POPLAR FOREST QUARTERLY LETTER

Poplar Forest Capital

Active. Contrarian. Value.

J. Dale Harvey
CEO, CIO

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Dear Partner,

Up until a month ago, I'd never heard of Bryce Hall. I now know that he's a social media star with 13.5 million TikTok fans. Bryce is making enough money from his 15 second videos and YouTube posts to live with friends in a Hollywood Hills mansion. When LA's bar scene was closed due to COVID, this 21-year-old entrepreneur turned his house into a renegade night club. Police were summoned, warnings were given, citations were issued, and ultimately the authorities shut off the power and water to end the partying.

Kids have been throwing parties as long as parents have been going away for weekends. As a parent, I once returned home earlier than promised to find a raging shindig at our house. Suffice it to say, I sent everyone packing before things got too out of hand. That's the adults' job: to shut down the party before anyone gets hurt. Historically, the Federal Reserve has played that role for investors. William McChesney Martin was the ninth and longest serving Fed Chair (1951-1970) under presidents of both parties. As he famously said, "**The Federal Reserve… is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.**"

Today on Wall Street, the "cool kids" (the new Nifty Fifty – all COVID Winners) have been enjoying a blowout bash. Elon Musk, Jeff Bezos and Reed Hastings are in attendance as are the heads of Mastercard, Nvidia and Peloton, among others. They're toasting the success their businesses have had as we all sheltered at home. Congress also got an invite. And why not? Members of Congress are like rich kids with their parents' credit cards; they keep buying everyone drinks while assuming that someone else will pay the tab later. Current Federal Reserve Chair Jerome Powell is there too, but not as a chaperone – he's offering everyone free shots of Patron! The Fed has decided that the United States needs higher prices so they're going to keep interest rates artificially low until the Fed's preferred measure of inflation (core PCE) averages at least 2% over some undefined (but long) period of time. The Fed's current thinking is that rates will stay low until well into 2023.

The partygoers don't seem worried about tomorrow's hangover. It's as if they are following the words of former Citigroup CEO Chuck Prince, who said in 2007: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Staying on the dance floor with bank stocks in 2007 turned out to be ill-advised. Today's investors continue to treat financial service companies as untrustworthy drunks, even though they've cleaned up their acts. Time will tell if the current market darlings suffer the same fate, but I don't like their odds given their elevated valuations.

Low Interest Rates Can't Solve Every Problem

While investors seem to be increasingly addicted to free money, I'm becoming ever more worried about the unintended long-term consequences of low rates, especially given the Fed's new ultra-dovish policy targeting higher inflation. As former Fed Chair Martin also said: "What's good for the United States is good for the New York Stock Exchange. **But what's good for the New York Stock Exchange might not be good for the United States**."

The biggest issue facing the U.S. economy today is health related, and low interest rates simply can't cure COVID. In fact, seniors, those most at risk for COVID, are likely to have bonds as a large part of their investment portfolio. It seems morally reprehensible to me to penalize those who have prudently saved for retirement and who have a fixed income allocation befitting their age. Other constituents that the Fed is turning into losers are big fixed income investors like pension plans, life insurers, and foreign governments with healthy balance sheets.

In the last decade, inflation, as measured by core CPI, averaged 1.9%, while core PCE (an index of personal consumption expenditures favored by the Fed) averaged just 1.65%. While some would think the last decade's experience is consistent with the Fed's mandate for stable prices, the Fed isn't satisfied – it wants 2% PCE! However, with the interest rates being held at artificially low levels – 0.0% on cash and 0.7% on 10-year Treasury bonds as of 9/30/20 – the 2% inflation targeted by the Fed would materially erode cash and bond holders' purchasing power. For example, with 2% inflation, what costs $10,000 today will cost $12,190 a decade hence. Meanwhile, a 10-year Treasury bond yielding 0.7% will be worth just $10,722. In terms of standard of living, the fixed income investor who buys 10-year Treasury bonds could easily lose 12% of the value of his or her money. Keeping money in cash will be even worse. In effect, **the Federal Reserve's easy money policies are confiscating the wealth of savers while subsidizing borrowers**. I think this is bad public policy.

Perhaps the biggest beneficiary of this stealth wealth confiscation is the Federal Government. For the coming year, the Federal deficit is projected at $3.3 TRILLION – more than 15% of GDP. (And that assumes Congress doesn't add to the tab. Republicans "only" want to spend an extra $1.6 trillion while the Democrats are demanding another $2.2 trillion.) This deficit adds to decades of spending in excess of revenues which should soon push total Federal Government debt past $27 trillion. If I owed $27 trillion, I would want interest rates to be as low as possible too! Just think: for every 1% increase in interest rates, the cost of financing our debt goes up by $270 billion a year – that's over 1% of GDP.
In the decade before the Great Financial Crisis, 10-year Treasury bonds yielded 2.5% more than inflation. Over the last decade, the premium has been more like 0.5%. Today, yields are well below inflation. If

price increases reach 2% a year, and bond yields return to a more normal premium relative to inflation, then we could be looking at 2.5% to 4.5% yields on 10-year Treasury bonds as compared to 0.7% today. The Government could be looking at substantially higher interest costs in coming years and I'm not sure how we'll pay for it beyond borrowing more money still. Presumably, **the debt mountain can easily keep growing as long as bond buyers are willing to lose purchasing power every year;** can we really count on that to continue forever?

In the run-up to the financial crisis, many of the leading mortgage finance companies offered subprime borrowers adjustable rate mortgages with artificially low initial interest rates. Home buyers who could cover the first few months of payments ran into problems when those teaser rates escalated. Lenders were less concerned about repayment because they believed the homes would hold their value even if the borrowers defaulted. This time around, it feels like the Federal Reserve is playing the role of Countrywide and Fannie Mae. The Treasury keeps borrowing more and more to plug the deficit and financing it at artificially low rates. **Implicitly, those who are lending to the Government (by buying Treasury bonds – or bonds with tight spreads relative to treasuries) are saying they do not believe that inflation will be a problem during their investment time horizon**.

As long as everyone keeps drinking the "no-inflation in my lifetime" Everclear-spiked Kool-Aid, things will be fine. However, if all the revelers head for the exits at the same time, we could have trouble. I suppose too few remember the bond market rout in 1994 when 10-year treasury rates increased more than 2% in nine months.

Outlook – No One Knows How Long the Growth Stock Party Will Last

The current growth stock party on Wall Street may continue to rage for months or even years, but at some point, the bar tab will have to be paid. It seems most likely that payment will come in the form of much higher interest rates. Given this, an investor would seem to have two choices: 1) keep dancing because no one knows when the party's going to end or 2) leave early, get a good night's sleep and prepare for the morning after.

As a practical matter, Poplar Forest Capital never set foot on the growth stock dance floor; we're still sitting home with all the other value investors who skipped the soirée. The closest we got to the parquet was QUALCOMM, the semiconductor company we invested in several years ago when the company was mired in controversy about its cellphone chip technology licensing deals. We believed it had the best technology in the business and that it would prevail in battles with regulators, customers and competitors. Ultimately, Apple conceded and Intel threw in the towel. Today, the controversy has been resolved favorably for shareholders and the stock has been deemed a 5G winner worthy of an 18.5x P/E multiple. Relative to the shares of current party goer Nvidia, a semiconductor company valued at 57x earnings, QUALCOMM still looks attractive. However, relative to our portfolio of businesses trading at 13x depressed 2020 results and 11x forward estimated earnings, QUALCOMM just didn't make Poplar Forest's cut anymore. We eliminated it from our portfolios during the third quarter.

We continue to be selective in evaluating new ideas and, as a result, we added no new companies to our portfolios in the third quarter. In looking at new investments, we are seeking businesses with strong balance sheets, healthy free cash flow and opportunities for margin expansion. We're also spending a fair bit of time researching companies with above average dividend yields, as I believe that may provide downside protection when the growth stock disco ends.

Get Your Tickets to ValueFest!

While growth stock performance has been particularly impressive in the last three years, the party really started in the aftermath of the Global Financial Crisis ("GFC") in 2007-2008. The repercussions of the GFC were more than a decade of disappointingly slow economic growth and low inflation. In a slow growth context, it isn't surprising that investors increasingly flocked to companies with exciting new technologies and innovative products. In addition, with exceedingly low inflation and interest rates, it became ever easier to justify fancy multiples for those companies. However, with numerous COVID vaccines in development, I think the stage is set for a handoff from growth to value. We started to see signs of this in early September. Perhaps it was simply a visit from the cops with a request to turn down the music, but the growth darlings started to underperform.

With more than six months of experience under our belts, Americans' ability to live with COVID continues to improve. Worries about a big surge in cases when kids returned to school seem, so far, to be misplaced as reported cases in the U.S. have stayed fairly controlled since Labor Day. With a vaccine expected by year end, confidence in economic recovery should continue to build. With the economy doing better than forecast, banks' credit costs have been benign. By as early as next spring, an increasingly vaccinated population should start returning to normal life and (especially if Congress provides additional fiscal stimulus to help bridge the gap) economic growth could be very robust. If that comes to pass, then investor conversations could quickly shift from the current talk of stimulus and low interest rates to accelerating economic expansion and increased inflation expectations.

As we saw in 2013 and 2016, value stocks have historically done well in periods of accelerating economic growth.[1] With global economies emerging from synchronized recessions of historic proportions, we should be able to enjoy several years of progress. We are already seeing evidence of this with strength in transportation and housing related stocks. Copper, long an indicator of expanding industrial demand, recently reached a new two-year high price. Our portfolio, with 24% in financial services and 12% in energy and materials, should be well positioned for a change in sentiment.

The value party will start small. I imagine a BBQ attended by the few stalwarts who never stopped believing that there can be beauty in unloved and out-of-favor companies and industries. Our menu will be built around tried and true processes for turning inexpensive ingredients into mouthwatering meals: the slow smoking of brisket, ribs and pulled pork (not to mention cole slaw, baked beans and a keg of ice cold beer.) Entrance to ValueFest shouldn't be expensive – and if you're reading this, you already have a

[1] In 2013 and 2016, the Russell 1000 Value Index return was 32.53% and 17.34% respectively.

ticket. Please, invite your friends! The current stock market "cool kids" won't be coming to our party until much later, after they can see, in hindsight, the benefits of paying low prices relative to the fundamental value of businesses.

For most everyone I know, 2020 has been a year to forget – and it's not over yet. We have a consequential election in just over a month and the run-up to voting could see continued, or even increased, market volatility. Given the expected magnitude of mail in voting, we are unlikely to have a winner on election night; it could take weeks before we know who'll be president. But America will get through it. We are resilient. Human ingenuity may soon bring us a COVID vaccine. The investment environment can change quickly, and I believe that the portfolios we've built at Poplar Forest are well positioned for the coming recovery.

Sincerely,

J. Dale Harvey
October 1, 2020

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.

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

As of 9/30/2020, the Poplar Forest Funds did not hold any securities mentioned herein.

Index performance is not indicative of a fund's performance. Past performance does not guarantee future results.

Consumer Price Index (CPI): Is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The annual percentage change in a CPI is used as a measure of inflation.

Core CPI: is a method for measuring core inflation. It is the consumer price index (CPI) excluding energy and food prices. There are many other methods for calculating core inflation, but this is the most popular measurement.

Core PCE: is defined as personal consumption expenditures (PCE) prices excluding food and energy prices.
The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Earnings Per Share (EPS): the net income of a company divided by the total number of shares it has outstanding.

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® 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.

Spread: the difference between two prices, rates or yields.

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