

# Portfolio Commentary

## Q4 Market Update

U.S. stocks traded higher during Q4, reflecting softening inflation data and a slowdown in the pace of interest rate increases from the Federal Reserve. For the quarter, the broader market, as measured by the Russell 3000 Index, rose 7.2%. Q4 started strong following reports that broader inflationary pressures were beginning to moderate. Shares reversed course in December as more hawkish commentary from the Fed led to falling prices. Fear of a pending recession remains high and the yield curve remained inverted at the end of the quarter. Stocks traded higher across the market cap spectrum led by strength in Mid Cap companies. Stylistically, Value had one of its strongest quarters of relative performance versus Growth since the popping of the Tech Bubble. Cyclical sectors generally had the edge over Defensive. In terms of market factors that drove performance, Value (lower valuation) and Yield (higher) had a positive impact on relative returns. Volatility factors presented headwinds, while Growth, Quality, and Momentum factors had a mixed impact.

## Key Performance Takeaways

The London Company Small-Mid Cap portfolio returned 6.9% gross (6.7% net) during the quarter vs. a 7.4% increase in the Russell 2500. Stock selection & a temporarily elevated cash balance were headwinds to performance, partially offset by sector exposure.

The SMID portfolio slightly trailed the benchmark in Q4, but it exceeded our upside capture expectations of 85-90%. The portfolio struggled to keep pace with the robust return of the market. Weakness in several larger holdings plus our elevated cash position were a drag on performance. The cash proceeds from the acquisitions of two holdings (Alleghany & Citrix) arrived in Q4. This temporary increase in our cash exposure was a headwind in a strong up-market. Looking ahead, we believe the strong cash flow generation and capital flexibility of our businesses should provide meaningful protection if market fundamentals continue to deteriorate.

## Top 3 Contributors to Relative Performance

**Lancaster Colony (LANC)** – LANC outperformed the benchmark in both Q4 and 2022. LANC's earnings results continue to outpace expectations. The quality of LANC's brands has enabled them to push pricing at retail and alleviate some of the heavy gross margin pressure from input cost increases. The outlook for margins looks favorable heading into 2023, with multiple levers in management's control. We are attracted to LANC's cash balance sheet and willingness/ability to invest behind high-return organic projects, such as expanding the manufacturing footprint to support key SKUs.

**Deckers Outdoor (DECK)** – DECK outperformed the benchmark in both Q4 and 2022. DECK maintains top brands

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

in the footwear industry, which has allowed them to generate resilient results despite the headwinds facing retailers this year. Management does a great job managing the UGG and HOKA brands through innovative styles and investments in marketing and inventory. DECK has become more diverse through the growth of HOKA and the expansion of UGG into new categories. The net cash balance sheet (no debt) is an additional element of downside protection.

**AerCap (AER)** – AER continues to execute extremely well in the current environment. Now that AER has achieved their leverage target following the loss of their Russian assets, they are looking to resume share buybacks. Given the favorable demand environment for commercial aircrafts and engines as well as AER's strong market position, we believe the company should generate improving rates of return on incremental capital deployed.

## Top 3 Detractors from Relative Performance

**Entegris (ENTG)** – ENTG underperformed during Q4 after reporting lower than expected sales and reducing guidance. There are industry-wide concerns about economic weakness negatively affecting sales, but demand in leading-edge nodes and high-performance computing continues to be favorable. ENTG is a unit-driven business, and the competitive position of the core businesses has not eroded. ENTG has drastically increased its size and scale to become one of the most diversified players in the semi-materials industry. We remain attracted to the industry's high barriers to entry, limited competitors, and high switching costs.

**Armstrong World Industries (AWI)** – AWI underperformed the broader market during Q4, reflecting project delays and macro related uncertainty. While company earnings are sensitive to changes in the economy, we note that roughly 70% of sales are for repair and renovations, which have remained stable in prior economic contractions. AWI remains well positioned as the leader in the market for ceiling tile.

**Broadridge (BR)** – BR underperformed the broader market during Q4. We believe the market overreacted to a seasonally small quarter where both revenue growth and expenses were a bit worse than expected. BR continues to benefit from position growth in equities and funds while continuing to innovate in corporate governance/client communications. Free cash flow conversion should improve in 2023, and now that peak spending on the UBS integration has passed, more cash flow should be available for capital returns and smaller acquisitions.

## Sector Influence

We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:

- **What Helped:** Underweight Healthcare (a weaker performing sector) & overweight Cons. Staples (a better performing sector)
- **What Hurt:** Underweight Energy & Industrials (two better performing sectors)

## Trades During the Quarter

- **Received Cash:** **Alleghany (Y)** – Berkshire Hathaway completed its acquisition of Y in an all cash deal.
- **Initiated:** **Trex Company (TREX)** – TREX is the market leader in composite decking. Composite decking is a secular growth story. It represents 25% of all decking by volume, with room to run, and the wood conversion trends with renovations appear secular. Composite decking is an oligopoly. TREX is the dominant leader with >45% market share, but the top three players combined hold >80% share. TREX's competitive advantages include its excellent brand recognition, vast distribution, and its cost structure. TREX is unique due to its high usage of recycled materials, which also helps provide a gross margin advantage over competitors. It also has great EBIT margins, a variable cost structure and very strong returns on capital. The balance sheet is clean, with little leverage. The stock sold off 65% due to concerns around the macro environment, but they entered the downturn from a position of strength. They have been responding rationally and buying back their stock on weakness. We believe TREX will emerge on the other side in good shape fundamentally, and the negative sentiment presented a good entry point to own this quality compounder.

## Looking Ahead

As we enter 2023, conditions remain fragile, and the lagged effect of 2022's rate hikes and Quantitative Tightening (QT) may lead to further economic weakness. Inflation remains higher than desired, but inflation readings have improved from peak levels. Meanwhile, the labor market remains tight and the service side of our economy remains strong. As the Fed continues to balance its goals of stable pricing and full employment, additional rate hikes are likely early in the year. It is hard to predict what could happen longer term, but the message from the Fed is that rates will stay higher for longer. Much will depend on the level of inflation and the performance of the broader economy. In terms of the equity market, we recognize the difficulty in determining what is already factored into stock prices at this point in the economic cycle. With higher interest rates likely, equity valuations may experience multiple compression, while a slowing economy may lead to weaker earnings from many companies. The next phase of this slowdown will likely hinge on the path of earnings, credit spreads, and employment. In this more challenging environment, we continue to expect greater volatility in share prices and lower expected returns relative to the strong returns generated from 2009-2021. Longer term, we continue to believe that quality attributes and solid company fundamentals will lead to strong risk-adjusted returns.

Looking ahead, we believe the strong cash flow generation and capital flexibility of our businesses should provide meaningful protection if market fundamentals continue to deteriorate.

## Annualized Returns

As of 12/31/2022

	QTD	1Y	3Y	5Y	10Y	ITD
SMID Cap (Gross)	6.9%	-13.8%	5.2%	8.2%	10.2%	14.5%
SMID Cap (Net)	6.7%	-14.4%	4.4%	7.4%	9.4%	13.7%
Russell 2500	7.4%	-18.4%	5.0%	5.9%	10.0%	13.6%

## Disclosure Notes

The London Company's performances are size weighted and annualized based on calculations for the period ending 12/31/2022. 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 Advisor, 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. As of July 1, 2022 The London Company redefined the composites to exclude dual contract relationships and any potentially bundled fee scenarios. This policy is not retroactive, but will continue to apply going forward.

**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. Returns are calculated and stated in U.S. 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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