



## 2010 Annual Review

To my partners,

Three years ago, Poplar Forest Capital was an infant. I was working by myself at home. I had commitments from eight prospective clients willing to invest \$17 million in an initial investment partnership. Beyond that, I had a supportive family, 27 years of personal investing experience, a successful 16 year stint at the Capital Goup, and aspirations of achieving:

*superior, risk-adjusted returns over full market cycles by investing in underappreciated companies and industries*

Poplar Forest has grown a lot since then. We now have eight employees and we're currently expanding our office space by 50% to accommodate growth. The initial eight client partners were joined by 22 new investors in the limited partnership. At year-end 2009, we launched a mutual fund which allows us to effectively serve smaller clients without diluting our portfolio management and client service efforts. With over 600 investors in the mutual fund, we now oversee roughly \$225 million of investments on behalf of more than 650 client partners.

This has all occurred in a very challenging environment. The bursting of the housing bubble and the Great Recession that followed called into question the survival of many leading financial institutions. Despite aggressive action by the Federal Reserve, recovery from the recession has been more anemic than I expected. Unemployment is high, consumers are nervous and governments' financial positions are stretched.

Our first limited partnership was established within two days of the market top in 2007. From there, the market, as measured by the S&P 500, dropped 47% through our first six quarters of operation before rising 50% in the next four quarters. From there, the stock market, like the U.S. economic recovery, has languished as investors debated the risks of a double dip recession. This has been a challenging period, but we are pleased with what we've accomplished and we're very excited about the long-term investment opportunities we see today.

As this is our third anniversary, I'm taking time to discuss our approach to investing in addition to discussing the current environment. Some of you will have heard this before, for others it will be new. It is important to understand what we do and how we do it. **I believe the consistent execution of our investment process will allow us to achieve our goal of superior long-term returns.** I hope you agree.

## **Investing – Do You Want to be an Owner or a Lender?**

My Webster's Dictionary defines "invest" as:

***“to commit (money) in order to earn a financial return”***

The committing of money generally comes in two basic forms – lending money or buying ownership. It is important to distinguish between being a lender and being an owner as these roles require different approaches.

**For a lender, the primary question is: “Will I get my money back?” The second question is related: “Am I being properly compensated for taking the risk of not getting my money back?”** If the risk of not getting paid back is low, the interest rate charged on the loan is usually low; if the risk is high, the interest rate is usually high.

For an owner, the questions are different. **The two dimensions of financial return for the owner are the cash received during the time of ownership and the value received if that ownership position is sold to someone else.** As in lending, risk is clearly an important consideration. In addition, growth is also an important variable for an owner.

Growth is a key differentiator in the perspective of lenders and owners. Generally speaking, the best case for a lender is to get the original loan amount returned plus some amount of interest along the way. For the owner, there is the prospect of receiving a growing stream of income plus the potential for a sale price in excess of the original purchase price; there is also greater risk of loss.

### **Buying Bonds vs. Lending Money**

I suspect many people inherently think that “buying a bond” is an ownership transaction – it isn't. **You can tell yourself that you “own” that bond, but what you've really done is agreed to step in as a lender to someone you don't know who has agreed to pay you what he/she originally borrowed plus interest.**

When I reflect on the challenges of the last three years, a root cause was ill-advised lending. At its core, the housing bubble was a result of too many people borrowing money to buy homes they couldn't afford. For any number of reasons, lenders stopped asking: “Will I get my money back?”

In the “good old days”, a bank would collect deposits from one set of customers and turn around and lend that money to people who wanted to buy things like houses and cars. Depositors might have collected 3-4% on their money while borrowers might have paid 6-8% for the loan. The spread in rates between deposits and loans was used to cover the bank's costs and cover loan losses (loans not repaid in full) with any excess being profit for the owners of the bank. **With very little spread between these two rates of interest, lenders needed to make sure they'd get paid back.**

A lending process that wasn't broken got "fixed" with nifty new products. Instead of holding loans to maturity, lenders packaged loans into Collateralized Mortgage Obligations (CMOs), Collateralized Debt Obligations (CDOs) and other obtusely named "investment vehicles". These new "investment vehicles" were then sold to investors of many stripes. Many of the buyers were funds who were in turn owned in retirement plans set up to benefit folks who had no idea they were lending money to sub-prime borrowers. What was once a straightforward lending process became a packaging and sales effort such that the ultimate borrower and lender were separated by myriad middlemen (each taking a cut of the action).

In the aftermath of the housing bubble's bursting, much more attention has been paid to lending standards. Banks have regained focus on that simple question of "Will I get my money back?" Dubious borrowers no longer have the ability to borrow money. Highly qualified borrowers can get loans, but the process is much more difficult. Applications have grown in length. Proof of income and ability to repay are paramount. Riskier borrowers now pay higher rates, if they can get a loan. The interest rate charged on credit cards recently reached a nine year high. **Sanity seems to have returned to lending.**

**Almost...**

I believe there is one area of the investment landscape where lenders have grown more reckless in the last couple years – in the Government bond market. Frankly, I'm shocked by the terms the U.S. Government gets when it borrows money. **Today, the decision to "Buy a 10-year Treasury" is really a decision to loan the U.S. Government money for 10 years in return for a 2.5% yield. At a time when the U.S. Government's financial position is worse than it has been for generations, its cost of borrowing money is lower than it has been for generations.**

If the name on the credit application said "Sam Smith" or "Sam Incorporated" instead of "Uncle Sam" (the U.S. Government), lenders looking at the potential borrower's financial statements would likely stamp "DENIED" on the application. At best, the borrower might get a "sub-prime" or "high yield" loan with a high interest rate. It's amazing that a highly levered institution running persistent annual operating deficits can borrow money for 10 years at 2.5% and for 30 years at 3.7%.

The pushback to this argument is that the Government can always print money to pay its debts. That is true, but the reality of such an outcome is a corrosive loss of purchasing power on the part of the lender. I return to my original observation about a critical difference between lending and owning – lenders get no participation in growth. **If the Government is forced to start printing money to pay its debts, consumer prices are apt to climb at a rate higher than the 2.5% currently being paid as interest each year. The person willing to lend to the U. S. Government today will get paid back in ten years – unfortunately, the money received then may buy less than it could today.**

**Interest rates that I consider silly for U.S. Government bonds greatly influence the price of corporate bonds and mortgages.** I was quite surprised when Microsoft

recently borrowed \$1 billion at an interest rate under 1.0% with repayment due in three years. A few weeks ago, Norfolk Southern issued \$250 million of bonds bearing interest at 6% that come due in 100 years. Yes, 100 years. Those lending to Norfolk Southern (by buying the bonds) have clearly forgotten lenders' rule number one (will I get my money back?); absent major advances in science, these new lenders will be long dead before Norfolk Southern is required to repay the loan.

I believe currently low interest rates are driven by fear and rear window investment practices. The fear factor generally focuses on the economy and the potential for a double dip recession and/or deflation. Rear window investing is simply the decision of many to "invest in bonds" because bonds have done much better than stocks over the last decade. But as we've all heard countless times, past performance is no guarantee of future results.

At the end of 1999, rear window investing said buy equities and sell bonds. There was no fear; technology was unleashing massive productivity which was to have driven inflation-free growth for the foreseeable future. Equities had greatly outperformed bonds for years and too many extrapolated those trends into the future. When we look back a decade from now, I believe we will see March 2009 as the low mark for stocks and the low mark for interest rates. I suspect we are in for years of rising interest rates (falling bond prices) and rising stock prices. While you may not lose money if you hold bonds to maturity, the prospective returns from stocks seem much better than those of bonds. In my opinion, **it's time to be an owner, not a lender.**

### **The Owner's Perspective – Cash is King**

Each share of stock you own represents a small ownership interest in what is usually a large business. In addition to (or instead of) a piece of paper demonstrating this small ownership interest, you might own a large piece (perhaps all) of a small business. For example, your family might own a car dealership. The owner of a car dealership spends little time, if any, valuing his business. Time is better spent serving customers and trying to figure out how to sell more cars. How then does the car dealer judge his success?

In the long run, the car dealer knows there will be good years and lean years. When the economy is robust and his models are in demand, he'll make great money, when the economy is weak or his models are unpopular, he may lose money; what's most important is how much the dealership makes over many years, perhaps a generation or more.

***"How would you feel if you owned the whole company at the current price?"***

This simple question frames our analytical approach at Poplar Forest. Like the car dealer, we answer the question by focusing on each company's ability to generate cash over time. We focus on "normal free cash flow" or the amount of cash a business generates in an "average" year after paying its operating expenses and investing as necessary to

support its growth plans. If you owned 100% of a business, you could pay all of this free cash flow to yourself every year.

This long-term approach to analyzing businesses results in an assessment of business values that fluctuates far less than prices do in the stock market. In addition, we aim to invest in businesses that we'd be happy to own for at least the next five years. Given this mindset, minute-to-minute or day-to-day changes in a stock's price don't change our view of that business's value. However, **fluctuating stock prices do give us an opportunity to buy when we think investors are undervaluing a company and sell when that is no longer the case.** Many of these fluctuations are driven by emotion.

While it is impossible to eliminate emotion from our work, our process seeks to minimize its influence as much as possible. For each investment we review, **our fair value assessment is based on an assumption that three years in the future, calm and cool-headed investors will pay a rational price for the business in question.** Generally, this rational price is the price at which they might expect to earn a 9-10% return on their investment. This process does not imply that we are confident the general market level will be "fair" in three years, this is simply a **recognition that the undervaluation we perceive may take a few years to correct.**

Once we've made our assessment of fair value, we compare it to the current market price. The goal is to identify companies which offer the potential of at least a 15% annual total return over the next three years (when we assume the stock will be fairly valued). In more practical terms, this is the equivalent of buying something at a 33% off sale. In the last couple years, it seems that every store I see has an advertisement in the window promoting a sale. In the same way that the Mall is full of stores offering "30-40-50% OFF!", the stock market appears to be offering an equal number of bargains.

One of the hard parts of investing is assessing how long these "30-40-50% OFF" sales will last and how big the discounts will ultimately be. There is a very real possibility of buying a shopping cart full of 40% off merchandise and then watching the store manager put up a new sign offering 50% off. In the short run, there is no way of knowing if you got the deal of the decade - that can only be known with hindsight.

### **An Owner's Perspective on Price and Value**

The Securities and Exchange Commission (SEC) defines fair value simply: "market value where market quotations are readily available." When we report to you the "value" of your account at the end of a quarter, it is a very simple exercise of multiplying shares owned by the last sale price of each stock on the last trading day of the quarter (with minor adjustments for pending dividends and expenses). If one's investment time horizon is five minutes, the most recent transaction price is probably a good estimate of a security's value. If the time horizon is five years, the recent price may be very misleading.

The SEC's definition of value reminds me of the Churchill's famous observation that "democracy is the worst form of government except for all the others that have been tried." On Election Day, we trust the masses to give the right people the keys to government; likewise, **the SEC dictates that we trust the masses to properly price our securities each day.** In a way, this is the worst way to value a company as for each transaction the buyer presumably thinks the stock is worth more than the seller. In effect, the last seller is telling us our portfolio is overvalued each day while the last buyer is saying the opposite.

There are any number of reasons a buyer and a seller may disagree on the worth of a particular investment. The parties may be focusing on different aspects of the available data. Emotion may factor into the equation. Nobel prizes have been awarded for theories based on the assumption that investors act rationally. That premise may be correct on average, but an average includes highs and lows that sometimes bear little resemblance to each other. In my practical experience, the mass of investors is rational about 60% of the time; 20% of the time they are too fearful and 20% too confident.

We believe the investments in our portfolio are trading at substantial discounts to their fair value. I believe we are currently in that 20% of the time when investors are simply too fearful. While we must price the portfolio based on the assessment of the fearful masses as reflected in current stock price quotations, we expect their opinion to migrate in our direction over time. If we are approximately correct in our assessments of fair value, then the results should work out fine over time.

Given the inherent problems with short-term security prices, how should an investor judge the results of his/her investment advisor? When I evaluate investment results, I focus on a full market cycle – a period that includes a market decline of at least 20% and a bull market gain that equals or exceeds the bear market decline. As a practical matter, I would generally expect a full market cycle to run at least four or five years. As Poplar Forest Capital has only existed for three years, it will take at least a couple more years until we have sufficient data to really begin to be able to judge our full-cycle results.

### **Outlook – Short-term versus Long-term**

*“The US economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many ‘structural’ burdens, as opposed to familiar ‘cyclical’ problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought; the debt hangover; the banking collapse; the real estate depression; the health care cost explosion and the runaway federal deficit.”*

I think the Time Magazine quote above sums up quite well the sentiment of observers today. What I find most interesting is that **the quote is from Time's September 1992 issue. The critical question to ask then was “will things improve?”** not “how bad is it?” In the seven years following Time's report, stock prices more than tripled. While

historic performance is no guarantee of future results, buying stocks when the headlines are dire has proven quite rewarding in the past.

Stock prices are a function of two factors – fundamentals and emotion. Fundamentals are the reasonably easy to measure factors like earnings and free cash. Emotion is harder to measure but is generally reflected in valuation measures like price-to-earnings ratios. Generally speaking, when a company's prospects are deemed to be poor, its stock trades at a low price-to-earnings ratio; perceptions of robust prospects typically lead to high price-to-earnings ratios.

One of the big surprises of the last year has been on the fundamentals side. Given the weakness of the economic recovery, corporate earnings have been terrific. These outstanding fundamentals are driven by productivity improvements and non-US exposure. On a fundamental basis, given recent results, it is easy to argue that the U.S. stock market, as measured by the S&P 500, should be 10-15% higher than it is today. Current stock prices seem to reflect rampant fear of future economic prospects.

**As in 1992, the critical question today is: will things improve?** In the short term, much depends on the outcome of the coming elections. The increased regulatory burden created since the last election has led Corporate America into “wait-and-see” mode. Uncertain regulatory costs and the prospect of higher taxes have created uneasiness that has in turn hampered economic recovery. Current polls suggest a bit more balance will be found in the halls of Congress after Election Day. I would not be surprised to see the market appreciate ahead of Election Day if polls continue their current pattern. In addition to a potential reduction in regulatory uncertainty, new bank capital standards will soon be in place which will greatly reduce the biggest uncertainty in the financial system. All in all, I expect the emotional backdrop to improve as we move towards year end.

Longer term, investment results are driven more by fundamentals than by emotion. In addition, the price you pay for your investments will have a big influence on the results you ultimately enjoy. As I mentioned, we believe the prices of fixed income securities are high and the prices for stocks are low relative to their underlying fundamentals. I describe these fundamentals a bit more in the section that follows.

**Given our outlook for higher interest rates, we are also increasing our focus on balance sheet strength. Given the choice between a company with high leverage and a similar company with lots of cash on the balance sheet, we'll go for the latter.** As an example, in the just completed quarter we liquidated our investment in DineEquity and reinvested the proceeds into Electronic Arts. DineEquity is a restaurant chain (IHOP and Applebees) that has a very high level of outstanding debt. In contrast, Electronics Arts, a video game company, has no debt and a very large cash balance. Both businesses are heavily dependent on consumer spending and we'd rather own the one with the big cash balance.

## What We Own

By investing with us, you currently own a piece of 31 different businesses. **One way to assess your investment is to look at our proportionate share of the results for each of these 31 businesses** – this approach is consistent with the way our friend the car dealer thinks about his business.

Over the last 12 months, the 31 companies in which we are invested generated over \$92 billion of net income and almost \$140 billion in cash from operations. Of this amount, \$29 billion of that cash was reinvested in the businesses in the form of capital spending (new plant and equipment). On an operating basis, our 31 companies generated roughly \$110 billion of aggregate free cash flow. If we owned 100% of these 31 companies, we'd have a giant pile of cash to divvy up amongst ourselves – but we don't own 100%.

Like a minority partner in our friend's car dealership, our share ownership can provide a means of assessing how much cash could potentially accrue to us – our proportionate share. To do this, we simply multiply the financial results of each business by our percentage ownership of the business. On a proportionate basis, our share of our 31 companies' free cash flow equaled over \$15.6 million over the last 12 months. What might be done with the cash?

As an investor in publicly-traded companies, there is a Board of Directors at each company charged with overseeing the deployment of the cash generated by our businesses. We invest in companies that tend to return cash to shareholders, though not all of it is returned.

Dividends and share repurchase are ways to return to shareholders their share of a business's free cash. In the last 12 months, our portfolio companies returned roughly 22% of the proportionate free cash flow generated. Another 27% 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. Given the state of affairs of the last few years, it is probably unsurprising that our Boards have taken a conservative approach to returning cash.

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 (9/30/10), 29 of our 31 companies had investment grade quality balance sheets.

In summary, our portfolios include 31 companies that collectively generate lots of free cash, and that have strong balance sheets and solid market positions. 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 12-13x this year's expected earnings and at a 44% discount

to our assessment of their fair value. It's rare for a car dealer to offer a luxury sedan at 40-50% off, but that appears to be similar to the value proposition of our portfolio today.

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. As I discussed, our proportionate share of the free cash flow generated by our companies exceeded \$15.6 million over the last 12 months. Thinking like the car dealer, if our companies' Boards chose to pay out all the cash generated, it would equal almost 10% of those companies' value at quarter end (9/30/10) – and this is after sufficient capital spending to support growth of these high quality businesses.

**Which sounds better, hiding money in cash with little or no return, lending to the U.S. Government for 10 years at an interest rate below 3% or owning an interest in strong and growing companies generating substantial free cash flow? We believe it is time to be an owner, not a lender.**

### **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-process until 1823 when, at age 80, health forced him to stay at Monticello. Three 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-process 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. We've now completed the first three miles of the marathon and there is much ground to cover before we rest.

Most of you reading this letter arrived after the laying of the 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,



J. Dale Harvey  
September 30, 2010

P.S. Attached is a copy of the Poplar Forest Capital Privacy Policy. The SEC requires us to send you a copy of this policy annually.

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## **PRIVACY POLICY**

Poplar Forest Capital LLC (“Poplar Forest”) may collect nonpublic information to process and administer clients’ business. This includes:

- Information provided to Poplar Forest, such as on applications, questionnaires, contracts, or other forms.
- Transactions, account balances, account history, and transactions with us, affiliates, or third parties.
- Information provided by clients and their representatives.

### **Security Measures:**

It is the policy of Poplar Forest to restrict access to nonpublic information to those employees, agents, representatives, or third parties who need to know the information to provide products and services to its clients. This includes:

- Physical safeguards including a staffed reception desk to check people who arrive at the office.
- Electronic safeguards including firewalls for server database protection, passwords for computer login for on-site computers, and limited access to the off-site computer room.
- Restricting access to information regarding current and former clients to those required to have access in order to service those client needs.

### **Sharing of nonpublic information:**

Poplar Forest does not share nonpublic information about its current or former clients with anyone except:

- As permitted by law.
- Affiliated Poplar Forest companies, brokers, banks, agents, employees, and third parties who need to know this information in order to perform services on behalf of clients.
- Other financial institutions with whom we have a relationship, which may include banks, attorneys, trustees, third-party administrators, registered broker/dealers, auditors, regulators, and transfer agents, in order to service client accounts.

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

**In addition to the attached Privacy Policy, the SEC requires us to offer to you a copy of Part 2 of our ADV each year. Please let me know if you would like a copy of our ADV.**

*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.**

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 41.92% of total Fund assets. The Fund's 10 largest holdings at September 30, 2010 (in alphabetical order):

Abbott Labs  
Aetna Inc.  
Axis Capital Holdings  
Cintas Corp.  
International Business Machines Corp.  
McGraw-Hill Companies Inc.  
Omnicom Group Inc.  
Oracle Corp  
Robert Half International, Inc.  
Tyco Electronics 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 cash from operations less capital spending. It is the discretionary cash that a company has after all expenses and is available for purposes such as dividend payments, acquisitions or share repurchases.

Projected Earnings Per Share (EPS) Growth rates are forecasts; actual EPS Growth rates may differ from projected EPS Growth rates. Actual P/E ratios may differ from projected P/E ratios. The projected P/E ratios of the Fund and index is not a measure of future performance of the Fund.

The Poplar Forest Partners Fund is distributed by Quasar Distributors, LLC.