THE
LONDON
COMPANY

January 11, 2021

To clients and friends of The London Company:

*"In the business world, the rearview mirror is always clearer than the windshield"*
*– Warren Buffett*

Buffett often has captured the essence of big investing trends and truisms in simple and succinct turns of phrase. It has been one of the reasons his tenets of investing have reached such a wide and varied audience of investors for so long. His use of the images of looking back and looking forward from the driver's vantage point likely resonate with many of us as we conclude 2020 and move ahead into 2021. A yearend letter by design attempts to look back at what has transpired over the past 12 months and put some important context around those events. After the tumultuous series of events that clearly defined 2020, the prevailing sentiment is a sense of collective relief that we now are leaving last year in the rearview mirror. Certainly the defining feature of 2020 was the unfathomable impact and consequences brought about by the worldwide COVID-19 pandemic. Everyone is keenly aware of the horrific loss and disruption caused by its spread, we need not revisit that in our letter. However, cognizant that, like us, so many of you have been touched by COVID's many and far-reaching tentacles, we want to extend our sincere hopes that you and your families and loved ones remain safe and resilient during this period.

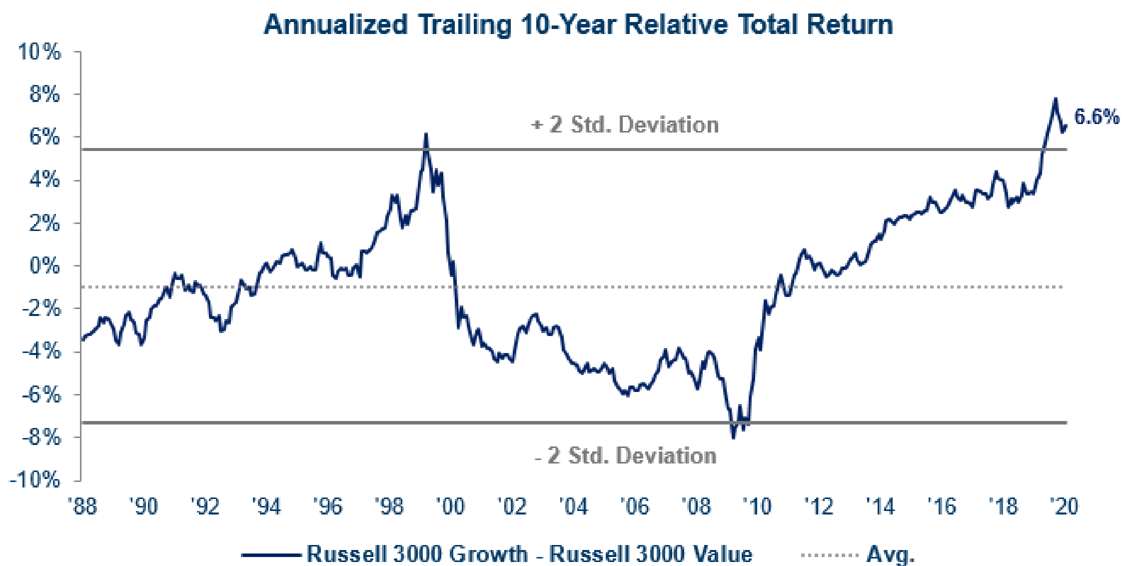
It would take a jumbotron rather than a rearview mirror to capture and display all of the roadside attractions that we encountered over the past 12 months, so we will attempt to focus on those key points that most moved the dial. This time a year ago, we were reflecting upon strong 2019 asset class returns across the board. The S&P 500 enjoyed a 30%+ gain to cap off a decade of prosperity, leaving many investors to question how long could this continue? The response in our letter at that time was "*it is what it is*" which we explained as follows. "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."

For January and the first half of February, that proved to be the case as the markets pushed on to higher highs, extending the longest bull market in history. In the backdrop, however, COVID emerged from the shadows in a distant Chinese province and became that agent of change that eclipsed our investment reality, turning it into "*it was what it was*." From the

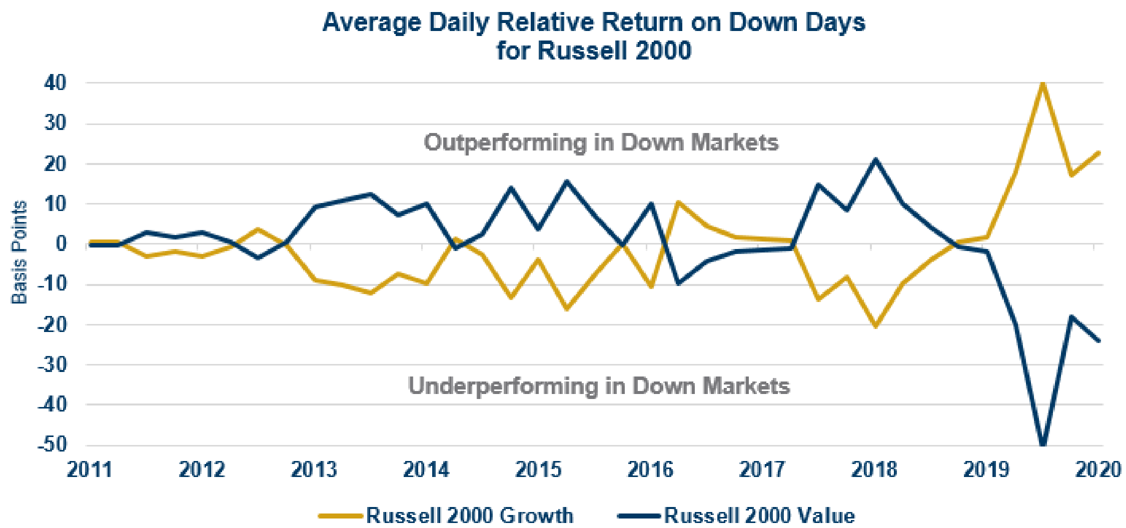
804.775.0317 TEL 804.649.9447 FAX www.tlcadvisory.com 1800 Bayberry Court, Suite 301, Richmond, Virginia 23226

market top on February 19th, we experienced twin societal and financial panics that precipitated not only the end to the longest bull market in history but also the fastest bear market in history! For anyone who has endured Disney's Tower of Terror ride, the 16 day market freefall until the S&P 500 hit bottom on March 23 made the Disney experience tame by comparison. Among the many other records that were broken in the first quarter, the Russell 2000 suffered its worst quarter in history (down 30.6%) while US government 10 year bond yields cracked the 1% barrier, representing 150 year lows.

Several important developments came out of this market/economic shock that shaped the investment landscape for the remainder of the year. First, growth both extended its decade-long stylistic leadership in a rising market, but also then played superior defense during the meltdown, an outcome contrary to history. Interestingly, growth stocks outperformed uniformly well across the capitalization spectrum from small to large. This unexpected turn of events reflected investor's belief that the technology-heavy representation in the growth benchmarks would be better positioned for an unprecedented environment in which the bricks and mortar economy essentially shut down overnight and migrated to an online/virtual/hybrid world. In the larger capitalization area of the market, this pivot further exacerbated an existing trend toward the small handful of FAANG names, which already had become outsized weightings in the benchmark. With the top 5 names constituting over 20% of the benchmark and delivering absolutely stellar returns, we witnessed a material skewing in the benchmark's overall performance due to this top-heavy concentration, beyond what occurred leading up to the top of the internet bubble period. In the small cap realm, it was more form over substance as the fundamental and financial profiles of many growth constituents simply did not support the defensiveness they delivered. Small cap growth stood precedent on its head by creating more alpha when going down than when going up. In the following two exhibits, we underscore this dominance of growth and its newfound protector of downside that has persisted for much of the year:



*Source: Strategas*



*Source: Furey Research*

The second takeaway from the pandemic's intrusion into our everyday existence was the crystallization of the vast ideological divide between the Democratic and Republican parties in a Presidential election year. Although the two parties long have shared little to no common ground, the questions of how to deal with COVID and with a shell-shocked economy became the twin polarizing issues surrounding one of the most contentious elections in our nation's history. After months of rancor and pointed jousting, the election ultimately was decided in favor of challenger Biden, although his victory remains a point of bitter dispute and in some quarters a refusal to accept the Electoral College results. In a year of unprecedented events, almost everything about our Presidential election channeled us into unchartered waters. The uncertainty from the political election process clearly created recurring headline risk and posed an overhang to the market, yet not one that shackled equities. From the March lows, the "V" (or "K") shaped recovery across much of our economy was emulated by a "V" shaped rebound in stocks. By June the S&P 500 had recouped all of its losses and regained positive ground, and leadership largely reverted back to what we had been seeing. The Biden victory did however spark a dramatic shift within the market leadership post-election and altered the market narrative during the fourth quarter. We will visit this last point shortly as we discuss how our portfolios performed in 2020.

The third major consequence of the pandemic enshrouding the economy in a fog of uncertainty came from the rapid deployment of fiscal and monetary policy responses. Cognizant that economic shutdown would add devastating financial harm atop health and societal calamity for millions of Americans, Congress opened the stimulus floodgates while the Fed unleashed its own torrent of liquidity. While the stimulus bills may have been passed with many imperfections, the sheer size delivered a blunt force economic jolt to counteract the panic and light a path forward. Similarly, the Fed was able to call upon its playbook from the Great Financial Crisis and provide a calming beacon to the frazzled financial markets. Thus far, the fiscal and monetary support that has been provided has been staggering but effective. If one were to total the initial and subsequent stimulus bills, inclusive of the $900B

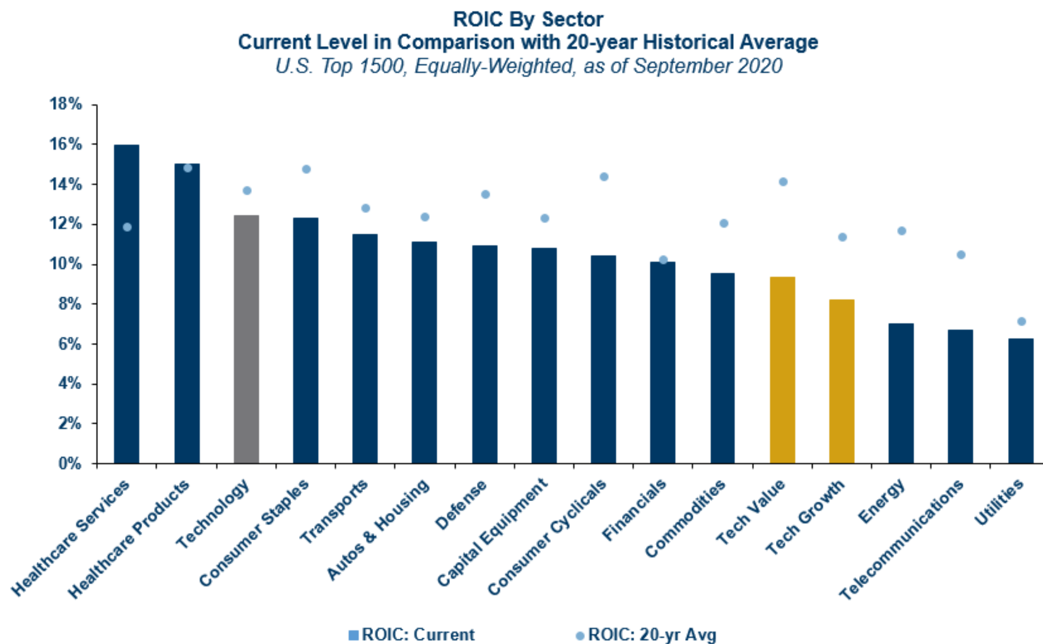
bill that was just passed in December, it is estimated that over the next two years approximately 8% of GDP will have been injected into our economy. Not to be outdone on magnitude, the Fed in total has increased the size of its balance sheet by 75% in 2020 and grown money supply year over year by 25%, astounding increases in liquidity aimed at keeping interest rates low for the time being and facilitating economic recovery. While these actions were and are intended to be bridges that carry the economy until such time that vaccines become widely available, and complement other initiatives to flatten the pandemic's still-worsening spread, they clearly succeeded in turning a market rout in March into another very strong year in the equity markets.

While 2020 will go into the record books as a terrific year for growth, the records set during the fourth quarter will relate to the incredible comeback staged by value and small cap stocks. As we discussed in our third quarter letter, the large cap rebound had yet to trickle down to small caps, with the Russell 1000 up 6.4% for nine months while the Russell 2000 was in negative territory, down (8.7%). We noted the atypical dispersion of those returns so late in a calendar year. Also, the performance spread between growth and value remained at record levels across the capitalization spectrum. Against this backdrop our portfolios performed well both in the third quarter and at the nine month mark vs our benchmarks. Our larger cap strategies were performing strongly relative to the value benchmarks, but were not able to keep pace with the FAANG stock effect embedded in the core market benchmarks.

Needless to say, with that set up, and the confluence of fresh catalysts—encouraging economic data, massive stimulus, multiple COVID vaccines fast-tracking to FDA approval, renewed investor appetite for risk, and the election outcome—the table was set for major mean reversion. To wit, large cap stocks, as measured by the Russell 1000 Index, rose around 13.7% for the quarter. Mid Cap stocks, as measured by the Russell Mid Cap Index rose 19.9%, while the Russell 2000 skyrocketed 31.3%. For the Russell 2000, that return was the best quarterly showing in its history, an amazing bookend to its worst ever quarterly return just nine months earlier. The value benchmarks did even better. High beta, low quality, weak balance sheets, cyclically-exposed and industries left for dead by pandemic disruption led the revival. Valuation and profitability were disregarded factors during the period. For The London Company, it was a quarter that rewarded just about everything we don't subscribe to and punished the essence of what we do value in our portfolio holdings. For example, one of the attributes that we most covet is superior return on invested capital (ROIC). It has served us well over the long term and is core to our stock selection process. ROIC compensates investors for the efficient use of capital by a company's management. Looking at how the top quintile of ROIC companies performed vs the worst, here is the 2020 roadmap and how its relative performance collapsed during the quarter:

*Source: Cornerstone Macro*

Our pursuit of superior ROIC and strong balance sheets in our investments naturally leads us toward and away from different market sectors depending upon the opportunity set. The following table compares ROIC trends by sector, and aligns with our beliefs on how portfolios should be constructed. We introduced this visual last quarter but want to include it again to emphasize why we weren't positioned to capture the value ricochet in the latest quarter. The value sectors have tended to have lower and declining ROIC over time and while they can enjoy periods of outstanding returns, that outperformance is predicated upon sustained profit recoveries that tend to get discounted in the market well in advance of actual bottom-line improvement. Implicit in a value-based approach is the ability to correctly forecast both at a macroeconomic and industry level, and a similar ability to time the entry and exit of the positions. These are investing skills we do not consider within our bailiwick.




*Source: AllianceBernstein*

We really don't expect to keep up with our benchmarks when short term returns are as robust as witnessed in the last quarter. Generally in up markets, we would expect to capture 80-85% of the upside and insulate those gains during drawdowns. Over market cycles, that pattern of performance has built our record of favorable risk-adjusted returns. Clearly our expectations are not achieved every quarter. Last quarter, our upside capture ranged from below 50% to a touch above 70%, with only our Small Cap portfolio achieving better than 80% capture. The quarter's impact served to decouple our relative annual results versus core benchmarks leaving us behind in all of our strategies for the year. At the same time, we still compared quite favorably versus the value benchmarks for all of 2020. While disappointed by the degree of underperformance in q4, we remind ourselves and our readers that it represents a short time interval and does not in any way invalidate our longer term strategy. As we review the factors and attributes and types of businesses that drove the powerful quarterly rally, we are not really surprised that our comparative performance was weak.

Shifting from the rearview mirror to what appears before us out the windshield, there is no imminent turn in the road that changes the investment landscape nor provides great clarity. As was the case in 2020, controlling the COVID pandemic and fully re-opening the global economy are still the dominant issues facing investors. The transition to a Democratic administration should usher in broad policy reprioritization, but the slim majority it will hold in Congress could restrain some of the more controversial agenda ambitions. With an accommodative Fed and the tailwind of stimulus still wending its way through the economy, most investors are feeling more confident about the prospects for an acceleration in GDP and corporate profits. While the yearend surge in COVID has dampened some of the recent progress, reports on jobs and manufacturing orders and activity are supportive. The private sector has done an impressive job of coping with and adapting to the COVID world, which has translated into better than expected earnings and forward guidance.

Investors increasingly are willing to ratchet up risk tolerances as they look through what is still a devastating pandemic and a slower than promised rollout of the vaccination program. Much of this optimism is predicated on vaccines becoming widely available and accepted as an effective frontline defense against the pandemic. The premise is straightforward but the timeline and outcome less so. We are seeing the manifestation of risk appetite in many ways. The rotation to financially weaker and still unprofitable high beta companies can only be further rewarded if economic improvement and earnings improvement can be sustained, especially since the tailwind from fiscal and monetary stimuli are intended to be stopgap measures. 2020 was a year of record IPO activity, and unusually, one in which that unseasoned and unprofitable cohort outperformed. While money continued to flow out of traditional equity mutual funds, ETFs continued to garner significant inflows. We have commented on numerous occasions about the effects and distortions that passive and programmatic trading have had upon the market. This trend remained in force but was augmented by a new source of incremental impact: the return of the retail investor. After years of dormancy, individual investors used the pandemic lockdown as an impetus to open brokerage accounts. According to a December article in the *Wall Street Journal*, over 10 million new brokerage accounts were opened during 2020, and as much as 40% of those were

established on the Robinhood platform. We are not experts on Robinhood but widespread anecdotal evidence suggests a speculative bent to these new participants. This trading activity is reported to have averaged 20% of total daily volumes, and as much as 25% on peak trading days, enough to move the dial in the market.

We respect Buffett's caution about assuming too much clarity out the windshield view, so are not inclined to make fearless forecasts about the year ahead. However we do find the historical evidence instructive about forward market behaviors following periods of major gains over short time periods. The nine months from the March low produced an eye-popping 65.8% rally, one of three instances in which returns exceeded 60%. As the table below illustrates, following those bursts, forward returns tended to be muted, and we should not be surprised by potential double digit drawdowns in the ensuing 18 months:

| S&P 500 Performance +9 Months Off Lows & Next 9 Months | | | |
|---|---|---|---|
| **S&P 500 Low Date** | **+9 Months Off Low** | **Next +9 Months** | **Max Drawdown Months 10 to 18** |
| 10/22/1957 | 19.1% | 24.4% | -4.4% |
| 6/26/1962 | 26.9% | 11.9% | -6.5% |
| 10/7/1966 | 25.3% | 1.7% | -10.1% |
| 5/26/1970 | 39.6% | -5.3% | -13.9% |
| 10/3/1974 | 51.5% | 8.4% | -14.1% |
| 8/12/1982 | 60.4% | -4.8% | -10.1% |
| 12/4/1987 | 18.1% | 23.1% | -7.4% |
| 10/11/1990 | 27.6% | 7.2% | -6.8% |
| 10/9/2002 | 29.0% | 13.7% | -6.6% |
| 3/9/2009 | 62.0% | 0.8% | -17.1% |
| 3/23/2020 | 65.8% | ? | ? |
| | **Average** | **8.10%** | **-9.70%** |

*Source: Strategas*

Whether past is prologue to future this time out remains to be seen. On the one hand, equity valuations are on the rich side, having been beneficiaries of material multiple expansion over the past two years. On the other hand, many companies stockpiled cash over the course of the past year and cash within S&P500 companies is very high. In an improving economy, the outlook for that cash to be returned to shareholders is promising, especially with regard to dividends. Despite all of last year's distress and 42 dividend suspensions, total S&P 500 dividends actually edged up slightly on a year over year basis. More optionality with respect to capital allocation is a favorable scenario for us and one we will continue to seek along with high profitability, strong ROICs, and solid balance sheets. While we experience periods where growth passes us on one side, and other periods where value can pass us on the other side, we choose to stay within our lane and adhere to our approach and not become distracted in our journey forward.

As always, we appreciate and value highly the trust you have placed in us.

Best regards,

The London Company

**Important Disclosures:**
Past performance is no guarantee of future results. This report is for informational purposes only. The statements contained herein are solely based upon the opinions of The London Company and the data available at the time of publication of this report, and there is no assurance that any predicted results will actually occur. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell any specific securities and should not be considered investment advice of any kind. In making an investment decision, individuals should utilize other information sources and the advice of their investment advisor. All data references are as of December 31, 2020 unless noted otherwise.

The London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies, fees and objectives, are fully described in the firm's Form ADV Part 2, which is available by calling (804) 775-0317, or can be found by visiting www.tlcadvisory.com.

LCO-20-400