Q3 | 2021

SMID Cap

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 Small-Mid Cap portfolio declined -1.6% gross (-1.8% net) during the quarter vs. a -2.7% decrease in the Russell 2500 Index. Outperformance was driven by strong stock selection, while sector exposure had little impact.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Underweight Healthcare & Comm. Services (two of the weaker performing sectors)
  - *What Hurt*: Overweight Cons. Staples (a weaker performing sector) & underweight Energy (the best performing sector)
- The Small-Mid Cap portfolio captured roughly 59% of the benchmark's downside during Q3, exceeding expectations. A rebound of quality factors, especially in the smaller cap space, aided relative performance. For the year, the portfolio still trails the index, which isn't surprising given the notable low quality, high beta leadership rally earlier in the year.

Top 3 Contributors to Relative Performance

- **Churchill Downs (CHDN)** – CHDN rebounded during Q3. CHDN management continues to deploy growth capital into high ROIC projects (e.g. expanding the historical race wagering business). Additionally, CHDN recently announced an agreement to sell the Arlington Racetrack in Illinois at an attractive price and announced a new repurchase authorization.
- **AerCap (AER)** – We believe sentiment was strong for AER, given the favorable demand environment for air travel as countries eased lockdowns. Despite fears of the delta variant of COVID, no evidence suggests that air travel demand will ease soon. We believe that following the GE Capital Aviation Services acquisition, no other aircraft leasing business is better positioned to capitalize on growth in air travel going forward.
- **Entegris (ENTG)** – ENTG had a strong Q3 led by solid operating results, semiconductor demand, and node transitions. The outlook remains attractive given wafer starts, purity requirements, and new fab construction projects. ENTG is gaining share as customers look to de-risk their supply chains by adding suppliers. ENTG's size, scale, and diversification are best-in-class. We remain attracted to the industry's high barriers to entry, limited competitors, and high switching costs.

Top 3 Detractors from Relative Performance

- **Lamb Weston (LW)** – LW struggled in Q3 due to concerns around inflation and supply chain issues. Supply issues were magnified due to the higher volumes. The issues are short term and LW has responded to control what it can. We remain attracted LW's market share, balance sheet, pricing power & industry tailwinds.
- **Armstrong World Industries (AWI)** – AWI gave up some ground during Q3, but the stock is still up roughly 30% YTD. The 2Q earnings release highlighted a broad-based business recovery as most delayed projects have resumed. AWI has been successful in raising price ahead of inflation and maintains its leading position in the consolidated ceiling tiles business.
- **UniFirst (UNF)** – Like many other companies, UNF faced supply chain challenges related to procurement. Investors reacted negatively after management acknowledged that margin pressures may continue into FY22. We continue to like UNF for its strong balance sheet and competitive positioning.

Trades During the Quarter

- **Reduced: Old Dominion Freight Line (ODFL) & Martin Marietta (MLM)** –Trims reflect the recent strength and resulting increase in market capitalizations, which exceed $20B.
- **Initiated: AerCap (AER)** – AER engages in aircraft leasing and aviation finance. Aircraft leasing is driven by the volume of global demand for air travel, which has roughly doubled every 15 years. While air travel will likely take a few years to recover to the 2019 high, we believe the outlook for the aircraft leasing industry is favorable in the long run. Furthermore, in the near-term, airline balance sheets were ravaged by the pandemic, requiring more capital constraint. Lessors should be net beneficiaries for years to come (more leases & less purchases), similar to the post-GFC years 2010 to 2014. Few players are left after larger conglomerates exited the space. AER acquired GE's Capital Aviation Services business (at an attractive discounted price/book), making it the largest aircraft lessor & purchaser by far. AER's tremendous scale positions it well to capture growth opportunities and earn outsized returns on equity. AER utilizes long lease terms with duration matched contracts & hedging, which give it significant revenue visibility and solid financial stability. AER's balance sheet is very strong, even after completing the GECAS acquisition. Finally, we believe AER is attractively valued, and the margin of safety is elevated given the discounted book value of the GECAS assets.

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.

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Performance

As of September 30, 2021

	QTD	YTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
SMID Cap (Gross)	-1.6	10.2	28.4	13.6	13.6	14.1	16.6
SMID Cap (Net)	-1.8	9.6	27.4	12.8	12.8	13.3	15.8
Russell 2500	-2.7	13.8	45.0	12.5	14.3	15.3	16.5

Inception date: 3/31/2009

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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: 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.

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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