



## 2011 Annual Review

To my partners,

Four years ago, I established Poplar Forest Capital with a straightforward mission:

***Superior, risk-adjusted returns, net of fees and taxes, over full market cycles by investing in under-appreciated companies and industries***

Said differently, we strive for above average investment results. Generating above average results requires a different approach. Being different means sometimes being out of sync with the broad market. I've lived through such situations before (especially in the late 1990s) and that experience is particularly helpful today.

Over time, I have found a multi-year investment horizon to be an advantage. That said, in the current environment, **our results this year have been penalized by our long term approach as investors are currently focused on shorter-term issues including the financial crisis in Europe and slowing global growth.** When fear is pervasive, as it is today, time horizons shrink.

We recognize the worries on which many market participants are focused – Europe is certainly a mess and there may be a recession in 2012. But recessions come and recessions go – we don't value our companies based on depressed earnings during a recession. **Our portfolios will generally have what we consider to be the most attractive 25-35 stocks we can find based on normalized earnings and free cash flow when viewed over a three to five year investment horizon.** This type of approach is decidedly unfashionable today.

Our investment process is disciplined and we stick to it. During the year, our investment process did not turn up any particularly attractive companies in the utility, energy and consumer staples areas and it identified a large number of financial services companies as being very attractive. Our process drives our portfolio. We aren't Pollyanna, we simply pursue value.

A year ago, roughly 14-15% of our portfolios was invested in financial service companies. As those investments declined in value, we bought more. At 9/30/11, financial service companies accounted for 20-21% of our portfolios. Financial service companies face great near-term uncertainty, but they appear to be the market sector with the most under-appreciated long-term earnings power. We've been early with these investments, but I think we should be rewarded in the long run. While our investment results may look worse before they get better, I believe the issues concerning investors today will fade with time and that value will ultimately prevail. I don't know how much longer our portfolios will remain out of favor, but I think the long-term gains should compensate us for the short-term pain.

## ***Europe – How about EuroTARP?***

I believe the fiscal crisis in Europe is the single biggest issue influencing the economy and stock market today. **The situation in Europe looks eerily similar to the U.S. in 2008-09. Our problem was imprudent bank lending to sub-prime home buyers; Europe’s problem is imprudent bank lending to sub-prime governments** (like Greece). If the Europeans let Greece fail, as we did with Lehman, the feared result is another global financial crisis. At the same time, the option of bailing out Greece is distasteful to many as it effectively rewards the Greeks for their poor fiscal behavior (spending well in excess of revenues).

**The core issue is insufficient bank equity capital to handle bad loans.** Concerns about sufficient capital (solvency) can create a liquidity crisis which is the equivalent of draining the oil out of an economic engine. At present, Europe’s leaders are seeking to address the liquidity issues without dealing with the underlying question of solvency. We’ve seen this movie before.

In the early days of the housing bust, the U.S. government focused on liquidity, just as the Europeans are today. However, as investors realized that home prices could fall materially, they realized that too many banks were holding mortgages on their books at value far higher than justified by the market. It became clear that marking-to-market those loans would decimate bank capital thus creating a solvency problem for many lenders. Difficult choices were made. Lehman Brothers was forced into bankruptcy and was liquidated. Wachovia and Washington Mutual effectively, but not technically, went bust with their corporate corpses assumed by Wells Fargo and J.P. Morgan.

The Government responded with the Troubled Assets Repurchase Program (TARP). TARP, originally created to address liquidity, quickly morphed into a mechanism for recapitalizing the U.S. financial system. Fannie Mae, Freddie Mac and AIG were taken over by the Government. Bank of America and Citigroup were forced to raise major amounts of capital at highly dilutive rates. Today, Citigroup trades for about 5% of its pre-crisis value – while the value destruction wasn’t 100% as in the case of Lehman, it’s close. As TARP evolved from a liquidity program to a solvency program, market confidence began to grow. The stock market bottomed a few weeks later as investors gained confidence that our financial system would survive.

TARP was followed by expanded capital requirements and increased regulatory oversight including stringent “stress testing” of our banks’ capital positions. With capital cushions well established, banks are lending again. Some banks demonstrated sufficiently strong, stress-tested levels of capital that they have been allowed to return capital to shareholders through the payment of dividends and repurchasing of stock. The U.S. financial system has been successfully recapitalized.

One of the faulty beliefs in Europe is that a government can’t go broke. If a bank has lent money to a government (a “sovereign credit”), then they can continue to carry

that loan on their books at its original value. The problem today is the widespread belief that Greece is effectively bankrupt. Their debt trades in the public market at roughly 50% of its face value. If the banks holding Greek debt were forced to mark-to-market their loans, it could wipe out their equity capital. If their equity capital is wiped out, they fail, thus potentially causing a domino effect of problems for other banks given the interconnectedness of the financial system.

**A solvency crisis can't be remedied by simply lowering interest rates or by providing emergency liquidity facilities. If the governments of Europe are going to do anything, my hope is that they'll move to shore up the capital positions of their banks.** It need not be called TARP, but it needs to accomplish the same thing. The current effort to lengthen the maturity of Greece's debt (extend & pretend) seems unlikely to work. Will Europe's political leaders come together with a plan to strengthen the European banking system? I don't know. However, I am confident that if they don't address bank capital soon, then markets will force their hand. **Stock markets around the globe are hostage to the European bank solvency problem and we are unlikely to make major gains until this is resolved. And if politicians don't act soon, the market may fall further and thus force action – the situation may have to get worse before it gets better.**

### *The U.S. – Stimulus Hasn't Worked*

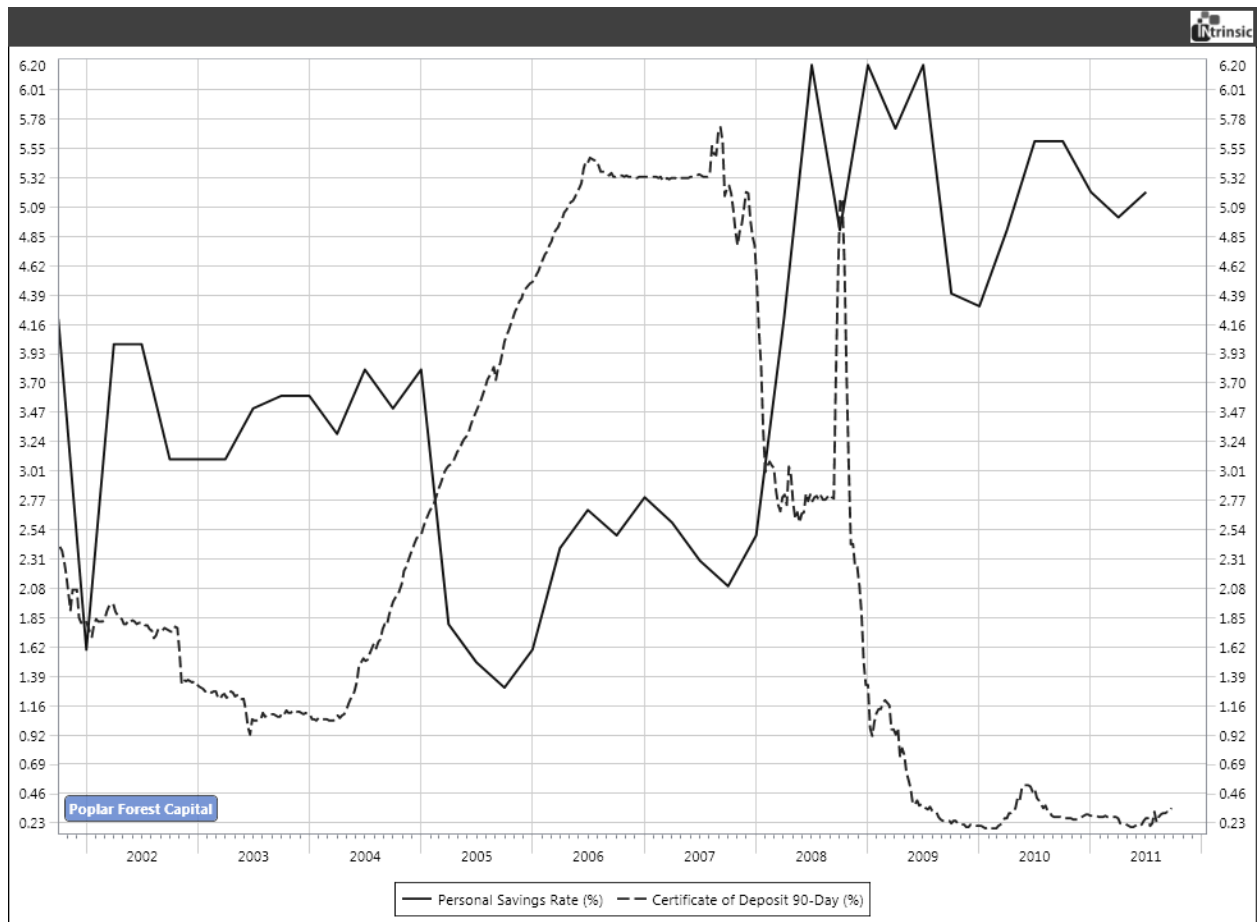
If the market only had to contend with the solvency of European banks, things would be much easier. Unfortunately, there is a long list of concerns outside of Europe. For the U.S., we're dealing with a surprisingly weak economy at a time that global growth appears to be slowing. Quite simply, the economy has not responded to historic fiscal and monetary stimulus in the way the textbooks predicted. I believe stimulus hasn't worked because businesses and consumers know we can't afford it - **money handed out by the Government in the form of stimulus must be recouped in the form of either higher taxes or lower spending in the future.**

Washington is filled with academicians and politicians who can tell you what the textbooks say should be done – more stimulus and lower interest rates. They say stimulus hasn't worked because we didn't give away enough money; I disagree. **If there is a "problem", it is that consumers and businesses are acting rationally to temporary stimulus programs.**

**If someone receiving a dollar knows they are going to have to give it back (and perhaps more) in the future, they do the prudent thing, they save the dollar.**

The textbooks said people would spend "stimulus" money and that spending would save the economy. But the people felt differently; as you can see in the graph on the next page, savings rates are up despite the decline in interest rates. This is the so-called Paradox of Thrift – in the long run, higher savings are a good thing, however, in a recession, higher savings rates leads to slower economic growth. A rational reaction of individuals has basically neutered Government sponsored stimulus. Why should we expect additional rounds of stimulus to work any better than the

early rounds? I'm reminded of Albert Einstein's definition of "insanity: doing the same thing over and over again and expecting different results."



While the White House pleads for another stimulus package, I think the more important work is being done by the Congressional Joint Select Committee on Deficit Reduction. If this bipartisan committee can deliver a balanced approach to deficit reduction – perhaps our country's greatest challenge - then perhaps confidence will grow as consumers and businesses grow less fearful of our long-term fiscal situation.

Businesses, consumers and investors all hate uncertainty. We all know that the Federal Government needs to make progress on balancing the books. Will they make progress or will partisan bickering get in the way? I don't know. Will taxes go up or will spending be cut? I don't know. What I do know, is that something needs to be done. If the Joint Select Committee can deliver on its mandate, we'll all feel better. In my opinion, **the work of this committee will have a far greater impact on the economy than any stimulus program.**

## ***Past Parallels***

Investing would be so much easier if we simply knew with certainty what would happen in the future. The pesky problem with the future is that it is unknowable in advance. So what is an investor to do?

The field of Behavioral Finance suggests that more often than not, **investors extrapolate the past when they are uncertain about the future.** If stocks have gone nowhere for a decade, the easiest decision is to assume they will go nowhere in the future. Likewise, if bonds have been a great investment for three decades, surely they will be great in the future. But past performance is no guarantee of future results; simply extrapolating the past can be hazardous to your financial health.

At Poplar Forest, we deal with uncertainty by focusing on the long term and through the use of scenario analysis. We view the future as a range of potential outcomes with a Bear Case, a Base Case and a Bull Case. We strive to identify individual investments where our downside does not involve the permanent loss of money (our definition of risk) while the Base Case meets or exceeds our minimum 15% per year hurdle rate. The Bull Case is simply the prospect of extra icing on the cake. We can use this approach to create a hypothetical illustration of what could happen for the market as a whole. The paragraphs that follow discuss three hypothetical futures; additional information on our underlying assumptions can be found on page 13.

***Bear Case –an Investment Ice Age.*** In this scenario, politicians fail to come together to solve problems - the Joint Select Committee on Deficit Reduction fails and European leaders try to “extend & pretend”. The world’s developed economies fall into recession. The S&P 500 falls to a low of 900. Recovery from recession is weak as bickering politicians failed to address the root causes of our problems. Operating earnings for companies in the S&P 500 fall from \$95 per share in 2011 to \$75 in 2012 (down 21% - typical for a recession) with muted growth of 4% per year thereafter. By 2021, S&P 500 earnings equal \$110 per share as compared with \$95 in 2011 – a compound annual growth rate of just 1.0-1.5% per year for a decade. This is similar to the experience of the Japanese – they’ve tried “extend & pretend”, stimulus and low interest rates for years with little to show for it beyond an elevated level of government debt relative to the size of their economy.

***Base Case – Reasonable Progress.*** In general, we believe that people act rationally – and politicians are people, too. Elected officials grudgingly get their job done, but higher taxes and/or lower government spending constrains economic growth relative to expectations. In this scenario, we assume economic growth in the U.S. will be a muted 2% per year with 2% inflation. Nominal GDP growth of 4% a year might translate into corporate revenue growth of 4% per year with profits growing a little faster. Earnings on the S&P 500 would grow from \$96 in 2011 to \$175 in 2021 – a compound annual growth rate of 6% per year.

**Bull Case – A Return of Confidence.** Elected officials do their jobs well and confidence in our political system grows. Voters decide that Big Government isn't the answer - stimulus is ended, regulations are rolled back and the populace follows the advice of the 1936 movie *Swing Time* with Fred Astaire & Ginger Rogers: "For when my chin is on the ground, I pick myself up, dust myself off, start all over again". America's "can do" spirit is restored. As confidence builds, businesses start hiring again and the economy grows 6% or more per year in nominal terms. The benefits of operating leverage and free cash flow might allow earnings to compound 10% per year from \$97 in 2011 to \$250 in 2021.

***Hypothetical Illustration of Potential Returns as described***

	2021 Earnings	Expected P/E Ratio	Implied Price	Annual Gain from S&P:		
				900	1131	1300
Ice Age	\$110	12x	1320	3.9%	1.6%	0.2%
Reasonable Progress	175	16x	2800	12.0%	9.5%	8.0%
Return of Confidence	250	20x	5000	18.7%	16.0%	14.4%

The table above is an illustration of hypothetical returns from stocks in the three alternate futures we see as possible. The implied Annual Gain in the chart also excludes dividends - total returns might be at least 2% higher than indicated if current corporate dividend policies are maintained. A comparison of the hypothetical long-term returns of stocks relative to the return of fixed income investments, points to one of two conclusions: either 1) stocks are very attractive or 2) the outlook for the economy over the next ten years is grim. It is hard to see how Treasury bonds beat stocks over the next decade barring another Great Depression. While an Investment Ice Age is certainly possible, we view such an outcome as a worst case scenario. In my opinion, stocks are very attractive.

While history rarely repeats, it does often rhyme. The appendix to this letter presents data on earnings growth rates for ten year periods following a peak in S&P 500 profits (to examine what might happen if 2011 is a peak in profits). Outside of the Great Depression, the worst ten-year stretch was the 1950-1960 period when profits grew just 1.4% per year. Interestingly, this weak growth period overlaps with the strongest growth period in 1945-1955 when earnings advanced 12.4% per year. **Over the 17 periods examined, the greatest clustering of experience was in decades experiencing earnings growth of 5-7% per year.** Our base case scenario is consistent with this most common experience.

While the Return of Confidence scenario is not our base case, I continue to be drawn to the parallels between the environment today and that of the late 1970s. Then, we'd endured a costly war in Vietnam, while today's corollary is Iraq and Afghanistan. Oil and other commodity prices were high and the economy had stagnated – that sounds familiar. There was recession in 1980 followed by a double dip in 1981-82 ; investors fear our 2008-09 recession will be followed by a 2011-2012 double dip. We were/are challenged by a strong Asian competitor – Japan then, China today. The stock market, then and now, had/has gone nowhere for over

a decade (1968-1980 and 2000-today). The President (Carter/Obama) was/is a smart man who believes that government is the answer to the problem; the American people weren't/aren't so sure.

Investment planning would be so much simpler if we knew whether the future was a period of prosperity similar to 1980-2000 or if we knew we were facing a decade of stagnation similar to Japan. While an Investment Ice Age is certainly plausible, I believe we'll work our way out of this mess.

### ***Investment Implications***

Investor sentiment is often more important than economic or company specific fundamentals. We use valuation tools as a gauge of sentiment, as a way to assess investor confidence or pessimism. From our vantage point, investor fear is pervasive and confidence is currently lacking. While it feels uncomfortable to buy when others are selling, pessimism and investor uncertainty can breed opportunity.

During the "New Era" of the tech bubble, stock prices, as measured by the S&P 500, reached 1500 for the first time. This equated to 25x the earnings expected for the year. The dividend yield on stocks dropped to roughly 1%. In an environment where everyone loved stocks, there was little interest in 10-year Treasury bonds which yielded 6%.

In contrast, at 1160 (the middle of the recent 1100-1220 trading range for the S&P 500), stocks sell for less than 12x this year's expected earnings and the dividend yield has risen above 2%. In an environment where no one seems to love stocks, there is tremendous interest in 10-year Treasury bonds which now yield less than 2%. The price/earnings ratio on stocks has been cut in half while their dividend yield has doubled; meanwhile, Treasury bond yields have been cut by two-thirds. This marked shift in valuation signals a dramatic shift from unbridled optimism in 2000 to persistent pessimism today.

This persistent pessimism has pushed the dividend yield on stocks above that of Treasury bond yields for only the second time in over 50 years (the first was during the '08-'09 bear market). With interest income taxed at 35% while dividends are taxed at 15%, the after-tax yield on stocks looks even more compelling. In addition, dividends offer the prospect for growth while interest payments don't.

**A dividend yield on the S&P 500 that exceeds the yield on 10-year Treasury bonds suggests investors believe that stock prices will be lower ten years from now. If dividends grow 5% per year, as they have historically, the S&P 500 could be 15% lower in ten years and it would still generate after-tax total return better than buying and holding to maturity a 10-year Treasury bond.**

## ***What We Own***

When stocks sold off in August, our team examined all of our investments under the assumption that a recession was coming. I asked everyone to think critically about the businesses we own – are there any that we would be uncomfortable owning if a 2012 recession became reality? As a result of this work, we sold a couple things. In general, we finished this “what if” exercise with increased confidence in the companies we own. Our current portfolio includes 27 investments that we are very happy to own even if we have to live through a recession in 2012.

By investing with us, you currently own a piece of 27 different businesses. **One way to assess your investment is to look at our proportionate share of the results for each of these 27 businesses.** This approach will hopefully help explain why we are so bullish about the long-term opportunities in our portfolio.

Over the last 12 months, the 27 companies in which we are invested generated over \$95 billion of aggregate free cash flow. If we owned 100% of these businesses, we’d have a giant pile of cash to divvy up amongst ourselves – but we don’t own 100%. As a minority partner in these businesses, our proportionate share of our companies’ free cash flow equaled roughly \$22.8 million over the last 12 months. The majority of that free cash flow was returned to use either directly or indirectly.

In the last 12 months, dividend payments made by our portfolio companies returned roughly 26% of the proportionate free cash flow generated. Another 69% was used to repurchase shares (which results in an effective increase in our ownership of businesses we like). Hypothetically, all of the free cash generated could have been returned to us; in practice, some free cash flow is used for acquisitions or for the reduction of debt. In the last 12 months, our companies’ Boards of Directors returned 95% of the free cash generated. This is a substantial increase from the 49% return rate last year; we take this as a sign of confidence in the underlying businesses and a statement of the attractive valuation of our businesses.

Another way to think about the investment appeal of our companies is to compare the free cash generated by the businesses to the quoted prices of those businesses. Our proportionate share of the free cash flow generated by our companies totaled \$22.8 million over the last 12 months. If our companies’ Boards chose to pay out all the cash generated, it would equal 9.5% of those companies’ value at quarter end (9/30/11) – and this is after sufficient capital spending to support growth of these high quality businesses.

As a general rule, we aim to have at least 85% of our portfolio invested in companies with “investment grade” rated debt – a sign of financial strength. In another sign that high quality companies are “on sale”, at quarter end (9/30/11), 25 of our 27 companies had investment grade quality balance sheets.

In summary, our portfolios include investments in 27 businesses that collectively generate a lot of free cash, that have strong balance sheets and solid market

positions and that are run by shareholder-oriented management teams. We believe these are above average companies deserving of premium valuations relative to the average company in the S&P, yet these companies collectively trade at a discount to the S&P. Our optimism with respect to future returns is driven by the values we see – our companies currently trade at 10x this year's expected earnings and at a 47% discount to our assessment of their fair value. **Which sounds better, hiding money in cash with little or no return, lending to the U.S. Government for ten years at an interest rate of 2% or owning an interest in strong and growing companies generating substantial free cash flow? While we have no idea what the market will do over the next three months, when we look out three years or more, we see incredible opportunity.**

### ***Uncertainty – Not Just the Market, People Too***

Poplar Forest's first four years of operation have been marked by far more uncertainty and volatility than I expected. The market started down two days after we launched our first limited partnership. That big down market was followed by a huge rally, but now stocks are down again. I've never been a big fan of roller coasters and I know many investors have grown tired of the volatility we've seen, not just in the last four years, but in the last decade.

After peaking in a time of euphoria in early 2000, the market has churned for years. In 2000, investors were confident in a future driven by new technology. That confidence was shattered by the bursting of the tech and housing bubbles. With each crisis, investors have grown more disillusioned with stocks. The confidence expressed by many investors in early 2000 has been replaced by pessimism and uncertainty. Stocks, as measured by the S&P 500, are roughly 20% lower than they were at the close of business on September 30, 2000.

Uncertainty is always a factor in investing. While the future is always unclear, at times uncertainty seems magnified – this is one of those times. I suspect heightened uncertainty will be with us for an extended period of time and you should expect this topic to be a theme we revisit for at least the coming year.

**As mentioned earlier, the two things we are watching most closely right now are the work of the Joint Select Committee on Deficit Reduction and progress on recapitalizing Europe's banking system. Will we make progress? I don't know exactly what will happen, but I certainly hope that logic and prudence will win out over political bickering.**

Uncertainty doesn't pertain only to our investments, but also to our people. In early August, Brinda Budhraj, one of our three analysts, shared with us her decision to rededicate her career to public service. Brinda left us in September and we wish her great success in her new endeavors. All of us at Poplar Forest will miss Brinda, but we know the world will benefit from her skills, talents and compassion. While she is no longer on our investment team, she is staying a client and we hope for many more years of shared success with Brinda and with all of you.

The continued turmoil in the financial markets has not just given us exciting investment opportunities, but also great hiring opportunities. While we are sad to lose Brinda, we are excited to announce two new hires: Derek Derman and Steve Burlingame. Derek and Steve have both earned the CFA charter and they bring many years of valuable investment experience to Poplar Forest.

Derek received a B.A. in Economics from U.C. San Diego in 1991 and an M.B.A. from Cornell in 1995. Derek has spent his career in and around investing including 14 years working as either an investment analyst or Co-Portfolio Manager. Most recently, Derek worked as a Managing Director at Trust Company of the West where he was Co-Portfolio manager responsible for over \$3.5 billion of client assets. Derek started his career covering the financial service industry and he will be leading Poplar Forest's analytical efforts in this area going forward.

Steve received a B.A., Cum Laude, in Economics from Claremont McKenna College in 1999. After graduation, he joined Brandywine Asset Management to cover healthcare and technology companies. Steve left Brandywine to join Trust Company of the West. Like Derek, Steve was promoted to Managing Director and served as Co-Portfolio Manager responsible for over \$9 billion of client assets. Steve started his career covering the healthcare industry and he will be leading Poplar Forest's analytical efforts in this area going forward.

In addition to adding new analysts, the Poplar Forest Sales and Marketing team doubled in size earlier this year with the hiring of Kevin Quadros. Kevin has worked in investment sales, marketing and client service since 1994 and his experience includes work in building out distribution of newly formed mutual funds. Kevin is based in Boston and is primarily responsible for clients east of the Rockies, while Chris Morphy continues to primarily handle our sales, marketing and business development efforts in the Western part of the country.

In this time of uncertainty, it is wonderful to have experienced professionals like Derek and Steve join Peter McAniff and Cathy Lloyd on the analyst team while Kevin helps Chris share the Poplar Forest story on a nationwide basis. This is a very talented group of investment professionals and I feel particularly fortunate to have them all as part of the Poplar Forest family.

### **In Closing – Thank you**

In 1806, Thomas Jefferson oversaw the laying of the foundation for his “retreat” at Poplar Forest – a place out of the limelight where this very private man could focus on his passions for reading, studying and thinking. For Jefferson, Poplar Forest remained a work-in-progress until 1823 when, at age 80, health forced him to stay at Monticello. Four years ago, I began laying the foundation for my Poplar Forest – a place that would allow me to pursue my passion for investing. Like Jefferson, I hope to be actively pursuing this passion well into my 80s. I also suspect that Poplar Forest Capital will remain a work-in-progress for my lifetime – like any sound business, we will need to evolve over time. The foundation and principles on which

we build will not change, but their expression and functionality will. In the last year, we've added three experienced professionals to our team and I know each of them will make a great contribution to our efforts.

Most of you reading this letter arrived after the laying of Poplar Forest's cornerstone and I hope many more will join us in the years ahead. And while I thank you all for your support and encouragement, I'd like to extend a special thanks to those first eight client partners who made this all possible.

Thank you for joining me in this exciting venture,

A handwritten signature in cursive script, appearing to read "Dale".

J. Dale Harvey  
September 30, 2011

**Appendix – Earnings and Dividend Growth for the S&P 500 in 10 Year Periods Following a Peak in Profits**

	Peak EPS	EPS in 10 yrs	Compound Annual EPS Growth	Starting Div.	Ending Div.	Compound Annual Dividend Growth
Dec '29 - Dec '39	\$1.61	\$0.90	-5.7%	\$0.97	\$0.62	-4.4%
Sep '37 - Sep '47	1.22	1.55	2.4%	0.77	0.79	0.3%
Sep '41 - Sep '51	1.19	2.51	7.7%	0.70	1.52	8.1%
June '43 - June '53	1.10	2.51	8.6%	0.59	1.42	9.2%
June '45 - June '55	1.00	3.22	12.4%	0.65	1.57	9.2%
Dec '50 - Dec '60	2.84	3.27	1.4%	1.47	1.95	2.9%
Mar '56 - Mar '66	3.69	5.34	3.8%	1.73	2.78	4.9%
Sep '59 - Sep '69	3.43	5.89	5.6%	1.81	3.15	5.7%
Dec '66 - Dec '76	5.55	9.91	6.0%	2.87	4.05	3.5%
Sep '69 - Sep '79	5.89	14.63	9.5%	3.15	5.51	5.8%
Sep '74 - Sep '84	9.11	16.56	6.2%	3.59	7.38	7.5%
Mar '80 - Mar '90	15.29	21.67	3.5%	5.80	11.32	6.9%
Dec '84 - Dec '94	16.64	30.60	6.3%	7.53	13.18	5.8%
June '89 - June '99	25.22	41.02	5.0%	10.30	16.21	4.6%
Sep '95 - Sep '05	35.18	66.57	6.6%	13.58	21.48	4.7%
Sep '97 - Sep '07	40.64	78.60	6.8%	15.33	26.97	5.8%
Sep '00 - Sep '10	53.70	71.86	3.0%	16.34	22.36	3.2%
Median			6.0%			5.7%

Data source: Professor Robert J. Shiller – [www.econ.yale.edu/~shiller/data.htm](http://www.econ.yale.edu/~shiller/data.htm)

**Earnings Growth is not a measure of the Fund's future performance.**

**Information on Hypothetical Illustration found on pages 6-7:**

*Current consensus estimates for operating earnings for the S&P 500 in 2011 are in a range of \$95-97 per share.*

*The Bear Case – Investment Ice Age scenario starts with the low end of current expected earnings (\$95) and grows those earnings 1.5% per year consistent with the experience from December 1950 to December 1960. This is the lowest observed growth rate outside of the decline experienced in the Great Depression (Dec. 1929 - Dec. 1939). The Hypothetical P/E of 12x is approximately the low end of the range of P/E ratios over the last 25 years as reported by Intrinsic Research.*

*The Base Case – Reasonable Progress scenario starts with the mid-point of current expected earnings (\$96) and grows those earnings by 6% per year – the median experience for ten year periods following a peak in earnings. The Hypothetical P/E of 16x is the median P/E ratio for the S&P 500 over the last 40 years as reported by Intrinsic Research.*

*The Bull Case – A Return of Confidence scenario starts with the high end of current expected earnings (\$97) and grows those earnings by 10% per year. This is a discount to the highest reported earnings growth since the depression (12.4% reported from June 1945 - June 1955) and generally consistent with the second best result of 9.5% compound growth between September 1969 to September 1979. The Hypothetical P/E of 20x is approximately the high end of the range of P/E ratios over the last 40 years (excluding the period of the Tech Bubble when P/Es were higher) as reported by Intrinsic Research.*

*The “Implied Price” on the table on page 6 is determined by multiplying the hypothetical “2021 Earnings” by the hypothetical “Expected P/E Ratio” in each of the three hypothetical scenarios discussed above.*

*The “Annual Gain from S&P” is calculated by use of the following formula:*

*Annual Gain = ((FV/CV)^(1/10))-1, where:*

- *FV = “2021 Earnings” multiplied by “Expected P/E ratio”*
- *CV = S&P levels indicated in the table: 900, 1131 and 1300*

*The S&P 500 closed at a level of 1131 on September 30, 2011.*

### ***Important Information for Investors in Poplar Forest Fund, LP:***

*This is not an offering. An offering will be made only by means of a final offering memorandum and only in those jurisdictions where permitted by law. Past performance is not indicative of future returns. Performance is preliminary and un-audited, and subject to change. Results are net of all standard fees and expenses. Fund returns are inclusive of the reinvestment of dividends and other earnings.*

*The fund is subject to a variety of risks, including but not limited to: investments may be volatile and subject to stock market risk; investments may be illiquid; an investor could lose all or a substantial amount of any investment in the fund; there is no secondary market for interests in the fund nor is one expected to develop, and there are substantial restrictions on transferring an investment in the fund; fees and expenses of the fund may be higher than those of other investments and will reduce the portfolio return. Consult the fund's offering memorandum for complete risk disclosures and other important information.*

### ***Important Information for Investors in Poplar Forest Partners Fund:***

*The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 626-304-6000 or by visiting [www.poplarforestfunds.com](http://www.poplarforestfunds.com). Read it carefully before investing.*

**Mutual fund investing involves risk. Principal loss is possible. The fund 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 fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. The fund may invest in medium-sized companies, which involve additional risks such as limited liquidity and greater volatility than larger companies.**

*Past performance does not guarantee future results.*

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 information provided herein represents the opinion of J. Dale Harvey and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Fund holdings and sector allocations are subject to change at any time, and should not be considered a recommendation to buy or sell any security.

As of September 30, 2010, the Fund's 10 largest holdings accounted for 43.86% of total Fund assets. The Fund's 10 largest holdings at September 30, 2011 (in alphabetical order):

Abbott Labs  
Axis Capital Holdings  
Baxter International, Inc.  
Cintas Corp.  
International Business Machines  
McGraw-Hill Companies Inc.  
Microsoft Corp.  
Omnicom Group Inc.  
Staples Inc.  
TE Connectivity Ltd.

The price to earnings (P/E) ratio is a common tool for comparing the prices of different common stocks and is calculated by dividing the current market price of a stock by the earnings per share.

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.

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