Poplar Forest Partners Strategy Quarterly Update

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June 30, 2015

Poplar Forest Capital

Dear Partner,

This is a milestone year for me: in mid-June I celebrated my 50th birthday. There was a fancy dinner with friends and a week away from the office to relax in Napa Valley. What a great way to mark this transition to the second half of life. For me, celebrating my birthday means summer has finally arrived!

I've always loved summer. Swimming in the pool. Vegetables fresh from the garden. Trips to the beach. And as Alice Cooper sang in his rock anthem "School's Out for Summer": "No more pencils, no more books, no more teachers' dirty looks." Students get a few months of escape from late nights of homework. Some will use the break from school to make a little money while others will simply work on their tans. Parents, meanwhile, pack fewer lunches. The pace of activity slows and we all get a chance to refresh ourselves.

Technically, the solstice, on June 21st, marks the beginning of summer in the northern hemisphere. Culturally, though, Memorial Day weekend seems to be the unofficial start of the season. In either case, a calendar tells us when the season has changed. But it's not that simple. At a minimum, summer can't really start until school's out – and that rarely corresponds to the solstice or Memorial Day. I think we know summer not by the calendar, but its signs: longer days, warm weather and bathing suits.

Managing money would be so much easier if investment cycles worked with calendar-like precision. While markets can be described as seasons, they are unpredictable in duration (a bear market winter followed by the recovery of spring, and the growth of summer that ultimately gives way to the slowing of fall). **I've read several reports recently that suggest a bear market is coming soon because we've been in an up market for six years. I've heard other analysts say we're due for a recession for similar reasons. I don't think it works that way.**

When I started in the business, the common belief was that market cycles lasted about four years. For example, the patterns appeared sufficiently predictable that some investors started making portfolio decisions on the belief that a bear market would occur in the first two years of each U.S. President's term. Rules like that happened to fit a pattern of past market behavior, but correlation does not imply causation. The funny thing about markets is that once a trading scheme becomes popular, the pattern underlying it tends to change.

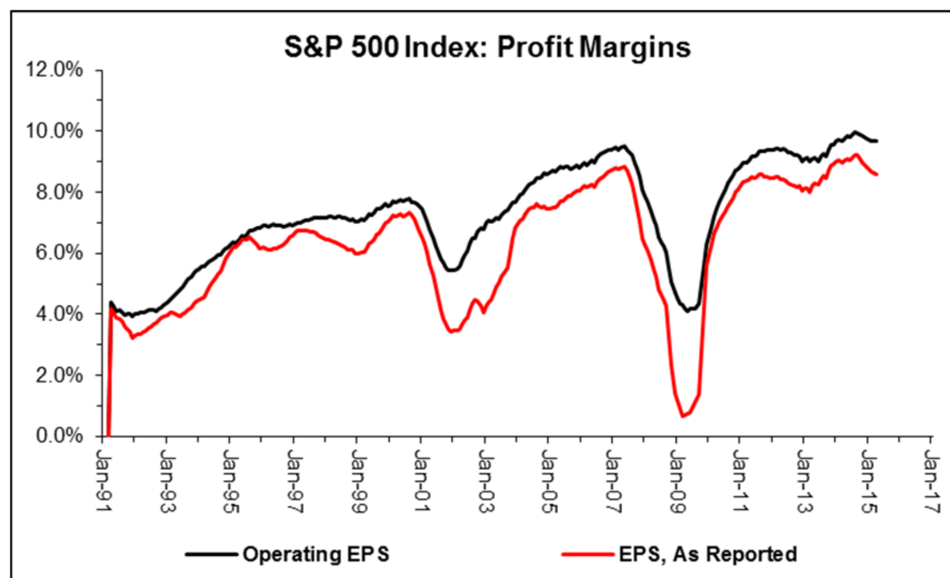
In the "good old days," investors had to contend with a bear market decline (generally 20% or more) roughly every four years. As you can see in the table on the next page, from 1956 until 1990, market cycles lasted about 50 months (an average of 51 months measured high to high and 49 months when measured low to low). The average magnitude of decline in the 1956-1990 period was roughly 28%. If that old pattern had continued, we'd have experienced four bear markets in the last 25 years; in contrast, we've only had two, but boy have they been doozies!

Stock Market Cycles as Measured by the S&P 500:

Date of market high	Months from high to high	Date of market low	Months from low to low	Magnitude of decline	Recession ?
8/2/56		10/22/57		-21%	Yes
12/12/61	64	6/26/62	56	-28%	
2/9/66	50	10/7/66	51	-22%	
11/29/68	34	5/26/70	44	-36%	Yes
1/11/73	49	10/3/74	52	-48%	Yes
9/21/76	44	3/6/78	39	-19%	
11/28/80	50	8/12/82	53	-27%	Yes
8/25/87	81	12/4/87	64	-34%	
7/16/90	35	10/11/90	34	-20%	Yes
3/24/00	116	10/9/02	144	-49%	Yes
10/9/07	91	3/9/09	77	-57%	Yes

Source: Yahoo Finance and Poplar Forest Capital calculations

The current market cycle, measured from the peak in 2007, is 92 months old. I don't think the calendar is the key to determining the end of the cycle; **I believe that bear markets and recessions occur to correct excesses.** The severity of the last two bear markets was driven by the magnitude of the excesses they corrected: in one case, ridiculously over-valued technology and other "new economy" stocks and in the second, over-valued homes financed by over-levered financial institutions.



Source: Stifel

Some commentators believe corporate profit margins are a warning sign of excess. At the moment, profit margins for the companies in the S&P 500 look high relative to history. Bears suggest that profitability is mean-reverting and that competition will ultimately dampen earnings. Bulls argue that we shouldn't worry; they say higher margins are the result of younger, more profitable companies taking share as the economy becomes more information-centric. For example, in the technology

space we see higher margin companies like Apple and Google outgrow less profitable companies like IBM and Xerox:

	Revenue ($billion)			Operating Margin	
	2010	2014	% Change	2010	2014
Apple	$65.2	$182.8	+180%	28.2%	28.7%
Google	29.3	66.0	+125%	35.4%	25.6%
IBM	99.9	92.8	-7%	19.8%	21.4%
Xerox	21.6	19.5	-10%	8.2%	8.0%

Source: Capital IQ and Poplar Forest calculations

This sort of structural shift is occurring within industries and between industries as our economy evolves. In addition, the profit contribution from overseas operations skews historic profitability comparisons given both the increasing amount of income generated overseas and the generally lower tax rate on those earnings.

In addition to voicing concerns about high margins, some investors are worried about valuation. According to Intrinsic Research, the current 18.4x ratio of price to trailing earnings for the S&P 500 is a bit above the 30-year median of 17.3x. Assuming constant profits, a price decline of just 6% would bring this valuation measure back in line with history. While stocks aren't "cheap" on a historical basis, they aren't "expensive" either; the S&P's ratio of price to trailing earnings is still well below the 21x (or more) seen at some past market peaks.

I have never claimed to be an expert market timer, and, fortunately, **the success of our investment program doesn't depend on correctly forecasting the direction of the stock market**. That said, I do believe it is important to understand the "season" in which we are making investment decisions. In trying to assess the transition from what I'm calling summer to a fall investment environment, I focus on three questions: 1) Is the Federal Reserve trying to slow the economy? 2) Do we see evidence of exuberant investor behavior? 3) Can we find individual stocks that look attractive on a multi-year basis?

As I see it: 1) The Federal Reserve is still HIGHLY accommodative (more than I think is warranted) and is far from trying to slow growth; 2) Investor behavior doesn't appear frothy, though the private market valuations of emerging technology companies and corporate mergers & acquisitions activity merit attention; and 3) **Our bottom up process continues to yield new investment ideas**.

Selectivity is Key!

I have no idea when the next bear market will arrive and I would not be surprised to see a modest correction when the Federal Reserve finally starts to raise interest rates. However, if investors shift money from bonds to stocks in fear of rising interest rates, the stock market could move much higher; perhaps we'll get back to P/E ratios of 20x or more.

While some investors seem to have fallen in love with passive investment vehicles which are always fully invested in hundreds of companies, **we believe in selectivity**. We are stock pickers, not market timers, and we believe that building concentrated portfolios of high conviction investments should help us avoid over-valued sectors while positioning us to potentially profit when the market comes to recognize the bargains we believe we've found. Our bottom-up process includes an examination of the profit margin of each of the companies in which we invest with an eye towards avoiding those that are enjoying unsustainably high margins. For example, roughly 2/3 of the companies owned in the Partners Strategy are expected to generate below average profitability in 2015 relative to their own history. **The S&P 500 may be at historically high margins, but our portfolio isn't**.

Likewise, we seek stocks at prices that look low relative to our assessment of normalized earnings. **While the Partners Strategy portfolio presently trades at a 15-20% discount to the S&P 500 on a current earnings basis, the discount jumps to over 40% based on our estimates of normalized earnings.** While we do not know how the market will treat each of our investments in the short term, the embedded discounts of the stocks we own give us confidence about the long-term prospects of our portfolios.

There's an old adage that the markets climb walls of worry. As I've discussed, there are certainly factors on which worriers can choose to focus like profit margins and the length of this cycle relative to past cycles. We are attentive to these issues, but we believe the highly selective portfolios we've assembled are well suited to the market environment in which we live. While acknowledging that a recession and/or a bear market could unexpectedly develop, I feel good about the long-term outlook for the companies in our portfolios based on our assessment of their future prospects, the sustainability of their free cash flow, and their financial strength.

As active investors, we usually have a couple companies that are slowly making their way out of the portfolio as we (hopefully) sell into strength while other investments grow in size. At present, I see more stocks to buy than to sell. I feel great about the businesses we own and the stocks we're buying given the prices of their shares relative to their future prospects and the discipline of our contrarian, bottom-up, long-term approach to investing.

The ability to be patient and to invest for the long term is only made possible because of thoughtful client partners who entrust us with their money for years (and hopefully decades). We will continue to do what we've done from the beginning: invest alongside you with the goal of generating market beating, long-term returns. Thank you for placing your confidence in the Poplar Forest team!

Dale

J. Dale Harvey
July 1, 2015

Contrarian Value- Partner's Strategy

Poplar Forest Capital
Contrarian Value - Partners Strategy
Average Annual Total Returns

	2Q 2015	Calendar YTD	1 year	3 year	5 year	Annualized Since Inception (11/1/2007)
Composite Gross	3.04%	2.70%	3.55%	23.54%	18.76%	8.76%
Composite Net	2.78%	2.19%	2.52%	22.29%	17.50%	7.57%
S&P 500	0.28%	1.23%	7.42%	17.31%	17.34%	6.10%
Russell 1000 Value	0.11%	-0.61%	4.13%	17.34%	16.50%	4.96%

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

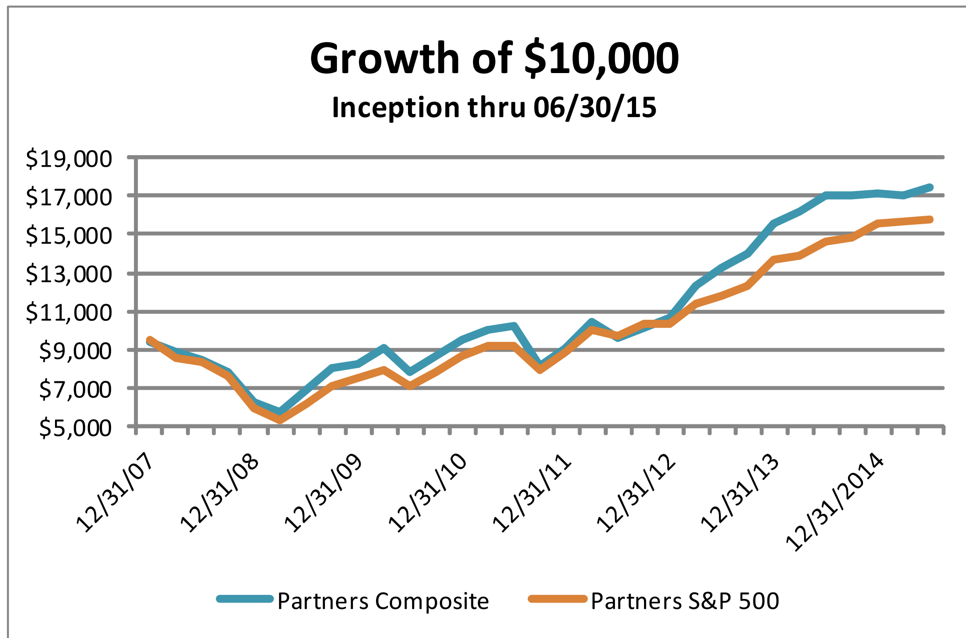
For the quarter ending June 30, 2015, the S&P 500 produced a total return of just 0.28% due to worries about rising interest rates and a weak Chinese economy compounded by continued Greek drama. Against this backdrop, the Strategy generated a return of 2.78%.

As I've highlighted in past letters, we've felt that our exposure to financial service companies would be a plus in an environment of rising interest rates and that was certainly the case over the last three months. Six of the seven investments we have in the sector increased in price during the quarter. The U.S. Federal Reserve appears close to starting the process of increasing interest rates to more normal levels. As this comes to pass, we believe that our investments in this area will continue to benefit the Strategy. Given appreciation during the quarter, financial service companies now account for almost 27% of the Strategy's net assets.

Weak results in the consumer sector partially offset the strength in financials. Three of the four stocks we own in this area declined in price during the quarter for a mix of macroeconomic and company specific reasons. Several years ago, consumer stocks accounted for roughly a quarter of the Partners Strategy. Most of those investments proved timely and we harvested gains and reduced our exposure to the area as the stocks increased in price. At the end of the quarter, the Strategy's investment in consumer companies equated to 8% of the Strategy's net assets.

While we are happy with the recent quarter's results, we focus on long-term investing. This leads us to place far more emphasis on the long-term when evaluating performance. On an absolute basis, we are pleased with what we've been able to accomplish since launching the Strategy over seven and a half years ago. Since inception, the Strategy has generated a compound total return of 7.57% per year. In comparison, the S&P 500 has produced a 6.10% return during this period.

The chart below is a hypothetical representation of how $10,000 would have grown had it been invested in the Strategy (to $17,495) or in the S&P 500 (to $15,745). If we are successful, the gap between the lines on the chart will widen over time.



Past performance does not guarantee future results. This chart illustrates the performance of a hypothetical $10,000 investment made in the Strategy since the Strategy's inception on 11/01/2007. It assumes reinvestment of dividends and capital gains, but does not reflect the effect of any applicable sales charge or redemption fees.

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.

As of June 30, 2015, the Contrarian Value Partners Strategy's 10 largest holdings accounted for 44.04% of total assets. The Strategy's 10 largest holdings at June 30, 2015:

Eli Lilly – 5.11%
Lincoln National – 4.69%
Baker Hughes – 4.65%
American International Group – 4.59%
Citigroup – 4.39%
Metlife – 4.36%
AECOM– 4.19%
Mattel – 4.06%
TE Connectivity – 4.02%
Hewlett Packard – 3.98%

The Price to Earnings (P/E) Ratio reflects the multiple of earnings at which a stock sells.

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.

Active investing has higher management fees because of the manager's increased level of involvement while index investing has lower management and operating fees. Investing in both actively managed funds and index funds involves risk and principal loss is possible. Both actively managed funds and index funds generally have daily liquidity. Actively managed mutual funds may have higher portfolio turnover than index funds. Excessive turnover can limit returns and can incur capital gains.

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.

An S&P index fund is a type of mutual fund with a portfolio constructed to match or track the components of the Standard & Poor's 500 Index (S&P 500).

EPS (Earnings Per Share) is calculated by dividing a company's net income by its outstanding common shares. **Earnings Growth is not a measure of a company's future performance.**

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®).

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%. Past performance is not indicative of future results and individual account performance may vary.

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 Christopher E. Morphy at (626) 304-6000.