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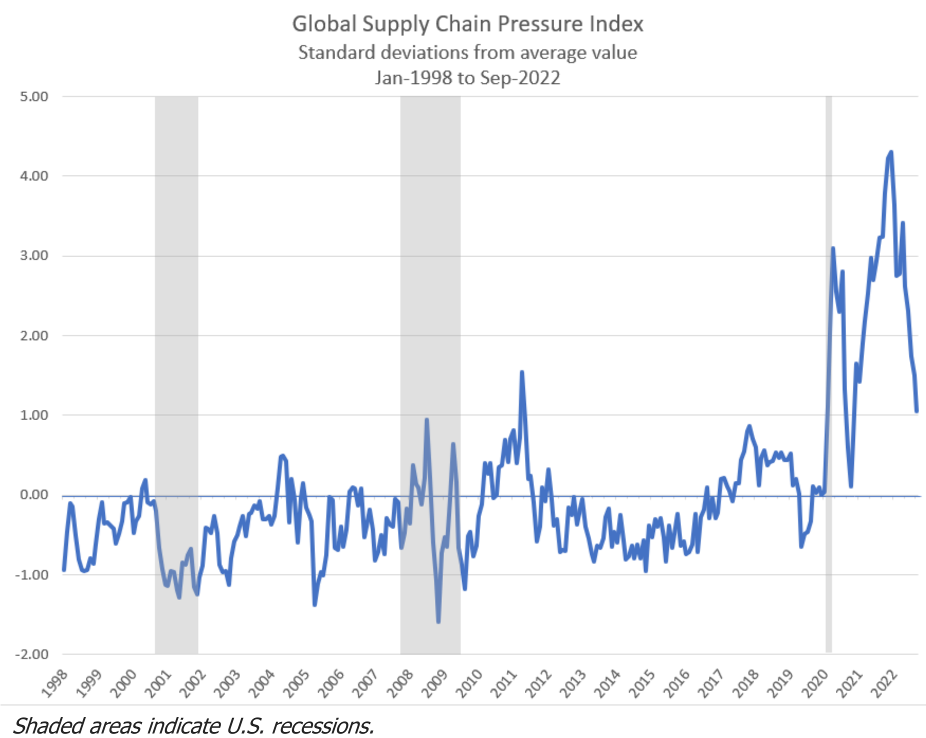
Questions of Value – From undersupplied to oversupplied?

Questions of Value is a series of memos addressing common questions from our clients about the Partners Fund and value investing. We welcome your feedback!

During the last two years, demand has exceeded supply for countless goods and services with the end result being rising prices and higher than expected inflation. More recently, however, we are seeing signs of this trend reversing. For instance, a number of consumer retail and technology hardware markets have experienced unexpected increases in inventories which has caused many businesses to pivot from price hikes to price cuts. Companies in these industries mistakenly assumed unusually high demand during the pandemic would persist well into 2022 and were then caught off guard when demand began to normalize or decline. Prior supply chain delays in these markets also caused businesses to double order to ensure they didn't lose market share. As supply chain pressures eventually eased, this pattern of over ordering led to above average levels of supply entering the market right as demand was weakening. Demand seems likely to broadly weaken across the economy in 2023 in response to the Federal Reserve's interest rate hikes which suggests many more companies may encounter markets that swing from a state of undersupply to oversupply. In this memo, we explore some of the investment opportunities and risks that may emerge if the economic backdrop shifts from demand exceeding supply to supply exceeding demand.

Supply chain pressures are rapidly easing

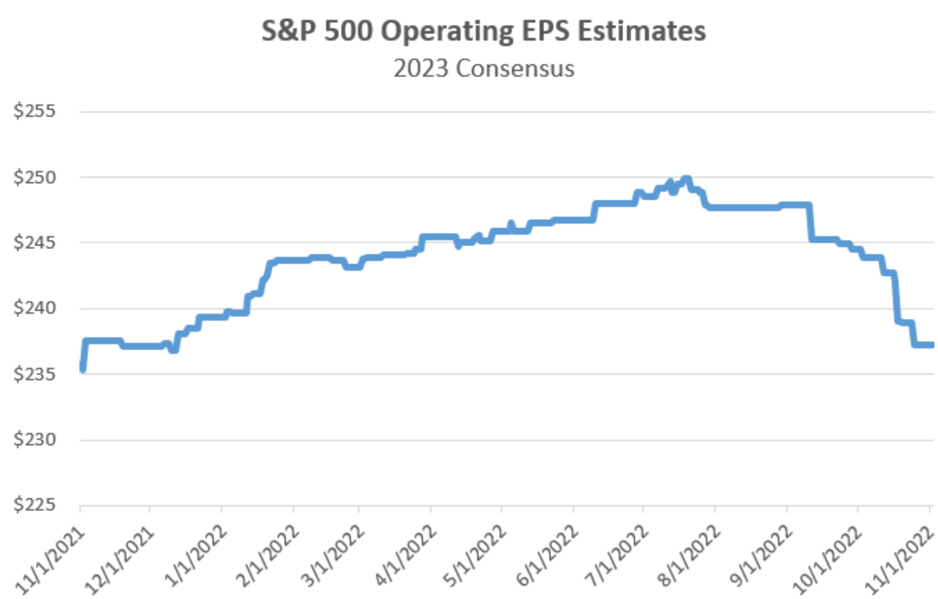


Shaded areas indicate U.S. recessions.
Sources: Poplar Forest Capital; Federal Reserve Bank of New York, Global Supply Chain Pressure Index

2023 recession concerns are top of mind for most investors and there is a growing list of companies whose stock prices now reflect a slowing economy. During third quarter earnings calls, many management teams expressed concern about an economic slowdown and some even predicted a recession. What concerns us, however, is the number of management teams that think they will be able to sustain elevated prices, or even raise prices, in the face of diminishing demand. If the economy materially weakens next year, we believe it will be challenging for businesses to maintain market share without adjusting their prices. This pricing dynamic is already playing out in the home goods, home building, leisure wear, and semiconductor markets – each of which has shifted from a state of undersupply to oversupply. Many companies serving these end markets have seen their stock prices crater during 2022 as multi-year expectations for pricing, sales, and margins were revised lower. In some instances, stock prices have fallen to levels suggesting not only low expectations for 2H'22-2023 but skepticism around a normalization of demand and margins in 2024 and beyond. **Attractive investment opportunities may be emerging among those businesses already confronting cyclical demand declines while still pursuing credible long-term strategies for sales growth and margin improvement.**

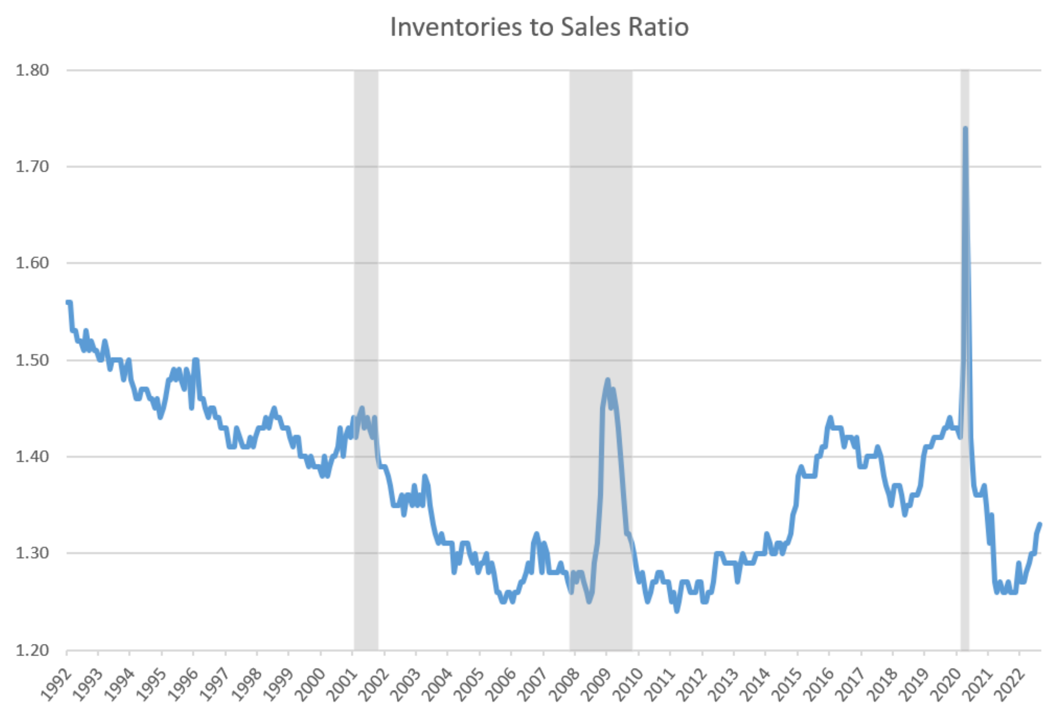
S&P 500 earnings estimates for 2023 have declined about 5% since early July and now hover between $230-$240 per share. It seems increasingly likely that S&P 500 EPS estimates have further fall as domestic and global increases in interest rates negatively impact demand. Falling earnings estimates do not always translate into falling stock prices, however, since investors and stock prices tend to anticipate changes in earnings before they actually occur. This pricing anticipation explains why a company's stock price may sometimes rise after a bad quarter, in which earnings were below management's expectations, or fall after a good quarter, in which profits exceeded management's forecast. Many stocks have already experienced significant price declines in response to rising discount rates and concerns about slowing growth in 2023. The relevant question for most investors probably isn't whether 2023 consensus EPS estimates have further to fall, but rather where the biggest sources of opportunity and risk lie relative to the expectations embedded in stock prices that have already declined.

Consensus 2023 EPS estimates for the S&P 500 have declined 5%



Sources: Poplar Forest Capital, S&P Capital IQ

We believe a fertile opportunity set may be emerging among companies that have already "taken their medicine" on weakening demand, pricing, and margins. Conversely, we see risks for companies selling relatively undifferentiated products whose stock prices embed expectations for continued price increases and margin expansion in 2023-24. Many management teams have faced margin challenges during 2022 and been unable to raise prices fast enough to offset rising wages, input costs, and previously discussed supply chain pressures. As a result, these companies have taken an increasingly aggressive stance on pricing throughout 2022 and are communicating an expectation for continued price increases to enhance their profit margins in 2023. Easing supply chain pressures and falling commodity prices may create margin tailwinds for many businesses next year but borrowing costs and wage increases are likely to be headwinds, particularly during the first half of 2023. With stable to rising unit demand, our research suggests margins would expand for most businesses as the aforementioned tailwinds outweigh the headwinds. Unfortunately, rising rates and various measures of consumer and business sentiment suggest unit demand is likely to weaken and/or decline for many industries over the next 12 months. Flat-to-falling unit demand usually causes companies to cut prices in order to maintain market share. One indicator of weakening unit demand is a rising ratio of inventories relative to sales. Third quarter financial results for many cyclical industrial, consumer, and technology companies showed evidence of rising inventory ratios. Management teams will be developing their 2023 business plans in the next few months and we foresee the potential for high magnitude margin disappointments if pricing assumptions don't accurately reflect the risk of deteriorating unit demand. **Caution is warranted for companies whose valuations don't compensate investors for the risk of falling unit demand, weakening prices, and rising inventory-to-sales ratios.**



Shaded areas indicate U.S. recessions.
Sources: Poplar Forest Capital; U.S. Census Bureau, Total Business: Inventories to Sales Ratio [ISRATIO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ISRATIO, October 31, 2022.

Let's Discuss — We'd Love To Hear From You

Please contact Drew Taylor (**dtaylor@poplarforestllc.com** or **(626) 304-6030**) or your Poplar Forest relationship manager with feedback and suggestions for future Insights. Follow us on LinkedIn where we commonly post useful and informative material.

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.

Partners 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.

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Past performance does not guarantee future results. Index performance is not indictive of fund performance. To obtain fund performance, visit www.poplarforestfunds.com or call 1-877-522-8860.

Consensus EPS estimate: A consensus estimate is a forecast of a public company's earnings-per-share (EPS) based on the combined estimates of all equity analysts that cover the stock.
Earnings Per Share (EPS): The net income of a company divided by the total number of shares it has outstanding.
Global supply chain pressure index: An index from the New York Federal Reserve Bank that tracks the state of global supply chains using data from the transportation and manufacturing sectors.
Inflation: A general increase in the prices of goods and services in an economy.
Inventory-to-sales ratio: A measure of the amount of inventory held by a company compared to the amount of sales that company generates.
Margins: Refers to profit margins. A measure of a business' profitability expressed as a percentage and measuring every dollar in sales that a company keeps in profits.
Operating EPS: The earnings per share (EPS) of a company that comes from its standard business operations.
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.