THE
LONDON
COMPANY

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To clients and friends of The London Company:

*"Outlined against a blue-gray October sky, the Four Horsemen rode again. In dramatic lore they are known as Famine, Pestilence, Destruction and Death. These are only aliases. Their real names are Stuhldreher, Miller, Crowley and Layden. They formed the crest of the South Bend cyclone before which another fighting Army football team was swept over the precipice at the Polo Grounds yesterday afternoon as 55,000 spectators peered down on the bewildering panorama spread on the green plain below."*

*– Grantland Rice, The Four Horsemen*

Renowned early 20th Century sportswriter Grantland Rice penned these famous words in tribute to the backfield of the legendary 1924 Notre Dame football team. A classics major at Vanderbilt University, Rice's deep-rooted connection with literature stretched back into the Book of Revelations, whence the above quote originally was drawn and repurposed into the sports pages of the New York Herald Tribune. While Rice's elegant writing style long ago succumbed to a modern world of tweets, Facebook posts, and blogs, his Biblical metaphor rides on under the guise of a new and ever-expanding cast of characters and aliases.

Stock market pundits number among those writers who more than once have channeled their inner-Grantland to help describe events that have dominated financial headlines. Over the course of the past three decades, there have been multiple occurrences of markets characterized by narrowing performance breadth, where the mantle of leadership has fallen upon a small handful of hugely successful names. Generally, these leaders have been the perceived best in breed growth stallions that left the rest of the equity herd in a cloud of dust and accounted for a disproportionate percentage of the market's overall return. During the height of the internet bubble in the late 1990's, amidst a backdrop of entrenched "real" economic malaise, the "new economy" four horsemen travelled under the identities of Microsoft, Cisco, Dell, and Intel. Prior to the Great Recession of 2008-2009, another quartet of dominant horsemen returned bearing the names of Apple, Google, Amazon, and Research in Motion. It should be noted that the emergence of both sets of vaunted "Four Horsemen" occurred during periods of economic slowing which tilted the investment landscape in favor of those tight pockets of growth and momentum-oriented strategies. It should be further noted that both periods preceded and were truncated by deep economic recession and a rough period for the equity markets.

Which brings us to 2015 and the year just ended - one that witnessed another manifestation of the market horsemen, this time dubbed the "FANG"-gang, or specifically Facebook, Amazon, Netflix, and Google. As in the two previously-cited episodes, 2015 was a year of scarce global

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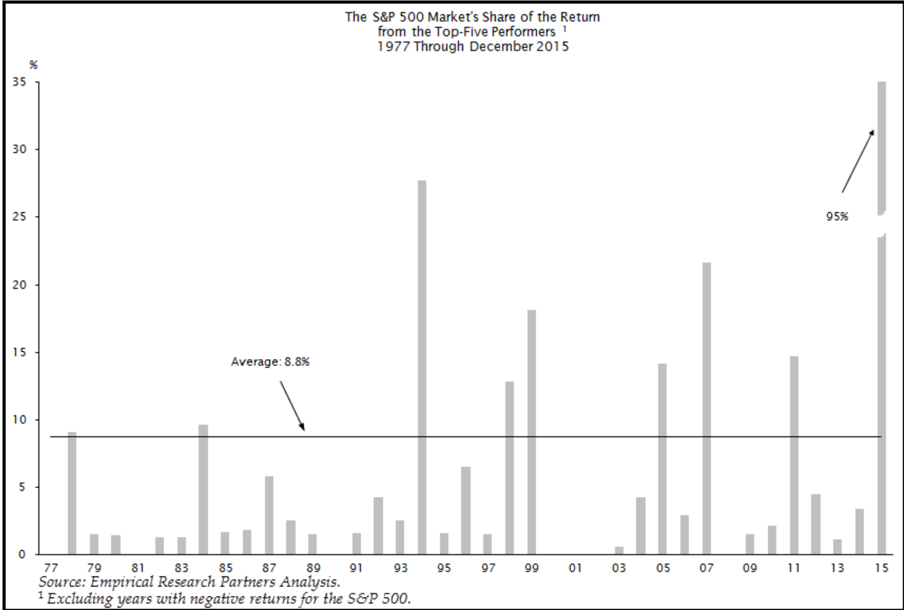
growth - low real economic output domestically and outright distress across the emerging market complex, which created an ideal investing terrain for those chosen few growth/momentum winners, but rife with landmines for much of the rest of the market. According to Empirical Research Partners, in 2015's negligible return year for the S&P 500, the top 5 stocks (FANG+Salesforce.com) accounted for a whopping 95% of the benchmark's return, which is an unprecedented 10x the magnitude of comparable past narrow market episodes and far beyond the 8.8% average (and typically more like 2-4% contribution experienced in most years) when S&P returns have been higher. As the chart below dramatically depicts, return has been uncommonly concentrated in the latest year's Four Horsemen +1.



*Source: Empirical Research Partners Analysis.*
[1] *Excluding years with negative returns for the S&P 500.*

Meanwhile the original Biblical four horsemen appeared to have run rampant throughout the rest of the equity market, notably across the energy and commodities complexes, inflicting widespread financial death, destruction, famine, and pestilence upon everything in their path. The below chart underscores how much residual damage remains unrepaired following the brutal market correction during the third quarter, with over 75% of the Russell 3000 (a broad measure of the total market capitalization exposure) still 10% or greater below the 52 week price highs, and over 50% of the constituents 20% or greater below the 52 week price highs.

| | **Number of Stocks** | **% of the Index** |
|---|---|---|
| No. Stocks -10% or more from their 52-Week High | 2250 | 75.2% |
| No. Stocks -15% or more from their 52-Week High | 1851 | 61.8% |
| No. Stocks -16% or more from their 52-Week High | 1791 | 59.8% |
| No. Stocks -17% or more from their 52-Week High | 1739 | 58.1% |
| No. Stocks -18% or more from their 52-Week High | 1673 | 55.9% |
| No. Stocks -19% or more from their 52-Week High | 1616 | 54.0% |
| No. Stocks -20% or more from their 52-Week High | 1555 | 51.9% |

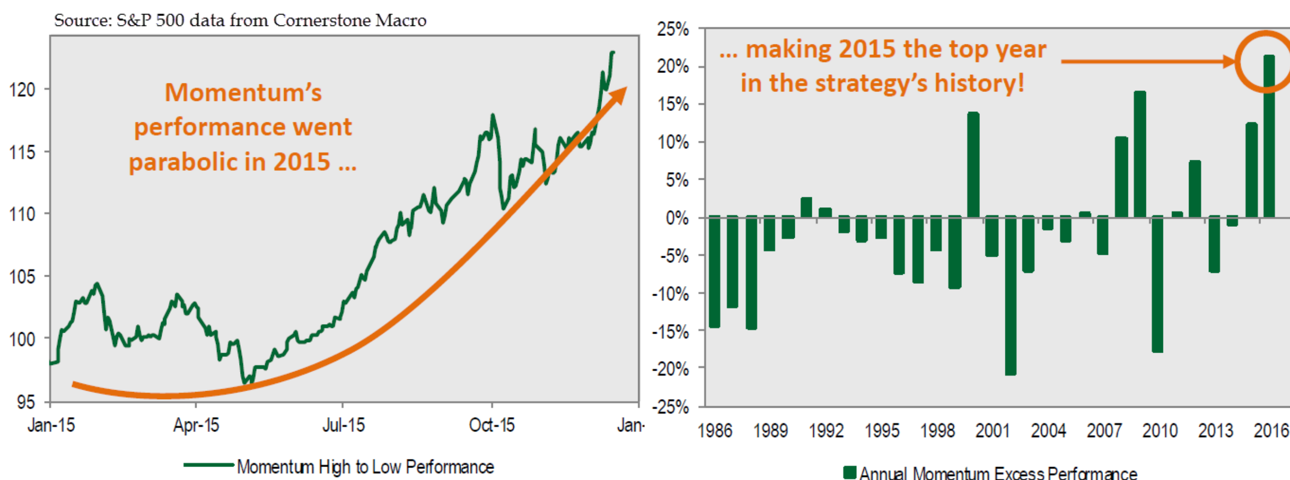
Source: Cornerstone Macro

If it felt to you like a very difficult and painful year as an investor, your sentiments are shared by many other investors including the team here at The London Company. Beyond the extreme paucity of issues generating outperformance within the S&P 500, growth/momentum-based strategies held a sizeable advantage up and down the entire market capitalization spectrum, as shown in this simple style/size performance box below:

| Returns | Value | Blend | Growth |
|---|---|---|---|
| Large | (3.8) | 1.4 | 5.7 |
| Mid | (4.8) | (2.4) | (0.2) |
| Small | (7.5) | (4.4) | (1.4) |

Total Return; Large Blend is S&P 500, Large Value/Growth is Russell 1000 Value/Growth; Mid is Russell Mid; Small is Russell 2000
Source: S&P, Russell, Bloomberg, and RBC Capital Markets

As noted, momentum approaches enjoyed a banner year in 2015 to such a degree that results have been described as "parabolic". The following two graphics, courtesy of Cornerstone Macro, illustrate just how well momentum fared this year:




Additionally with respect to the concentration of these returns (which tends to go hand in hand with momentum), consider the fact that the average stock, whether measured by mean or median return, trailed its respective benchmark in nearly every market capitalization, some by a wide margin. Not surprisingly, with market leadership so confined and most stocks yet not able to recover from the late summer beat down, managers of all stripes have found it challenging to add value to client portfolios. In a recent report, Strategas researched historical manager returns over the past 15 years and found that in S&P 500 benchmarked products only 24% of active managers were able to outperform in 2015, the second worst year in the study and only slightly better than

the 17% of active managers who outperformed in the toughest year of 2014. Even legendary investor Warren Buffett had a tough year, with his bellwether vehicle Berkshire Hathaway lagging badly with the shares down over 12%, recording only his 5th negative return year in the past 25. Long term investing in most cases did not deliver short term benefits this past year. Short term investing did not distinguish itself with any better short term returns either. Hedge Funds, which have supplanted traditional, long-only investors as the dominant force in daily trading volumes and price movements, also finished in the red for the year. Most hedge funds tend to have blink of the eye holding periods, quick triggers with losing positions, and notoriously momentum-driven DNA, all of which exacerbated the trends already at work in the market and served to dig the spurs deeper into the FANG-gang. Small wonder then that the 2015 horsemen rode so hard!!

So, in a year that featured and celebrated the return of the fabled horsemen, it felt to us at times that we were contesting them more astride the "Four Shetland Ponies", a bit overmatched and struggling to maintain pace in an adverse setting. We had similar feelings in the past when other horsemen-led markets simply outran us. The stylistic headwinds of growth, momentum, and a persistent narrowing of return really began in 2014 and impacted us in the year ago fourth quarter as well as throughout most of 2015. We are disappointed to report that we turned in lagging performance across most of our strategies in 2015, with none of them outperforming for the fourth quarter and only Income Equity, where benchmarked against the Russell 1000 Value, and Concentrated finishing ahead for the full year. While impactful, certainly the market-related headwinds were not the only factors working against us last year. On balance, we did not turn in a stellar year with stock selection. The specific contributors and detractors varied by strategy, but in some cases we felt that the price reactions overcompensated for changes in the fundamental developments, something we view as transitory and not actionable within our longer term investing horizon. In other cases, we misjudged the speed and magnitude of change, and where not seen as transitory we did take action. In our smaller capitalization strategies, we especially were hurt by limited exposure to the momentum-infused technology and healthcare sectors, and weak comparative results in a few of the positions we held there. Finally, because of a robust M&A pipeline that removed several names from our portfolios, a few of our replacement ideas have yet to pan out as we envision they should. As we look back at our historical pattern of returns, we have found a tendency among our newly established positions to require some time to "season" before becoming portfolio contributors, and at first can drag on short term performance. Market-timing has never been a hallmark of investing acumen here at The London Company, as was evidenced by several of our ideas in 2015. On the positive side of the ledger we also had a number of very strong performers and did participate in the tsunami of M&A activity through targeted companies that we held.

Looking ahead to 2016 our crystal ball remains as clouded as it was entering 2015 and 2014 and 2013 and…….you get the picture. We do not pretend to be what we are not, and The London Company is not a top-down, predictive-based firm. We have built a distinguished long term record and reputation by minimizing portfolio harm inflicted by forecast risk, and not attempting to juxtapose our bottom-up, balance sheet-centric stock selection with macro-analysis and its likely impact on future outcomes where we are trying to out-guess and out-smart everyone else.

The landscape entering 2016 does not look immediately different than the one we have just left behind. We do not know how much longer the horsemen will lead the charge and the narrow

growth/momentum cadre carry the flag. Recent economic data has been mixed, although outside the beleaguered energy/commodity sectors reasonably healthy. However, what remain unknown are the full secondary and tertiary effects of the commodity bust as the fallout ripples through the financial markets. The Fed has embarked upon its long-ballyhooed "liftoff" in interest rates, but the pace of future rate increases should remain data-dependent, thus measured. Global economies continue to be mired in a host of challenges, leading to predictions of another year of anemic growth and endless initiatives to resuscitate much of the world through accommodation and liquidity. Overall, the data suggests that corporate America remains in good shape, extending the long running theme of abundant cash-flow generation, coupled with strong balance sheets and limited reinvestment opportunities, leading to large capital returns to shareholders. While 2015 was a record year for M&A transactions, it is noteworthy that the market has altered its view toward deals, reacting more negatively to such news later in the year rather than with the prevailing sanguine reaction that had existed earlier in the year and in the preceding years. Finally, activists continue an unabated assault upon countless corporate management teams in behind the scenes and very public displays of rancor and demands for change. Entering an election year, change might be a word that the weary American citizenry will embrace as it votes to select its next President and confront an incumbency of stagnated governance.

We are not satisfied with our scorecard for 2015, but we remind ourselves and our clients that our focus and the strength of our process has been and remains long term in nature, and that our results will deviate both positively and negatively from benchmarks over shorter time frames. Returning to the aforementioned Shetland pony, despite its diminutive stature and inability to ride with the four horsemen, it is a breed with a set of characteristics that we aspire to emulate here as riders: hardy, strong, good-tempered, and very intelligent by nature. For its size, the Shetland is reputed to be the strongest of all horse and pony breeds, with a dense coat that can withstand harsh weather. Likewise, we strive to build equally durable portfolios, thoughtfully-constructed, that can withstand the test of time and repel these occasional periods of harsh market weather. We are not going to win every race, every year, and not when we are lined up against those periodic Triple Crown Thoroughbreds, but will continue to run our race and adhere to the principles of long term investing that endeavors to protect downside for our clients over full market cycles.

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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