



June 2022

Poplar Forest Quarterly Commentary

J. Dale Harvey

CEO, CIO

Dear Shareholder,

When I first moved to California in 1991, I didn't know much about mountain lions. California has embraced these big cats in a way only California would. You may have read news stories about bridges being built over freeways to allow mountain lions (also known as pumas or cougars) to more easily navigate SoCal's suburban sprawl. In Northern CA, the geography is more suited to our feline friends, with lots of trees and underbrush in which they can conceal themselves. In late April, my wife and I got a call informing us that P1 (Puma #1), the grand dame of NorCal mountain lions, had been hanging out on a property we own in Sonoma County for eleven straight days. Cougars generally stay on the move as they hunt for food, and it was unusual for a big cat to remain in one place for such an extended period. The local expert, Dr. Quinton Martens, asked if he could come check on P1 and, since we happened to be in the area, I asked to tag along. A few hours later, Dr. Martens and I – each armed with no more than a walking stick – stomped into the underbrush, hoping to locate P1. As we set off, the scientist offered just one crucial bit of advice: "When you see her, DON'T RUN!"

Later, it occurred to me: That advice applies not just to cougars in the wild, but also to bears in the stock market.

In my last letter to you, I suggested that market conditions could get a little bumpy as the Fed set about normalizing monetary policy. While the magnitude of the market decline has been slightly worse than I expected, our focus on absolute value has cushioned the impact of the interest-rate driven decline in valuations. So far this year, the Partners fund has lost less than 4% as compared to the S&P 500's 20% decline (*View Partners Fund standardized performance [here](#)*). During this time, as measured by Russell's indices, large cap Value stocks fell 13% while their Growth siblings plummeted 28%. Rising interest rates may hurt highly valued shares more than they do low P/E stocks and while I always hate to lose money, we are pleased with how our portfolio has held up this year.

The table below disaggregates the total return investors have received into two components, the change in valuation driven by higher inflation and interest rates, and the contribution of earnings growth and dividends. As you can see below, not only are value stocks cheaper (and thus less exposed to higher interest rates), they have also been delivering superior fundamental returns (earnings growth plus dividend payments). Our portfolio's low P/E ratio has been particularly helpful in mitigating higher rates and our companies have been delivering even better fundamentals.

	Price to Estimated Earnings	YTD Total Return (6/30/22)	YTD Change in Forward P/E	YTD Earnings Growth + Dividends
Poplar Forest Partners (IPFPX)	9.1x	-3.6%	-15.6%	12.1%
Russell Value Index	12.9x	-12.9%	-21.2%	8.4%
S&P 500 Index	16.1x	-20.0%	-27.1%	7.2%
Russell Growth Index	21.1x	-28.1%	-32.0%	3.9%

Source: CapitalIQ, Poplar Forest calculations

Given solid fundamentals and discounted valuations, I continue to believe this value cycle can run for several more years. We think our portfolio is particularly well positioned given our forecasts of 8-10% annual earnings growth and a valuation of roughly 9x expected earnings. While there is increasing worry that the Federal Reserve (the "Fed") may drive the economy into recession to combat inflation, I believe our portfolio is well positioned to navigate the current environment.

With 35 years of experience under my belt, I have learned to treat bear markets the way Dr. Martens treats mountain lions: by cautiously looking for signs of trouble, but then not running away when you see a lion (or bear)! In fact, **bear markets often create buying opportunities for those investors who can stay focused on long-term value in the face of distressing newspaper headlines.** History suggests that it is better to be a buyer than a seller in a bear market as the stock market has always recovered and moved on to new highs.

Recession – I'm Not Convinced

From my vantage point, the decline in stock prices this year has been primarily a function of an inflationary-driven revaluation of financial assets. At this point, the price-to-earnings ratio of the market is back to reasonable levels, yet market commentators are ringing alarm bells suggesting that there is more pain to come as the U.S. enters recession. I've read some articles that suggest a recession is already underway, while a recent report from the Federal Reserve Bank of New York stated: "The chances of a hard landing... as occurred during the 1990 recession are about 80%." While I respect the Fed's economic models, their track record isn't great. It feels like only yesterday the Fed was saying inflation was going to be transitory – and we all know how that worked out.

As I read all the stories about a pending recession, I am reminded of economist Paul Samuelson who said that the stock market had predicted nine of the last five recessions. Predicting a recession is incredibly difficult as consumers and businesses often respond to changes in economic variables, like interest rates, in ways that may quickly upend top-down economic forecasts. While my parsing of the data suggests a far less dire outcome than the Fed does, at Poplar Forest we don't rely on top-down models when building our portfolios. Our process focuses on normalized earnings and free cash flow. I think it would be a terrible mistake to value a business based on the economically depressed earnings it might generate in a recession. A recession will come someday, though perhaps not as soon as the naysayers predict, so my team and I are building an economic slowdown into our multi-year projections of earnings and free cash flows. As a result, our out-year, normalized earnings estimates have come down a little, but the prospective returns we expect are still above our hurdle rate.

I remain optimistic about the outlook for economic growth given the term structure of interest rates. Fundamentally, I think the Fed wants to avoid recession, but they need people to be sufficiently worried about one to change their behaviors in ways that will bring inflation down to more acceptable levels. The current environment reminds me of 1987, 1994, and 2018. In all three of those years, the Fed was aggressively raising short-term interest rates; in all three cases, a recession was avoided because the Fed didn't go too far. These three periods stand in stark contrast to the late 1990s and 2005-2006 periods

when interest rate increases led to the bursting of the Tech and Housing bubbles, not to mention bear market declines that none of us want to live through again.

Recessions bring with them significant reductions in earnings estimates that make recession-driven bear markets much more painful as compared to revaluation driven selloffs. Like trackers looking for signs of animal activity, we can observe feedback loops when monitoring recession risk. When investors grow concerned that the Fed has raised interest rates too much, they may migrate to the perceived safety of long-term Treasury bonds. As more investors buy bonds, they may drive up the price, which has the effect of lowering the interest rate they receive. The spread between long-term (10 year) and short-term (3 month) interest rates is one of those trail markings which may help the bear hunter follow its quarry, as a very narrow or negative spread is a danger sign. Importantly, so far this year, **long-term interest rates have increased in lock-step with short rates – the spread between the two remains decidedly positive.** This key indicator of trouble remains far from the danger zone. I believe this indicates minimal recession risk in the near term, barring some exogenous shock. Higher rates will likely slow activity in rate-sensitive industries like housing, but I do not believe these pockets of softness will bring down the entire economy.

A Revaluation-driven Bear Market

As I’ve said, while it seems likely that earnings growth will slow a bit in coming months, I believe the underlying cause of the current bear market is a fundamental revaluation of financial assets driven by increased inflation. In order to protect their purchasing power in an inflationary environment, investors are demanding higher yields on their investments. While the Fed has increased its target for short-term interest rates by 1.6% this year, the interest rate on 10-year Treasury bonds has increased by a slightly lower 1.5%. If we want to compare stocks to bonds, we can invert the traditional Price/Earnings ratio and look at Earnings/Price – the so-called earnings yield. When we do this, we see that the earnings yield on stocks has increased commensurately with the interest rate on bonds. This bear market isn’t about recession, it’s about a higher discount rate on financial assets of all kinds.

	12/31/2021		6/30/2022		Change in Yield
	Forward P/E	Earnings Yield	Forward P/E	Earnings Yield	
3-month T Bill		0.06%		1.70%	1.6%
10 Year Treasury Bond		1.52%		3.01%	1.5%
Russell Growth Index	31.0x	3.2%	21.4x	4.7%	1.5%
Russell Value Index	16.3x	6.1%	12.9x	7.7%	1.6%

Source: CapitalIQ, Poplar Forest calculations

If this assessment of minimal recession-driven earnings risk is close to the mark, then the nadir of this bear market may be achieved when interest rates peak. That is unlikely to happen until we see concrete signs of moderating levels of inflation. As this process continues to play out, value stocks should have an advantage given their current valuations.

While the prices of the stocks in our portfolio have declined modestly, their earnings have continued to grow, thus leaving the portfolio looking even more attractive today than it appeared at the start of the year. Because we love what we own, we’ve made fewer than normal changes to the portfolio over the last three months. We added no new companies to the portfolio and we liquidated one investment – Reliance Steel & Aluminum.

Reliance is the leading company in the steel service industry. Basically, they buy steel in bulk at wholesale prices and sell it in smaller batches to their customers after a markup. When steel prices go up, their

revenues and profits grow. When we first invested in Reliance, the company had operating margins of roughly 7% and we believed that normal margins should be closer to 10%. The stock had a low P/E ratio and depressed earnings – a combination that I love. Over time, margins improved as industry supply and demand balances improved. In just the last three years, Reliance’s revenues have increased more than 50% and their earnings per share have almost tripled as margins have improved to 15%. During this time, earnings have risen even more than the stock price, so the stock’s current P/E ratio looks very low. So why did we sell our stake? We believe the low P/E ratio may be a misleading representation of value as Reliance’s margins now look unsustainably high. New steelmaking capacity is coming on line and we expect increased supply to drive down the price of steel and Reliance’s earnings with it. While we love cheap stocks, our focus is on normalized earnings and at this point, Reliance’s earnings are, in our opinion, abnormally high. We refer to this type of stock as one that is “cheap on a peak.” Stocks like this can become value traps.

Protecting Our Flock

I’m sure you are wondering how, walking stick in hand, I survived my trip into the underbrush. Here’s what happened: Dr. Martens and I were trying to locate P1 with the help of a tracking collar Dr. Martens had given her 15 years ago. But long before his handheld receiver told us we were within 15 feet of her, we realized why she had hunkered down on our property for eleven days: Food! My neighbor, Hugo, had recently moved his flock of 60 sheep onto our pasture. He had built an enclosure, but it was insufficient to keep P1 out. Mountain lions hunt by sight and Hugo’s enclosure was constructed of a chain link fence that allowed P1 a clear view of an all-she-could-eat buffet. The result: as Dr. Martens and I bushwhacked, we found the remains of six sheep. The naturalist explained to Hugo that if he covered the bottom six feet of fencing with shade cloth, then P1 would no longer see the sheep, would likely lose interest, and then move on. Hugo made the change, and his flock has been safe ever since.

But yes, you read that right: at one point Dr. Martens informed me that P1 was closer to us than 15 feet. “She can see us,” he told me. “But she’s staying out of sight.” I can still feel the adrenaline surge I felt. But she never materialized.

While our portfolio has produced a small loss through the first six months of the year, we feel good about our job as shepherds of your money. Our investment approach is focused on long-term, normalized earnings and free cash flow, but we also pay attention to balance sheet strength, the quality of the businesses in which we invest, and we seek to buy stocks at discounted valuations. Over the last twelve months, our portfolio companies have generated substantial free cash flow – roughly 8.7% of the portfolio’s value. That free cash flow is like an incredibly large stick which we can use to help fend off predators. We believe these tools may help defend our portfolio from the market bear that is searching for more vulnerable prey.

In my experience, changes in stock market trends are often associated with bear markets unleashed by seminal events like the bursting of the Tech and Housing bubbles, and, more recently, the COVID crisis. After the Tech Bubble burst, value stocks beat growth stocks for seven years in a row. The important thing was to identify the trend and then stay on the track! Likewise, after the Global Financial Crisis (the “GFC”), Growth stocks were the leaders for 10 out of 13 years as central banks around the world followed easy money policies that encouraged risk taking and that benefited long-duration growth stocks.

I believe the COVID crisis has created a new investment paradigm driven by a fundamental change in the inflation narrative. In the years following the GFC, the world’s central bankers worried about falling prices (deflation). The Fed and other central bankers around the world felt they knew how to handle inflation, but they were all scared of unleashing a deflationary beast they couldn’t control. As a result, they kept interest rates abnormally low to discourage deflation. These policies sowed the inflationary seeds that are flowering now, magnified by the societal changes wrought by COVID.

COVID appears to have permanently altered the employment market. Roughly three million workers left the workforce during the pandemic and it appears that at least a million of them have permanently decided to retire or stay home for other reasons. On top of this, clean energy policies have discouraged the development of new oil reserves, a change that has supported much higher energy prices. Scarce labor and a tighter supply/demand balance in energy markets likely means inflation will run a little hotter in the next decade as compared to the last. If central bankers shift from worrying about deflation to concerns over inflation, then interest rates may be structurally higher as compared to the last decade. This seems like the type of fundamental change that can drive a multi-year run for value stocks. Our focus on under-earning companies may also provide a welcome tailwind to our results if our assessment of company-specific profit improvement proves close to the mark.

As investors grudgingly acknowledge that the investment world has changed, we expect to see continued volatility in the stock market. We have a deep bench of new investment ideas that we have thoroughly researched and we are prepared to pounce if market volatility drives the prices of these targeted stocks to levels that we believe may provide great risk-adjusted, long-term investment results.

I have dealt with several bear markets in the 35 years I've been managing money. I believe this experience will be valuable as we navigate the volatility that may accompany additional increases in short-term interest rates as the Fed tries to tame inflation. I will be watching 10-year treasury yields closely for signs that the Fed has gone too far, but for now, conditions appear favorable. Just as P1 moved off of our property in search of easier prey, at some point this stock market bear will move on as well. When that happens, we hope to get handsomely rewarded for a portfolio of quality businesses that are growing, generating substantial free cash flow, and yet are valued at just 9x expected earnings. As you know, the Poplar Forest investment team invests alongside you and we will do all that we can to help protect and grow our flock.

Sincerely,



J. Dale Harvey
June 30, 2022

DISCLOSURES

Copies of fund prospectuses can be accessed [Poplar Forest Funds prospectus](#). 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 6/30/22:

United Therapeutics	4.63
Chevron	4.60
AmerisourceBergen	4.50
AT&T	4.35
Allstate	4.30
National Fuel Gas	4.24
Dollar Tree	4.18
IBM	4.06
Wells Fargo	3.88
American Intl. Group	3.88

Cornerstone Fund Top Ten Equity Holdings and Percentage Weights as of 6/30/22:

United Therapeutics	3.09
AmerisourceBergen	3.02
Perrigo	2.78
Merck	2.72
AT&T	2.70
Allstate	2.62
Organon	2.61
National Fuel Gas	2.58
Las Vegas Sands	2.57
Dollar Tree	2.50

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.

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.

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.

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.

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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