Q3 | 2021

Income Equity

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US stocks posted roughly flat returns during Q3. Despite the spread of the COVID-19 Delta variant, the market rallied for the first two months of the quarter, following solid economic data. However, September was a difficult month for stocks reflecting concerns around potential changes in monetary policy, persistent supply chain issues resulting in higher inflation, and some political drama. The weak September resulted in slightly negative returns for much of the market for Q3. Large Cap indexes held up better than Small Cap. Growth modestly outperformed Value in the Large and Mid Cap space, while Value outperformed in the Small Cap arena. Defensive stocks outperformed the more cyclical shares across the board. Turning to factors, Growth, Quality, and Momentum factors had the most positive impact on relative performance, while Value and Volatility factors had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Income Equity portfolio declined -2.3% gross (-2.4% net) during the quarter vs. a -0.8% decrease in the Russell 1000 Value. 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 Materials & Industrials (two weaker performing sectors)
  - *What Hurt*: Underweight Financials (a better performing sector) & overweight Info. Technology (a weaker performing sector)
- While Quality factors outperformed during Q3, the impact was somewhat masked in the large cap space. Higher quality stocks actually saw much of their Q3 relative performance gains erased in September. The atypical September selloff was unlike normal pullbacks in that riskier equities (higher beta & lower quality) outperformed in the final weeks. Additionally, rising yields led to outperformance of the Financials sector, which includes many banks. The four largest banks represent 7.5% of the Index and each outperformed in Q3. The atypical selloff and our lack of banking exposure were headwinds to relative performance for the Income Equity portfolio. Importantly, the portfolio characteristics are very attractive vs. the broader market and we remain very confident in each holding.

Top 3 Contributors to Relative Performance

- **Lowe's (LOW)** – LOW's shares rose 5% during Q3 driven by strength in sales (same store sales up over 30% over the last 2 years). LOW continues to benefit from DIY spending and remodeling activity from the Pro customer. Operating leverage has improved and we remain attracted to management's plans to improve margins while efficiently allocating capital.
- **Microsoft (MSFT)** – MSFT reported a very strong quarter and demonstrated that it has one of the best positions in large cap tech. The cloud business remains very strong in terms of financial impact and visibility. While the equity is not inexpensive, MSFT has one of the best growth profiles in its sector and should be able to sustain double-digit growth for several years with the backing of a first-class management team and fortress balance sheet.
- **Apple (AAPL)** – AAPL reported a very strong quarter that greatly exceeded expectations. AAPL's ecosystem is as strong as ever; evidence can be seen in units, installed base, revenue, margins, cash flow, and engagement. Management did point to supply chain issues that could limit growth for the remainder of the year. Cash flow was strong, up 30%, and the board used the opportunity to grow the dividend by 5% and spend on share buybacks that drove the share count down -4%. AAPL ended the quarter with $52B net cash. We believe there is room to accelerate the buyback pace given the increasing cash flow.

Top 3 Detractors from Relative Performance

- **United Parcel Service (UPS)** – UPS reported strong quarterly results that were overshadowed by guidance that suggests deceleration in the back half of the year. Perception, however, is being clouded by tough comparisons and the timing of some expenses. We believe that under new leadership the company will continue to improve, as well as meet the strong demand for package and freight delivery into peak season with ease. Strong cash flow YTD allowed UPS to hit its debt reduction targets early, and the board announced a $5B share repurchase plan.
- **Nintendo (NTDOY)** – Shares of NTDOY struggled in Q3 and YTD. We believe the underperformance reflects concern that NTDOY may not be able to elongate the hardware cycle as planned and that margins will decline. We note continuous improvements from NTDOY in recent months that reflect efforts to elongate the hardware cycle, monetize intellectual property, and improve corporate governance. Additionally, NTDOY has paid out a special dividend and repurchased1.5% of shares outstanding. We also believe NTDOY trades at a significant discount to our estimate of intrinsic value.
- **Crown Castle (CCI)** – Recent quarterly results from CCI were below expectations due to timing of activity in both the tower and small cell businesses. The tower business continues to be resilient as carriers are still spending money to enhance networks, but CCI did not increase organic tower growth, which impacted the stock. Recent insider activity was positive giving us additional confidence in the business. We believe CCI is well positioned for future growth and remain attracted to its highly visible, stable revenue stream based on long term contracts.

Trades During the Quarter

- **Exited: Organon & Co. (OGN)** – Sold the small position that was a spin-off of Merck's women's health & generics business.

Looking Ahead

We maintain a positive view on the US economy and expect strong real GDP growth in 2021, but note the rate of growth in the second half of the year will likely decelerate vs. the first half. The US consumer is in great shape and labor markets continue to improve. Separately, the manufacturing and services segments of the economy are firmly in expansionary territory. That said, the Delta variant remains a potential risk. Further, fiscal stimulus will likely start to wane and the Fed will likely begin to reverse some of its accommodative monetary policies later this year and into 2022. This could lead to slower growth in 2022. In terms of equities, we recognize valuations are on the rich side. At current valuations along with various short-term risks to the economic outlook (e.g. rising inflation & potential tax increases), we expect greater volatility and possibly more muted returns in the near term. Longer term, we continue to believe quality attributes and solid company fundamentals will lead to strong risk adjusted returns over time.

Past performance should not be taken as a guarantee of future results.

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Performance

As of September 30, 2021

	QTD	YTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
Income Equity (Gross)	-2.3	11.9	20.5	12.0	12.7	14.1	9.6
Income Equity (Net)	-2.4	11.6	20.0	11.6	12.2	13.6	9.0
Russell 1000 Value	-0.8	16.1	35.0	10.1	10.9	13.5	7.3

Inception date: 12/31/1999

Contact information

The London Company
of Virginia, LLC
1800 Bayberry Court, Suite 301
Richmond, VA 23226

T 804.709.1244
F 804.649.9447
info@TLCAdvisory.com
www.TLCAdvisory.com

Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending September 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.

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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