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February 2023

Questions of Value – Is selectivity now required for double-digit returns?

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!

As we reflect on the last decade, one important trend worth highlighting is the vast number of asset classes and portfolios that generated abnormally high annualized returns. For instance, from January 2013 to January 2023, the stock market (as represented by the S&P 500 Index) posted an annualized total return of approximately 13% — as compared to annualized returns of 8% and 10% over the last 25 and 50 years respectively[1]. It is human nature to extrapolate recent trends into the future and many of our clients are wrestling with how to calibrate their return expectations for the next decade. In this memo, we explain why we think it prudent to plan for a decade of single digit annualized returns from passive equity indexes like the S&P 500 and, conversely, why achieving double-digit returns is likely to require active portfolio management and much greater selectivity.

As shown in the table below, 10 years ago in January 2013, S&P 500 forward profit margins were 10%, the forward P/E ratio for the market was < 14x, the dividend yield was > 2%, and the 10-year U.S. government bond yield was 2%. Those starting conditions, which included margins and valuations *below* historical averages, contributed to an *above* average annualized total return of 13% through January 2023. In contrast to 2013, current forward expectations for S&P 500 profit margins are 13% (~30% higher), the forward P/E ratio is 18x (~30% higher), the dividend yield is < 2% (~20% lower), and the 10-year government bond yield is 3.5% (~75% higher).

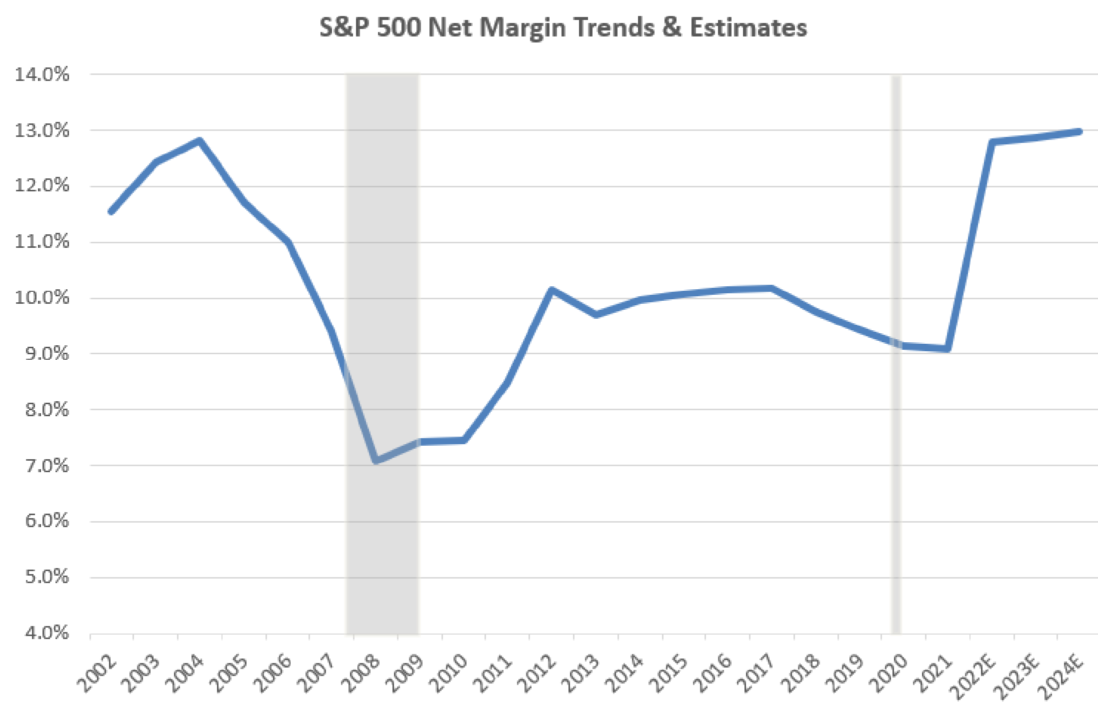
10-Year Comparisons	1/31/2013	1/31/2023	% Difference
S&P 500 Forward Profit Margins	10%	13%	32%
S&P 500 Forward P/E	13.8x	18.4x	34%
S&P 500 Dividend Yield	2.2%	1.7%	-23%
10-Year Treasury Yield	2.0%	3.5%	74%

Sources: S&P Dow Jones Indices, S&P Capital IQ, Poplar Forest Capital

The economy is constantly changing and, at times, there can be good reasons to think that future trends in profit margins will deviate from past trends. For instance, as more asset-light businesses, such as software companies, gain share of economic activity that can push margins higher. On the other hand, adverse changes to interest rates, tax rates, and accounting rules can have an equal or greater impact on profitability. In the short-term, many investors expect profit margins to be sustained at historically high levels. This expectation is supported by CEOs across the economy pivoting, at least temporarily, away from funding growth at any cost and towards emphasizing margins, free cash flow, and capital returns to shareholders. Over the next 10 years, however, when we evaluate the puts and takes on profit margins, our conclusion is that S&P 500 margins are unlikely to be substantially higher than today. Stock prices tend to follow trends in earnings per share (EPS) which is simply the product of profit margins and sales growth per share. As we contemplate the outlook for future returns, the starting point for profit margins looks elevated relative to history (see chart below).

[1] Poplar Forest Capital calculations based on S&P 500 data. Annualized total returns assume dividends are reinvested.

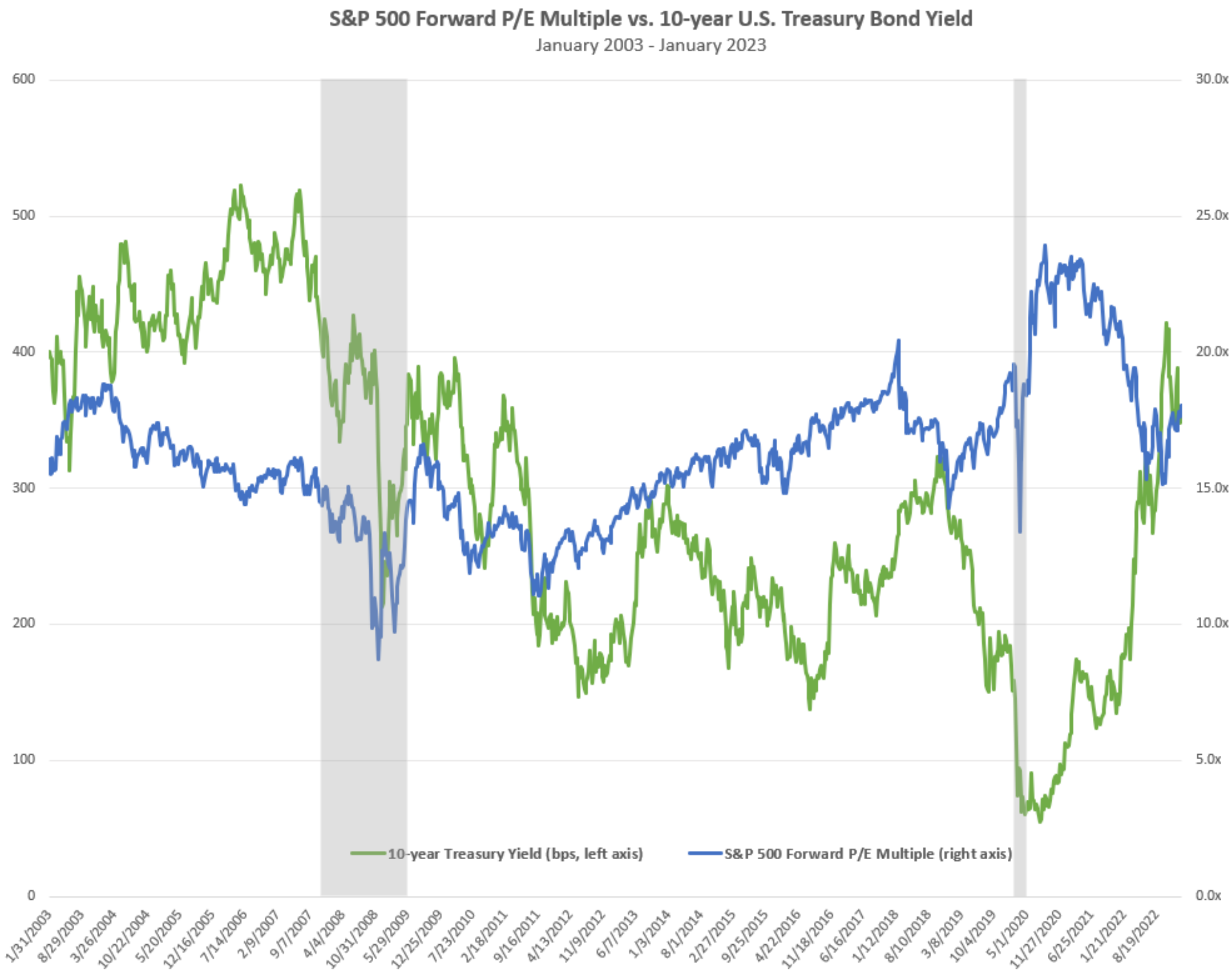
For sales, an assumption of mid-single digit growth seems reasonable. S&P 500 sales growth is often less volatile than margins and correlates to national and global trends in economic growth. So, if sales grow at a mid-single digit rate and margins are at similar levels ten years from now, then EPS growth of 5-7% is feasible. This compares to longer term EPS growth of about 7% during the last 20, 30, and 50 years[2]. Accordingly, EPS growth over the next decade may fall modestly below the historical 7% trendline due to a lack of margin expansion. We would also observe that margins and EPS are likely to decline whenever the next recession strikes and, in the interest of conservatism, we underwrite new and existing investments assuming a recession sometime in the next few years. Beyond long-term trends in EPS growth, the other driver of fundamental returns are dividends, which we assume will roughly track EPS growth and offer an approximate ~2% yield. In summary, the combination of say, 6% EPS growth and a 2% dividend yield, would result in an ~8% fundamental return for investors over the next decade excluding any changes in valuation ratios.



Margin trends and other business fundamentals are impacted by index rebalancing. Recessions are shaded.
Sources: S&P Capital IQ, Poplar Forest Capital

On valuation, as the chart below indicates, the forward P/E multiple for the S&P 500 has ranged between 13-20x over the last 20 years, excluding extreme periods like the global financial crisis or the post pandemic bull market. During the global financial crisis, valuations declined towards 10x which contrasts with valuations expanding towards 25x during the post pandemic bull market when interest rates hit record lows. The stock market's current valuation of ~18x 2023 consensus EPS estimates from Wall Street research firms suggests that, similar to margins, valuation multiples are towards the higher end of the historical range observed over the last 20 years. Accordingly, when thinking about the impact of valuation multiples on future returns, we think it reasonable to assume multiples modestly contract or, at best, are stable 10 years from now. We don't have high conviction in our ability to precisely predict returns in the short run, but we do believe the current investing fact pattern suggests it would be prudent for investors in passively managed stock market indices to plan for single digit annualized returns over the next decade. For instance, an 8% fundamental return from EPS growth and dividends combined with a 0-1% decline in valuation would yield a 7-8% annualized return — OK relative to other asset classes, but a big step down compared to the double-digit returns of the last decade.

[2] According to Intrinsic Research, S&P 500 Operating EPS growth was 6.7% from 1972 – 2022, 7.3% from 1992 – 2022, and 7.4% from 2002 – 2022.



Recessions are shaded.
Sources: Intrinsic Research, Poplar Forest Capital

Thankfully, we and our clients have the ability to be selective with our investments. **In contrast to the market, many of our investments in the Partners Fund are in companies with profit margins that are depressed relative to history (not elevated) and priced at forward valuations closer to 12x 2023 EPS (not 18x). Of equal importance, these companies are run by management teams executing self-help strategies that we believe can drive long-term earnings power and stock prices significantly higher in the years to come.** The building blocks for mid-teens equity returns still exist but they are becoming scarcer and increasingly require the application of distinctive investment processes focused on only the very best long-term investment ideas. Much greater selectivity will likely be required for investors to sustain the double digit equity returns of the last decade into the next.

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.

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 medium sized companies may involve greater risk than investing in larger, more established companies because 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 Funds invest 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.

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

Earnings growth is not a measure of the Fund's future performance.

Basis Points (BPS): A unit of measure used in finance to describe the percentage change in the value of financial instruments or the rate change in an index or other benchmark.
Consensus EPS estimate: A forecast of a company's projected earnings based on the combined estimates of all equity analysts that cover the stock.
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.
Forward P/E: A version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation.
Free Cash Flow: The cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.
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.
Margin expansion: An increase in the rate of profit a company makes on its business.
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.
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.

Poplar Forest Capital, LLC, is the adviser to the Poplar Forest Funds, which are distributed by Quasar Distributors, LLC.