

POPLAR FOREST PERSPECTIVES



BOTTOM-UP INVESTING AFTER MACROECONOMIC ANOMALIES

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We were recently asked how we can be bottom-up investors when we invest in sectors, such as financial services and energy, which are influenced by top-down forecasts for interest rates and oil prices?

This is an important question since most investors would acknowledge that very few companies are immune to major changes in key drivers for their industry or the broader economy. The simple answer is that, with valuation as our north star, we apply the same, bottom-up investment process across all sectors of the economy, regardless of their macroeconomic sensitivity.

Before answering the above question in greater depth, let's first differentiate between the traits of bottom-up and top-down investment strategies. As bottom-up investors, we spend our time deeply analyzing individual companies, identifying key questions, evaluating the risk of a permanent loss, and establishing a range of intrinsic values based on various simulations of the future. Very few investments meet our standards for risk and return but, for those that do, we target a three to five year holding period and a mid-teens return. We execute this process day in and day out across multiple industries and the end result is a diversified, high conviction 30 stock portfolio. In contrast, top-down investors usually spend most of their time trying to forecast important economic variables such as GDP growth, interest rates, commodity prices, etc. As divergences appear between their forecasts and market expectations, they create a portfolio of stocks and other securities expected to benefit when the divergence narrows. Given the fluidity of economic variables, top-down investors often have much shorter holding periods for their investments than we do.

Additionally, top-down investors usually own many more securities, often 50 to 150, to help diversify away the risks that may arise from not deeply analyzing the specific companies they own.

So, as bottom-up investors who aren't trying to out-forecast the top-down crowd, how do we get comfortable owning banks or oil service companies, whose profitability and value will ebb and flow with economic variables such as interest rates and oil price? We're usually most interested in these sorts of companies following some sort of macroeconomic anomaly which creates industry turbulence and causes growth expectations and valuations to fall to attractive levels. In addition to a discounted price, we generally look for four additional traits: company specific staying power, self-help opportunities, a highly attractive prospective return profile, and low risk of a permanent loss.

When we began aggressively investing in banks in 2011, valuations and profit expectations were terrible. Most banks were trading at sizable discounts to book value and single digit P/E's, which implies the market thought that earnings would decline for years to come. The banks were being sued over their bad behavior during the global financial crisis, lending standards were tight, and regulators were requiring ever higher levels of capital. Moreover, interest rates were near 50 year lows, further depressing bank profitability. As contrarians, we found this sort of investing context exceptionally attractive and believed we had multiple ways to win and few ways to lose on a multiyear basis. As we began analyzing our odds of a permanent loss in these investments, we developed conviction that the risk of loss was low since the banks' market valuations didn't account for self-help opportunities around cost reductions and asset sales of non-core business lines.

Additionally, since the government was aggressively stress-testing bank balance sheets to confirm they had staying power, we had confidence that the banks we owned would survive any unexpected macroeconomic surprises. In simple terms, through company-specific restructuring initiatives alone, we felt that we could achieve our threshold rate of return. If interest rates were to normalize to more normal levels, our returns would be enhanced and these would potentially shift from good investments to great investments. While we have consistently expressed a view that normalized interest rates¹ are likely to be higher than current rates, we've also stated we don't know when rates will normalize.

Incidentally, even though interest rates haven't meaningfully increased since the second half of 2011, we exited one of our bank investments after the stock price reached our price target. As we've noted before, throughout Dale's 20+ year career as a portfolio manager, his investment process has always been price sensitive.

Somewhat similar to our playbook in financial services, over the last few years we've gone from owning no energy companies to having approximately 11% of the portfolio invested in the sector as of June, 30, 2017. We've focused our energy investments around companies with self-help opportunities, staying power,

Interest rates are near 50 year lows:



Source: Intrinsic Research, Poplar Forest Capital estimates

Interest rates in August of 2017 are actually modestly lower than in the second half of 2011, when we were aggressively buying bank shares, so our views on normalized interest rates haven't materialized and yet almost all of our bank investments have outperformed the market. How is that possible? **It's possible because in the wake of macroeconomic anomalies, such as 50 year lows in interest rates or the -80% decline in oil prices from the second half of 2014 to the first half of 2016, investors can become so fearful that select investment opportunities emerge enabling you to earn attractive returns even if the macroeconomic anomaly persists.**

and the ability to generate good returns at \$40/barrel and great returns at higher prices. We believe energy industry cost structures support a normalized range for oil prices between \$40-\$70/barrel. This is a wide range, which reflects the inherent unpredictability of oil prices and we know oil prices could move outside of this range due to shorter term supply and demand imbalances. Ultimately, oil prices tend to reflect the marginal cost of supply, which we estimate is \$40-\$70/barrel.

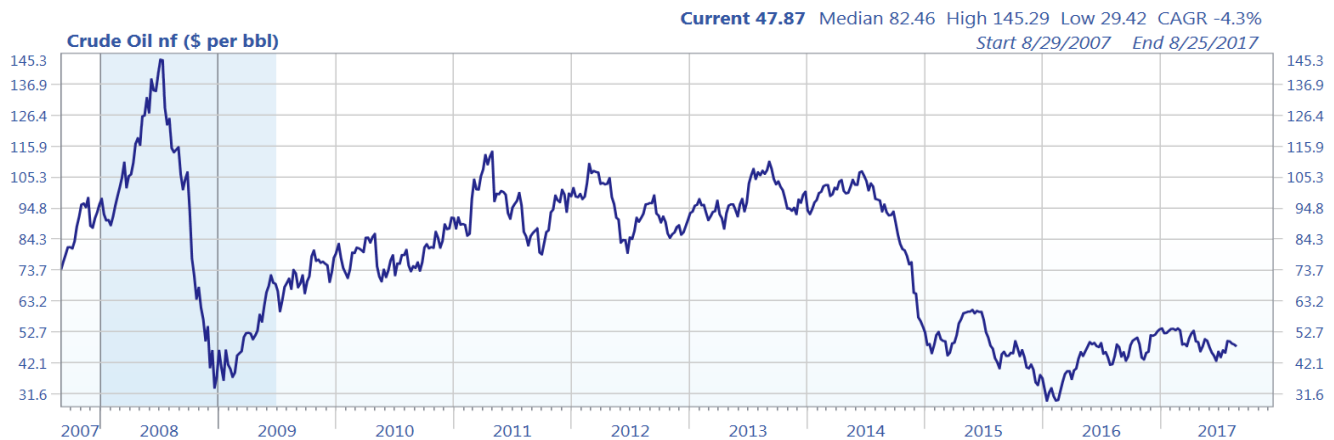
Selectivity is important in investing and we believe the risk of a permanent loss is low in our energy investments since valuations don't appear to be giving credit for cost structure improvements and other company-specific restructuring initiatives.

In terms of staying power, we believe our energy investments all have strong or dramatically improved balance sheets and an underappreciated ability to survive lower oil prices. Finally, we estimate all of our energy investments meet or exceed our threshold. These companies have the potential to be good investments if oil prices are relatively stable and *great* investments should oil prices rise in the next few years. Despite no major improvement in interest rates, we

were able to generate attractive returns with our financial services investments. Similarly, even if there isn't a major increase in oil prices, we believe our energy investments may also generate attractive returns. **In conclusion, macroeconomic anomalies may create long-term value investing opportunities.**

We'd love to continue the conversation. Please contact [Patty Shields](#) to schedule a time to further discuss this, or any other topic of interest.

Oil prices dramatically declined from late 2014 to early 2016:



Source: Intrinsic Research, Poplar Forest Capital estimates

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For mutual fund performance, please click the following links: Partners Fund Performance, Cornerstone Fund Performance, Outliers Fund Performance

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