THE LONDON COMPANY

INVESTMENT COUNSEL

Stephen M. Goddard, CFA
Jonathan T. Moody, CFA
J. Brian Campbell, CFA
Mark E. DeVaul, CFA, CPA
Andrew J. Wetzel, CCO

1801 Bayberry Court, Suite 301
Richmond, Virginia 23226

Telephone: 804-775-0317
Facsimile: 804-649-9447

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"The significant problems we have created cannot be solved at the same level of thinking with which we created them." – Albert Einstein

To the clients and friends of The London Company:

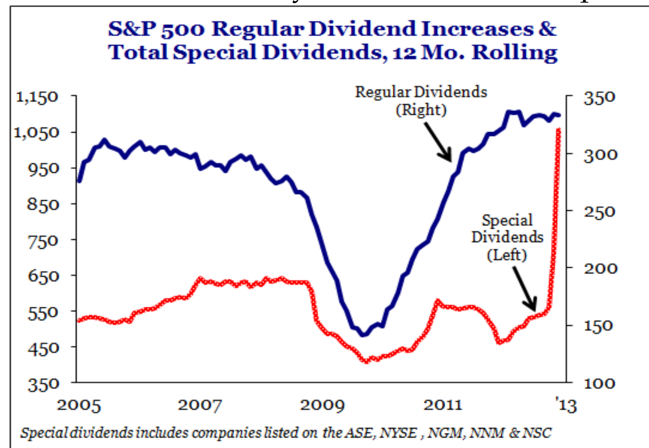
It is no secret that Einstein was a genius, but the prescience of his above quote when applied to our problems in Washington holds truer today than most could have possibly imagined. After months and months of rhetoric and inaction, Congress finally approved a semi-solution on the dawn of the New Year to avert the dreaded "*fiscal cliff*". The proposal failed to address all of the concerns in entirety, but it removed a worst-case scenario and gives us the unwelcome joy of additional debates in the months ahead. To be fair, the problems we face have been accumulating for decades, so this is not to place blame on one party or another, but simply an observation that much of the struggle to compromise and solve our fiscal issues is beguiled by static thought and tired ideology. Unfortunately, there are neither easy solutions nor any Einsteins in Washington, diminishing the ethereal hope that a brand new year will resolve any of our old problems.

Nonetheless, the equity markets have been moving forward *and upward* without the need for answers. Quite surprisingly, 2012 was resilient and provided U.S. equity investors with a strong year of double-digit returns across the board. The S&P 500 ended the year up 16% and the Small Cap Russell 2000 Index was slightly ahead at 16.3%. All sectors of the S&P 500 were positive with Financials and Consumer Discretionary leading the way. The only two sectors that returned less than 10% were Energy and Utilities. In the Russell 2000, Consumer Discretionary and Materials led while Energy and Utilities lagged. Most of the gains were made earlier in the year, as the fourth quarter was relatively benign after enduring the Presidential election and the heightened uncertainty of falling off the cliff.

The London Company performed as expected. We kept pace in the up market and achieved double-digit returns while maintaining a lower risk profile. Our large cap portfolios ended the year slightly behind the indices, while our small and mid cap portfolios profited from strong stock selection to best their respective benchmarks. Within our large cap strategies, the positive stock selection we had in Materials was offset by our selection in Technology and underweight in large cap banks. The Financials were the best performing sector in the S&P 500 and accounted for a vast majority of the year-over-year

earnings growth for the entire index. Within our small and mid cap strategies, the positions in Consumer Discretionary, Industrials, and Materials did well and more than offset our overweight and selection in the underperforming Consumer Staples sector. Overall, we avoided major disasters and benefited from our larger weighted holdings continuing to do well. Companies that are earning solid returns on capital and generating excess free cash flow are being rewarded.

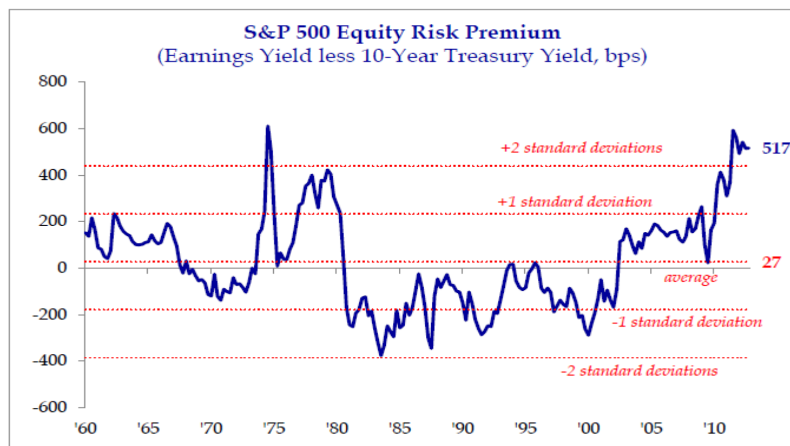
A good number of the companies we own are generating excess cash and are returning it to shareholders in record amounts, as seen by the historic spike in special dividends this past quarter. A byproduct of ample cash and the uncertainty around taxes, companies were content to pay out as much as possible during 2012. The chart to the right shows the soaring rise with 1,000 plus companies issuing a special payday to shareholders. The resurgence of regular dividends, up 17% year-over-year, has been occurring since 2009 (blue line) and should continue to pace upward for the foreseeable future. Despite the one-time payments and a number of companies moving regularly scheduled 2013 dividends into 2012, we expect regular dividends to continue to rise. Corporate cash is still at record levels and the average payout ratio is at historic lows. The 30% payout ratio of the S&P 500 gives sufficient room for companies to meet investors' ever-increasing demand for yield. Another favorable development in enabling higher dividend payouts is taxes. While the semi-solution to the "fiscal cliff" deal is a partial fix, it does put to bed the issue of taxes. In a nutshell, income taxes will mostly remain constant for those making under $450k a year. For those above that threshold, the dividend tax rate only jumps 5%, from 15% to 20%. This level is much more tolerable than feared and should not inhibit demand for income.



Source: Strategas

The 10-year Treasury currently yields 1.8%, which is less than the current rate of inflation at 2%. U.S. debt holders are actually accepting negative 'real' returns (nominal rate less inflation). As we have mentioned before, the Federal Reserve's easy monetary policy is aiding borrowers at the expense of savers. This financial repression is caused by setting interest rates to near zero and creatively finding ways to push liquidity into the market through quantitative easing. The end result is that interest rates of all kinds are artificially low, causing fixed income investors to suffer and debt issuers to benefit through lower interest costs. Borrowing money at low rates has partially helped companies refinance debt, buy back shares, and pay those special dividends. Risk-averse companies that hoard cash and don't invest are being punished through lower returns on their equity. The Fed, transparent throughout, has slightly changed their mandate of keeping rates low from *until 2015* to *until the unemployment rate is under 6.5% and inflation expectations are less than 2.5%*. Chances are good that we will maintain low rates for some time.

With yield scarce it is tempting to stretch on risk tolerances, making current an old saying, "More money has been lost chasing yield than at the point of a gun." If pensions, endowments, and traditional retail investors seek income, dividend paying equities are where to look. With 58% of the companies in the S&P 500 currently paying a yield greater than the 10-year Treasury, equity investors get both income and capital appreciation potential. An added benefit is that equity valuations appear very reasonable when compared to bonds. As shown below, the equity risk premium is at peak levels, implying that equities have to appreciate or the prices of bonds have to fall to revert back to historic norms. Barring a prolonged global recession, this chart gives support that downside risks to equities appear limited.



Source: Strategas

Companies with excess cash and shareholder-oriented management teams are traditional hallmarks of our portfolios, yet we understand long-term wealth accumulation comes from ownership of those select companies that can reallocate capital in high return investments over many years. Healthy free cash flow generation in a slower growth world is becoming a rarity. When we discover an attractive investment candidate we strongly believe it needs to contribute meaningfully to portfolio results. We believe our philosophy of not over diversifying the portfolio is a distinct advantage in today's market. Another advantage of active management in the current environment is that market forecasts and the dispersion of potential outcomes are as wide as they have been in years. Even the Federal Reserve's Open Market Committee (FOMC) has a 200bps range on unemployment over the next three years and 100bps range on GDP growth. There are simply too many variables to speculate on what the macro stage will provide.

As contrarians, we gain confidence that the news headlines are more bearish than bullish. It is always easier to see what could go wrong over what could go right. While we expect volatility to stay elevated from the drama of further Congressional blustering and upcoming debates on the debt ceiling, sequestration, and entitlement reforms, we are optimistic that the market will continue to work its way higher. As we said last quarter, it is not what we know that scares the market, it is what we don't. Domestic economic data has been surprisingly good and global central bankers are doing "*whatever it takes*" to avoid deflation, keep rates low, and push money into risky assets. As visibility improves,

confidence is likely to increase, potentially boosting M&A activity, capital investment, and overall equity valuations.

Having a longer-term investment objective is not easy when one is measured in quarterly or monthly installments. Much of our success is dependent on having excellent clients and partners who understand our objective and exhibit patience when needed. As always, The London Company's primary focus is on downside protection and providing our clients above average returns with less risk over time.

We are fortunate to have great clients and we would like to share with you some of our success this past year. We ended 2012 with another record year in terms of asset growth and employees. As we start 2013, we are pleased to announce the addition of a new Portfolio Manager to our staff, Jeff Markunas. Jeff brings over 28 years of experience managing equity teams, products, and processes. During his tenure, he helped launch and served as lead portfolio manager of a successful mutual fund with an 18 year track record. We are delighted to have him as a member of our team.

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

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Important Disclosures:

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