# Portfolio Commentary

## Market Update

U.S. stocks posted positive returns during Q2, with most of the gains generated during the month of June. The broader market, as measured by the Russell 3000 Index, returned 8.4%. Slowing inflation, optimism around the potential benefits of artificial intelligence (AI), and better than expected economic news driven by solid consumer spending combined to lift the market higher. While growth of the overall economy has slowed, a strong labor market with rising wages has allowed the economy to avoid a much anticipated recession.

Shares of larger, technology related companies led the equity market. Market leadership was narrow as seven large cap companies drove the Core and Growth indices. Market performance was bifurcated across the market cap spectrum, with Large and Mega Cap stocks materially outperforming. Style, sector, and factor leadership largely mimicked Q1. Growth continued to dominate Value, and the Growth-oriented Info Technology, Cons. Discretionary and Comm. Service sectors generally led across the market cap spectrum. Turning to market factors, companies exposed to Growth and Volatility factors (higher beta) posted the best results, while Yield and Value factors were laggards. Quality and Momentum factors had a mixed impact.

## Key Performance Takeaways

The London Company Income Equity portfolio returned 2.1% gross (2.0% net) during the quarter vs. a 4.1% increase in the Russell 1000 Value Index. Sector exposure was positive, offset by stock selection.

The Income Equity portfolio trailed the Russell 1000 Value in Q2 and came up short of our long-term 85-90% upside capture expectations. Strength in the broader market, limited benefit from Quality factors, and headwinds from higher dividend paying stocks contributed to the relative underperformance.

## Top 3 Contributors to Relative Performance

**Apple Inc. (AAPL)** – Continuing the trend from Q1, AAPL and the rest of the "Magnificent 7" significantly outperformed the broader market during Q2. Investor sentiment was enhanced by AAPL's introduction of its augmented reality headset, named Apple Vision Pro. The company's rich ecosystem of hardware and software provide it with an almost unassailable competitive moat.

**Microsoft (MSFT)** - MSFT and the rest of the "Magnificent 7" significantly outperformed the broader market during Q2. Investor sentiment was enhanced by MSFT's strengthening of ties with OpenAI and their ChatGPT product. We remain attracted to MSFT's recurring subscription business, cloud leadership, and strong balance sheet.

**Lowe's (LOW)** - Despite headwinds from the housing market, LOW outperformed in Q2 after reporting stronger sales in the Pro channel and achieving SG&A leverage. Looking ahead, we believe that LOW is positioned to gain market share, while improving margins, and increasing share in the Pro business. Management expects to use debt to repurchase shares this year. Lowe's has a very strong balance sheet and returns cash to shareholders through dividends and share buybacks.

## Top 3 Detractors from Relative Performance

**Target (TGT)** – TGT lagged the broader market in Q2 reflecting headwinds that include a more challenging macro environment and the impending return of student loan payments. These headwinds may lead to slower traffic in stores and could temper the pace of recovery in TGT's EBIT margin from trough levels in 2022. Additionally, the retailer faced backlash and negative press this quarter regarding Pride-related merchandise. We view these headwinds as near-term in nature and expect TGT can return to a structural EBIT margin well above current levels in the medium-term.

**Crown Castle (CCI)** – CCI, the only REIT in the portfolio, underperformed during Q2, reflecting expectations for slower than normal growth in the next couple of years. The slower growth is due to the impact of higher interest rates on outstanding debt and the loss of revenue from T-Mobile ($200M) following the Sprint merger. Most of the debt carries fixed rates (only 12% variable rate debt) with longer dated maturities. The tower business (70% of revenue) remains solid with high visibility toward mid-single digit revenue growth, driven by increases in demand for wireless data. The stock offers a dividend yield over 5% and stable growth.

**Progressive (PGR)** – PGR underperformed during Q2 due to concerns about additional price hikes needed to maintain its targeted profitability ratio. PGR continues to increase auto policies in force, but recent costs were higher than expected. To combat weaker than expected margins, PGR is reducing advertising spending and increasing prices on insurance. Looking ahead, we believe PGR remains well positioned reflecting its more flexible pricing platform and tech solutions that monitor and price for distracted driving.

## Sector Influence

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

- What Helped: Underweight Utilities & Energy (two weaker performing sectors)
- What Hurt: Underweight Comm. Services (a better performing sector) & overweight Cons. Staples (a weaker performing sector)

## Trades During the Quarter

- Reduced: **Progressive (PGR) -** Trim reflects the recent strength in the shares and the relatively high valuation of the stock (4.8x Price/Book). We remain confident in the long-term fundamentals of the business, but felt that reducing it to a 3% position was prudent. PGR continues to gain market share while adhering to conservative underwriting principles.
- Increased: **Charles Schwab (SCHW) –** Addition follows initiation of the position back in March. With the recent bank volatility negatively affecting shares of SCHW, we decided to build a full position slowly. There is no change in our positive outlook for the long-term growth of the business.

> As we face an economic slowdown with a higher cost of capital environment, we believe companies with strong balance sheets and the ability to self-fund their operations should have a tangible advantage in 2023 and beyond.

## Looking Ahead

Uncertainty remains high as we enter the second half of 2023. Continued progress on the inflation front is encouraging, and labor market strength may continue to underpin consumer resilience. That said, we note that core inflation remains above the Federal Reserve's long-term target of 2%, and it is likely the Fed maintains a restrictive posture if the labor market strength continues. Importantly, monetary policy works with a lag, and we have probably not felt the full impact of prior rate increases or the full effects of tighter lending standards. We remain cautious, as the odds of a recession are still high and the risks of a credit crunch are elevated.

Narrow markets can be quite fragile. The concentrated, top-heavy nature of the market creates an environment prone to risk reversals, and we continue to expect greater volatility in the months ahead. In addition, valuations appear relatively high vs. history, despite concerns about a pending recession and higher interest rates. As inflation concerns subside, we believe growth and employment will come into greater focus. Since the October 2022 bear market low, 100% of the market's rally has been attributable to P/E valuation multiple expansion. Meanwhile, earnings growth has been weak, and it could weaken further if we enter a recession. We may experience muted returns in the near term, given recession odds and elevated valuations. In that environment, companies that are higher quality, reasonably valued, and prudently returning capital to shareholders are likely better positioned. By that measure, we believe the attractive shareholder yields, quality value orientation, and high active share of our portfolios provide us with a compelling advantage in a fragile market environment with elevated uncertainty.

### Annualized Returns
As of 6/30/2023

| | QTD | YTD | 1Y | 3Y | 5Y | 10Y | ITD |
|---|---|---|---|---|---|---|---|
| **Income Equity (Gross)** | 2.1% | 3.6% | 6.9% | 11.2% | 10.0% | 10.3% | 9.1% |
| **Income Equity (Net)** | 2.0% | 3.4% | 6.5% | 10.8% | 9.5% | 9.8% | 8.4% |
| **Russell 1000 Value** | 4.1% | 5.1% | 11.5% | 14.3% | 8.1% | 9.2% | 7.0% |

Inception date: 12/31/1999. 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 June 30, 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. An investment in a London Company strategy is subject to risks, including the loss of principal.

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**Composite Creation/Inception Date**: December 31, 1999

**Composite Definition:** The Income Equity strategy invests mainly in common equities with a focus on higher overall dividend yield orientation, which may be supplemented with primarily investment grade, preferred equities. This strategy has a more conservative orientation, with a focus on capital preservation, income and growth, in order to provide greater yield and downside protection relative to our Large and Mid Cap strategies. Our Income Equity strategy is designed to generate above-average, absolute returns over full market cycles. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with no minimum dollar amount of assets. The product is measured against the Russell 1000 Value Index and has a creation and inception date of December 31, 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 relationships and any potentially bundled fee scenarios. This policy is not retroactive, but will continue to apply going forward.

**Benchmark Description:** The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected 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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