Poplar Forest Capital

Active. Contrarian. Value.

December 2021

Poplar Forest Quarterly Commentary

J. Dale Harvey
CEO, CIO

Dear Partner,

I love college sports – football in particular. That's because, more often than not, the emotion of student athletes transcends what I see when professionals take the field. As I write this, a season that started in late August is entering its final stretch of bowl games and three matchups that will lead to the crowning of a national champion from among football's final four: Alabama, Michigan, Georgia, and Cincinnati.

Alabama's success comes as a surprise to no one. In recent years, it (along with Clemson) has dominated college football. Since Nick Saban became head coach of The Crimson Tide in early 2007, the team has won six national championships. But Michigan? Its ascendance was unexpected.

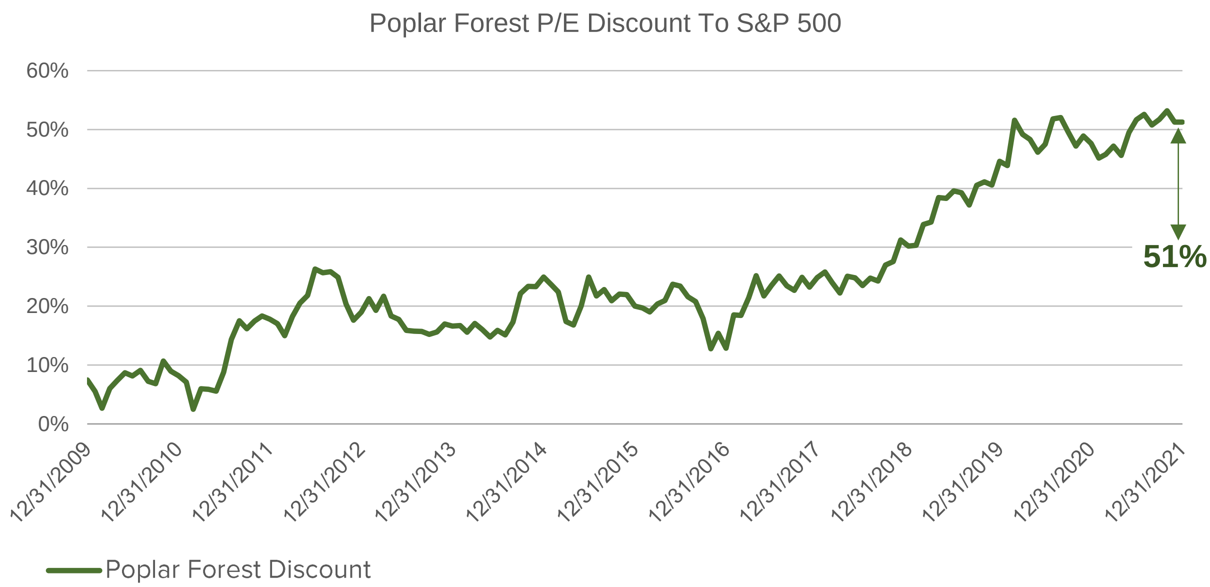
You can probably guess where I'm headed with this. Poplar Forest opened its doors just a few months after Saban took the reins at Alabama. If his team were a stock, it'd be a leading growth stock – the kind that has been in favor for about as long as Saban has coached Alabama. But Michigan represents the kind of stock we are drawn to at Poplar Forest: an historically successful program that had not been living up to its potential. For eight years in a row, Michigan had lost to archrival Ohio State. Given their recent mediocrity, it was no surprise to anyone that Michigan was not deemed one of the 25 best teams in the country when the season began. Like comedian Rodney Dangerfield said, Michigan "don't get no respect!" On this last day of 2021, as the #2 Michigan Wolverines head into the Orange Bowl matchup against the #3 Georgia Bulldogs, the Wolverines are yet again considered the underdog and are expected to lose by a touchdown.

When you think about it, our portfolio looks a lot like Michigan. Over the last 12 months, our investments have returned more than 35%, yet the current P/E ratio (10.7x) is lower than it was this time last year (11.8x) as these stocks' underlying fundamentals (earnings and dividends) improved by almost 50% - 20% more than the S&P 500 (see the Appendix for more detail). Looking forward, we believe earnings should grow 8-10% a year for the next few years, yet the portfolio trades at less than half the P/E ratio of the S&P 500. Talk about getting no respect!

In the long run, we understand that our companies are unlikely to increase their earnings as quickly as the leading growth companies, but we believe the future will be much brighter than implied by the portfolio's current valuation. Much of the discounted valuation can be traced to the current unpopularity of value stocks. Historically, value stocks have grown their earnings about 3% a year slower than growth stocks. Given this dynamic, it is understandable that over the last 18 years, the Russell Growth Index has been valued at an average 33% premium to the Value Index. That said, the growth premium has increased to 95% – something that last occurred in the inflating of the late-1990s Tech Bubble – a period that was followed by seven consecutive years of value stock outperformance.

Source: S&P Global Capital IQ; growth represented by iShares Russell 1000 Growth ETF (IWF); value represented by iShares Russell 1000 Value ETF (IWD)

Likewise, Poplar Forest's portfolios are currently valued at one of the largest discounts to the S&P 500 since we've been in business. In effect, the odds-makers are suggesting that the outlook for our companies is less attractive than it has ever been. We disagree. Our companies may be underdogs, but when we look out over the next 3-5 years, we believe that their fundamentals will more than beat the spread.



Source: S&P Global Capital IQ; S&P 500 represented by SPDR S&P 500 ETF Trust (ARCA: SPY)

Gambling versus Investing – I Want an Edge

I'm not much of a gambler. Yes, I may have bet my brother $20 that the Dodgers would beat the Braves in the playoffs, and I've been known to participate in a friendly poker game, but that's about as far as it goes. I have no special insight when it comes to picking which sports team will beat its opponent; if I'm going to risk any serious money, I want an edge. I want to believe that my odds of success are far better than the 50/50 chance of a coin toss.

At Poplar Forest, we believe that our analysis and judgement give us that edge. We strive to manage our emotions and the cognitive biases that can lead to sub-optimal decision making (and to gain advantage when others make those emotion-driven mistakes). Like a coach who tries to build a winning football program, we believe that our understanding of the opposition will allow us to build a long-term winning record. The behaviors that we see as particular opportunities include:

***Extrapolation/Recency Bias**:* Predicting the future is difficult. Given that, it is easy to see why people extrapolate the past into the future. For example, the pre-season odds makers in Vegas believed that Alabama and Clemson had the best chances of winning a national championship this year. Those two teams had made it to the last six playoffs and won it all in four of those six years. In the prior six seasons, Clemson had won 79 games while losing just seven. For a team that won 92% of their games, including six trips to the playoffs and two national championships, it seemed reasonable to extrapolate that success into the future. As it turned out, the Tigers didn't even win their conference, much less a national championship.

***Loss Aversion Bias**:* In simplest terms, most individuals think it's much better to not lose $100 than it is to win $100. Academic research demonstrates that the pain of losing is psychologically twice as powerful as the pleasure of gaining. The combination of the Extrapolation/Recency and Loss Aversion Biases is what most often creates opportunities for us. When a company isn't doing well, it is generally assumed that those struggles will continue into the future. Earnings estimates come down and the stock's valuation often compresses. If the underperformance is based on transitory causes that can reverse over time, the underperforming team could offer great recovery potential.

We spend our days looking for stocks that have the potential of the maligned Michigan Wolverines. We use a number of tools to determine if the skepticism reflected in the stock price is reasonable or if short-term challenges are obscuring long-term opportunity. Our process seeks to do this by:

1) ***Focusing on fundamentals**:* Much investor attention is focused on the past performance of a stock's price. If the stock price is going up, it is expected to keep going up – that stock has what's referred to as "positive momentum." Sometimes that positive momentum convinces investors to overlook underlying fundamentals like valuations that reflect too much optimism, the potential for margins to have reached unsustainable levels, or changes in management. Clemson had been a great team for years and that success was expected to continue, despite the fact that their Heisman Trophy winning star quarterback went pro after last season.

Our process is focused on normalized earnings, sustainable organic growth, and free cash flow generated after investing for that growth. While we aren't immune to the past performance of an individual stock, we are much more interested in the difference between the price of a stock and our assessment on the company's fair value.

2) ***Investing with a differentiated time horizon**:* We invest with a three-to-five year time horizon. This means we have to rely on our own proprietary research. For example, on average, 14 Wall Street analysts have 2021 earnings estimates for each of the companies we own. If you look out a few years, there are fewer than two estimates, and nine of our companies don't yet have a single estimate for 2025. Popular stocks on Wall Street often have 25-30 analysts actively following them, meaning it is hard to find an edge. Our companies get less attention, and we like it that way.

I believe that, on average, the stock market does a very good job of reflecting the known information about businesses. That said, a very rational reaction to short-term news flow may not be a good reflection of long-term potential. Football teams often lose a star player to injury and yet still go on to win games without him.

3) ***Being selective:*** Inherently, value investors favor the underdog. As much as I like an underdog, many of them are just plain dogs - in stock market parlance, these are referred to as "value traps." We believe that our fundamental research process can help identify the Michigan Wolverines hiding at the dog pound.

I think about index funds as follows: buying a Growth Index Fund is akin to betting on the favorite in EVERY football game; likewise, investing in a Value ETF is similar to assuming the underdog will always prevail. Neither approach makes sense to me as I believe it is possible to pick more winners than losers.

In Closing – I Feel Great about 2022

As this year came to a close, investors grew concerned about the rapidly-spreading COVID Omicron variant, particularly in light of an outlook for reduced fiscal and monetary stimulus. At Poplar Forest, our work suggests that while Omicron headlines could look quite dire in January, this could be the wave that creates enough natural immunity to finally put COVID in the market's rear-view mirror. With the Build Back Better Act's seeming demise, fiscal stimulus will be diminished at the same time that the Federal Reserve is normalizing monetary policy by reducing purchases of bonds and potentially raising short-term interest rates as early as March. Given how strong economic growth has been in recent months, these actions seem prudent as inflation fighting tools. Nevertheless, changes in policy make investors nervous as they worry about the Fed making a mistake. We will be watching the yield curve for clues, but our working assumption is that the economy is strong enough to continue to deliver attractive earnings growth in the coming year. In short, the year may start off rocky, but we think optimism could bloom just as tight ends and defensive backs gather for spring practice.

Given this outlook, I am particularly excited about the prospects for our portfolio. We believe the companies in which we are invested can grow their earnings 8-10% per year for at least the next few years. On top of that, the dividends they currently pay equal more than 2.3% of the value of the portfolio. These are solid companies with strong balance sheets and favorable long-term fundamentals, yet our portfolio is valued at less than 11x earnings while the S&P trades at more than 21x.

A market environment, that for years has favored growth stocks while shunning lower-valued issues, continues to provide great opportunities for us. In football terms, we had a great recruiting class in 2021; we added seven companies to the portfolio. The additions came in six different sectors and on both sides of the ball – offense and defense. We believe these new additions have vastly superior ratios of risk versus reward as compared to the players they replaced on the roster.

I'm also very excited to announce that the Poplar Forest team will be playing in a new stadium as of the first of the year. After 14 years at 70 South Lake Avenue, we are moving to new offices a couple blocks away at 225 South Lake. The brand new space is bright, open, and welcoming and we'd love to have you come visit us!

Finally, I'd like to say a special word of thanks to Nina Punaro. Nina joined us 14 years ago when we were just getting off the ground and we would not be the Poplar Forest we are today without her. The many of you who have interacted with her over the years know how conscientious she is and how much she strives for perfection in all her work. She has kindly and gently copy edited almost every letter I've written and I know that Strunk & White would give her an A+ on her efforts. When you come to visit our new offices, you'll soon see a portrait of Nina hanging in a place of honor. To me, she epitomizes what we mean when we talk about serving "Mrs. Jones." At Poplar Forest, every client is an individual by whom we seek to do right. While Nina will be retiring at the end of January, she will forever be a part of the Poplar Forest family.

I wish you all a happy, healthy and highly profitable New Year!

Sincerely,

Dale

J. Dale Harvey
December 31, 2021

Appendix

Investor returns are driven by dividends and changes in stock prices. Stock price changes are, in turn, a function of earnings growth and changing valuation. It may be helpful to disaggregate returns between changes in valuation (more sentiment driven) and changes in earnings estimates (fundamentals). In doing so, I think forward earnings estimates are most helpful as they tend to leave out temporary, current year variables like the credit reserve releases that have helped banks this year. The table below disaggregates the impact of changing P/E ratios on total return. As you can see, Poplar Forest's portfolio delivered stronger fundamentals than were reflected in stock prices. We believe this creates additional upside as other investors grow to appreciate the strong results of the companies in which we are invested.

	2021 Total Return	Starting P/E	Ending P/E	**Change in Valuation**	**Change in Fundamentals**
Poplar Forest	**+39%**	11.8x	10.7x	**-14%**	**+53%**
Russell 1000 Value	**+25%**	17.9x	16.3x	**-12%**	**+37%**
S&P 500	**+28%**	23.1x	22.0x	**-6%**	**+34%**

Click Here for Standardized performance and disclosures
P/E Source: S&P Global Capital IQ; S&P 500 represented by SPDR S&P 500 ETF Trust (ARCA: SPY); Russell 1000 Value represented by iShares Russell 1000 Value ETF (IWD); Data as of 12/31/21 for the calendar year.

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 12/31/21:

Advance Auto Parts	5.07
CVS Health	4.84
Wells Fargo	4.78
Dollar Tree	4.68
National Fuel Gas	4.67
Chevron	4.55
American International Group	4.33
Equitable Holdings	4.32
CNH Industrial	4.26
AmerisourceBergen	4.25

Cornerstone Fund Top Ten Equity Holdings and Percentage Weights as of 12/31/21:

Advance Auto Parts	3.52
CVS Health	3.23
Dollar Tree	3.17
National Fuel Gas	3.07
Wells Fargo	3.05
Chevron	3.03
United Therapeutics	2.96
AmerisourceBergen	2.82
Allstate	2.77
Equitable Holdings	2.69

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.

POPL-20211221-0061
ML21-005284 exp 9/27/22