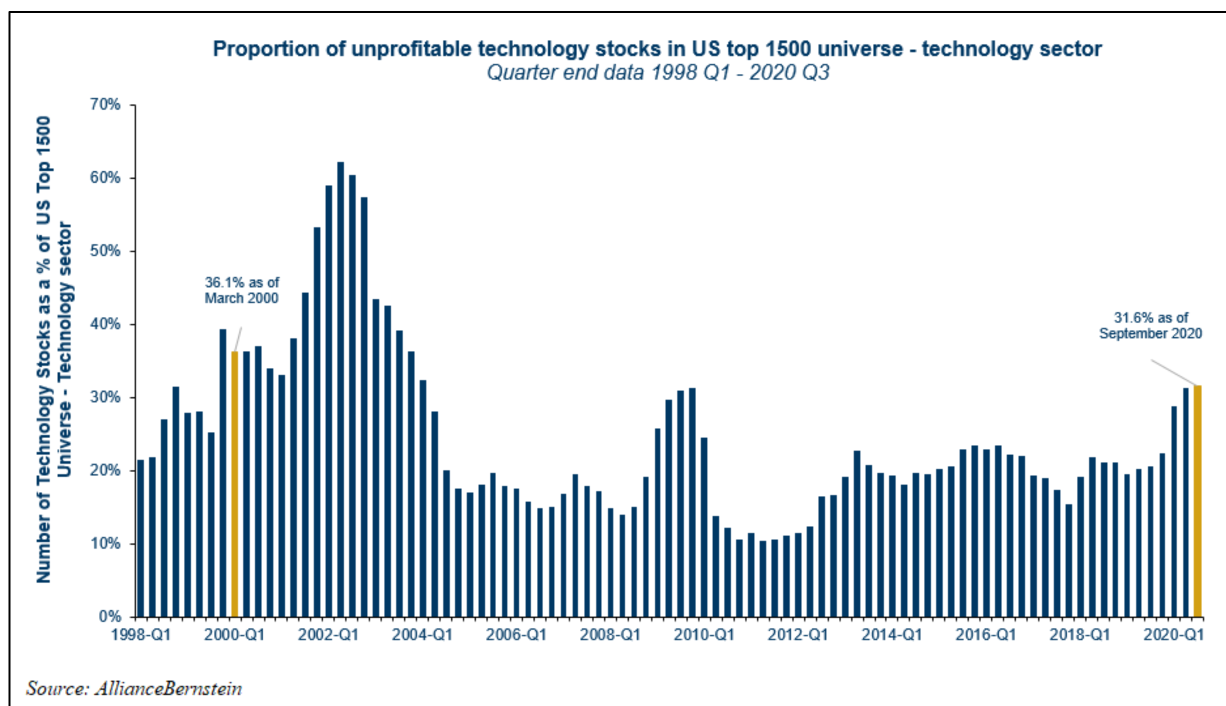
There are a few other points to consider before closing out this discussion and moving on to a review of our performance. First, we are not fans of the attempts to discretely classify value and growth stocks although recognize that it is an embedded analytical cornerstone in the money management business. Market composition changes over time, reflecting the underlying changes in a dynamic economy. Simply put, value today does not really resemble value of 20 years ago, where the cohorts then offered above-average financial and quality characteristics and lower betas that offered downside protection. Today's value cohorts by and large provide lower quality, weaker financial profiles, and higher than market betas. Given this long term deterioration, it is unsurprising to see that value declines greater than 80% of the time when growth declines, thus providing scant refuge in difficult markets. Recently, we have seen growth actually provide better downside protection than value, thus turning one tenet of classic value investing on its head.

We do not view the opportunity set through the lens of growth or value, instead believing that financial strength and profitability are critical to constructing concentrated portfolios capable of delivering downside protection over full market cycles. One of our preferred yardsticks is return on invested capital (ROIC) which captures the efficiency of how company managements invest shareholder capital. Superior ROIC coupled with our evaluation of meaningful margin of safety underpin all of our strategies and we believe buttress our companies during periods of stress. This chart from Bernstein conveys and summarizes many of the points we have been making in this letter through a sector level comparison of

how profitability stacks up today versus the past 20 years. By displaying the data on an equal weighted basis rather than a market cap weighted basis, they have removed the obvious distortion in the data that the top-heavy names have created:



As you should expect, our portfolio exposures tend to come from those sectors of higher ROIC, and we have much more limited exposure to the sectors of lower and falling profitability. One of the notable consequences of the multi-decade slide in value stocks can be seen in how far current sector ROICs are beneath past measures. If these trends cannot be arrested and repaired, we believe it will be hard for the headwinds to abate. Returning to the technology sector, profitability has improved and sustained overall for most larger cap names, but less so as you delve deeper into the murky waters of smaller cap tech. As Bernstein underscores, over 31% of the technology names in the S&P 1500 still are losing money. The "value" and "growth" groups shown represent the lowest and highest quintiles based on forward P/E and both tails have inferior sector-relative outcomes.



Source: AllianceBernstein

We acknowledge the lengthy preamble, but feel that the context included offers a clearer roadmap to how our strategies performed and why they largely met our expectations. In the quarter, all of our strategies outperformed the primary benchmarks other than SMID, which lagged slightly but remains ahead of its benchmark for the year to date. In our concentrated approach of building portfolios with less than 35 positions, stock selection can vary plus or minus on a quarter to quarter basis and is not deemed significant either way over the short term. Greater participation by some of the more economically-sensitive sectors and less headwind from the mega-cap tech stocks benefitted our Large Cap and Income Equity strategies. In a period when large cap benchmark returns were strong but also punctuated by a September setback, we were pleased to have delivered good comparative results. Economic sensitivity had a trickle-down benefit in our other portfolios as well, but we continue to observe that moving down the market capitalization spectrum introduces a different set of factors and performance drivers. Often times, having limited or no exposure to a sector can positively or negatively impact short term performance as much as what is owned. For example, in the Russell 2000, quarterly results favored growth over value, but outperformance was derived from highly leveraged, loss making companies with bottom quintile ROICs. As we often have told our clients, we just are not going to play in the sandboxes where castles of dreams are built upon that type of sand.

For the year to date, differing cross-currents have produced different benchmark results. Stylistically, growth has been a relative super-nova compared to value at every point in the size chain. Our results in our larger strategies have fared extremely well versus the value benchmarks, but the mega-cap effect of technology (plus Amazon which is classified as a consumer discretionary) have set a pace we have not fully matched. We do have positive returns both in Large Cap and Income Equity, and having executed a few small but timely adjustments believe the portfolios remain built for long term durability. Mid Cap and SMID

both have outperformed thus far in 2020 and seem to be hitting a sweet spot in the market-underneath the mega-cap tech impact but above the equally extreme fatal attraction investors have shown in their quest for growth to the bad business models and bad financials inherent in so many healthcare and technology entities. To us, our Small Cap portfolio, while below the benchmark return, shares the hallmarks of our other strategies, but is walking among the legion of "zombie companies" that haunt the ever-shrinking small cap investment landscape.

As we forge ahead in these still unchartered waters, we and others are probing for persuasive evidence that confirms or refutes the Soros-type market bubble. So much of the forward view is complicated and obscured by the blunt force collision of unpredictable and constantly changing factors. We and most others find ourselves dealing with informational over-load processing the 24/7 news flow gusher emanating from the global pandemic, the falling economic and societal dominos resulting from the pandemic, the effects of societal unrest and change to the status quo, and a political process that has struggled to meet the needs of the nation it represents. The upcoming Presidential election and Supreme Court confirmation hearings both will weigh heavily on this narrative, but a greater risk to us is falling victim to "paralysis by analysis" in attempting to assimilate and forecast all of these moving parts. As our longtime readers and partners know, we stay attuned to but do not try to incorporate the forecasting of macro events into our process. We always have felt best equipped and best connected at the company level, adhering to a long term focus that has successfully carried The London Company through our first 25 years. Although we continue to refine our strategy and strengthen our team and our firm for the next 25 years, we are not looking to change the core of what has gotten us to this point. With regards to strengthening our core, we would like to highlight that part of strengthening our team includes the recent addition of Steve Owen, our new CEO, to the management team. We are most fortunate to have his experience and strategic insight on board to help guide our development and manage our ever growing operations over the next 25 years. Stephen Goddard, our Founder, will continue in his primary role as CIO, focusing on investments and research as always. The collaborative talents of the two "Steve's" should be a powerful combination.

As always, we appreciate and value highly the trust you have placed in us.

Best regards,

The London Company

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