THE
LONDON
COMPANY

January 8, 2018

To clients and friends of The London Company:

*"Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except* ***death and taxes****."    - Benjamin Franklin*

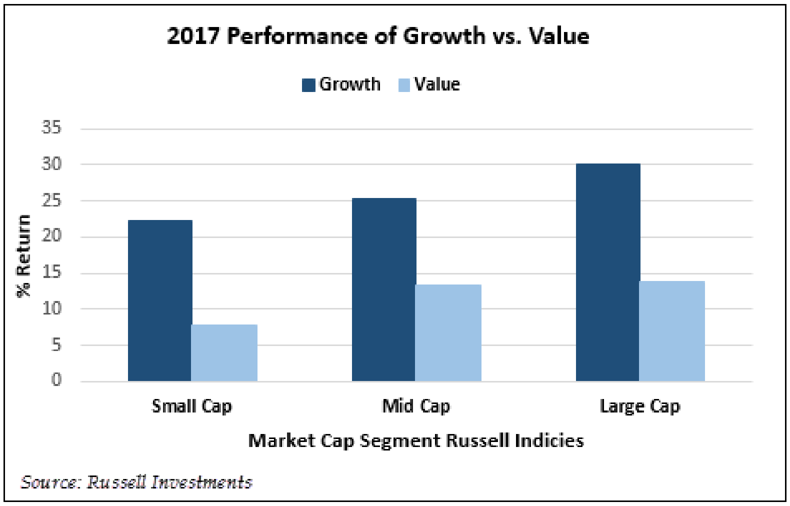
Franklin's oft-quoted rumination is our jumping off point for this quarter, which seems appropriate given how much the matter of tax saturated the news headlines and reverberated across the capital markets during the fourth quarter. Penned in a 1789 letter to French scientist Jean-Baptiste Leroy, an acquaintance from his previous service as US Ambassador to France, Franklin was contrasting two of life's great certainties with his own lingering private uncertainty as to the durability of our fledgling Government and Constitution. Leroy, meanwhile, was facing a darker hour of greater political turmoil amidst the French Revolution, a counterpoint not lost upon Franklin. Perhaps Franklin's quandary can be retrofitted into 2017, a year in which political and geo-political upheaval and polarization produced a laundry list of risks and doubts, none of which caused even the slightest ripple of negative equity market impact. As the latest quarter demonstrated, even the ageless certainty of taxes, or rather the expected benefits of reforming those taxes, provided a major tailwind to close out a record 2017 and propel a surge of optimism into 2018.

There is no doubt that the Tax Cuts and Jobs Act is the most substantial piece of tax legislation in the past 30 years. It is noteworthy that enactment is occurring deep into an economic and market recovery, unlike previous legislation aimed at jumpstarting weak or recessionary economic conditions. Individuals, small businesses, and corporations alike should immediately benefit from a myriad of rate reductions, bracket adjustments, accelerated investment credits, and a window to repatriate accumulated offshore earnings among the many ingredients. The intended stimulative effects upon domestic economic growth are estimated to be significant - potentially layering an additional full point of real GDP growth on an economy already emerging from a long period of slow but steady expansion. At the individual level, generally lower taxes should translate into higher consumption. At the corporate level, the repatriation of foreign earnings, coupled with a reduction in statutory tax rates and the ability to fully expense capital investments should accelerate profit growth and promote expansion, investment, greater return of shareholder capital, and likely even more M&A activity. How the $1.5 trillion cost of this bill will be funded remains to be seen, but is not a current concern. Although the benefits appear tilted toward larger corporations, in actuality smaller companies should reap greater tax savings given the disparity in current and proposed statutory rates versus prevailing effective tax rates.

All of these possibilities and projections stoked the animal spirits in the market during the fourth quarter. As measured by the Russell Indices, large cap stocks performed slightly better than mid-cap stocks (+6.6% vs +6.1%), but doubled the +3.3% return of small cap stocks. Although growth was the dominant stylistic driver for all of 2017, value fared relatively better in the fourth quarter as the economic picture brightened not only in the US but across the globe. In turn, investors refocused on the broader array of companies and industries poised to benefit from a pickup in economic activity. For The London Company, the overall environment proved more hospitable in the closing months than during the preceding ones. All of our strategies outperformed the primary benchmarks for the quarter (gross of fees), allowing us to finish the year on a positive note. For Income Equity, we would observe that while outperforming the primary Russell 1000 Value Index, it did finish slightly behind the S&P 500.

Throughout 2017, we have written about a number of factors at work that posed challenges for our approach to investing. We do not like to engage in "excuse making" when performance trails over parts of the market cycle, but we also do not attempt to "adapt" to environments in order to chase performance. That said, our strategies delivered somewhat mixed results for the year, with large cap and mid cap both outperforming, and income equity outperforming its primary Russell 1000 Value benchmark. Our concentrated strategy was able to capture 97% of its benchmark which gained 21.7%. In our smid and all cap strategies, we fell short but captured nearly 90% of the benchmark upside in a very robust return year that also exceeded 20%, relative performance that fell within the zone of our expectations. Small cap fell considerably short of its mark, as did income equity when compared to the S&P 500. While we employ a consistent methodology across all of our strategies, variations in relative returns are not uncommon due to the concentrated nature of each strategy and material differences in composition and constituency of the various benchmarks to which they are compared. We would like to recap a few of the key drivers in the year just ended before attempting to tackle the cosmic question of where the markets go in 2018.

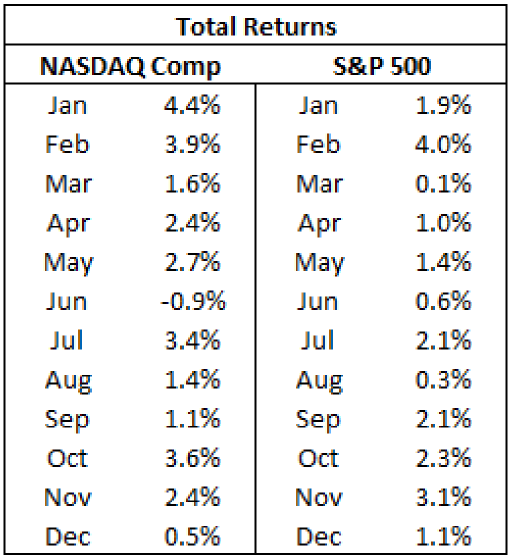
As noted above, investors in 2017 heavily favored growth at all points in the market cap spectrum, with a particular affinity for large cap growth. Within the Russell indices, the performance disparities are visually glaring, as reported by Russell Investments and shown below:



*Source: Russell Investments*

In the world of small cap, the representation bias of technology and healthcare issues in the benchmark again was a significant driver of return. As we have pointed out in the past, this group is heavily populated with unprofitable, high growth businesses that have enjoyed a good run of profitless prosperity. The retelling of this dynamic does not lessen its multiyear impact - including 2017- and we continue to find these attributes incongruent with our assessment of what offers our portfolios downside protection. In the world of large cap, the beneficiaries of the quest for growth included both cyclical and secular companies. Far and away, the revitalization of the "FAANG" stocks turbocharged the entire information technology sector, generating a return almost 2x that of the Russell 1000 and S&P 500 benchmarks. While the materials, consumer discretionary and healthcare sectors also outperformed, the differentials and weightings were smaller thus less incremental to returns.

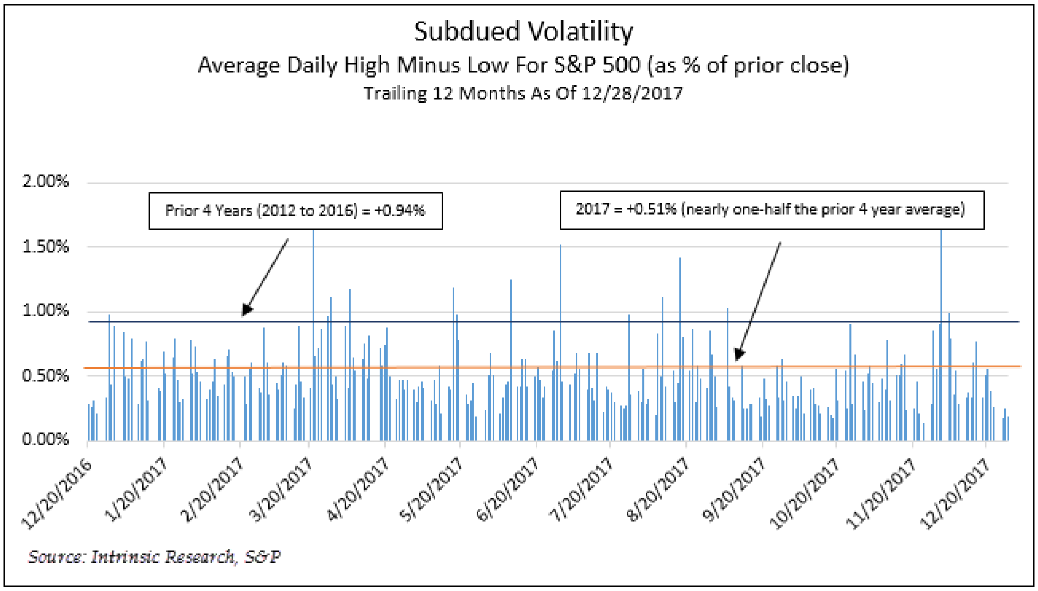
Not only were the returns outsized for growth generally and for technology specifically, these returns were conjoined by an unprecedented absence of volatility. For the first time in its history, the technology-heavy NASDAQ index advanced 11 out of the 12 months, and only posted a nominal loss in the month of June. The S&P500 bettered that by scoring a perfect "12" in closing higher in all 12 months of the year for the first time on record. The path to history followed this sequence:



| Total Returns | | | |
|---|---|---|---|
| NASDAQ Comp | | S&P 500 | |
| Jan | 4.4% | Jan | 1.9% |
| Feb | 3.9% | Feb | 4.0% |
| Mar | 1.6% | Mar | 0.1% |
| Apr | 2.4% | Apr | 1.0% |
| May | 2.7% | May | 1.4% |
| Jun | -0.9% | Jun | 0.6% |
| Jul | 3.4% | Jul | 2.1% |
| Aug | 1.4% | Aug | 0.3% |
| Sep | 1.1% | Sep | 2.1% |
| Oct | 3.6% | Oct | 2.3% |
| Nov | 2.4% | Nov | 3.1% |
| Dec | 0.5% | Dec | 1.1% |

*Source: Morningstar*

So if 2017 felt like the market moved higher in a straight line, that feeling was confirmed by the facts that investors indeed experienced a year bereft of any broad-based downside. Here at The London Company, where downside protection is our mantra, there was limited opportunity to exploit market risk and protect against meaningful decline. For us, 2017 was a little reminiscent of the old television commercial that featured the Maytag Repairman, the guy who patiently waited by the phone for a service call that never rang because Maytag appliances never ran into problems. Not only have we witnessed unabated or nearly unabated monthly progress, even the day to day market volatility contracted to historically low levels. As shown below, annual volatility remained subdued while daily fluctuation has been trending 50% below where it has been over just the past four years. As we described in our last quarterly letter, the market has functioned as if operating within the eye of a hurricane, insulated from all of the tumult that has surrounded it socially, politically, geopolitically, and even meteorologically. And not to belabor the point, but this protective bubble also has been a durable one, lasting since February of 2016 without a 5% correction, at this writing now the second longest period measured. Bubbles typically are viewed as market-negative events, but this one, at least metaphorically, is quite welcomed. Across the long expanse of time, we have seldom experienced a tranquil bull market quite like this one.



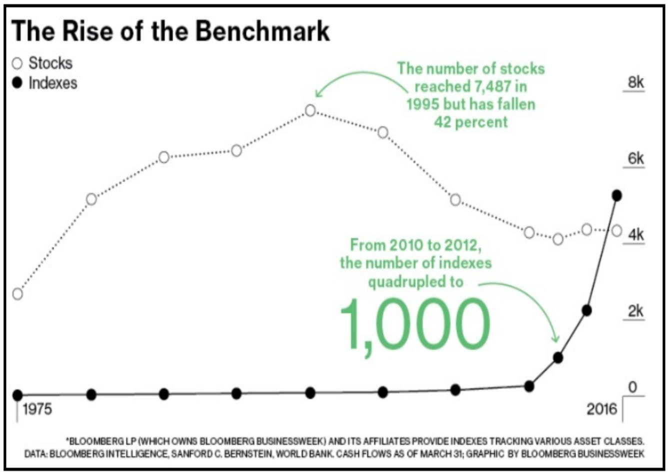
Subdued Volatility

Average Daily High Minus Low For S&P 500 (as % of prior close)

Trailing 12 Months As Of 12/28/2017

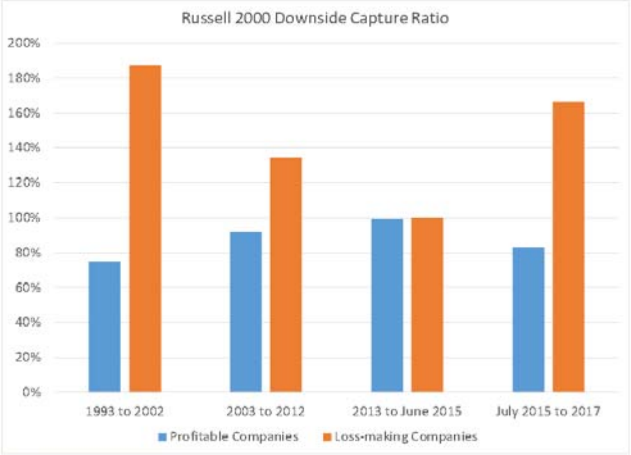
*Source: Intrinsic Research, S&P*

Some of that insulation has been sourced from the Federal Reserve's accommodative monetary policy that has blunted interest rate risk while supporting a backdrop of low interest rates, low inflation, low growth, and low organic reinvestment opportunities globally. Additional insulation likely has been created as a consequence of the seismic pivot away from active equity management and individual stocks in favor of passive investment vehicles in a burgeoning array of fund-oriented products. The real and potential impacts stemming from the explosion in passive investing is another topic upon which we have devoted space in several of our past commentaries, owing to several negative feedback loops that we and others see building as more and more money flows into these products. As certain as death and taxes, the rise in indexed investing has materially altered the landscape particularly for smaller cap stocks where index-inclusion supersedes fundamentals and profitability as a criteria for investment. Approximately one-third of today's small cap index constituents have failed to earn a profit in the past 12 months, a period of respectable economic health. Historically unprofitable companies have performed extremely poorly on the downside, one of several reasons we eschew owning these names. As the supply of products surpass the supply of underlying individual stocks, what could provide insulation and dampen volatility in the present tense could reverse and exacerbate non-fundamental volatility in the future. We surely do not have the ability to forecast when and how such circumstances could align, but will provide two exhibits in the "food for thought" category regarding this matter:



The Rise of the Benchmark

*BLOOMBERG LP (WHICH OWNS BLOOMBERG BUSINESSWEEK) AND ITS AFFILIATES PROVIDE INDEXES TRACKING VARIOUS ASSET CLASSES. DATA: BLOOMBERG INTELLIGENCE, SANFORD C. BERNSTEIN, WORLD BANK. CASH FLOWS AS OF MARCH 31; GRAPHIC BY BLOOMBERG BUSINESSWEEK



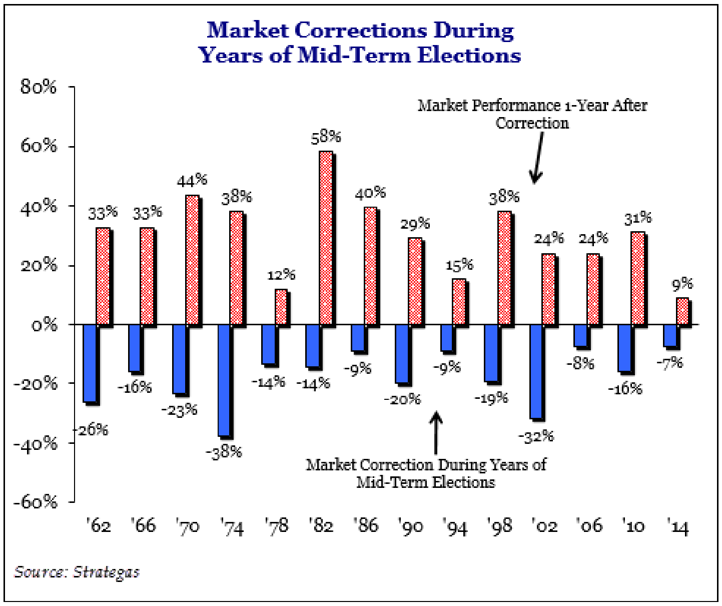
Russell 2000 Downside Capture Ratio

*Source: FRP and FactSet; as of 12/29/17*

Turning our attention to the year ahead, we recognize and understand the surge in positive sentiment that is being reflected in the markets. It has been a distinguishing feature of this nearly 9 year old bull market that optimism has been as restrained as interest rates, inflation, and economic growth, and investors have been skeptical, net sellers of equities all the way up. In sharp contrast, investors are seeing a lot to like about where we are starting out in 2018. The economy appears to be on a firm footing with a number of building tailwinds, and will be receiving an additional jolt of financial adrenaline from tax reform. If history is any guide, investors likely could be surprised to the upside on the full economic impact. Also under-appreciated is the scope of deregulation being implemented by the current administration, which could further stimulate business investment. Business leaders and investors alike have become much more optimistic, and optimism engenders action and tends to be good for the capital markets. Outside the US, economies and markets also continue to recover.

Of course, external to the tranquil bubble of the market there remains a laundry list of risks and doubts that did not crash the market's party in 2017 but remain in play for 2018. Geopolitical concerns always top this list, with hot spots around the globe, none hotter than the bellicose relations with North Korea and the overhanging threat that the undignified verbal parrying escalates into the nuclear option being used. As the administration vigorously pursues a policy of "America First", especially in the areas of diplomacy and world trade, the risk of alienating key partners in North America, Europe, China and Russia grows while collaboration and respect wane. One outcome has been a 10% decline in the value of the US dollar, an unusual development given our brightening economic prospects and a possible harbinger of entering a more contentious period for global trade and relations.

While there appears to be great certainty about the forthcoming benefits from tax reform, there is far less certainty as to the interplay of these benefits with the Federal Reserve's path to interest rate and balance sheet normalization, fiscal policy initiatives, and the consequences of divisive and confrontational governance that is viewed as deeply unpopular by a broad swath of Americans. The Fed has targeted a series of three interest rate increases in 2018, but the actual pace of economic activity and resultant inflationary pressures will dictate faster or slower action. So far, the bond market appears to be offering a non-confirming anticipatory signal, with the yield curve flattening in an environment where it typically would be steepening ahead of rising rates and inflation, which is the consensus forecast. Perhaps the bond market is grappling with the $1.5trillion dollar question of how fiscal policy will need to be amended in order to fund the Tax Cuts and Jobs Act. Maybe the ugly spectacle of Washington's partisan politics and the response by voters in the recent elections have created reasonable doubt as to where the balance of legislative power will be following this year's mid-term elections. Historically, the mid-term elections have worked against the incumbent majority, and given the market's pause. While history has not been the most reliable guide over the course of this recovery and bull market, it should be noted how the market has tended to fare leading up to these elections:



Market Corrections During Years of Mid-Term Elections

*Source: Strategas*

After an excellent stock market year that essentially went up in a straight-line with unprecedented consistency and low volatility, the unknown today is what and how fully has the market already discounted both the positives and the negatives of the investment landscape. By many conventional measures, market valuation is elevated but supportable in the still-low interest rate and inflationary backdrop. We would not expect the year ahead to repeat 2017 but that should not be extrapolated into an automatic negative call. We are not making a call on the market. Those of you who are familiar with our past letters and beliefs already know that we don't try to develop macro forecasts and build our portfolios on what "could" happen. Rather, to death and taxes we add our own third certainty, which is the strength of a company's balance sheet and look to that as our keystone in determining downside protection. Downside protection proved to be a luxury rather than a necessity in the year just ended, but the past can be an imperfect prologue to the future, and we subscribe to the truism that the market will tend to confound consensus and convention more often than not. We plan to stick to our knitting and look for the fundamental ingredients that stand the test of time, secure in the knowledge that the market cycle has not been repealed but agnostic in knowing the timing of that cycle.

Like that at the ready Maytag Repairman cited earlier, we expect to be poised to answer the "call" when the market moves out of the tranquil eye and into the right-front quadrant of whatever forces bear down upon us, and the investing cycle ceases to operate so smoothly.

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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