Portfolio Commentary

Full Year Market Update

For the year, the broader market posted solid gains, with the Russell 3000 up 26.0%. At the start of 2023, interest rates were rising, inflation was stubbornly high, and investors were bracing for a recession. Instead, inflation continued falling, consumers kept spending, and the unemployment rate fell to its lowest level since 1969. With slowing inflation, signs of better balance in the labor market, and normalized GDP growth expectations, the Federal Reserve indicated that it would pivot to rate cuts later in 2024. Huge rallies by the mega-cap Magnificent 7 (Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla, & Meta Platforms) were a big driver of overall index performance, and narrow market leadership remained a nagging concern for much of the year.

It was a year of bifurcated performance, led by the mega-cap stocks. Enthusiasm over artificial intelligence and robust gains by the Magnificent 7 led to significant outperformance of the Growth Indices and helped mask weakness in other corners of the market. Non-dividend paying companies significantly outperformed companies that pay a regular dividend, especially in the large cap space. Turning to market factors for the year, Volatility and Growth factors posted the strongest results. Value, Yield, and Momentum factors presented headwinds; while Quality and Momentum factors delivered mixed results.

Key Performance Takeaways

The London Company Small Cap portfolio gained 22.0% (21.2% net) for the year vs. a 16.9% increase in the Russell 2000 Index. Both sector allocation and stock selection were tailwinds to relative performance.

The Small Cap portfolio outperformed its benchmark and exceeded our 85-90% upside participation expectations. We typically would not expect such strong relative results in a robust, double-digit return environment, but several factors worked in our favor. Quality attributes, including high net interest coverage and returns on capital, shone prominently, particularly as many unprofitable companies in the lower market cap spectrum struggled. Our largest positions performed well, opportunistic trades and recent initiations paid off, and we navigated the year with few major setbacks. A sector-level leadership reversal also played a role, with our limited exposure to Energy and Utilities transforming from a drag in 2022 to a tailwind in 2023.

Top 3 Contributors to Relative Performance

Tempur Sealy (TPX) – TPX shares were strong in 2023. While the bedding industry remained soft during the year, volumes appear to be stabilizing. Despite the challenging market environment, the company's strong pricing power and significant share gains have helped curtail revenue declines. Management announced plans to acquire Mattress Firm, which has the potential to be materially accretive and strengthen the company's overall competitive position. Valuation remains compelling and robust free cash flow generation, and strong brand equity support our investment thesis.

NewMarket (NEU) – NEU outperformed after reporting solid earnings in recent quarters reflecting a recovery in pricing and margins after a long period of higher base oil and chemical prices. NEU also used stronger cash flow to repay debt and repurchase company shares. Late in the year, the company announced the planned acquisition of American Pacific Corp., a manufacturer of solid rocket propellants and fire suppressants. This acquisition will help diversify the business away from petroleum additives, which is likely in long-term decline. Sentiment in the stock cooled around the time of the acquisition.

Qualys (QLYS) – QLYS outperformed reflecting strong revenue growth and an acceleration in bookings. We have strong conviction in QLYS' ability to maintain its industry-leading profitability driven by a variety of cybersecurity products for small- and medium-sized businesses.

Top 3 Detractors from Relative Performance

Ingevity (NGVT) – Shares of NGVT underperformed the market in 2023 as a softer than expected demand environment and persistent raw material cost inflation forced management to lower guidance in two consecutive quarters. We believe the business is improving, as NGVT is investing in alternative fatty acid production capacity, which will allow it to enter new markets, support a cost advantage, and enable feedstock selection. We believe this will provide better products for customers and help mitigate raw material cost inflation. NGVT's current valuation is attractive, and the company's diverse product mix, growing pavement technology business, and monopoly position on activated carbon for automobiles provide ample downside protection.

Cable One (CABO) – Shares of CABO continue to be pressured by muted subscriber trends as a result of lower move activity and greater competition from fixed wireless offerings. However, customer churn remains near record lows while higher data consumption and speed upgrades continue to drive average revenue per user growth and margin expansion. CABO is well positioned as an advantaged provider of high-speed internet in rural markets. We believe its relatively low penetration, superior service, and M&A prowess are supportive of long-term earnings growth.

Lancaster Colony (LANC) – Fundamentals at LANC remain strong, but investor sentiment toward the manufactured food industry has weakened in recent months. These companies benefitted from price-driven growth the last couple of years, with prices now expected to moderate or even deflate going forward. With ERP and capacity expansions complete, and mix continuing to shift towards margin-accretive volumes, LANC should realize tailwinds to margins and free cash flow over the next 12 months. LANC has attractive opportunities for growth, and the cash balance sheet is available to support investment.

Sector Influence

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

- What Helped: Overweight Consumer Discretionary (a stronger performing sector) & underweight Utilities (a weaker performing sector)
- What Hurt: Overweight Comm. Services & Real Estate (weaker performing sectors)

Portfolio Characteristics & Positioning

We believe the Small Cap portfolio is positioned for long-term durability and possesses the fundamental ingredients that stand the test of time: wide moats, sustainably high returns on capital, strong cash flow generation, low leverage ratios, and trading at a reasonable valuation. As access to capital becomes more difficult and the cost of that capital is more expensive, we believe companies with strong balance sheets and the ability to self-fund their operations could have a structural advantage in 2024 and beyond. In an environment of possibly lower returns and greater volatility, we believe the Small Cap portfolio offers an attractive option for equity investors.

Portfolio Characteristics	Small Cap	Russell 2000
Pre-tax ROC (3 Yr. Avg.%)	16.4	6.7
Net Debt/EBITDA	1.7x	3.3x
Enterprise Value/EBITDA	14.2x	13.6x

Source: FactSet

Looking Ahead

After such a strong 2023, we believe investors should temper expectations for 2024. Stocks defied rate hikes, wars, collapsed banks, and recession fears in 2023. Now, calls for a soft landing are consensus; sentiment is overly optimistic; and markets are priced for very little risk. Predicting the future direction of the economy is always challenging. While we do agree the odds of a recession have come down, they are still elevated. A soft landing remains in reach, but much of that hinges on whether the Fed eases soon enough to avoid an employment problem. Perhaps this time it will be different, but historically the odds of sticking the landing have been very low. Even though we have greater clarity over the Fed's path from here, there still remains a long list of items creating uncertainty that could lead to greater volatility in 2024.

In terms of the equity market, we believe returns in the near term may be modest, with shareholder yield (dividends, share repurchase, debt reduction) comprising a significant percentage of the total return. Economic growth is likely to slow; earnings estimates appear optimistic; and valuations are somewhat elevated. Moreover, investors continue to expect a faster pace of rate cuts than members of the FOMC currently suggest. The difference in the pace of rate reductions could lead to greater levels of volatility in 2024. Markets are impossible to outguess in the short run, but we believe the antidote to uncertainty is quality and that solid company fundamentals will lead to strong risk-adjusted returns in the long run. With that in mind, the characteristics of our portfolios remain attractive, and we believe we're well positioned for an uncertain future.

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Annualized Returns
As of 12/31/2023

	QTD	1Y	3Y	5Y	10Y	ITD
Small Cap (Gross)	11.9%	22.0%	10.3%	14.0%	7.1%	12.5%
Small Cap (Net)	11.7%	21.2%	9.5%	13.2%	6.3%	11.9%
Russell 2000	14.0%	16.9%	2.2%	10.0%	7.2%	8.1%

Inception date: 9/30/1999. Past performance should not be taken as a guarantee of future results.
Performance is preliminary. Subject to change.

Disclosure Notes

The London Company's performances are size weighted and annualized based on calculations for the period ending December 31, 2023. 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.

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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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