Income Equity

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US stocks posted mid to high single digit gains during Q2. Solid economic data and improving corporate earnings were positives, partially offset by concerns about rising inflation, the timing of potential changes to monetary policy from the Fed, and the possibility of future tax increases. Growth outperformed Value across the market cap spectrum except in the Small Cap space. For the most part, cyclical sectors outperformed defensive, though it was mixed among mid and Large Cap stocks. With regard to factors driving performance during Q2, the dynamics weren't linear down the market cap spectrum. Amid Large Cap stocks, Growth and Quality factors had the most positive impact on relative performance, while Value factors had a negative impact. Amid Mid and Small Cap stocks, Volatility and Yield had the most positive impact, while the remaining factors produced mixed results.

Key Performance Takeaways for the Quarter

- The London Company Income Equity portfolio returned 7.1% gross (7.0% net) during the quarter vs. a 8.6% increase in the S&P 500. Both sector exposure and stock selection were headwinds to relative performance.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Underweight Cons. Discretionary (a weaker performing sector) & overweight Real Estate (a better performing sectors)
  - *What Hurt*: Underweight Info. Technology (a better performing sector) & overweight Cons. Staples (a weaker performing sector)
- The Income Equity portfolio outperformed the Value Index, but lagged the S&P 500 in Q2 amid a resurgence in growth factors. While we are pleased with absolute performance, the more defensive portfolio didn't keep up with the strong rally in Q2. Given the robust return environment, the strategy performed as we would expect and our year-to-date results are in line with our expectations of 85-90% upside participation in a rising market.

Top 3 Contributors to Relative Performance

- **United Parcel Service (UPS)** – UPS got a strong lift following an earnings report that showed a continuation of very strong volumes due to accelerated e-commerce sales and growing strength of Asian exports. Margins improved in line with the new CEO's plan to focus on profitability and return on capital. UPS is optimizing its business model to adjust to the current environment, while implementing a dynamic pricing model.
- **Target (TGT)** – TGT reported 1Q numbers well above expectations, highlighted by 23% comparable store sales growth and 5x EBIT growth. Despite an estimated $5B in market share gains during the pandemic, we believe TGT can maintain customers and continue to gain share in the future. The omni-channel offerings provide consumers with an easy shopping experience and TGT owned brands are resonating with shoppers. TGT increased its dividend by 30% in Q2.
- **BlackRock (BLK)** – BLK continues to benefit from positive equity market performance and is executing well internally. BLK reported Q1 earnings above expectations with strong base fee growth and margin expansion. We view BLK as a very well-run company with a widening moat, and we remain confident in the long-term compounding potential of the business.

Top 3 Detractors from Relative Performance

- **Intel (INTC)** – INTC declined 12% in Q2 reflecting recent weakness in its datacenter business driven by supply chain issues as well as company specific chip delays. INTC continues to struggle with a technology transition; however, we believe new CEO Pat Gelsinger is up to the task and that a lot of bad news is already priced into shares. We remain drawn to INTC's attractive valuation, strong balance sheet, and consistent cash flow generation.
- **Dominion Energy (D) –** D underperformed along with the utilities sector. 1Q results were largely as expected and we are not concerned about the fundamentals of the business. We view D's primarily regulated model and well-covered dividend as solid sources of downside protection.
- **Norfolk Southern (NSC)** – NSC shares were flat in Q2. After a strong run in Q1 resulted in elevated valuations, transportation stocks went out of favor in the middle of Q2. Strong volumes continue to be driven by intermodal, building products, and autos. We remain attracted to NSC's solid network, its long runway for margin improvement, and strong management team.

Trades During the Quarter

- **Exited: Coca Cola (KO)** – Sale reflects elevated valuation and concerns about possible long-term growth headwinds.
- **Reduced: Berkshire Hathaway (BRK.B)** – Reduced on recent strength, but remain confident in the long-term outlook. BRK.B is also the only portfolio holding that does not pay a dividend.
- **Initiated: Progressive (PGR)** – PGR is an insurance holding company, which engages in personal & commercial auto, residential property, and other specialty property-casualty insurance and services. PGR's strong brand and conservative underwriting philosophy give it a wide moat. It generates significant cash flow and its ROE (+20% vs industry 10%) is higher than the competition because of its direct and digital strategy, data and analytics. PGR is able to gain share and benefit from competitors' more erratic pricing strategies. PGR maintains a strong balance sheet, pays a variable dividend, and trades below its long-term average price/book ratio.

Looking Ahead

We maintain a positive view on the US economy and expect strong real GDP growth in 2021. Nearly half of the population has been vaccinated, and most of the economy has re-opened. The US consumer is in great shape along with the manufacturing and services segments of the economy. Fiscal and monetary policy should continue to be accommodative in the near-term. Despite the positives, we recognize that risks remain. Inflation concerns, talk of tax hikes, elevated equity valuations, some fiscal stimulus rolling off, and a more reactive Fed are noteworthy factors looming over markets. While we believe fundamental conditions remain positive, we note a confluence of market concerns could lead to increased volatility and more muted returns for equities in the near term. As we look at the characteristics of our portfolios today, the positioning is the best it's been in a number of years. Returns on capital and balance sheet strength continue to be very healthy. Given the level of quality, it is abnormal to see our portfolios trade at such attractive valuations relative to the respective benchmarks. We believe this will serve us well for both near-term volatility and long-term durability.

Q2 | 2021

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Performance

As of June 30, 2021

	QTD	YTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
Income Equity (Gross)	7.1	14.6	35.3	16.5	13.2	13.6	9.9
Income Equity (Net)	7.0	14.4	34.8	16.0	12.8	13.1	9.2
S&P 500	8.6	15.3	40.8	18.7	17.7	14.8	7.2

Inception date: 12/31/1999

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Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending June 30, 2021. The characteristics discussed herein relate to a representative account, and not every client's account will have these exact characteristics. As London manages its client portfolios according to each client's specific investment needs and circumstances, London cannot affirm that the characteristics of the account shown are similar to all accounts participating in the strategy. This is due in part to the timing of trades by the Adviser, market conditions, cash availability, and the timing of client deposits and withdrawals. Therefore, prospective clients should not assume that similar performance results to those shown would have been achieved for their accounts had they been invested in the strategy during the period. None of the information contained herein should be construed as an offer to buy or sell securities, or as investment recommendations. An investment in a London Company strategy is subject to risks, including the loss of principal.

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Composite Creation/ Inception Date: December 31,1999

Composite Definition: The Income Equity strategy invests mainly in common equities with a focus on higher overall dividend yield orientation, which may be supplemented with primarily investment grade, preferred equities. This strategy has a more conservative orientation, with a focus on capital preservation, income and growth, in order to provide greater yield and downside protection relative to our Large and Mid Cap strategies. Our Income Equity strategy is designed to generate above-average, absolute returns over full market cycles. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with no minimum dollar amount of assets. The product is measured against the Russell 1000 Value Index and has a creation and inception date of December 31, 1999. There is no use of leverage, derivatives or short positions. All actual fee-paying discretionary portfolios are included in one or more composites that have been managed for a full calendar quarter with limited restrictions and similar objectives. Composite may include accounts under dual contract.

Benchmark Description: The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. Benchmark returns are not covered by the report of independent verifiers. The Income Equity product is typically compared to the Russell 1000 Value Index. Any comparison to the Russell 1000, S&P 500, or their corresponding ETFs, is for illustrative purposes only.

Performance and Fees: Gross of fee returns are calculated gross of management and custodian fees and net of transaction costs. Net of fee returns are calculated net of actual management fees and transaction costs and gross of custodian and other fees. Returns may be net of miscellaneous fund expenses. The gross figures do not reflect the deduction of investment advisory fees. For example, an account that earned 15% per year for 10 years would have an accumulated return of 305% before fees and 270% after fees, assuming a 1% fee. Returns are calculated and stated in US dollars. Returns are calculated gross of withholding taxes on foreign dividends and interest. Dividends are reinvested. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

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