# Poplar Forest Partners Strategy Quarterly Update


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*June 30, 2017*

Poplar Forest Capital

To My Partners,

While many understandably view January 1st as the beginning of the year, July 1st comes closer to my idea of New Year's Day. During June, the school year ends, graduation ceremonies are held, and I celebrate Father's Day and my birthday. Life slows down as the weather heats up and it's a time well suited to contemplating past and present. July 1st is also a milestone for me as it marks the date, 21 years ago, that I first became a diversified portfolio manager. Yes, I'd been investing personally since age 14 and I'd run a sector portfolio since early 1992, but on that day in 1996, I felt like a baseball player who was called up to the major league team for the first time.

Since moving to the big leagues, I've watched first hand as value investing has come and gone in popularity. Too often, I've seen investors chase performance to their detriment while ignoring opportunities to invest in good strategies when they are out of sync with the broad market. While it may sound counterintuitive, Poplar Forest's short-term results are as bad as they ever have been relative to the S&P 500®, and I believe that makes this a particularly compelling time to invest with us.

In the late 1990s, early in my portfolio management career, I watched investors give up on value for the first time. It was christened a "new era," and those who focused on long-term value strategies were deemed dinosaurs headed for extinction. I was fortunate to work with wise and experienced professionals who understood the cyclicality of investing. They not only allowed me to manage money my way, but they also allocated more money to me at a time when my approach was decidedly out-of-sync with the market. When the tech bubble burst, value investing became fashionable again.

The concept of buying low and selling high can apply to investment strategies as well as individual securities. Emotionally, it can be difficult for clients to invest in a portfolio that is lagging behind the market, but we believe doing so can add to long-term results if the manager is following a sound strategy. As has happened in the past, value has once again fallen out of favor. Given this change in sentiment, I'm not surprised that we find ourselves well behind the S&P this year. Past experience suggests that this underperformance may be setting up a wonderful opportunity; we believe this might be a particularly good time to invest additional capital with Poplar Forest.

***Value Investing – Sometimes In Fashion, Sometimes Not***

I have long believed that using a value based investing framework gives an investor a distinct advantage over time. In essence, value investing is about buying stocks for less than they are fundamentally worth. Assessing fundamental value, however, is not so simple. The easiest approach is to simply compare the price of a stock to its current earnings or book value. That is the basis for most traditional value management strategies. Over time, even this simple method has been shown to work, though it doesn't beat the market every year. The table on the next page examines the returns of the Russell 1000® Value Index to the S&P 500®. The Value Index is designed to capture the performance of the "cheapest" half of the U.S. stock market.

| Value Stocks versus the Broad Market<br>Annual Total Return | | | |
|---|---|---|---|
| | **Russell 1000® Value Index** | **S&P 500®** | |
| 6/30/96 - 12/31/96 | +13.2% | +11.6% | Value better |
| 1997 | +35.2% | +33.4% | Value better |
| 1998 | +15.6% | +28.6% | |
| 1999 | +7.4% | +21.0% | |
| 2000 | +7.0% | -9.1% | Value better |
| 2001 | -5.6% | -11.9% | Value better |
| 2002 | -15.5% | -22.1% | Value better |
| 2003 | +30.0% | +28.7% | Value better |
| 2004 | +16.5% | +10.9% | Value better |
| 2005 | +7.1% | +4.9% | Value better |
| 2006 | +22.3% | +15.8% | Value better |
| 2007 | -0.2% | +5.5% | |
| 2008 | -36.9% | -37.0% | Value better |
| 2009 | +19.7% | +26.5% | |
| 2010 | +15.5% | 15.1% | Value better |
| 2011 | +0.4% | +2.1% | |
| 2012 | +17.5% | +16.0% | Value better |
| 2013 | +32.5% | +32.4% | Value better |
| 2014 | +13.5% | +13.7% | |
| 2015 | -3.8% | +1.4% | |
| 2016 | +17.3% | +12.0% | Value better |
| 1/31/17 - 6/30/17 | +3.0% | +8.7% | |
| | | | |
| **Compound Annual Return** | **+8.7%** | **+8.3%** | **Value better in 14 of 21 years** |
| **Value of $10,000 invested 6/30/1996** | **$57,764** | **$53,254** | **Value produced 8.5% more** |

**Past performance does not guarantee future results**

| Value vs. The S&P 500® – Not Always in Favor<br>Compound Annual Total Returns | | | |
|---|---|---|---|
| | **Value** | **S&P 500®** | |
| 2nd ½ 1996-1999 | +20.1% | +27.1% | |
| 2000-2006 | +7.8% | +1.1% | Value better |
| 2007-2015 | +4.5% | +6.4% | |
| 2016 | +17.3% | +12.0% | Value better |

The Value Index has produced a higher return than the S&P 500® in 14 of the 21 years I've been a portfolio manager. There were distinct periods like 1996-1999 and 2007-2015 when value was unfashionable, but over 21 years, the Value Index beat the S&P 500® by roughly 0.4% a year. That may not sound like much, but over 21 years, the Value Index delivered 8.5% more than the S&P 500®.

At Poplar Forest, our approach is more complex than simply buying the stocks that appear statistically cheapest. We believe that focusing on the quality of businesses and their long-term economics helps us avoid the stocks that are cheap for good reason while identifying companies that may not look cheap today, but do when we look several years into the future. We believe the analysis, experience and judgment that we apply to investing can't be replicated by a computer or an index creator, and the results of the process have more than justified the hard work over time.

As I have written about in past letters, I believe 2016 was the first year of a new cycle of outperformance for value strategies. In December 2015, the U.S. Federal Reserve raised interest rates for the first time since the financial crisis. After years of interest rate cuts and trillions of dollars of monetary stimulus, the Fed finally concluded that the economy was doing okay and that growth would continue with less intervention. Increased interest rates are a sign of improved economic times. And during those good economic times, value investing may do better than more conservative strategies like those that focus on low volatility and income. It took a little time for investors to agree with this outlook, but value strategies started to do better than the market after that first rate increase – well before the presidential election. While many view the election of President Trump as the spark that got the market going, I disagree; based on what we could see, businesses were doing well and business confidence was growing well before he won.

The Fed has continued to normalize monetary policy, and some commentators worry that they will go too far, that their actions will send us back into recession. This reminds me of a market adage from the 1930s – "three steps and a stumble" -- that suggested that if the Fed raised rates three times in a row, the stock market would experience a substantial decline. Like many market rules, there is a reasonable underlying argument here suggesting that when the Fed is trying to slow the economy by raising rates, they will likely succeed. When the economy slows, the market often takes a tumble. I think the current environment is quite different from the one that prompted that old market adage – the Fed isn't yet trying to slow the economy. Monetary policy is still stimulative with interest rates well below the rate of inflation. At this point, the Fed is simply starting to remove the extraordinary surplus provided in response to the Great Recession. At some point in the future, the economy may get too hot and the rate of inflation may rise to a level that will lead the Fed to try to slow the economy, but such an environment seems far from where we are today.

What's most troubling to me in the current environment is the loss of an absolute approach to value in the bond market. Historically, investors in fixed income securities demanded yields that substantially exceeded the rate of inflation. Over the last 40 years, 10 year U.S. Treasury bonds were priced such that they yielded a 3.3% premium to core inflation. Today, that premium is just 0.5%. Fixed income investors seem far more preoccupied with non-U.S. bond yields. In effect, the bond market is saying "who cares about inflation, just look at how much more you get from a U.S. Treasury bond relative to a German or Japanese bond." This reminds me of the logic many used to justify crazy valuations in the late 1990s tech bubble – "I know this stock trading at 60 times earnings doesn't look cheap, but its leading competitor is trading at 80 times." I think this type of faulty logic creeps in when a particular class of investment has produced great results – those owning the investment are afraid of selling too soon, so they use relative valuation to justify their decision.

**Style Cycles – An Alternative Approach to Evaluating Investment Results**

Investing is inherently a forward looking exercise; unfortunately, predicting the future is hard. Many take the easy way out – they look to the recent past to forecast the future. Despite the oft repeated phrase "past performance does not guarantee future results," the behavior of many investors is to buy what's recently done well in the belief it will continue to do well (while selling what has done poorly, thinking the bad performance will continue.) Invariably, this leads people to Buy High and Sell Low – which may not be a great formula for growing wealth.

While past results are an important tool in evaluating a money manager, in my opinion, the measurement period used is critical. I have long believed that the best approach to measuring results is over a full market cycle that includes both the bull and the bear phase. A full market cycle may be described as the period from a market peak, through a bear market decline of at least 20%, and back up to a new peak. The biggest problem with this assessment method is that market cycles have become very drawn out in recent decades – how is one to judge the results of funds that lack full cycle results?

| **Full Market Cycles** | | | |
|---|---|---|---|
| | | | |
| Date of Market Peak | 7/16/1990 | 3/24/2000 | 10/9/2007 |
| S&P Index Value at Peak | 369 | 1527 | 1565 |
| Time to Next Peak | 9 years, 8 months | 7 years, 6 months | 9 years, 8 months and counting |
| % Change Peak to Peak | 314% | 2% | 56% |
| | | | |
| Date of Interim Low | 11/11/1990 | 10/9/2002 | 3/9/2009 |
| S&P Index Value at Low | 295 | 777 | 677 |
| % decline from Peak | -20% | -49% | -57% |

As you can see above, the three most recent market cycles have lasted seven and a half years or more. Barring a surprise decline in the coming weeks, the current cycle is heading for the record books. Fortunately, bull markets don't die of old age -- they generally die when recession hits, and a recession does not appear to be imminent.

The inception date for the Poplar Forest Partners Strategy is November 1, 2007, days away from the 2007 market peak. We lived through the bear market and we've enjoyed the recovery since. With the market near all time high levels, our "since inception" results may be a good approximation of a full market cycle. Over this period, we've beaten the S&P 500® despite the fact that value has been out of favor; the Russell 1000® Value Index has lagged the S&P by -1.25%.

Within a full market cycle, there are often shorter periods of time when a particular investment approach is either in or out of favor. I believe being attentive to current investment fashion may be useful in trying to determine the best time to make a new or an additional investment.

As a firm that manages relatively concentrated portfolios of value investments, we often experience periods of time when our portfolios' results are decidedly out-of-sync with the broad market. As you can see below, we tend to produce results that amplify the style bias of the market – when value is in favor, we look smart; when value investing lags the broad market, we look dumb.

**Poplar Forest Partners Strategy – In Sync Periods**

| Time Period | Duration | Partners Strategy Return | Russell 1000® Value Return | S&P 500® Return | **Partners vs. S&P 500®** | Value vs. S&P 500® |
|---|---|---|---|---|---|---|
| 12/31/2007-3/31/2010 | 27 months | -2.94% | -19.29% | -16.03% | **+13.09%** | -3.25% |
| 11/30/2010-6/30/2011 | 7 months | +16.38% | +14.27% | +13.11% | **+3.27%** | +1.16% |
| 7/31/2012-8/31/2014 | 25 months | +87.25% | +56.50% | +52.02% | **+35.23%** | +4.48% |
| 1/31/2016-11/30/2016 | 10 months | +35.72% | +20.72% | +15.52% | **+20.19%** | +5.20% |

**Poplar Forest Partners Strategy– Out-of-Sync Periods**

| Time Period | Duration | Partners Strategy Return | Russell 1000® Value Return | S&P 500® Return | **Partners vs. S&P 500®** | Value vs. S&P 500® |
|---|---|---|---|---|---|---|
| 11/1/2007-12/31/2007 | 2 months | -6.03% | -5.81% | -4.85% | **-1.19%** | -0.96% |
| 3/31/2010-11/30/2010 | 8 months | -3.82% | +0.26% | +2.34% | **-6.17%** | -2.08% |
| 6/30/2011-7/31/2012 | 13 months | -7.66% | +4.07% | +6.91% | **-14.58%** | -2.84% |
| 8/31/2014-1/31/2016 | 17 months | -15.80% | -6.23% | -0.31% | **-15.49%** | -5.92% |
| 11/30/2016-5/31/2017 | 6 months | -4.81% | +5.55% | +10.81% | **-15.65%** | -5.27% |

*Performance data quoted represents past performance; past performance does not guarantee future results. Partners Strategy returns are net of fees and include reinvestment of dividends or interest.*

As you can see, lately our approach to investing has yet again become unfashionable. By the end of May, the magnitude of our "underperformance" reached levels seen at the extremes of the last two style cycles. But here's the thing to remember: client partners who invested when we were decidedly out-of-sync enjoyed substantially better-than-market returns in subsequent periods when investor preferences changed. For example, after being behind by 14.6% in the 13 months ending July 31, 2012, the Partners Strategy bested the S&P by over 35% over the next two years. If investment style cycles continue to follow past patterns, this may be a great time to invest additional funds with Poplar Forest.

In the recent out-of-sync period, our results have been hurt primarily by our energy and consumer investments. Energy stocks fell as oil prices declined; market hopes that OPEC cutbacks would bring petroleum supply and demand back into balance have faded as U.S. production has ramped up. Drilling has accelerated sharply in recent months, but with prices having fallen back to levels that make many projects marginally economic, at best, we may see a reversal in activity that takes the market higher in coming months. While higher prices would be a nice tailwind, we continue to believe that the companies in which we are invested each possess company-specific factors that should allow the stocks to deliver attractive long-term results even if oil prices don't head back to the $60s - it just may take a bit longer.

Our consumer investments have struggled in the face of multiple headwinds. Consumer spending has been lackluster and particularly confounding given current employment trends. In addition, the relentless advances being made by Amazon have led to a general belief in the demise of brick and mortar retailing, particularly at America's malls. Companies in the retail space have witnessed disappointing results and collapsing valuations which suggest market expectations of more pain to come. Our work led us to more bullish prognostications, and we have certainly been on the wrong side of these trends so far. The entire investment team is fully engaged in a process that includes bull/bear debates about these stocks as we seek to determine if we were simply too early in making these investments, or wrong altogether.

We've made mistakes with individual investments before and, try as we will, there will be more mistakes in the future. I've been investing the same way for 21 years now. While there will be periodic setbacks, I remain convinced that our approach of focusing on our best 25-35 investment ideas based on an assessment of normalized earnings and free cash flow will help us achieve our goal of market-beating long-term results. In the past, buying low – when our results were substantially behind the market – proved to be a rewarding strategy.

Many professional investors are afraid to invest in the relatively concentrated and benchmark agnostic way we do. They worry that their clients will flee if results lag behind a benchmark by too much. But to deliver better than average long-term results, one needs to be different than average. Being different may mean lagging behind broad market indices like the S&P 500® for certain periods of time. From my vantage point, being behind isn't a problem, it's an opportunity. An examination of the pattern of our results suggests that this may be a particularly attractive time to invest with Poplar Forest.

I'm thankful to have client partners who understand that investing is cyclical and who see the wisdom in counter-cyclically investing. Your patience allows us to build portfolios of our highest conviction ideas; we are particularly excited about the stocks we own today.

Thank you for your continued confidence in our approach and our team,

J. Dale Harvey
July 1, 2017

## Contrarian Value - Partners Strategy

**Poplar Forest Capital**
**Contrarian Value - Partners Strategy**
**Average Annual Total Returns as of June 30, 2017**

| | QTR | YTD | 1YR | 3YR | 5YR | Annualized Since Inception (11/1/2007) |
|---|---|---|---|---|---|---|
| **Composite Gross** | -1.91% | -1.05% | 18.99% | 6.18% | 16.86% | 8.50% |
| **Composite Net** | -2.16% | -1.55% | 17.82% | 5.13% | 15.69% | 7.34% |
| | | | | | | |
| **S&P 500** | 3.09% | 9.34% | 17.90% | 9.61% | 14.63% | 7.04% |
| **Russell 1000 Value** | 1.34% | 4.66% | 15.53% | 7.36% | 13.94% | 5.79% |

**Past Performance is not indicative of future results and individual account performance may vary. Please see additional disclosures at the back of this document.**

The Partners Strategy produced a –2.16% return versus the S&P 500®'s 3.09% in the quarter ending 6/30/17. This period was difficult for value strategies like those employed by Poplar Forest; the Russell 1000® Value index, for example, also lagged the S&P 500® with a gain of 1.34%.

For the quarter, the Strategy benefitted from investments in the healthcare, consumer and financial sectors with our top contributors being Coach (consumer), Citigroup (financial services), Abbott Laboratories (healthcare), AmerisourceBergen (healthcare), and Zimmer Biomet Holdings (healthcare). The bottom detractors that were most detrimental to our results were Baker Hughes (energy), Reliance Steel & Aluminum (materials), Mattel (consumer), MSC Industrial Direct (industrial), and Weatherford International (energy)[1].

Our investments in the energy and consumer sectors were a headwind to our results this quarter. Although we've found many high quality companies trading at deeply discounted valuations on normalized earnings in the consumer space, we've been early with our investments, and improvement initiatives are taking longer than expected. Due to negative investor sentiment and certain industry trends like drops in mall traffic and online sales challenges, stock prices remain depressed, but we see company-specific opportunities in these investments that we believe should overcome these headwinds. The primary driver of weak performance in our energy investments was a decline in oil prices due to unexpectedly robust U.S production. Our energy investments are companies with company-specific initiatives that should enable them to prosper, even while oil prices are near the lower end of the $40-$70 range we consider reasonable in the coming years.

[1] The top five and bottom five securities were objectively selected from among all securities holdings included in the Strategy for the measurement period. The identified securities represent the top five and bottom five based upon calculation of contribution-to-strategy return. The holdings identified do not represent all of the securities purchased, sold, or recommended for advisory clients. Past performance does not guarantee future results.

We eliminated Aetna from the portfolio this quarter, while establishing a new investment in Johnson Controls International, a high quality, multi-line company that operates in the buildings controls and power solutions industries. The company has repositioned itself from a cyclical auto supplier into a less cyclical industrial company with attractive growth prospects. Potential growth is backed by self-help initiatives, while a strong balance sheet and healthy cash flow generation can help provide downside protection. In addition, Hewlett Packard Enterprises successfully completed the spinoff of its enterprise services businesses, which merged with Computer Sciences to create DXC Technology. Subsequently, we sold our resulting shares of DXC, and the Strategy ended the quarter with 30 investments and roughly 4% cash.

**Disclosures**

**Investing involves risk. Principal loss is possible. Investments in medium-sized companies involve additional risks such as limited liquidity and greater volatility. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities.**

Opinions expressed are subject to change at any time, are not guaranteed, and should not be considered investment advice. Discussion of a particular security should not be considered a recommendation to purchase or sell that security. There is no assurance that any security discussed will remain in our portfolios for any particular length of time. Securities discussed do not represent an entire portfolio and in the aggregate represent only a small percentage of a portfolio. It should not be assumed that any securities discussed were or will prove to be profitable.

As of June 30, 2017, the Contrarian Value Partners Strategy's 10 largest holdings accounted for 45.71% of total assets. The Strategy's 10 largest holdings at June 30, 2017:

| | |
|---|---|
| **Zimmer Biomet Holdings** | **5.29%** |
| **Abbott Laboratories** | **5.13%** |
| **Citigroup** | **4.99%** |
| **MetLife** | **4.74%** |
| **Lincoln National** | **4.62%** |
| **Signet Jewelers Limited** | **4.31%** |
| **American International Group** | **4.21%** |
| **MSC Industrial Direct** | **4.19%** |
| **Bank of America** | **4.18%** |
| **Reliance Steel & Aluminum** | **4.06%** |

Book value of an asset is the value at which the asset is carried on a balance sheet. Book value is also the net asset value of a company, calculated as total assets minus intangible assets (patents, goodwill) and liabilities.

Free cash flow is revenue less operating expenses including interest expenses and maintenance capital spending. It is the discretionary cash that a company has after all expenses and is available for purposes such as dividend payments, investing back into the business or share repurchases.

Normalized earnings are adjusted to remove the effects of seasonality, revenue and expenses that are unusual or one-time influences. Normalized earnings help business owners, financial analysts and other stakeholders understand a company's true earnings from its normal operations.

Price/Earnings (P/E) Ratio is the ratio of a firm's closing stock price and its earnings per share.

Price/Book is the ratio of a firm's closing stock price and its fiscal year end book value per share.

The 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.

The S&P 500® Index is a market-value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. It is not possible to invest directly in an index.

The Total Return is the actual rate of return of an investment or a pool of investments over a given evaluation period. Total return includes interest, capital gains, dividends and distributions realized over a given period of time.

**Composite Specific Disclosures**

Contrarian Value – Partners Strategy Composite contains fully discretionary contrarian value accounts that will generally hold 25 to 35 companies with (i) an investment-grade debt rating, (ii) a history of paying stock dividends, and (iii) a market capitalization among the top 1,000 companies in the United States. These accounts are managed using a long-term approach to security selection. We define value investing as buying businesses at a discount to our assessment of fair value. We believe fair value is a function of sustainable free cash flow and the growth of that free cash flow. This perspective leads to an investment process that considers both valuation and growth. The balance between these two metrics will vary over time based on where we see opportunity. As no single benchmark is constructed in a manner consistent with our process, we present two indices: the S&P 500® Total Return Index with its balance of growth and value and the Russell 1000® Value Index which is comprised of companies with lower price-to-book ratios and lower expected growth rates.

Poplar Forest Capital LLC is an independent SEC-registered investment advisor that commenced operations in October 2007. Poplar Forest Capital LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Poplar Forest Capital LLC has been independently verified for the period October 31, 2007, through March 31, 2017. A copy of the verification report is available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Contrarian Value – Partners Strategy Composite was created on November 1, 2013, and has an inception date of November 1, 2007.

The S&P 500® Total Return Index focuses on the large cap segment of the market and includes 500 leading companies in leading industries of the U.S. economy, capturing approximately 75% coverage of U.S. equities. The Russell 1000® Value Index is market-cap weighted and measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The benchmark definitions and returns have been taken from published sources.

Composite results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The U.S. dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net-of-fee performance is calculated using the monthly fraction of the highest annual management fee incurred, applied monthly: for the period from composite inception through March 31, 2013: 1.15%, and for the period April 1, 2013 through current: 1.00%. The annual internal dispersion measure presented is an asset-weighted standard deviation calculation based on accounts in the composite the entire year. External dispersion is not presented prior to December 31, 2010, because 36 monthly composite returns are not available. Additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request. Past performance is not indicative of future results and individual account performance may vary. The firm maintains a complete list of composite descriptions, which is available upon request.

The investment management fee schedule is as follows: for pooled investment vehicles management fees are 1.00% with breakpoints outlined in the specific offering documents; for separate accounts it is 1.00% on the first $25 million and 0.60% on the remainder. Actual investment advisory fees incurred by clients may vary.

The compliant presentation and a list of composite descriptions are available upon request by calling Patty Shields at (626) 304-6045.