The London Company

Small Cap

Q4 | 2022

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 Cap portfolio returned 10.2% gross (10.0% net) during the quarter vs. a 6.2% increase in the Russell 2000. Both stock selection & sector exposure contributed to outperformance.

The Small Cap portfolio closed 2022 on a high note. It posted strong absolute & relative performance in Q4—far exceeding expectations of 85-90% upside capture in a rising market. Strong performance from several large positions more than offset continued sector headwinds—namely being underweight Energy. 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

Tempur Sealy (TPX) – TPX rebounded in Q4 after underperforming to start the year. TPX's 3Q results were better than expected as it continues to take price and gain market share despite declining demand for bedding products. Management has taken advantage of its strong financial position to invest in various growth initiatives and return significant capital to shareholders through repurchases. Valuation remains compelling and robust free cash flow generation, strong brand equity, and solid management execution support our investment thesis.

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.

IAA, Inc. (IAA) – IAA was a top performer after the announcement of the proposed acquisition from Ritchie Bros for a total purchase price of $46.88/share. The deal is currently set to close in the first half of 2023.

Top 3 Detractors from Relative Performance

Qualys (QLYS) – QLYS reported a challenging quarter, where billings growth deceleration was driven by adverse foreign exchange and weaker than expected new client growth. While there is still work to do on optimizing the company's go-to-market strategy, there is strong evidence that billings growth has started to improve, especially as QLYS continues releasing highly complementary cloud security and compliance solutions. We remain confident in QLYS' overall strategy, market positioning, and management.

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.

CTS Corp. (CTS) – CTS underperformed in Q4 after reporting third quarter results. Management tightened the range of its guidance, which was lower than the consensus estimate. CTS has started to see issues around consumer demand, softness in the industrial end market, and concerns about excess inventory in the channel. CTS has successfully moved up the value chain as it provides solutions for highly engineered, differentiated products. We remain attracted to CTS's market share position in niche markets and management's self-help initiatives.

Sector Influence

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

- What Helped: Underweight Healthcare (the weakest performing sector) & overweight Cons. Discretionary (a better performing sector)
- What Hurt: Underweight Energy & Utilities (two better performing sectors)

Trades During the Quarter

- There were no trades during the quarter.

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
Small Cap (Gross)	10.2%	-9.1%	7.2%	7.6%	8.1%	12.1%
Small Cap (Net)	10.0%	-9.7%	6.5%	6.8%	7.3%	11.6%
Russell 2000	6.2%	-20.4%	3.1%	4.1%	9.0%	7.7%

Inception date: 9/30/1999. Past performance should not be taken as a guarantee of future results.

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: 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. As of July 1, 2022 The London Company redefined the composites to exclude all dual contract relationship and any potentially bundled fee scenarios. This policy is not retroactive, but will continue to apply going forward.

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 the 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. 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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