THE
LONDON
COMPANY

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To clients and friends of The London Company:

"It's what it is"

- *The Irishman*

It is what it is…this short and versatile phrase can carry a lot of meaning. These words were recently spoken with an explicit understanding in Martin Scorsese's latest film, *The Irishman*. For those that have had the time and endurance to finish the Netflix movie (it's over 3.5 hours long), you know what that line means too. Without giving away any spoilers, mob boss Russ Bufalino (played by Joe Pesci) informs his muscle, Frank Sheeran (played by Robert De Niro) to pass along this dire message to his friend, Teamsters president, Jimmy Hoffa (played by Al Pacino). The message was shared in two pivotal scenes as a final warning that Jimmy's situation is now outside of his control, and that he must accept that reality, whether he likes it or not. The 'higher ups' are now calling the shots, and Hoffa, stubborn and controlling to a fault, refuses to believe it. The lack of understanding is a recurring theme throughout the movie, and the flaws found in all the main characters mostly revolve around their inability to face reality. Frank was particularly vulnerable to the lies he told himself, using his own personal delusions to justify his means.

When *it is what it is,* we acknowledge some things fall outside of our control. It is acceptance of the situation. And it means dealing with the circumstances as they exist while controlling what you can. As for how all this relates to the equity markets, it seems like we are at the point in the cycle where investors are accepting the reality that the strength and resiliency of the market *is what it is* and not much can change it. In 2019, apathy trumped uncertainty and the known risks that spooked stocks as we entered the year (China trade war, inverted yield curve, government shutdown, slow growth) became fleeting concerns. While we still have trade issues, slow growth, debt burdens and an election to form our current wall of worry, none of it seemed to matter this year as the market marched on. The 'higher ups' (namely the Federal Reserve) and other market forces overpowered any fears that could derail the party. To recap, the equity markets just ended an incredibly strong quarter, to end an incredibly strong year, to end one of the strongest decades ever, thus continuing the longest bull market in history.

The London Company has participated in and benefited from this environment. 2019 was a remarkably good year and one of our better relative performance years for a few of our strategies. That said, we end the decade cautious and recognize that now as much as ever is when we need to be our most disciplined. It is after periods of strength and the devaluation of risk when it could be easy for investors to let their guard down. So we acknowledge the

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resiliency of equities, but channel the characters of Scorsese's *The Irishman* to question the beliefs of this market and caution against any delusions that may be accepted as reality. We know better to think this time is different, so we control what we can and focus on the risks that remain present.

First, let's marvel at some market milestones. The S&P 500 Index has returned nearly 500% from where it was ten years ago, and it was the first time the index went a full decade without a bear market, never pulling back 20% on its ascent. Although we were very close at the end of 2018, the rout was stopped short in January and the S&P 500 subsequently rallied to post an impressive 31.5% return for the full year. This most recent quarter was prosperous, increasing 9.1%. The Russell 2000 Small Cap Index did well too, returning 9.9% for the fourth quarter and 25.5% for the full year. In fact, all assets classes were incredibly strong in 2019. Stocks, bonds, gold, oil, and all other commodities and nearly every index in every other country saw prices appreciate considerably.

The one commonality that helps explain the anomaly of why all assets appreciated was the increasingly generous monetary policies from the world's central banks. During the year, 67 central banks either cut rates or purchased assets to propel forward their easy monetary strategies, more than doubling the actions taken the last couple years (see chart below).

Global Central Bank Monetary Policy (2015-2019)

Year	# CBs Easing Policy	#CBs Tightening Policy	Net #	Net Policy	S&P 500 Total Return
2019	67	17	50	Easing	31.6%
2018	32	43	(11)	Tightening	-4.40%
2017	34	28	6	Easing	21.8%
2016	46	29	17	Easing	12.0%
2015	34	48	(14)	Tightening	1.4%

Source: @CharlieBilello, data via centralbanknews.info

It is likely no coincidence that equities performed best in the years of increased monetary easing. The S&P 500 had healthy double digit returns in '16, '17 and '19 compared to a flat and slightly negative returns in '15 and '18. Quantitative easing and perpetually low interest rates (or negative rates in some countries) have provided cheap capital and ample liquidity to grease the wheels of this bull market. Our Federal Reserve was particularly benevolent with three rate cuts in 2019. The policy shifted in January as they withdrew the planned 3 to 4 rate hikes just a month after the last one was poorly received, and foreshadowing that market sentiment would help dictate policy going forward. The Fed felt pressure from the markets and our President's twitter account after hiking rates in 2018 and did a 180-degree reversal, later cutting rates for the first time ever when the unemployment rate was below 4%. More recently, when the money markets saw the overnight lending rate spike in September, the Fed moved in to provide a backstop as lender of last resort. They have since increased their balance sheet by 30% in the last three months, injecting $400bn of capital and signaling they have the tools available to keep things stable. Investors have taken notice and taken advantage, using momentum and leverage to drive asset prices higher and higher.

As expected, some of the riskiest assets did best this quarter. Growth outpaced value to extend its longest stretch of outperformance since the 1930's. Cyclicality, quality, momentum and volatility factors also did well. M&A and stock buybacks were positive and helped drive multiple expansion across the board. The technology and health care sectors led while the utilities and real estate sectors lagged. Although all tides were lifted, we did see some dispersion with mega caps dominating in the large cap universe and biotech and pharma names driving the returns in the small cap space. For the S&P 500, the two largest companies were especially strong. Apple and Microsoft, the only mega caps over $1 trillion in market value, performed very well and had an outsized impact on the index return. Apple appreciated 89% and Microsoft increased 58% this year, together contributing nearly 15% of the total index return, more than the next eight largest companies combined. While fundamentals were supportive, their size in the index was also an advantage. As passive vehicles continue to gain assets, the largest weighted market cap companies get a boost. ETF's and index funds now have roughly $6 trillion in assets, so it makes sense to see this phenomenon continue. Simply not owning one or two mega cap names in an up market would make outperforming the benchmark nearly impossible. This market force is real and something that won't change until markets turn south, when the same indiscriminate buying turns into selling. To put the concentration at the top into perspective, the market capitalizations of just the top ten S&P 500 stocks are now three times larger than the entire Russell 2000 Small Cap Index for the first time since the tech bubble. It may not matter, but it's worth questioning if the overwhelming size of these companies are 100% fundamentally-based.

Speaking of small caps, this universe can be even more challenging for active managers, due to the fact that nearly 40% of the businesses in that index don't generate a profit and are being kept afloat by cheap capital. These companies are not investable for us but resumed leadership in Q4, and have valuations that are often disconnected from fundamentals, also partly due to passive vehicles. Biotech was the big winner for the index this past quarter, driving returns for the health care sector. According to our friends at Furey Research, Q4 was the narrowest market for small caps in 30 years. The Russell 2000 was up 10% this quarter but only three sectors beat the index return. The health care sector weight is 17% of the benchmark but it contributed 36% of the total index's performance, creating a significant headwind for investors like us not exposed to those companies.

The London Company portfolios performed as expected this quarter and mostly lagged the late market rally. Our Income Equity strategy did beat the Russell 1000 Value Index this quarter but was slightly behind the S&P 500. All of our other strategies trailed their respective benchmarks during the period. Fortunately, stock selection was very positive earlier in the year and most of our portfolios were able to offset this quarter to finish ahead of the benchmarks for the calendar year. Our Income Equity portfolio outpaced the value index and captured 90% of the S&P for the full twelve months. Our Small Cap, SMID and Mid Cap portfolios performed particularly well, perhaps even better than we would have thought. It isn't our expectation to outpace 25% and 30% index returns, but good stock selection, well-executed trades and a portfolio construction process that allows meaningful positions to contribute helped the products outperform this year. Mid Cap was the best

performing portfolio this year, on both an absolute and relative basis, as it continues to benefit from owning great businesses run by fantastic management teams. Only our Large Cap product did not perform as well as we expected, capturing 78% of the upside as a couple specific positions dragged that portfolio down relative to the others. Overall, we are very satisfied with our positioning and opportunity set. The operating metrics of our portfolio companies remain favorable with a strong quality bent, as seen through superior returns on capital and healthier balance sheets.

Those aforementioned metrics are very important to us and encapsulate our philosophy of preserving capital. We would be delusional to think markets will never go down again. It is a matter of when not if, so we must be prepared for that day to come. The trigger could be a credit issue, geopolitical concerns, or the 2020 election. Regardless, we borrow a line from Michael Lewitt, who writes *The Credit Strategist*, "it's not what you earn…it's what you keep." He has posted the same charts in his annual deck the past two years, reminding everyone that the average peak to trough at the end of a bull market is a 51% decline. It may not be imminent nor that severe next time, but there will be a time again when fear displaces greed. The most predictable risk is the credit one. The U.S. has added $11 trillion of debt this decade compared to $7 trillion of GDP. That is a dollar and a half of debt to every dollar of GDP growth. Debt at the corporate and sovereign levels have exploded and will be a challenge to service even if rates stay permanently low. Global debt is now over $250 trillion, a whopping 330% of global GDP. Negative rates in Europe have not yet been the answer, and our country is still running a trillion-dollar deficit without much market pushback. Corporations continue to borrow and repurchase shares, absorbing another $700bn in 2019. How central banks de-risk this debt burden will have a large impact on future returns. Asset prices and market stability have benefited this decade from cheap debt, stock buybacks and passive influences, but it's when the music stops and these forces revert that makes us wonder how the markets will respond.

In summary, we understand the market can be driven by non-fundamental factors far longer than we could imagine, yet simultaneously know things can change at a moment's notice too. It is this fear that keeps us positioned to participate but also to protect. Our objective is to assess risk before reward and simply focus on the things we can control. We can't fight the Fed and we can't predict what will happen next, but we remain patient and disciplined to our process. The market *is what it is*, but our long term success depends on us sticking to what we know how to do.

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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