Poplar Forest Capital

Active. Contrarian. Value.

March 2022

Poplar Forest Quarterly Commentary

J. Dale Harvey
CEO, CIO

Dear Shareholder,

My father taught me to drive in a sky-blue Ford pickup truck with "three on the tree" – a three-speed manual transmission whose gearshift was mounted on the steering column. Dad's hands-on lessons were terrific, but for sheer shock value, they paled in comparison to the gory car crash videos my classmates and I were forced to watch in Drivers Education class. Our teacher seemed determined to scare all of us into driving safely. Of all the lessons he drilled into us, he repeated one more than any other: "Drive defensively."

These days, the investment highway seems more treacherous than an L.A. freeway in a rainstorm. Among the obstacles in any stock picker's path: resurgent COVID in Europe and Asia, the Russian invasion of Ukraine and the resulting sanctions, soaring commodity prices, plunging consumer confidence, and last but not least, the Federal Reserve's recent decision to finally begin normalizing monetary policy. These driving conditions led to a number of traffic accidents as evidenced by the 13% selloff in the S&P 500 between January 3rd and March 8th. During this time, the Russell Value Index outperformed its Growth sibling by more than 12%. **Value has become defensive again, just as it was in the aftermath of the late 1990s Tech Bubble.**

At Poplar Forest, we aren't assembling our portfolios in a vacant parking lot; we've had to stay keenly aware of other drivers. And that has paid off. Our portfolios held up well during the recent stock market correction and we ended the first quarter with a gain of 4%. As we have said in the past, **when value beats growth, we expect to beat both. The recent quarter provided more evidence supporting that contention**. **And with our portfolio being valued at less than 11x earnings despite prospects for 8-10% annual earnings growth, we remain very excited about prospective returns.**

We have continued to follow the road less traveled in search of new opportunities. During the first three months of the year, we found two heavily-discounted investments and added them to our portfolios. One is a consumer healthcare company while the other is a transportation business whose shares have been buffeted by the current macroeconomic uncertainties. Importantly, both are "self-help" investments offering idiosyncratic profit improvement opportunities that are independent of the external environment – profit improvement potential that we believe is significantly underestimated by investors.

As we survey the road ahead, our biggest concern is inflation. If left unchecked, inflation eats away at the purchasing power of our investments. In an environment of ridiculously low interest rates, inflation is a value transfer from savers to borrowers. In the long run, taxing savings and subsidizing borrowing is bad public policy and can lead to serious misallocations of capital across the economy. At its essence, **high inflation readings are a reflection of a basic truth – demand exceeds supply for just about everything in the economy right now**: gasoline, food, cars, housing, semiconductors, etc. Inflation seems likely to continue to erode purchasing power until demand and supply come more into balance. This is particularly a challenge for low-income consumers and retirees living on a fixed income.

COVID Constrained Supply + Stimulus Driven Demand = Inflation

Two years ago, lockdowns intended to limit the spread of COVID resulted in a six-month, 10% economic contraction, as measured by inflation-adjusted Gross Domestic Profit ("real GDP"). To put that in context, during the Global Financial Crisis (GFC), real GDP shrank 4% over twelve months. The COVID lockdowns led to a 14.4% decline in jobs in just two months (as compared to a 6.3% loss over 21 months during the GFC). The Global Financial Crisis was, by a factor of two, the worst recession since World War II, and the COVID Crisis was more than twice as bad as the GFC.

In and of itself, a 14.4% decline in employment would have been devastating for the U.S. economy. The U.S. Federal Reserve (the "Fed") and Congress responded with unprecedented monetary and fiscal stimulus. As a result, the economic hardships from COVID were dampened and demand for goods remained strong as we all settled into new work-from-home routines. **Within 15 months of the lockdowns, consumer spending was at all time high levels.**

With demand having largely recovered from the COVID Crisis by late spring 2021, **it would have been prudent for the Fed to begin normalizing monetary policy. But they didn't. Instead, though we were no longer in a crisis, the Fed continued with crisis-based policies**. Stimulus driven demand quickly came up against COVID-constrained supply. Real GDP grew by 7% in the fourth quarter of 2021 (as compared with roughly 2% per year since the GFC), yet the Fed continued to leave interest rates unchanged while adding to their already bloated balance sheet by buying more bonds. With the Fed failing to do its job, the free market was left to use price as the mechanism to balance the books between elevated demand and constrained supply.

With free markets behind the wheel, investor focus has shifted to demand-destruction, for example: with consumers paying more for gasoline, they have less to spend on clothes. Some worry that reduced consumer spending could drive us into recession. I think that is unlikely given the underlying strength of the economy, but I acknowledge the disquieting message of plunging consumer confidence. While the road ahead may be bumpy, I remain hopeful that supply will recover more quickly than feared. We are starting to see the first signs of that when we talk with companies. While it is understandable that short-term traders may sell stocks based on potential revenue headwinds, normalized earnings and free cash flows should be relatively unaffected. Given our differentiated time horizon, these short-term selloffs may create opportunities for our long-term investment process.

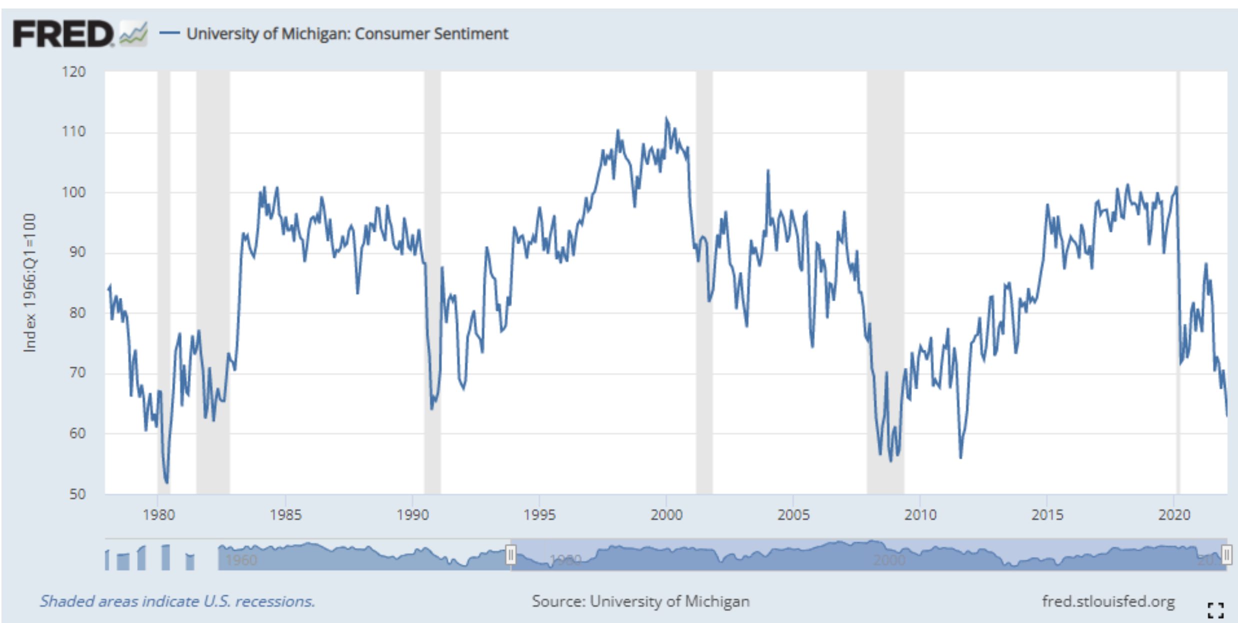
We are currently finding lots of compelling opportunities and I feel a bit like the proverbial kid in a candy store - I just wish I had a bigger shopping cart! We love the companies we own and they collectively trade at a 45% discount to the S&P 500 (based on relative multiples of estimated earnings over the next 12 months) despite comparable earnings growth, solid balance sheets and above market dividend yields. Bluntly put, we don't want to sell any of them right now. To fund the purchase of new investments, we expanded the Poplar Forest garage, which usually holds 30 investment vehicles, to make room for two more.

Potential Potholes: COVID, War, Consumer Confidence, Interest Rates

Here in the U.S., COVID cases have declined by more than 90% from the Omicron peak. In Europe, the news is not as good as case counts only fell around 50% from their peak, and they have started rising again. China is even more troubling as their zero COVID policy has resulted in limited herd immunity. In the short-term, lockdowns in China and the potential for COVID absenteeism in Europe could exacerbate currently constrained supply. Factories can't run at full capacity if their workforce is out sick. We will continue to monitor COVID data for signs of an emerging new variant that could derail a recovery in supply.

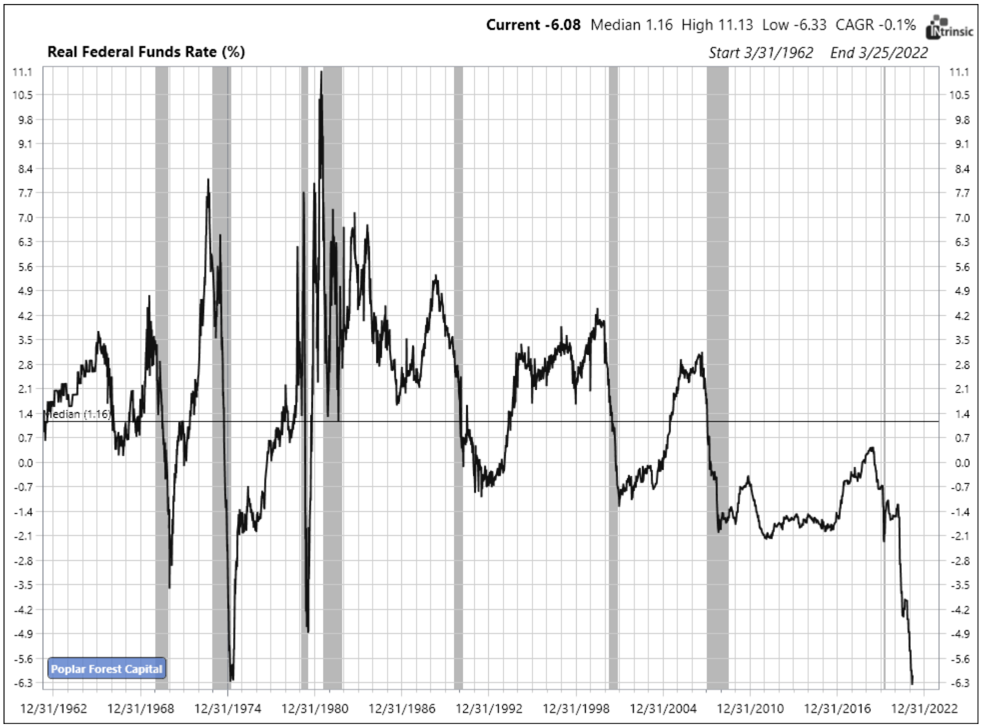
Likewise, the Russian invasion of Ukraine is not just a humanitarian disaster, it also adds to the world's supply problems. Sanctions have constrained Russian oil exports, and higher gasoline prices have reduced consumers' disposable income. Transportation costs are climbing and will make their way into the prices of finished goods. The prices of metals and agricultural products have also risen dramatically and these increases will further erode consumer purchasing power. The European economy was a bit weaker than the U.S. economy prior to the invasion, and given the geography, the war may push Europe into recession. We will be closely monitoring the situation in Ukraine and, in particular, the evolution of sanctions.

Given these challenges, it probably shouldn't be a surprise to see the recent decline in Consumer Confidence as reported by the University of Michigan. The current sentiment measure has fallen below the lows seen during the depth of the COVID Crisis and is a data point that is historically inconsistent – at this point in the recovery from a recession, people are usually feeling better. A pessimist would look at this chart and think that gloomy consumers will cut back on spending thus increasing the odds of recession. I look at it differently. I get concerned when conditions look too good to continue. During the peak of the Tech Bubble's excesses, sentiment exceeded 100 on Michigan's scale; today we are below 70 – that suggests a lot of upside potential. If I'm right about the underlying strength of the economy, we should see this economic indicator start to move higher.



Source: St. Louis Fed; University of Michigan. Start date = 01/01/1981, end date = 03/01/2022

While I believe the Fed is woefully behind in its efforts to at least normalize monetary policy, in March they at least took a first baby step with a 0.25% increase in short-term rates (and they suggested they will soon start to shrink their $9 trillion portfolio of bonds). Despite this, interest rates that are well below the rate of inflation continue to encourage borrowing in an effort to stimulate economic growth. Monetary policy is highly accommodative and the Fed will have to dramatically change its behavior if it wants to avoid being written up for reckless driving. With this first move, the Fed has begun to slowly take its foot off the gas but this seems insufficient to slow down the race car that is the U.S. economy.



As you can see in the graph above, during recessions short-term interest rates are typically cut to a level below inflation to encourage growth. With the exception of the post-GFC era, later in the economic cycle, when demand is more robust, short-term interest rates have been increased to a level 2-3% above inflation in order to cool the economy. Even after March's 0.25% increase, interest rates continue to be at historically low levels as compared to inflation. The Fed has not fundamentally changed its driving behavior despite getting a speeding ticket for the highest inflation in forty years!

We will be closely monitoring the bond market (credit spreads and the slope of the yield curve) for signs of stress, but our working assumption is that both short- and long-term interest rates will end up higher than expected by most market participants. Given the correlation between interest rates and stock price valuations, the S&P 500 could end up spinning its wheels as continued earnings growth is offset by lower valuations. This dynamic could continue to be a major challenge for the sports cars of the stock market (highly valued growth stocks), but should be less of an issue for the companies we own, given the four-wheel-drive power of their low absolute and relative valuations.

Help Navigating the Road Ahead

A recent study from the American Automobile Association (AAA) confirms what we've all seen firsthand – there are more risky drivers on the road. AAA's study found a marked increase in "younger and disproportionately male" drivers who are "a statistically riskier driver group than the average population." Meanwhile, "safety-minded individuals" are driving less. If ever there were a time to practice defensive driving, it's now!

Just as highways are crowded with more speed demons, the stock market seems to have more risky investors zigging and zagging about. I'm glad that I don't have to navigate all this traffic by myself. For years now, Derek Derman has been riding shotgun alongside me. He initially joined Poplar Forest in September 2011 as an analyst covering financial service companies. After putting up several years of outstanding investment results, he joined me as Co-Portfolio Manager when we launched the Cornerstone Fund in 2014. Derek and I have worked very closely ever since and I have grown to appreciate his sensitivity to risk. Derek has a keen eye for black ice and other dangers that could leave us broken down on the side of the road. In recognition of his contributions, I have named Derek Co-Portfolio Manager for the Poplar Forest Partners Fund.

While I will continue to be the guy driving the bus, I hope you will enjoy the ride a little more knowing that Derek, a 25-year investment veteran, is my co-pilot. I'm hopeful that with Derek's help, we'll have a smooth ride for many years to come. I want to be clear; I am just 56 years old, in great health, and I have no intention of getting out of the drivers' seat. But if something unexpected were ever to happen to me, I have every confidence that Derek, with the support of our outstanding analyst team, would keep driving in the direction of long-term investment success.

The era between the Global Financial Crisis and COVID was a challenging one for value investors. Many of you have been with me since the beginning and I appreciate the support you showed us when it appeared that we were getting left in the dust. Times appear to be changing – value has begun to outperform while also being defensive in recent market drawdowns. Like the Tortoise in Aesop's fairy tale, we have consistently followed our long-standing investment process despite what appeared to be an insurmountable lead held by the growth stock Hare. Investing isn't a quarter mile drag race, it's more like the multi-day, 6,200-mile Dakar Rally from Paris to Dakar Senegal. I believe we have the endurance, the equipment, and the crew to not just finish at Dakar, but to end up in the winners' circle.

Sincerely,

J. Dale Harvey
March 31, 2022

DISCLOSURES

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information and can be obtained by calling 1-877-522-8860 or by visiting www.poplarforestfunds.com. Read it carefully before investing.

Mutual fund investing involves risk. Principal loss is possible. The funds may invest in debt securities which typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. The funds may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater in emerging markets. Investing in small and medium sized companies may involve greater risk than investing in larger, more established companies because small and medium capitalization companies can be subject to greater share price volatility. The funds may invest in options, which may be subject to greater fluctuations in value than an investment in the underlying securities. When the Cornerstone Fund invests in other funds and ETFs an investor will indirectly bear the principal risks and its share of the fees and expenses of the underlying funds. Investments in asset-backed and mortgage-backed securities involve additional risks such as credit risk, prepayment risk, possible illiquidity and default, and increased susceptibility to adverse economic developments. Diversification does not assure a profit, nor does it protect against a loss in a declining market.

Value stocks typically are less volatile than growth stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice. Fund holdings and sector allocations are subject to change and should not be considered recommendations to buy or sell any security.

Poplar Forest funds are distributed by Quasar Distributors, LLC.

Partners Fund Top Ten Holdings and Percentage Weights as of 3/31/22:

Chevron	5.32
DollarTree	4.94
AmerisourceBergen	4.59
Wells Fargo	4.46
American Intl. Group	4.41
Allstate	4.25
National Fuel Gas	4.13
Equitable Holdings	3.98
CVS Health	3.81
AT&T	3.79

Cornerstone Fund Top Ten Equity Holdings and Percentage Weights as of 3/31/22:

DollarTree	4.26
AmerisourceBergen	3.88
Murphy Oil	3.44
Allstate	3.36
Chevron	3.33
United Therapeutics	3.32
Organon	3.18
National Fuel Gas	3.15
American Intl. Group	3.00
Equitable Holdings	2.99

Index performance is not indicative of a fund's performance. Past performance does not guarantee future results. Earnings growth is not a measure of the Fund's future performance.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a fixed basket of consumer goods and services (such as food, transportation, shelter, utilities, and medical care), and is widely used as a cost-of-living benchmark.

Dividend Yield: Represents the trailing 12-month dividend yield aggregating all income distributions per share over the past year, divided by the period ending fund or stock share price. It does not reflect capital gains distributions.

Earnings Growth: The annual rate of growth of earnings typically measured as Earnings Per Share Growth.

Earnings Per Share (EPS): The net income of a company divided by the total number of shares it has outstanding.

Free Cash Flow: Is equal to the after-tax net income of a company plus depreciation and amortization less capital expenditures.

An exchange traded fund (ETF): Is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same way a regular stock can.

Index Fund: Is a type of mutual fund with a portfolio constructed to match or track the components of a market index, such as the Standard & Poor's 500 Index (S&P 500).

Inflation: Is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over a period of time. Often expressed as a percentage, inflation indicates a decrease in the purchasing power of a nation's currency.

iShares Russell 1000 Value ETF (IWD): Is an ETF that seeks to track the investment results of the Russell 1000® Value Index (the "underlying index"), which measures the performance of large- and mid- capitalization value sectors of the U.S. equity market. The fund generally invests at least 80% of its assets in the component securities of its underlying index and in investments that have economic characteristics that are substantially identical to the component securities of its underlying index.

iShares Russell 1000 Growth ETF (IWF): Is an ETF that seeks to track the investment results of the Russell 1000® Growth Index, which measures the performance of large- and mid-capitalization growth sectors of the U.S. equity market. The fund generally invests at least 80% of its assets in the component securities of its underlying index and in investments that have economic characteristics that are substantially identical to the component securities of its underlying index.

Price/Earnings (P/E) Ratio: Is a common tool for comparing the prices of different common stocks and is calculated by dividing the earnings per share into the current market price of a stock.

Russell 1000® Growth Index: Measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Index is unmanaged, and one cannot invest directly in the Index.

Russell 1000® Value Index: Measures the performance of the Russell 1000's value segment, which is defined to include firms whose share prices have lower price/book ratios and lower expected long/term mean earnings growth rates. It is not possible to invest directly in an index.

S&P 500 Index: Is a market value weighted index consisting of 500 stocks chosen for market size, liquidity and industry group representation. The Index is unmanaged, and one cannot invest directly in the Index.

SPDR S&P 500 ETF Trust (ARCA: SPY): Is one of the most popular funds that aims to track the Standard & Poor's (S&P) 500 index, which comprises 500 large-cap and midcap U.S. stocks. These stocks are selected by a committee based on market size, liquidity, and industry.

Yield Curve: Is a line that compares the yield of bonds of equal quality but different maturity dates. In general, bonds with longer maturity dates offer higher yields than bonds with shorter maturity dates, thus producing an upward sloping yield curve.

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