

# THE LONDON COMPANY

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

1801 Bayberry Court, Suite 301  
Richmond, Virginia 23226

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To clients and friends of The London Company:

*When the gods wish to punish us, they answer our prayers.*

– Oscar Wilde

Before 20<sup>th</sup> century sociologists could develop the concept, Oscar Wilde observed the risks of unintended consequences. He understood human nature's propensity to seek the most direct, linear form of benefit without anticipating what the second, third or fourth derivatives of such an act might produce. The existence of such outcomes, more commonly negative than positive, often stem from ignorance, errors in analysis, or impatience due to favoring the immediate impact over the longer-term effects. Not surprisingly, politicians and government bodies have been particularly guilty of creating such scenarios. A classic example is Mexico City's attempt to curb air pollution in the late '80's. Known as *Hoy No Circula* (No Drive Days), regulation was put in place to reduce traffic 20% by restricting certain cars from the road one day a week based on the last digit of its license plate. In theory, this would reduce traffic and air-pollution; but in practice, drivers were incented to purchase a secondary vehicle with a different ending digit on its plate, and more often than not these were cheaper, older, copiously-polluting clunkers that only exacerbated the very problem they were trying to solve.

The London Company accepts the law of unintended consequences as an idiomatic warning that intervention into complex systems (i.e., financial markets) can create unanticipated and undesirable outcomes. The Federal Reserve has unintentionally crossed into such territory while adhering to their dual objective of price stability and full employment. The housing bubble that led to the credit crises of '07-'08 was largely due to interest rates being held too low for too long. Post the crises, the Fed fast-tracked an easy monetary policy and used all its creativity to help return the market from its depths. After three historic rounds of quantitative easing, interest rates remain artificially low and speculation high as to what asset bubbles may be forming today. It is this fear that keeps investors cautious...and hopeful that the gods *are not* wishing to punish us.

At the end of 2014, equities finished higher than expected, interest rates lower and oil prices freefalling much faster than thought possible. The latter has caused much consternation and is a topic we will discuss later in more detail. In regards to the equity market, The S&P 500 increased 4.9% in the fourth quarter to end the year up 13.7%. The index is now up

205% from its 2009 bottom and is 68 months deep into this bull market. Surprisingly, investor reception to such a feat has been met with the same fanfare as milk toast. The S&P 500 set a new all-time high 53 times in 2014, the third most on record and followed 45 best-ever days in 2013. The last time we crossed such illuminous milestones, the press and media ballyhooed the results, yet today many fear its ephemeral qualities and prepare for its looming descent. As natural contrarians, this foreboding gives us some optimism that the end might not yet be near.

Interestingly, the variability of equity returns increased this past year as large cap stocks widely outpaced their small cap brethren. After romping up 39% in 2013, the Russell 2000 Small Cap index finished the year up a modest 4.9% despite a late fourth quarter rally of 9.7%. The late charge pushed small cap returns into positive territory but they still trailed the S&P 500 by nearly 900bps. For The London Company portfolios, we had a similar fate in terms of relative performance. Our two large cap portfolios performed well and bested their respective benchmarks this recent quarter and full year, while our small cap and smid cap strategies trailed the indices for both time periods. Our mid cap and concentrated strategies were mixed, finishing slightly ahead for the quarter but behind for the year.

Overall, our 2014 results were consistently inconsistent. This is a rare occurrence given the identical team and process managing all products, but not unexpected given our portfolios' high active share, dependence on stock selection, and our relatively strong returns in 2013 during a 30+% market. Our large cap product benefited from its defensive bent and strong performance from the portfolio's consumer discretionary and technology stocks. For the fourth quarter and the full year, the large cap index was led by the more defensive segments of the market, specifically the utilities and health care sectors. While a low beta environment typically provides a tailwind, all of our excess returns originated from stock selection as sector allocation was neutral to returns. Our dividend-oriented large cap strategy had similar results for both the fourth quarter and full year due to strong stock selection from our energy, industrials and consumer discretionary holdings. Both portfolios benefited from legacy holdings as well as recently added positions, in addition to avoiding any major disasters.

The same cannot be said for our other strategies. The small cap strategy was well-positioned ahead of the Russell 2000 at the start of the fourth quarter, but quickly fell behind the market in October. In fact, October was our worst month since 2000 on a relative basis. The small cap index sprinted up almost 7% that month and was led by the smallest market cap holdings and what seemed like every stock in the index that we didn't own. Like the large cap indices, the more defensive-oriented utilities and health care sectors led this quarter and full year. Our limited exposure there hurt results. Our portfolio had some stock specific issues that detracted value too, but nothing drastic enough to change the long-term thesis on those holdings. It is also worth noting the very short time period in which our relative returns switched from positive to negative. We remain confident in these positions due to our business owner perspective and long-term outlook, despite the painful relative underperformance incurred over the three month period. We invest in companies in which we would buy outright if we could. Many of these holdings

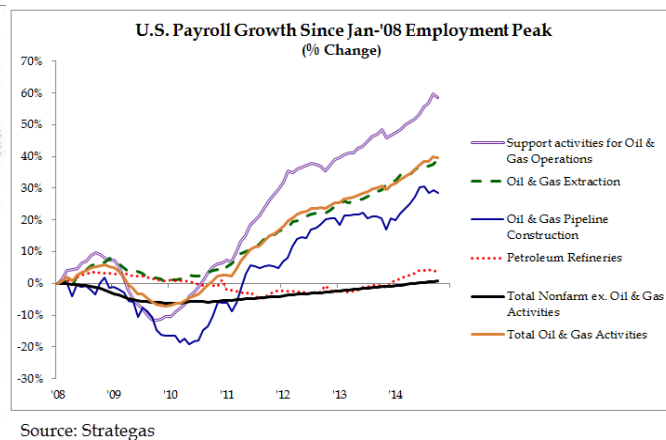
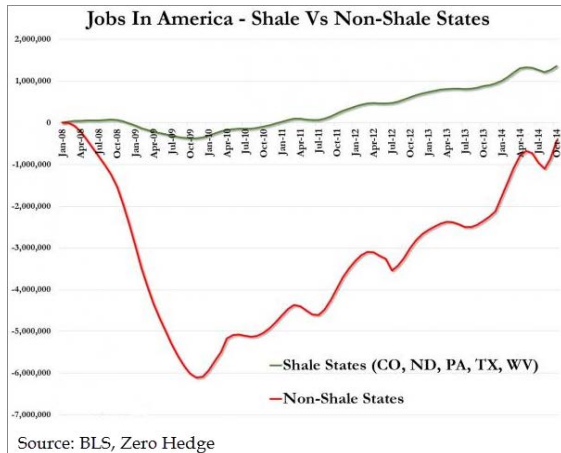
may not keep up in rapidly rising markets (ahem October) but should protect us when things aren't so rosy.

Specifically, in small cap we have a healthy exposure within our consumer discretionary sector, directly and indirectly, to outdoor sporting goods. Beyond possessing the targeted characteristics of high returns on capital, strong free cash flow, and capable managers; we believe these companies hold great brand loyalty and long-term competitive advantages. We are biased towards industries with few competitors and high barriers to entry, and even more so when we feel capital allocation is disciplined and competitor consolidation is likely. Over the past few years, many of these companies experienced increased demand as a secular growth story unfolded. That more cyclical spike in demand ended this past year resulting in sales declining and inventories rising. As the short-term cycle mean reverts and new normal is discovered, the valuation pendulum has extended beyond our estimates of intrinsic value given our views on operating margins and cash generation under the most draconian scenarios. We are optimistic this discrepancy will self-correct, and the favorable secular fundamentals will re-emerge.

For our smid and mid cap strategies, we had some of the same exposures as our small cap portfolio, but also had greater overall mean reversion this year given our strong returns in 2013. We outpaced both the Russell 2500 and Russell Mid Cap index a year ago despite the market being led by higher beta, lower quality stocks. Positive stock selection was instrumental in those returns and given our limited turnover, those positions didn't have the legs to keep up with the market this year. Our concentrated portfolio is inherently more prone to short-term fluctuations and suffered from the same aforementioned factors. In summary, slight variations amongst all our portfolios had outsized effects on total returns. However, we view this development opportunistically and the investment team continues its historical practice of adding personal capital to our products. We believe actions speak louder than words in this regard.

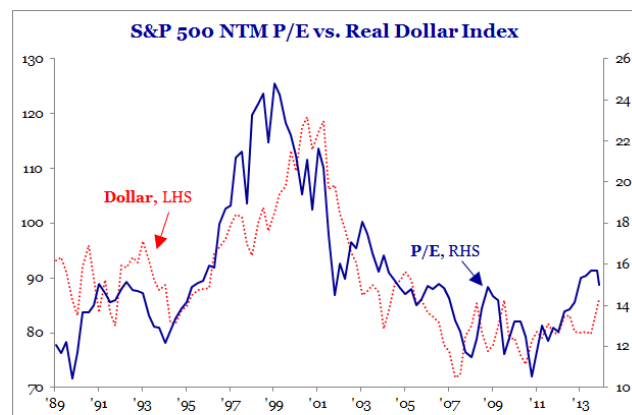
The biggest market development exiting 2014 has been the precipitous drop in oil prices. We have extolled the perils of forecasting in the past, and have historically been light in commodity-oriented companies given their speculative nature and volatile cash flow, but we too are shocked by the violent turn of events. The saying *nobody knows nuttin'* endlessly holds true in the energy sector. West Texas crude (WTI) ended 2014 at \$54 per barrel. It was over \$106 a barrel this past summer. Since 2006, oil prices have gone from \$40 to \$150, back to \$40 and then to \$115, and now back to \$50 (current price on Jan 5<sup>th</sup>). The recent decline of 50% may or may not hold, but the last time WTI fell that far that fast (1985-86) prices stayed there for 15 years. What is noteworthy to us is how important the energy complex has been to employment and GDP growth.

To put this into perspective, the majority of net job growth over the past six years has been energy related. Outside of these five shale states (TX, ND, PA, CO, and WV), there has been no net job growth. The other 45 states have lost 400K jobs since 2007 (see charts below).



Texas alone has added 40% of the net job growth, which, amazingly, led Houston to build more houses than all of California in 2013. With reported unemployment under 6%, the dependency on the shale industry shouldn't be overlooked. Moreover, the Manhattan Institute estimates that GDP growth would have been negative the last few years without the energy boom. With the energy complex accounting for an estimated 30% to 40% of all capital expenditures in the S&P 500, the price of oil and gas has huge implications across the board. The high yield debt market is now 15.7% energy related. This percentage has tripled over the past decade after more than \$500bn has been committed to shale drilling, and surprisingly, the borrowers are not just the big oil companies. There are an estimated 20,000 small E&P companies employing 15 people or less driving this boom and their ability to stay solvent depends on oil and gas prices staying above their marginal cost of production, a number, according to many, that is precariously close to the market prices today. The question to be answered is if the benefit of lower oil and gas prices to our consumer-led economy is enough to potentially offset the negative impacts on capex and employment.

Other factors influencing price are the production levels of OPEC (mainly Saudi Arabia), estimated global demand (mostly China), and the strength of the dollar to just name a few. Since oil is mainly priced in dollars, the relative strength of the U.S. dollar may crimp global demand. With global central bankers looking to board the easy monetary policy train, specifically Japan and the European Central Bank (ECB), the U.S. dollar index already has climbed to a 9-year high. Currencies typically move very slowly and in the same direction for long periods of time, so it is feasible this trend continues. Fortunately, a potential benefit could accrue to the domestic stock market, as price-to-earnings multiples historically have expanded with a rising dollar (see chart to the right).



In conclusion, we don't know where oil prices will go from here or how or when this bull market will end. We expect volatility to rise as the Fed exits quantitative easing programs and forecasts an eventual increase to interest rates. Organic growth remains difficult to produce, so the market's separation between the haves and have-nots could rise too. Our goal is to structure portfolios to withstand almost all environments and perform well across the full market cycle. We wear our long viewed lenses when thinking about the value of our portfolio companies and are not blinded by relatively short swings in the market's printed prices. We concentrate on downside protection so we can avoid overconfidence and other hubristic actions only to be 'surprised' by an alternative result. Lastly, we heed the advice of Oscar Wilde, and the percipient WWII prisoner-of-war who spent time with protagonist Louis Zamperini of the novel and recently released movie *Unbroken*. As both prisoners were blindfolded and bused through Tokyo on their way to a prison camp, Louis lamented both his missed opportunity to participate in the 1940 Olympics and his long-held desire to visit the city, when the fellow POW reminded him: be careful what you wish for.

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

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