THE LONDON COMPANY

INVESTMENT COUNSEL

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

1801 Bayberry Court, Suite 301
Richmond, Virginia 23226

January 6, 2014

To clients and friends of The London Company:

"There are two times in a man's life when he should not speculate: when he can't afford it and when he can." – Mark Twain

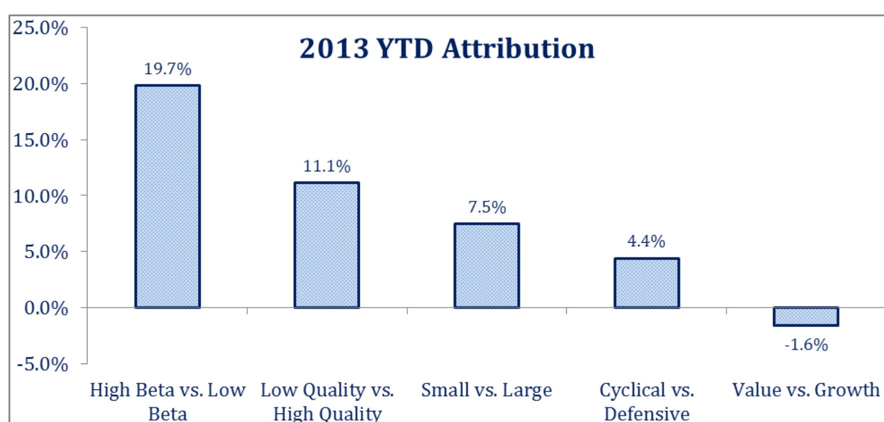
Mark Twain was famous for elegantly stating the obvious. His words above, generally speaking, offer simple, good advice. For The London Company, they speak to our core beliefs. The quote represents an invaluable part of our process and is what differentiates us from traders and market speculators. It reiterates our first priority of preserving capital by not relying on future forecasts when evaluating new investments. It means concentrating our efforts on company-specific data and not making decisions based on the complex, unpredictable macroeconomic environment that typically dominates investor attention. It's the reason why we say, "I don't know" when asked which way the market will move for the upcoming year.

Forecasting the future is inherently difficult, but 2013 was particularly challenging for prognosticators. Stocks, bonds, and commodities all moved in divergent directions and yielded returns not seen in over a decade. This time last year, very few pundits, if any, predicted the U.S. stock market would surge 30 plus percent to post its best year since 1995, or that most bond funds would lose money and post their worst year since 1999….or that Gold, the pinnacle of speculation, would fall 28% and end its 13-year streak of positive returns. Not many experts anticipated the rapid rise in interest rates this summer after the Federal Reserve hinted at the inevitable *tapering* of its quantitative easing program. And no one expected the Fed to delay its foreshadowed intentions in September to only initiate the very slight dialing back of its program three months later. Analyzing the *when* and *how much* of the Fed's tapering decision dominated headlines for much of the year. When combined with concerns about a fiscal cliff overhang, sequestration, a government shutdown and the politicking of a new Federal Chairperson, there was enough market moving material in 2013 to fog up even the clearest of crystal balls. Yet regardless of what worries surfaced, the stock market remained resilient throughout.

The S&P 500 ended the year up 32.4% and the Small Cap Russell 2000 Index was up 38.8%. By and large, The London Company portfolios performed as we would have expected. We kept pace with the market and stayed within reach of the index returns while maintaining a lower risk profile. Our Large Cap and Income Equity portfolios ended the fourth quarter and year behind the indices, while our Small-Mid and Mid Cap portfolios profited from strong stock selection to best their respective benchmarks for both time periods. The Small

Cap portfolio finished the quarter ahead of the index but couldn't match the strong return for the full year.

Fortunately, we adhere to Twain's wisdom and stay fully invested at all times. By keeping cash low and not trying to speculate on market movements, we participated in most of this year's gains. Market participants that rotated out of equities or increased their allocation to cash would not have fared as well. Even predicting which pockets of the market would shine was difficult as market leadership continuously shifted throughout the year. For example, the fourth quarter was a microcosm of the full year, in that higher quality, lower beta, defensive names (all common characteristics of our portfolios) did well early in the period to only to succumb to lower quality, higher beta, more cyclical resurgence later. For the full year, all of our portfolios fared well the first few months and then had to overcome formidable stylistic headwinds the rest of the way. The chart below illustrates the obstacles we faced.



Source: Strategas

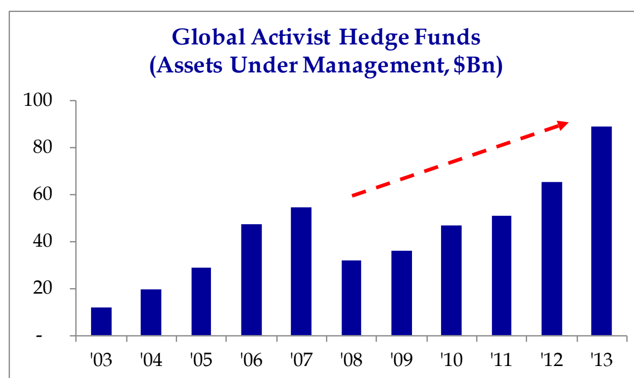
As often is the case, our portfolio construction allowed a handful of our stronger performers to meaningfully contribute so we could post respectable returns. In the Small-Mid and Mid Cap strategies we benefited from our overweight and strong stock selection in the consumer-oriented names. A few of these companies more than doubled this year and offset our underexposure and lagging positions in the Health Care, Financials, and Materials sectors. The Small Cap portfolio was particularly challenged as smaller sized companies in the Russell 2000 Index did better than our portfolio positions. We traditionally have found better opportunities in the upper range of the capitalization spectrum and are not concerned about this year's aberration. Our Large Cap and Income Equity strategies were hurt by our underweight in the Consumer Discretionary, Health Care and Industrials sectors, all up over 40% this year. Our positions within the latter two sectors performed well, but were offset by underachieving names in the Technology and Materials sectors. Overall, we performed as we expected given the landscape and avoided any major disasters that could have derailed results.

Companies that are earning solid returns on capital and generating excess free cash flow continue to be rewarded. Strong free cash flow yields have been a predominant trait of the best performing stocks for the past few years. Higher profit margins and lower capital expenditures are leaving management teams with an abundance of cash and few reinvestment opportunities. The willingness of management teams to put cash to work is

helping separate the performance winners from the losers. Those companies allocating capital back to shareholders generally are being rewarded with higher valuation multiples. Over 80% of this year's gains in the stock market came from multiple expansion, or the price investors are willing to pay for the expected stream of future dividends and cash flows. The remaining 20% came from earnings growth, which has struggled to gain traction and is the impetus behind the Fed's zero interest rate policy and quantitative easing programs.

As a consequence, the artificially low interest rates are penalizing companies that hoard cash. Although it began to narrow in 2013, the gap between the cost of debt and cost of equity remains incredibly wide. The more opportunistic management teams are actively taking advantage of this phenomenon and borrowing money at low rates to repurchase their higher cost shares. While 2012 was the year of special dividends given the excess cash and uncertainty around taxes, this past year has been very strong for stock buybacks. Companies have repurchased nearly $500bn in stock this year, akin to creating their own quantitative easing program. Given the favorable response by the market, this value creation tool is increasingly being recognized by buyers of assets and activists.

While M&A activity has been somewhat slow to rebound, apathy for excess cash on balance sheets is witnessed nearly every time a transaction does take place. The stock prices of acquiring companies are still appreciating on announced deals, a historically unusual occurrence. The quick accretion of these deals is causing a spike in activism that is fostering a change in reception by management teams and boards of directors. Forbes is calling this the *Golden Age of Activist Investing* and Time Magazine just placed Carl Icahn, the notorious corporate raider, on its recent cover and labeled him the most important investor today. For Icahn and others, activism has never been easier. The ability to garner willing listeners has been surprising to him as he was quoted as saying, "Being admitted to all these boards without a proxy fight would have been unthinkable only a year ago." In fact, activists have seen a 50% increase this year in their ability to win board seats. The negative stigma long associated with these battles has diminished. Even SEC chair, Mary Jo White, recently stated the landscape has shifted from a more defensive view by management and boards to a more proactive outlook. Past success is aiding this transition as is the current environment of excess cash and slow growth. Investors are also taking notice and beginning to allocate more capital to these strategies *(see chart)*. While The London Company hasn't invested with an activist's agenda, many of our holdings have been the object of desire by said participants and we have benefitted from the actions of others.



Source: Strategas

Looking forward, we think activism will continue and M&A will eventually recover, although our patience in this regard has been sorely tested. The reasons for not speculating are plenty, but being wrong quite often must be one of them. We don't know what the market will do in the year ahead but we acknowledge that there is less uncertainty today than there was a year ago. The visible tail risks have been mitigated and

tolerance for risk has increased. We would be surprised to have a repeat of 2013, but also recognize that this market rally wasn't universally loved and that market forces are unlikely to change without cause. Profit margins will remain high until capacity is added or labor costs increase. Monetary policy will be accommodative regardless of the tapering and interest rates will be favorable even if they increase. Until recently, money flows into equities have been non-existent despite the best-in-class returns. Pensions and Endowments, in an effort to reduce volatility, have cut their exposure to equities in half the past five years and will now have to confront those past decisions in upcoming meetings.

The 5-year returns at the end of 2013 will no longer include the disastrous 2008. The rolling returns from stocks (now up 173% from 2009 market bottom) have greatly outperformed when compared to bonds and alternative asset classes. The extra fees demanded by those hedge funds will be tough to defend. Even if the market suffers a pullback in the short-term, the long-term dynamics remain favorable. Corporations are producing significant cash flow and multiples being paid are reasonable. In the meantime, we will remain fully committed to our disciplined process so we can protect your capital and seek great investment opportunities to the best of our ability.

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 London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies and objectives can be found by calling us at (804) 775-0317, or visiting www.TLCadvisory.com, and are more fully described in Part 2 of Form ADV, which is available upon request.