



June 2021

Poplar Forest Quarterly Commentary

J. Dale Harvey
CEO, CIO

Dear Partner,

I've always liked to cook, but staying home during the pandemic gave me the chance to up my game. I've tried new things (my grill-seared ahi tuna is a hit), honed some old skills (my sourdough bread is better than ever), and also begun reading more about cooking. I loved the 2006 book *Heat*, in which writer Bill Buford describes learning to cook in Italy. So when my wife heard he had a new book out – *Dirt*, in which he searches for the secret of French cooking – she bought it for me.

I have a particular fondness for French food and *Dirt* read like a love story. I devoured it. By the end of its 432 pages, I'd laughed, cried, and added the city of Lyon, where much of the book takes place, to my bucket list. My wife thinks Buford has made my sauces better. But he also taught me something about teamwork.

A French restaurant does not succeed, Buford writes, only because of its Chef de Cuisine, or head chef. Excellence requires a team. In a French kitchen there is the Sous Chef (the head chef's deputy) and several Chefs de Partie (those who run particular stations like meat or fish or vegetables or desserts). There are behind-the-scenes staff procuring supplies and paying the bills and a front-of-house workforce directly interacting with customers. As I read *Dirt*, I couldn't help but think that successful investment firms aren't so different.

At Poplar Forest, I may be the Head Chef, but I couldn't do my job without the help of an amazing team: Derek, my Sous Chef; Cathy, Nick, Steve, Phyllis and Gregg our Chefs de Partie; Ryan, Erin, Marla, and Nina, who keep everything running smoothly behind the scenes; and Drew, Chris and Patty who interface with our clients. Many of our team members have been at Poplar Forest for more than a decade; they joined when we had just a handful of patrons, as they believed we were cooking up something special. To the Poplar Forest team: thank you for all that you do for our clients and for putting your trust in me those many years ago!

Good Food Requires Good Ingredients

One of the most frequent questions I'm asked right now is: how long will this value cycle last? I don't know precisely – nobody does – but the opportunity for outperformance continues to look very large. There is still a wide dispersion in the valuation of “growth” and “value” stocks, and we at Poplar Forest are still finding plenty of interesting new investment ideas. **I think the availability of good ideas is a critical measure of how much further we have to go in the value cycle.** I remember the difficulty of finding good ideas in 2006-2007 – that was a sign that the 2000-2006 value cycle was nearing its end. If a chef can't find good ingredients at the farmers market, his or her restaurant's daily specials are not apt to taste very special.

During the second quarter, we added three new stocks to the portfolio: Allstate, United Therapeutics and Organon & Co. In addition, we have been doing the prep work on a half dozen tasty-looking investment opportunities. If our additional research

supports our initial assessments of these businesses, I would expect at least a couple of them to make it onto Poplar Forest's menu. It feels like we are moving from a macro-driven environment to a "stock pickers'" market - the new ideas that appear most interesting are in a number of different industries. Our investment theses are not driven by a macroeconomic forecast or "risk on/risk off" expectations. We have identified what we believe are mispriced stocks with company specific catalysts for value creation.

During the second quarter, we liquidated our investments in Morgan Stanley, Stanley Black & Decker and ViacomCBS as we believed their respective stock prices adequately reflected, on a risk-adjusted basis, the future we see for each company. Here's a closer look at the new ingredients we've added to the portfolio:

Allstate is the fourth largest writer of auto insurance and the second largest provider of homeowners insurance in America. Until recently, Allstate also offered life insurance and annuities. The stock has long traded at a discount to peers like Progressive (17.3x '21E) and Mercury General (16.0x '21E). We believe a large portion of the discounted valuation was due to the life insurance and annuities businesses. The disposition of these operations freed up billions of dollars of capital, some of which was used to fund the acquisition of auto and home insurer National General, while also freeing funds for additional share repurchase. We believe the repositioned company will enjoy accelerating growth and that the stock's P/E ratio (8.6x '21E) will expand to a level more in line with its peers.

United Therapeutics was founded in 1996 with the goal of developing life-extending treatments for patients suffering from lung disease. The company has been very successful in serving niches like pulmonary hypertension (excessive blood pressure in the lungs) and is expanding into other end markets and launching new devices to deliver medications to patients. Management believes that they can double the number of patients served over the next three years – an expectation that, if met, could bring a doubling of their revenues and EPS. Despite this impressive growth potential, the shares are currently valued at 12.5x estimated 2021 earnings. In addition, the company boasts a balance sheet with \$3.2 billion of cash and investments and just \$800 million of debt. If you reduce the stock price by the amount of net cash on the balance sheet, the P/E ratio drops to just 8.5x.

Organon & Co. was spun out of Merck in early June. The company is comprised of a collection of mature products with little or no growth but with substantial cash generation. As is sometimes the case with spinoffs, selling by Merck shareholders who are less interested in the company's financial profile created what we believe is an extreme valuation dislocation. In the few weeks that the shares have been traded, they have changed hands at less than 5x expected earnings per share. The stock would still be cheap at our target valuation of 7-8x earnings, but such a valuation could see a 40-60% increase in the share price.

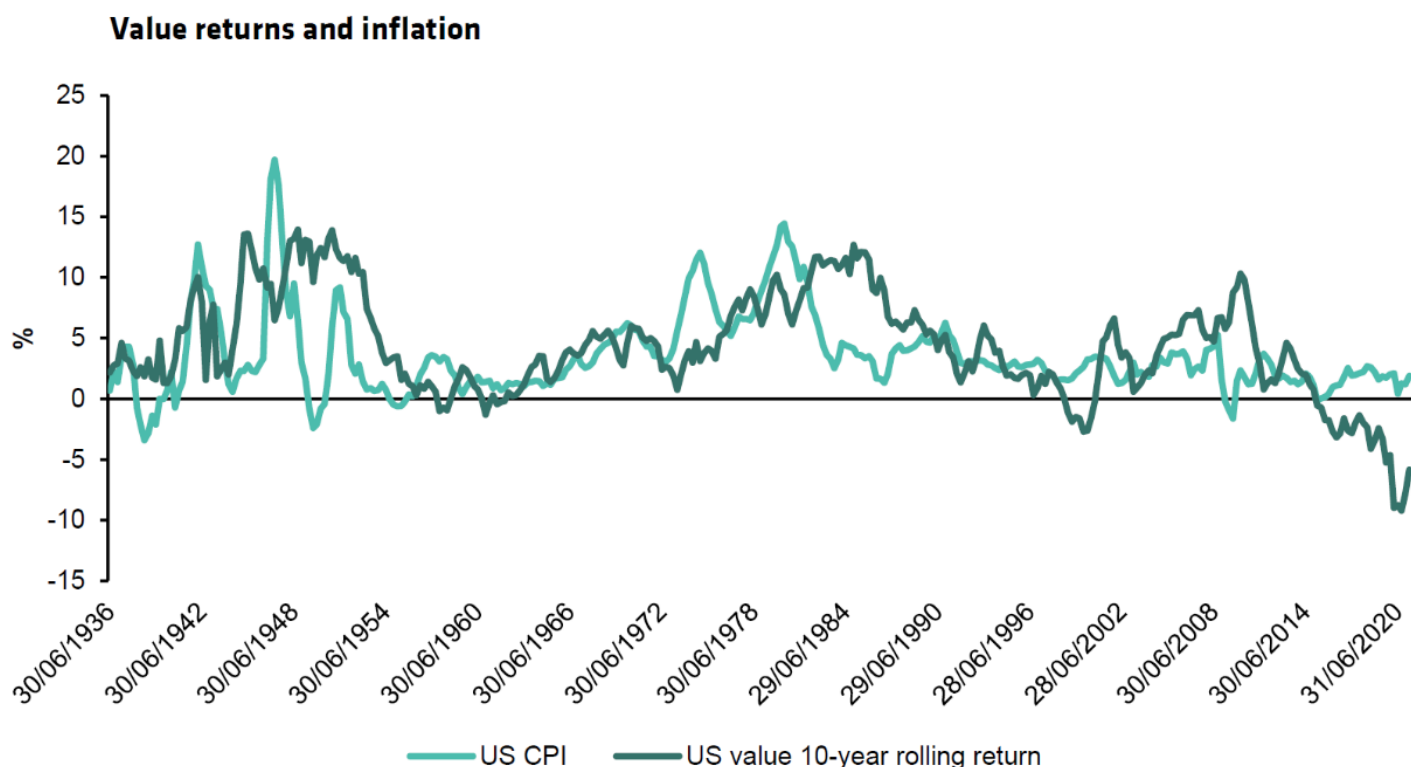
Outlook – Value Could Keep Cooking!

While I continue to see a very profitable path forward for value stocks, the stock market never moves in a straight line. Volatility can be our friend as market zigs and zags (which signify shifting data and sentiment) may provide us with opportunities to improve the risk/reward profile of our investment strategy. To put this in context, from 2000-2006, a period of seven consecutive years of value stocks beating growth stocks, the Russell 1000 Value Index produced a 7.8% compound annual return as compared to the -4.9% annualized loss of its Growth sibling. But this massive outperformance wasn't consistent from one quarter to the next. In fact, out of the 28 quarters in this period of massive outperformance, the Russell Value Index only beat the Growth Index in 17 quarters – just 60% of the time.

With growth stocks having reasserted themselves as interest rates trended lower during the second quarter, some naysayers are already predicting the end of this value cycle. I couldn't disagree more. For one, I continue to believe that bond yields have separated from reality due to price manipulation on behalf of central banks at home and abroad. Negative real yields

will continue to fuel the global economic oven with the benefit being robust earnings growth. This means there should be fewer reasons to pay a premium for earnings growth, as it won't be scarce. Furthermore, when interest rates do start to normalize, that may put downward pressure on the valuations of the leading growth stocks. In short, **value stocks appear to offer competitive earnings growth potential and their valuations can improve as interest rates normalize.** That combination may be a powerful wealth creator.

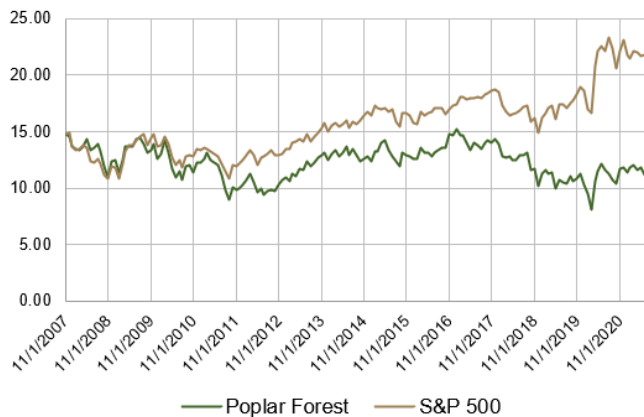
A continuation of the unprecedented, pandemic-induced emergency monetary measures (0% short-term interest rates and the buying of tens of billions of dollars' worth of bonds every month) is not the course of action I'd vote for if I were on the board of the Federal Reserve, but I don't get a vote. The Fed has made clear that it is very comfortable with accelerating inflation. Those worried about the risk of higher than expected inflation should keep in mind that, **historically, value stocks have done better than growth stocks in periods of increasing inflation.** As you can see below in data from a recent Bernstein Research report,ⁱ value stocks already have a large gap to close if inflation simply returns to the "normal" levels of the last decade (roughly 2%) and even more upside if inflation accelerates to higher levels.



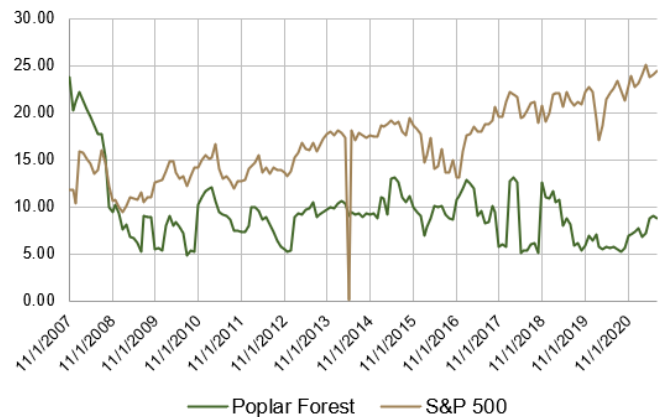
Source: Ken French database, Datastream, Bernstein analysis

With an economic backdrop that should be positive for value stocks, our portfolio continues to trade at what we believe is an overly discounted level. Consensus earnings estimates for the companies we own have increased by roughly 15% in the last three months and, as a result, the strategy's P/E ratio has fallen to roughly 11.1 times forward expected earnings as of June 30, 2021 (as compared to the S&P 500 at 22.0x and the Russell 1000 Value Index at 17.2x).

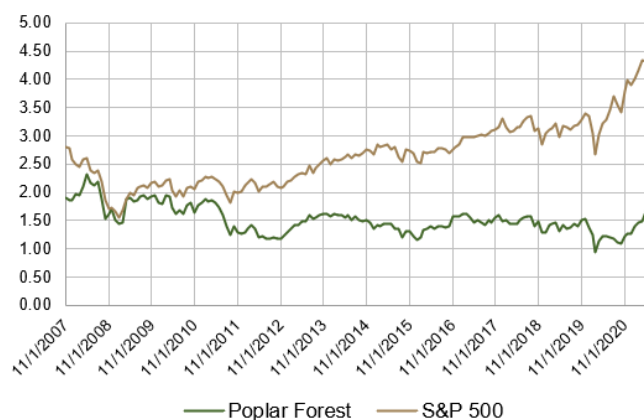
Price to Forward Earnings



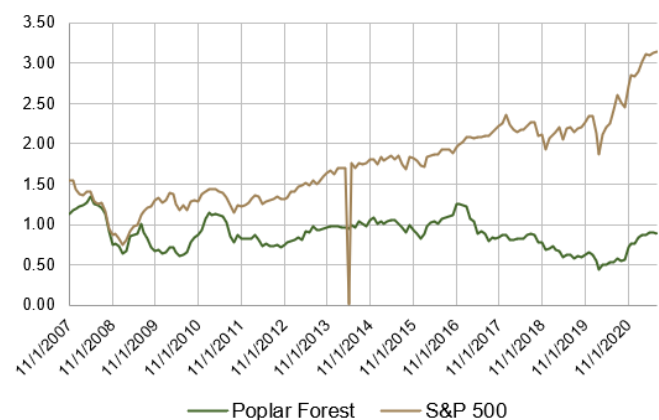
Price to Cash Flow



Price to Book Value



Price to Sales



Source: S&P Global Capital IQ, Data as of 6/30/21

As you can see above, by following a recipe that focuses on absolute value, we have produced portfolios that have maintained their value characteristics even as broad measures of the stock market have gotten progressively more expensive. At a time when the S&P is recording all time high prices, we believe these valuation gaps can provide some downside protection should there be an inflation-induced market correction while also providing substantial upside as market valuations normalize. In summary, I continue to be excited about the prospects of our portfolio and about potential additions to our investment menu.

Whether you are enjoying burgers and hot dogs or a fancier repast, I hope you and your family have a healthy and happy Fourth of July and a delicious summer!

Sincerely,

J. Dale Harvey
July 1, 2021

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.

Value stocks typically are less volatile than growth stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Index performance is not indicative of a strategy's performance. Past performance does not guarantee future results. Earnings growth is not a measure of the Strategy's future performance.

Partners Strategy Top Ten Holdings and Percentage Weights as of 6/30/21:

Wells Fargo	4.80%
Ally Financial	4.54%
Advance Auto Parts	4.54%
Murphy Oil	4.29%
Equitable Holdings	4.26%
CVS Health	4.21%
Chevron	4.15%
National Fuel Gas	4.08%
DXC Technology	4.01%
Allstate	3.98%

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.

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.

Price/Cash Flow Ratio: A stock valuation measure calculated by dividing a firm's cash flow per share into the current stock price. Financial analysts often prefer to value stocks using cash flow rather than earnings because the latter is more easily manipulated.

Price/Book Value Ratio: The price/book ratio of a fund is the weighted average of the price/book ratios of all the stocks in a fund's portfolio.

Price/Sales Ratio: This ratio represents the amount an investor is willing to pay for a dollar generated from a particular company's operations.

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.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a fixed basket of consumer goods and services (such as food, transportation, shelter, utilities, and medical care), and is widely used as a cost-of-living benchmark.

ⁱ www.bernsteinresearch.com; Portfolio Strategy: Strategic Outlook for Factors, and Why They Are Needed in Portfolios; Inigo Fraser-Jenkins, 6/7/2021