THE
LONDON
COMPANY

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To clients and friends of The London Company:

"Young man, I believe the markets will fluctuate."
- John Pierpont Morgan

Mr. Morgan shared these words over a hundred years ago to a young gentleman inquiring about the forthcoming direction of the stock market. It is a century later and his answer is as true today as it was then. The fourth quarter of 2018 was a stark reminder that things can change quickly and market fluctuations do exist. After nine years of steady gains and relative calm, we experienced a market decline this quarter that was swift and at times relentless, taking many by surprise. Although the speed and severity of it may seem abnormal, history reminds us that extreme price swings are in fact common in financial markets. This point was highlighted in the book, *The (Mis)Behavior of Markets*, by famed mathematician Benoit Mandelbrot. The inventor of fractal geometry (a concept less complicated than it sounds) discovered the science behind the why and how consistent patterns and symmetrical shapes are repeatedly found in nature and space. Yet, when he tried to rationalize the price movements of financial instruments his results weren't so clear. Not surprisingly, he observed price movements for risky assets do not adhere to a well-mannered bell curve, but a violent one that can cause extreme pain for investors. Violent and seemingly random price swings often spur fear and alarm since we are all hardwired to seek patterns in almost everything. As we look for answers and try to make sense of it all, it is unsettling to capitulate and just know that some things are unknown or even more likely, unknowable. Mandelbrot agreed and later concluded that "…bubbles and crashes are inherent to markets. They are the inevitable consequence of the human need to find patterns in the patternless."

Normal price movements, whatever we believe that to be, are really just what we are used to, so it's natural to feel angst when something new arises, particularly after a long period of familiarity. After all, it was just a little over a year ago when your Uber driver was talking about Bitcoin and the stock market was breaking records for extreme low volatility. At that time we heeded caution about those abnormalities and wrote that stability often begets instability. As we digest what is happening today, there are a host of potential explanations to point your finger towards, but the reality is there isn't just one or even a handful of precise reasons. The stock market is a complex organism with many moving parts. It is a reflection of what we see, feel and believe, meaning psychology and sentiment can be just as big of a factor as rising interest rates and trade wars. This can be particularly true in the short term.

In addition, there are other market structure factors (i.e., passive vehicles and quantitative trading) that have blossomed in the past few years that may also be exacerbating the extreme price swings which we will discuss later in this letter.

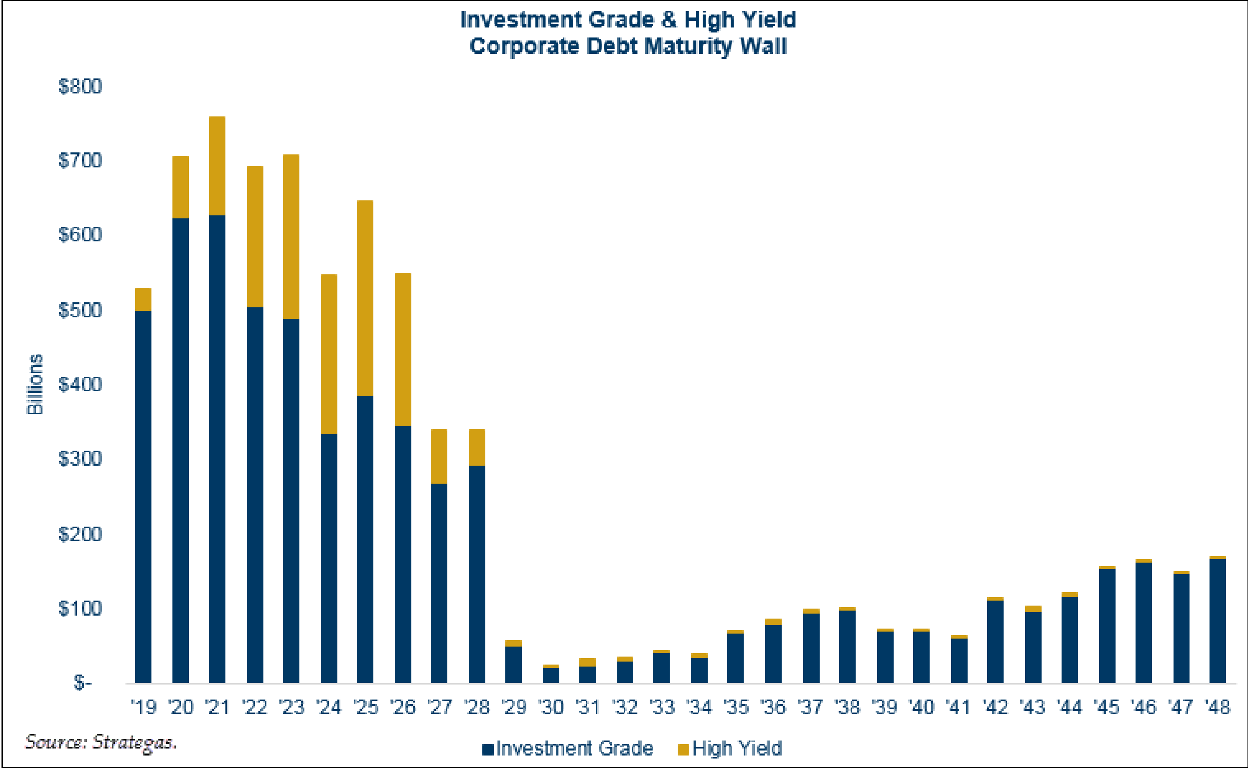
The London Company knows predicting the future is futile, so we attempt to focus our efforts on the things we can control. It is easier to sleep at night knowing what you own and why. And since our modus operandi is to assess risk before reward, we have traditionally been better prepared to handle market stress. This quarter, we repeated that past pattern as our portfolios held up better than our respective benchmarks.

So, how bad was it? The S&P 500 Index dropped 9% in December to end the fourth quarter down 13.5%. It was one of the worst final months on record and the biggest quarterly drawdown since 2008. There was a brief, intraday moment when the S&P 500 crossed that notable "20% bear market threshold," but it didn't hold so technically we remain in bull market territory (as of this writing) even if it doesn't feel that way. The Russell 2000 Small Cap Index crossed that line by finishing down 20.2% for the quarter. Our portfolios did best in the most volatile times and ended the three month period respectively ahead of the indices. Our income equity composite performed as expected, capturing roughly 75% of the market downside during the quarter. Our smid and mid cap portfolios did particularly well, capturing less than 70% while our small cap portfolio was in the mid-80's range. Finally, our large cap and concentrated portfolios finished in mid-90's range. Although the latter three portfolios relatively outperformed, they were negatively impacted more than our other strategies due to some larger weighted holdings underperforming, particularly in the consumer discretionary and industrial sectors. Overall, stock selection was positive across all portfolios for both the quarter and full year.

For the year, large caps outpaced small caps with the S&P 500 finishing down 4.4% and the Russell 2000 Index finishing down 11%. The trailing twelve months brought volatility back in vogue as stock leadership seemed to change monthly. The ending result was an odd combination of health care, utilities, and technology leading the way in 2018, an accurate reflection on the challenge of the year.

The London Company's efforts to preserve wealth lead us to invest in profitable businesses with balance sheet strength. We seek companies that generate excess cash and that are void of excess leverage. As we rehash the year and the litany of potential items that drove the late market decline (slowing economic growth, tightening monetary policy, trade wars, government shutdowns, etc.) we are keenly sensitive to avoiding those risks that are predictable. It reminds us of the Charlie Munger saying that avoiding stupidity is often easier than seeking brilliance. The Federal Reserve has raised rates nine times since 2015, and Chairman Powell doesn't appear to be as sensitive as his previous two predecessors to the market's reaction when acting. The December hike was the most recent and allowed the Fed Funds rate to finally surpass inflation (~2%), so real rates (the nominal rate less inflation)

would no longer be negative. Given the market weakness heading into the decision, the reaction to the hike was negative, pressuring stocks further and boosting 10-year treasury prices higher, reflecting increased fears that economic growth is slowing. Higher bond prices on 10-year Treasuries means longer yields retreated, flattening the yield curve and ushering in more concern about a potential recession if the curve were to fully invert (long yields lower than short yields). Whether economic growth continues or the yield curve inverts, we are being extra cautious regardless given the late innings of this credit cycle. The upcoming wave of debt refinancing is particularly perilous in a rising rate environment, and even more so when the Fed is no longer providing liquidity from buying assets. Deutsche Bank estimates more than $2 trillion of government and corporate debt will need to be refinanced in the next three years. The increased cost to the corporations that took out cheap debt when rates were historically low could be substantial. As the wall of maturities begins to hit and hundreds of billions needs to be absorbed (see below), less profitable and inconsistent cash generating companies will be negatively impacted. It's another reason why we lean towards quality and balance sheet strength. Access to credit is not a wanted obstacle when times get tough.



Source: Strategas.

The warning signs are starting to show, with a record number of debt downgrades this quarter. Goldman Sachs estimates $176bn worth of corporate bonds fell from an 'A' rating to 'BBB', a massive amount and the largest negative rerating since credit spreads widened in late 2015 due to crashing oil prices. For the past decade debt has been so cheap and available, management teams have been incentivized to borrow money and buy back stock. Some of this money was used to invest in capital expenditures and people, but much of it was used

to boost earnings growth through the repurchasing of shares and M&A activity. 2018 may end up being the biggest year on record for share buybacks, perhaps surpassing $900bn. The London Company appreciates companies returning capital to shareholders, but our preference is for buybacks to be executed either systematically or opportunistically, when management teams have a reasonable understanding that their equity is trading below fair value. Unfortunately, most management teams often face buyback decisions when flush with cash and nowhere to go. Fresh off the new tax cuts, buybacks outpaced capex for the first time since 2007, another year when those purchases ended up being poorly timed. Corporate stock buybacks have been an important accelerant to this bull market, potentially creating another unintended headwind if they were to slow or be diverted to higher interest expense as debt is refinanced.

At the beginning of the letter we discussed the potential impact passive vehicles and high frequency trading may be having on the markets. It is not a new topic, but one we have monitored and written about before. The issue is quantifying the impact that index funds and exchange traded funds (ETFs) are having on equity prices. These vehicles, often used by quantitative hedge funds and algorithmic programs are becoming the vast majority of daily trading volume. JP Morgan estimates 85% of the daily trading now is done by these operators and not fundamental, active investors. That means company fundamentals are not having as much of an influence on price discovery if the models are dictating trading. Particularly worrisome and noticeable last year is the inclusion of price momentum as a factor to determine the buy or sell trigger. Many models are built to buy or sell depending on where the momentum is moving, creating a feedback loop of itself and exacerbating both the up and down trends. It was evident in February with the popular low volatility strategies having a 28 standard deviation event that eventually bankrupted a few of these participants. A move that large is not within expectations. By definition, it is the epitome of a fat tail risk and fits into Mandelbrot's view of a violent and painful experience for investors. The models are geared for instant success, which runs opposite to our willingness to delay gratification. By sacrificing patience, you may end up with unintended events. These models may also help explain the enormous and random intraday, hour to hour changes we saw in the market this quarter.

So what can we do about it? We have become more aware of who owns our companies and flag ones that have significant passive ownership, understanding the risk of forced, indiscriminate selling. We also turn these perceived risks into opportunities. There will be dislocations of great businesses selling off more than warranted, and we still believe over the long term, despite the changing market structure, fundamentals and cash flow eventually drive returns.

Looking ahead, we are content to be patient and opportunistic. Since there are no style points in investing, we like to keep it simple and within our circle of competence. Our advantage is time, client understanding and knowing where not to fish. Sometimes that is easier said than

done and we have scars to prove past mistakes, but we are comfortable with where we sit today and like how the portfolios are positioned. Market valuations are now below their long term average for the first time in a long time, increasing our opportunity set of new ideas for the portfolios. We are especially thankful to have clients that know and understand what we are trying to accomplish. Having that longer term perspective is vital because the market has a knack for doing whatever it can to cause the most pain to the most number of people, particularly in the short term, and as we saw this period that pain can come at you fast.

We will finish with another Mandelbrot analogy. He reminds us that having greater knowledge of danger permits greater precaution. Thus, we build portfolios like a shipbuilder builds a vessel: its design is not just for the 95% of the time the weather is docile but for those days the winds blow. You need a strong hull and a tight sail because weather is unpredictable and being unprepared for the storm is a formula for disaster.

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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