Q1 | 2021

Small Cap

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US equities rallied during Q1 across major indexes and the market cap spectrum. Gains were driven by improving economic data, an accommodative Federal Reserve, recent fiscal stimulus, and continued progress with the rollout of vaccines to fight COVID. Small cap shares led the way with a 12.7% increase in the Russell 2000 Index. The Value indexes significantly outperformed the Growth indexes across the market cap spectrum. Cyclical sectors outperformed the more defensive sectors in the large and mid-cap space, while defensive sectors outperformed in small cap. With regard to factors driving performance during Q1, Value, Yield, and Volatility had a positive influence on relative returns. Growth, Momentum, and Quality factors had a mixed impact.

Key Performance Takeaways for the Quarter

- The London Company Small Cap portfolio returned 10.8% gross (10.6% net) during the quarter vs. a 12.7% increase in the Russell 2000 Index. Stock selection was a headwind to relative performance, partially offset by positive sector exposure.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Underweight Healthcare & Info. Technology (two weaker performing sectors)
  - *What Hurt*: Underweight Financials (a better performing sector) & overweight Real Estate (a weaker performing sector)
- In a very strong quarter for Small Cap stocks, the portfolio captured roughly 85% of the index return, in line with our expectations. Equity risk-taking continued to follow stronger economic data & positive vaccination news in Q1. Similar to Q4'20, our Quality focus with defensive, lower beta positioning was out of favor in this risk-on, pro-cyclical environment. Given our conservative positioning, we would not expect to outperform in a strong market, driven by high beta and low quality.

Top 3 Contributors to Relative Performance

- **Tempur-Sealy (TPX)** – TPX was up ~35% in Q1, continuing its recent momentum. TPX reported strong earnings and shared guidance that indicated mattress demand will remain elevated this year. TPX has benefitted from the recent tailwind of consumers eager to spend on their homes. TPX is poised to take share with new product launches and has been partially insulated from supply chain issues facing the broader industry.
- **Penske Automotive (PAG)** – PAG got a boost from higher US auto sales during Q1. Resilient demand and lean inventories led to higher sales prices across the board. PAG reported strong earnings and laid out growth plans for their used car superstores and commercial truck dealerships. They followed up with plans to acquire Kansas City Freightliner, a commercial truck retailer, which will materially bolster segment revenues.
- **Landstar System (LSTR)** – LSTR outperformed during the quarter after reporting strong 4Q20 earnings. LSTR is tied to spot rates for truck shipments, which are currently very strong due to the restarting of the industrial economy. The pass-through nature of the business keeps LSTR resilient in most market scenarios.

Top 3 Detractors from Relative Performance

- **NewMarket (NEU) –** NEU underperformed during Q1 as mixed improve, lack of pricing power restrained operating leverage to a degree, and rising base oil and other input costs will keep margins in checks for a few quarters.
- **Kaman (KAMN)** – KAMN's 4Q earnings report missed expectations. KAMN is still under pressure in its Commercial and Aviation business segment and is now facing new headwinds in its Defense segment as sales to foreign militaries have been delayed for review under the new administration. KAMN expects to realize cost reduction benefits and continued sequential improvement in its end markets affected by COVID.
- **Ingevity (NGVT)** – NGVT declined following the announcement of 4Q20 earnings, reflecting some skepticism around the Ingevity 2.0 plan unveiled during the call. The strategy calls for investment in a number of other end-markets and applications as well as alternative feedstock. After the call, we followed up with management and feel confident about their outlook.

Trades During the Quarter

- **Reduced: Churchill Downs (CHDN) & Bruker (BRKR)** – Reduced our position in both stocks as each company's market capitalization now exceeds $9B.
- **Increased: Cannae Holdings (CNNE)** – Added to our position in CNNE on recent weakness reflecting the discount to our sum of the parts value and our long term belief in the ability of Bill Foley to create value from its various investments, including Ceridian, Corelogic, and Dunn & Bradstreet.
- **Initiated: Qualys (QLYS)** – Qualys provides cybersecurity and compliance solutions, which enable its clients to identify prioritize, and remediate risks to information technology infrastructures. QLYS also offers solutions through a software-as-a-service model, primarily with renewable annual subscriptions. QLYS should continue to benefit from the long-term secular tailwinds that drive sustainable growth in cybersecurity. QLYS's products are critical but also low-cost relative to a company's overall security budget, helping ensure high retention rates and recession resistance. We believe QLYS is among the best managed in the industry. Many past decisions have positioned QLYS ahead of peers in terms of product quality, structurally higher margins, and competitive moat. QLYS generates high operating margins with growing cash flow generation and has a very strong balance sheet.

Looking Ahead

We maintain a positive view on the economy and expect strong real GDP growth in 2021. The reopening of parts of the economy, continued success with the rollout of vaccines to help eliminate the coronavirus, additional fiscal stimulus, and accommodative policies from the Federal Reserve are all positives. However, the coronavirus remains an issue, especially the threat of new variants. Long term, we remain optimistic about the prospects for the US economy and expect real GDP growth in the 2-3% range. In terms of the equity market, we recognize valuations are on the rich side, while interest rates will likely remain low vs. history. At current valuations along with various short term risks to the economic outlook, we expect greater volatility in share prices and possibly more muted returns in the near term. Longer term, we continue to believe that quality attributes and solid company fundamentals will lead to strong risk adjusted returns over time.

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Performance

As of March 31, 2021

	QTD	YTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
Small Cap (Gross)	10.8	10.8	71.4	13.0	11.1	10.4	13.2
Small Cap (Net)	10.6	10.6	70.1	12.1	10.3	9.7	12.7
Russell 2000	12.7	12.7	94.9	14.8	16.4	11.7	9.4

Inception date: 9/30/1999

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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, 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: September 30, 1999

Composite Definition: The Small Cap strategy invests mainly in conservative, low-beta small cap equities with a focus on above-average downside protection. Primarily we seek profitable, financially stable small cap companies that consistently generate free cash flow, high returns on unleveraged operating capital, trade at significant discounts to their intrinsic values, and are run by shareholder-oriented management. Positions are usually within the market capitalization range of the major, domestic small 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 2000 Index and has a creation and inception date of September 30, 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: Primary: Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell 2000 Value Index measures the performance of small-cap segment of the U.S. equity universe. It includes those Russell 2000 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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