

THE  
**LONDON**  
COMPANY

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To clients and friends of The London Company:

We closed the chapter on 2021, but it feels like some of the pages got stuck together with those from 2020. It's Groundhog Day all over again as our nation wrestles with another winter surge of COVID-19. Only this time, we're on to the 15<sup>th</sup> letter of the Greek alphabet—Omicron. Moreover, it was another blockbuster year of equity performance with a strong fourth quarter to close 2021. The broad market, as measured by the Russell 3000, was up 9.3% in Q4 and 25.7% for the full year.

COVID-19 and back-to-back years of double-digit returns notwithstanding, the economic and market backdrop are markedly different than they were at the close of 2020. This time last year, only a fraction of our population was vaccinated; inflation was still muted; monetary and fiscal policy were still incredibly accommodative; economic growth was ricocheting; and the market was rewarding risk-takers and reopening beneficiaries, regardless of quality. Today, most of our population has been vaccinated or has contracted COVID-19; inflation is at 40-year highs; the Fed has outlined plans to begin tightening monetary policy while the year-over-year drop in fiscal spending represents a net drag; economic growth is range bound; and market breadth is much narrower with leadership further up the quality spectrum. Nevertheless, 2021 witnessed extremes and made history much like 2020 did.

In Q4, equity volatility briefly touched a post-COVID low in October before surging in late November and early December, following news of the Omicron variant and hawkish comments from the Fed. Fortunately, there was no coal in our stockings this year, and a late Santa Claus rally helped lift markets to new all-time highs. The S&P 500 achieved its third consecutive year of double-digit gains, and the index notched 70 new all-time highs in 2021, second only to 1995's 77. In fact, the S&P 500 has more than doubled over the last 3 years; its highest 3-year return since 1997-1999! On balance, it was a micro-driven year, and the market rewarded companies with positive earnings momentum across sectors, size and styles. Stylistically, Value beat Growth in 2021, but it was masked at the Large Cap level – something we explore below. Turning to factors, Value and Quality outperformed, but it was a bifurcated year for Quality. Following a historic risk-on, junk rally to start the year, there was an increased preference for Quality across the broad market in the second half of 2021, with an emphasis on profitability.

Things aren't always as they seem, and you really have to look no further than the headline indexes to have seen this play out in 2021. As the table below illustrates, it appeared to be a great year for equities, but there was actually a lot of carnage beneath the surface. Even though 91% of the S&P 500's constituents declined 10% or more at some point during the year, the index itself only suffered a modest 5% pullback along the way. Most of that resilience can be attributed to a handful of mega-cap technology names, and their outperformance was largely fueled by profitability. The dominant weight of this group in the S&P

Index	YTD Return	Index Maximum Drawdown from YTD High	% of Members with Positive YTD Returns	% of Members with at Least 10% Drawdown from YTD High	Average Member Drawdown from YTD High
S&P 500	28.7%	-5%	86%	91%	-19%
NASDAQ	22.2%	-11%	61%	94%	-43%
Russell 2000	14.8%	-12%	65%	99%	-39%

Source: Strategas, Charles Schwab.

500 and style indexes explains the leadership of Large Cap Growth in a year when Value beat Growth across most areas of the market. Compared to the S&P 500, the NASDAQ and the Russell 2000 indexes contain many more speculative, low quality companies that don't generate profits (roughly 6% for the S&P 500 versus 53% and 44% for the NASDAQ and Russell 2000, respectively). Many of these non-earners names were hammered in 2021, which was a welcome reversal from 2020. Market speculators have been on the "party like it's 1999" path for much of this recovery, but 2021 was a harsh reminder of the downside risk that comes with expensive, lower quality equities. In fact, according to Bloomberg, the last time the outperformance spread of profitable companies over money-losing stocks was this wide for Russell 3000 members was when the Tech Bubble popped, back in 2002.

While on the subject of comparisons to the Tech Bubble, valuations and risk-taking are at historic levels that bear monitoring. The following chart illustrates the rapid increase in the percent of stocks trading at Price/Sales ratios over 10x – which is a very, very high bar for making money over time. 2021 was all about earnings, and it saw the biggest improvement in forward earnings expectations in at least 30 years. Those strong earnings allowed stocks to grow into their elevated valuations. That said, given the level of inflation and the increasing willingness of the Fed to fight it, it seems unlikely that investors can rely on multiple expansion in 2022. So, going forward, continued earnings strength will be key. Such a backdrop favors strong businesses with pricing power and skilled management teams who are adept at navigating a more complicated landscape. In contrast, the speculative growth equities with high multiples and limited profits appear the most vulnerable, should we see higher long-term interest rates. While high valuations alone do not spell impending doom for equities in the near term, they do point to more limited gains in the long run. This is the case even as flows into equities this year have smashed records. Additionally, buying and speculation has increasingly been leveraged by rising levels of margin debt. Over the past 21 anomalous months, equity investors have been increasingly conditioned to embrace TINA ('there is no alternative' to stocks), 'buy the dip' and 'don't fight the Fed' mentalities. Now, at least one page of the playbook is poised to get more complicated, which could stifle some of the hope, complacency and optimism in the market.



Source: Strategas

For The London Company portfolios, all of our strategies finished ahead of their benchmarks for Q4 and largely performed as we would expect for the full year. After facing some stiff headwinds earlier in 2021, quality companies were rewarded in the second half of the year. We participated in that resurgence, plus our companies played particularly solid defense amidst the post-Thanksgiving volatility. For the year, both Large Cap and Income Equity outperformed their primary benchmarks, though the latter slightly trailed the S&P 500 but kept in line with expectations. The concentration of returns for the S&P 500 around a handful of mega-cap tech companies proved to be headwind to relative performance. For the year, our SMID strategy finished slightly ahead of its bogey and Small Cap handily outperformed the Russell 2000. Mid Cap gained ground in Q4 but not enough to overcome the shortfall earlier in the year. Some of the underperformance for 2021 is attributable to what we don't own, and we also had a handful of companies produce muted or negative performance, which was a drag on relative results in a double-digit return environment. On balance, we were encouraged to see such strong relative performance in a year of robust market returns. Three short months ago, however, it was a different. The market moved

against us for portions of the year, but we never deviated from our process and our patience was ultimately rewarded. We were opportunistic and found some new attractive names along the way that buttressed the quality and downside protection attributes of our portfolios. We picked up a lot ground in a short period of time – a reminder that fortunes can change quickly with a high conviction portfolio.

Turning our attention to the chapter ahead, we enter 2022 with a new and evolving set of consensus expectations for the path of economic growth and inflation along with likely monetary and fiscal policy. Supply chain shortages, historic inflation, a hawkish Fed, and a pandemic are the risks du jour, but months from now we could be talking about supply gluts, downward pressure on prices, a dovish Fed and an endemic. While it may be crystal ball season, we're reminded of Warren Buffet's quote about investing, "What you really want to do in investments is figure out what's important and knowable. If it's unimportant or unknowable, you forget about it." To us at The London Company, much of these macro dynamics fall into the unknowable category. That's not to say we are ostriches with our heads in the sand; instead, we remain focused on the facts and worry about things in which we have control. From where we sit today, we believe risks remain elevated even as optimism and complacency have been on the rise. While we think the economy is on solid footing, growth appears poised to decelerate to more normalized levels. Meanwhile, inflation is still elevated, financial conditions are set to tighten and we could see higher taxes later in the year. Though the worst of COVID-19 and the related supply chain complications appear to be behind us, these dynamics remain large unknowns whose disruption could persist well into 2022. Meanwhile, the valuation extremes and acute pockets of risk taking are worrisome. Given this backdrop, equity returns may be more modest and volatile going forward. In such an environment, we believe a long term-approach, with a focus on Quality factors that help dampen volatility, will reward investors.

Like the Scouts' motto, we have a perennial 'Be Prepared' approach. This has served us well since 1994 and we believe it's equally important as we enter 2022. The market is expensive by historical standards, but our portfolios still trade at reasonable relative valuations compared to their indexes. We believe the quality of the portfolios, measured by sustainably high returns on capital and modest leverage, enhances the margin of safety on the downside, but also provides room for further upside should the market grind higher from these levels. Taken together, we're very pleased with the positioning of our portfolios, especially as we enter a 2022 that faces more uncertainty than this same time in 2021. With any luck, this time next year, future mentions of Groundhog Day will revert back to Bill Murray or Punxsutawney Phil references and we will have closed the chapter on the COVID-19 pandemic for good.

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

Best Regards,

The London Company

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