Q1 | 2022

SMID Cap

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US equities traded lower during Q1 reflecting concerns about higher inflation, a shift toward tighter monetary policy, and the war in Ukraine. There are increasing signs of decelerating growth as high inflation is limiting purchasing power. The Federal Reserve increased the fed funds rate and plans to begin tapering its balance sheet; moreover, it is expected to be more aggressive with monetary policy, given elevated inflation and low unemployment. All of the major indexes traded lower, but Large Cap held up best. The Value indexes significantly outperformed the Growth. In general, cyclical sectors outperformed the more defensive. In terms of market factors that drove performance, Value, Yield, and Momentum had a positive impact on relative returns. Growth and Quality were mixed, and Volatility factors had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Small-Mid Cap portfolio declined -11.0% gross (-11.1% net) during the quarter vs. a -1.5% decrease in the Russell 2500 Value Index. 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*: Overweight Materials (a better performing sector) & Underweight Healthcare (a weaker performing sector)
  - *What Hurt*: Underweight Energy (the best performing sector) & overweight Cons. Discretionary (the weakest performing sector)
- After outperforming during Q4'21, the SMID portfolio lagged our expectations during Q1'22. No exposure to the Energy sector, few deep value holdings, and a handful of individual stocks drove the underperformance. While some of the stocks were down over the short period, we believe the fundamentals of the businesses are in good shape, and those companies should compound high returns on capital in the years ahead. If the market downturn were to extend beyond a quarter, we believe investors will focus more on higher quality factors like return on capital, consistency of cash flow, and balance sheet flexibility.

Top 3 Contributors to Relative Performance

- **Alleghany (Y)** – During Q1, Y rallied 25% after it announced it will be acquired by Berkshire Hathaway in an all cash deal valuing Y at roughly $11.6B. The deal's expected to close in Q4.
- **Jack Henry (JKHY)** – JKHY outperformed in Q1 due to better than expected quarterly results and momentum in core business wins. JKHY is benefiting from an acceleration in technology investments at financial institutions and customers converting to its cloud business. All three segments are performing above expectations, and margins are expanding with additional scale.
- **Hanover Insurance (THG)** – Like other insurance companies, THG received a significant boost from the market's expectation for higher interest rates as high inflation persists. Furthermore, THG delivered solid quarterly results with their 4Q21 earnings.

Top 3 Detractors from Relative Performance

- **Black Knight (BKI)** – Concerns about rising mortgage rates and the potential impact on housing negatively impacted BKI. Most of BKI's revenue comes from servicing current mortgages, not originations, but rate fears can still impact the stock in the near term. BKI also purchased additional shares in a company called Optimal Blue. The move may have suggested a conflict of interest on the part of Bill Foley, who holds considerable sway over both sides of the transaction. We still like the stickiness of BKI's revenues as well as their growth prospects.
- **Hayward Holdings (HAYW)** – HAYW lagged in Q1 following investor concerns about inflation as well as rising rates and the impact on housing related spending. This despite HAYW reporting core sales up 35%, a healthy backlog, and margin expansion. We remain attracted to the consolidated industry, visibility of aftermarket sales, and HAYW's competitive moat.
- **Deckers Outdoor (DECK)** – DECK was pressured alongside other retail peers in Q1 given heightened fears of inflation and supply chain issues. However, we believe these near-term headwinds overshadow a business that is getting better.

Trades During the Quarter

- **Exited: Copart (CPRT)** – Final sale of remaining position due to market capitalization, which is roughly $30B.
- **Reduced: Martin Marietta (MLM)** – Reduced due to market capitalization, which is roughly $24B.
- **Initiated: Cable One (CABO)** – CABO provides internet, video, and phone services to residential and business customers, but is primarily focused on high speed broadband connectivity in rural markets with limited competition and/or inferior DSL technology. The quality of CABO's network allows them to deploy faster residential internet speeds than most of their competitors, and CABO has ample unused network capacity, providing runway for increases in customer data consumption over time. CABO's commercial business is attractive and a great growth opportunity, with sticky client relationships and higher prices than residential. We believe CABO is an excellent broadband operator with superior profitability than its peers. Its utility-like service offers great defensive characteristics; meanwhile, it has a very attractive growth profile, consistent cash flow generation and strong returns on invested capital.
- **Spin-off: BellRing (BRBR)** – In late March, Post Holdings spun off shares of BRBR to shareholders. BRBR is primarily made up of its Premier Protein shake brand, a leader in the fast growing protein shake category. In addition, this business includes its Dymatize (protein powders) and PowerBar (nutritious snack bars) brands. BRBR is now roughly 1% of the SMID portfolio.

Looking Ahead

We expect greater volatility driven by higher than normal inflation, a more aggressive shift in monetary policy, and the war in Ukraine. Despite the many risks to the near term outlook, we believe there are reasons for optimism as well. Economic data is generally positive with solid corporate earnings, rising GDP, as well as low unemployment and higher wages for consumers. Separately, as the effects of COVID continue to fade, we could experience faster than expected global supply chain improvements, which could lead to lower inflation. Monetary policy will likely remain in focus. The big question is can the Fed get inflation expectations under control without causing a recession. We recognize the difficulty in navigating a soft landing, so the odds of a recession over the next couple of years have increased. That is the message we take from the recent inversion of the yield curve. In terms of equities, we note that multiple compression is likely given rising interest rates and higher than normal inflation. Given the unique risk backdrop, equity returns may be more modest and volatile going forward.

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Performance

As of March 31, 2022

	QTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
SMID Cap (Gross)	-11.0	-0.8	12.4	11.1	11.2	15.7
SMID Cap (Net)	-11.1	-1.5	11.5	10.3	10.4	14.8
Russell 2500 Value	-1.5	7.7	13.0	9.2	11.0	14.6

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Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending March 31, 2022. 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: March 31, 2009

Composite Definition: The Small-Mid Cap strategy is an extension of our Small Cap strategy with weighted market capitalization higher than our Small Cap portfolio, and is within the market capitalization ranges of the major domestic small to mid cap indices. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with a minimum of $100,000 in assets. The product is measured against the Russell 2500 Index and has a creation and inception date of March 31, 2009. 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: Primary: Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. Russell 2500 is a subset of the Russell 3000 Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell 2500 Value Index measures the performance of the small to mid-cap segment of the U.S equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. Benchmark returns are not covered by the report of independent verifiers. The SMID Cap product is typically compared to the Russell 2500 Index. Any comparison to the Russell 2500 Value 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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