Q3 | 2021

Small 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 Cap portfolio returned 0.6% gross (0.4% net) during the quarter vs. a -3.0% decrease in the Russell 2000 Value Index. Outperformance was driven by strong stock selection, partially offset by sector exposure.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Underweight Comm. Services & Healthcare (two weaker performing sectors)
  - *What Hurt*: Underweight Financials better performing sector) & overweight Cons. Discretionary (a weaker performing sector)
- The Small Cap portfolio protected on the downside during the quarter, exceeding expectations. A rebound of quality factors, especially in the smaller cap space, aided relative performance.

Top 3 Contributors to Relative Performance

- **Penske Automotive (PAG)** – PAG stock continues to benefit from robust demand and tight inventory levels for both used and new vehicles. Solid volume growth, improved unit profitability, and ongoing cost controls all contributed to impressive results for the most recent quarter.
- **Tempur-Sealy (TPX)** – TPX reported impressive 2Q results as mattress demand continues to outstrip supply. Sales growth was broad-based and primarily the result of share gains and expanded distribution. Management is investing in future growth by increasing domestic capacity, expanding its international footprint, and spending a record amount on advertising.
- **Murphy USA (MUSA)** – MUSA is benefitting from structurally higher fuel margins industry-wide. This trend is a function of a more consolidated and rational industry. MUSA's recent food & beverage push is also helping with foot traffic and margins.

Top 3 Detractors from Relative Performance

- **Kaman (KAMN)** – KAMN has yet to benefit from a recovery in Commercial Aviation, and revised sales guidance down on expectations. KAMN should actually be more profitable this year from the unintended benefit of mix. Benefits from structural cost reductions are starting to materialize and increased investment in R&D should yield new product innovation.
- **ACI Worldwide (ACIW)** – ACIW is experiencing a recovery in bank purchasing decisions and is benefitting from significant cost leverage as the cloud business scales. That said, we believe the stock has been pressured by event driven investors exiting, as a sale of ACIW no longer seems imminent.
- **CTS Corp. (CTS)** – Despite strength in end markets, CTS shares underperformed due to global auto production challenges, industrywide supply chain issues, and rising input costs. CTS is executing on its operational efficiency plans and management is taking the correct approach to improve the business over the long term.

Trades During the Quarter

- **Reduced: Tempur-Sealy (TPX)** & **First Industrial Realty (FR)** – Trims reflect the recent strength of the stocks and resulting increase in market capitalizations, which exceed $7B.
- **Initiated: Malibu Boats (MBUU)** – MBUU is a leading manufacturer of recreational powerboats. In a consolidated industry, MBUU's business model is differentiated from its peers by leading edge design innovation/R&D, vertical integration in manufacturing, and extensive dealer network. Innovation & strong brand portfolio positions it to broaden addressable market and increase share. Margins are among the highest in the boat group. Attractive ROIC stems from high market share, solid profitability & low capital requirements. Demand backdrop and outlook is strong, but it is a cyclical business. MBUU's balance sheet and the high quality nature of its business provide a measure of downside protection.
- **Exited: Churchill Downs (CHDN)** – Exited remaining position due to market cap. Continue to hold CHDN in other portfolios.
- **Initiated: Acushnet Holdings (GOLF)** – GOLF is a golf gear, apparel and products company, whose brands include Titleist & Footjoy. Titleist is the dominant brand in the industry with very durable share in the golf ball space— a recurring revenue stream with pricing power and high margins. GOLF has leading products and patents plus strong operating leverage to benefit from the renewed golf tailwinds. Even if the current tailwinds abate somewhat, the core GOLF customer (top 10% of golfers) will continue to purchase these products. GOLF has improved margins over time and is now raising prices. Given the quality nature of the business, we believe the valuation is attractive.
- **Increased: Qualys (QLYS)** & **ACI Worldwide (ACIW)** – Both stocks were purchased over the last year, and the additions reflect our positive longer-term outlook for each name.

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
Small Cap (Gross)	0.6	11.3	40.9	10.0	10.9	12.2	12.9
Small Cap (Net)	0.4	10.7	39.9	9.2	10.1	11.4	12.4
Russell 2000 Value	-3.0	22.9	63.9	8.6	11.0	13.2	9.9

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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: 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. The Small Cap product is typically compared to the Russell 2000 Index. Any comparison to the Russell 2000 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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