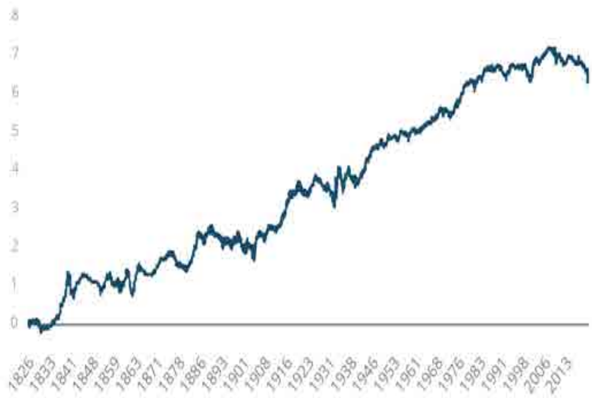
Why We Believe Value Will Work Again

December 1, 2020

Owning deeply discounted, high-quality businesses that are managed by good partners sounds intuitive, but it can be psychologically difficult in even the best of times. This year, value investing has been dramatically out of favor, with headlines again proclaiming the death of the strategy and well-established value managers shutting their doors. While value investing has been proven to work over the long-term, it is currently suffering its worst performance run in *at least two centuries.*

The Value Factor

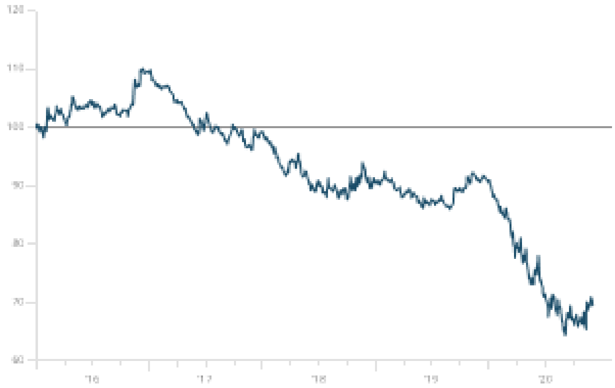
Cumulative Excess Return of Value vs. Growth



Source: Two Century Investments

S&P 500: Value vs. Growth

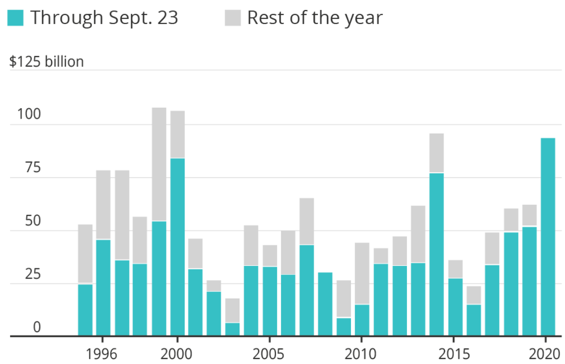
Relative Performance Dec 2016 – Nov 2020 (Daily)



Source: FactSet

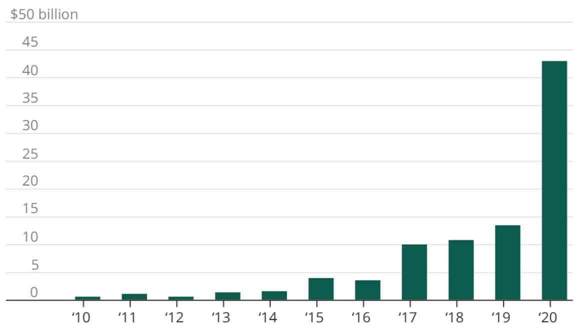
The last few years have seen the market's lust for growth go crazy. This has been hard to live through, but like the Nifty Fifty in the '70s and the Dot Com Mania in the '90s, you often need to see something like this before the market turns in a big way. We wrote in our third quarter letter about signs of market excess in US IPOs exceeding 2000 levels and 2020 being christened "The Year of the SPAC." We revisit those charts below.

Money Raised by US-listed IPOs



Source: Driebusch, C. (2020, September 25). IPO Market Parties Like It's 1999. *Wall Street Journal.* Retrieved from wsj.com; Dealogic

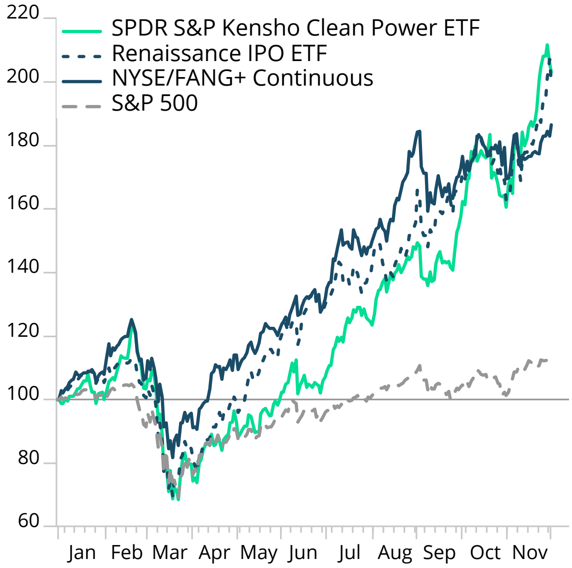
Money Raised in Blank-Check Company IPOs, Annually



Source: Wursthorn, M. (2020, September 30). Blank-Check Companies Get the ETF Treatment. *Wall Street Journal.* Retrieved from wsj.com; Dealogic

In yet another example of momentum trading and indexing mania uniting at exactly the wrong time, Tesla (currently a $700 billion+ market cap trading at more than 75 times forecasted 2022 earnings) will be added to the S&P 500 index soon. In a recent Wall Street Journal article, "A Stock Market Bubble? It's More Like a Fire," Jason Zweig likened market speculation to an "out-of-control blaze." As shown in the chart to the right, a few hot areas are overwhelmingly fanning the flames: technology stocks, alternative-energy and newly public companies.

Momentum on Fire



Source: FactSet

The Math is on Our Side

The good news is that simple math can show how value will win in the long term. The table below compares current and consensus for 2021/2022 earnings per share (EPS) and price-to-earnings (P/E) ratios for the following: S&P 500, top 5 largest S&P 500 stocks + Tesla, the "20/20 Club" (stocks with a P/E ratio >20x and return on equity (ROE) >20%, as defined in our second quarter letter), and the Longleaf Partners Fund as of November 22, 2020. The Longleaf Partners Small-Cap, International and Global Funds also have large disparities vs. their respective indices and the main momentum stocks within them.

	Earnings Per Share ($)		Price to Earnings (P/E)		Going In Cap Rate on '22 P/E
	2021	2022	2021	2022	
S&P 500	6.84	8.07	21.7	18.8	5.3%
S&P 500 Top 5 + Tesla	21.81	27.75	34.9	29.9	3.3%
20/20 Club	6.80	8.29	31.5	27.5	3.6%
Longleaf Partners Fund	6.31	7.74	13.0	11.4	8.8%

The S&P 500's and the 20/20 Club's 2022 EPS are likely overstated, given they are currently printing peak margins that are well over the long-term corporate average, with a strong potential for rising tax rates and increased regulation (that will also limit capital allocation flexibility) under a new Biden administration. On the contrary, consensus earnings for our portfolios in 2022 are understated with potential for significantly greater free cash flow than reported earnings from today's depressed levels. Our management teams will also have more flexibility to drive value recognition through accretive corporate actions.

We could see meaningful outperformance if we simply adjust the 2022 P/E multiples to slightly more normal levels, pricing "growth" at a premium and our "value" portfolio at a discount. At a 14.3x P/E (7% cap rate), our portfolio would return 26%, while at a 16.7x P/E (6% cap rate, actually above the market's long term average), the S&P would decline 11%, and the 20/20 Club at a 20x P/E (5% cap rate for its growth premium) would fall 27%. We also believe that our portfolio's EPS will continue to grow strongly beyond 2022.

Implied Returns Based on Various P/E Assumptions

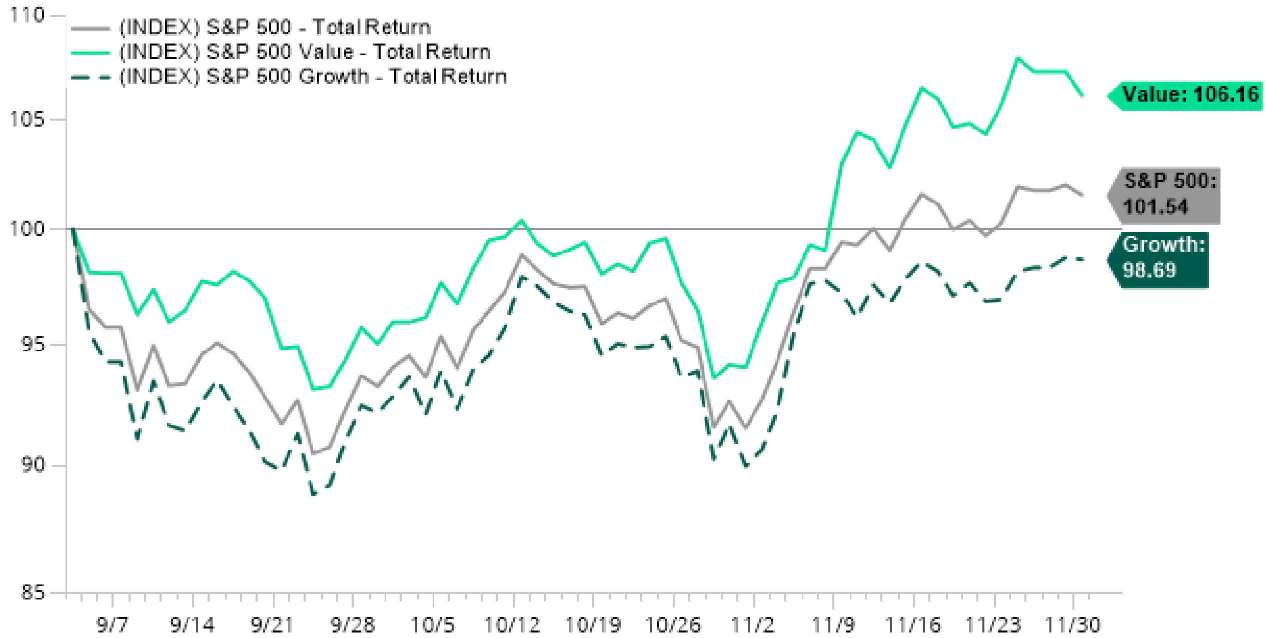
	2022 P/E		P/E Change	Performance from P/E Change
	Current	Assumption		
S&P 500	18.8	16.7	-2.1	-11%
S&P 500 Top 5 + Tesla	29.9	20.0	-9.9	-33%
20/20 Club	27.5	20.0	-7.5	-27%
Longleaf Partners Fund	11.4	14.3	+2.9	+26%

Actual investment results and performance are not guaranteed

It's only been three months, but the market might already be turning towards value, as shown in the chart below.

Performance Since Market Peak

9/2/2020 to 11/30/2020



Source: FactSet

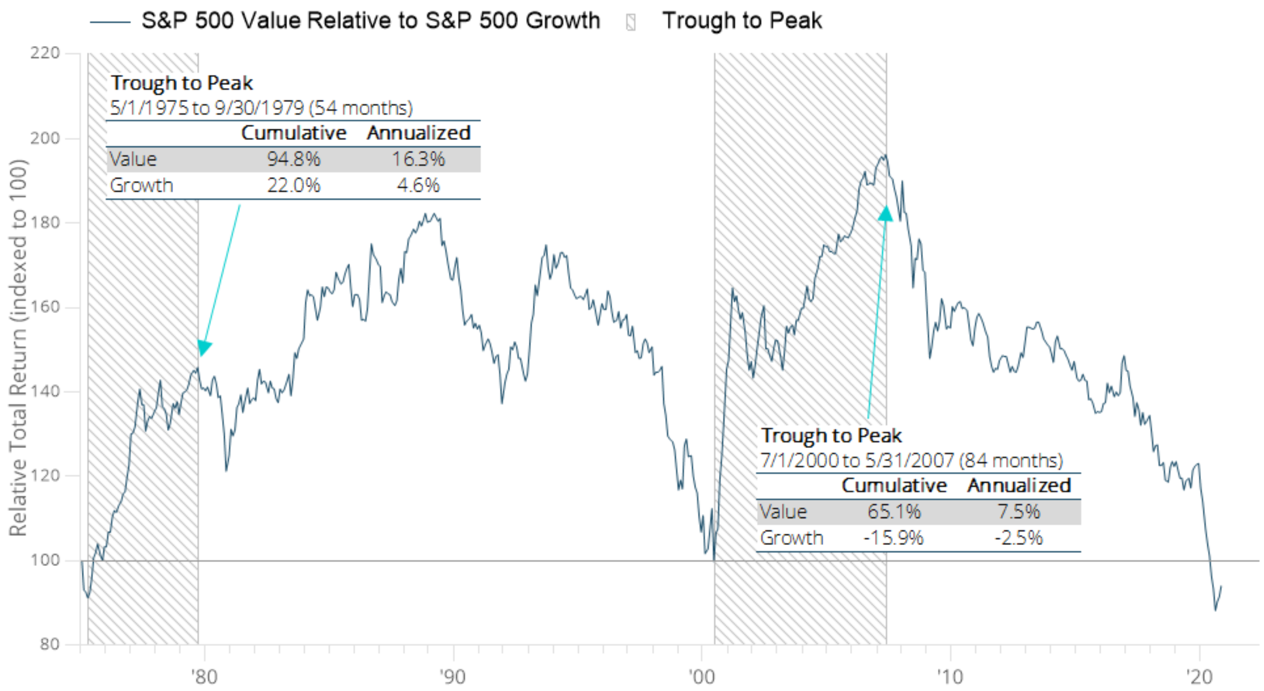
We could see a shift our way happen even faster and more meaningfully given: 1) simple multiple reversion math above usually happens quicker than you'd think it would once it starts, and then it often overshoots; 2) higher nominal interest rates in the wake of the war on COVID-19 would likely be good for our portfolio vs. the index that has benefited greatly from free money driving multiples for growth and perceived low volatility higher; 3) more value managers giving into the headlines and closing up shop or turning to growth at any price / closet indexing, leaving even less competition. Today's headlines look eerily similar to 2000 (the last time we saw this much multi-year relative underperformance for our portfolios) and the mid-1970s when we were founded.

Headlines: Now vs. Then

2020	FT FINANCIAL TIMES	*Covid condemns value investing to worst run in two centuries* OCTOBER 26, 2020
	The Economist	*Value investing is struggling to remain relevant* NOVEMBER 14, 2020
	Institutional Investor	*After 37 Years, Value Manager AJO Is Shuttering. It Won't Be the Last.* OCTOBER 16, 2020
2000	The New York Times	*The End of the Game; Tiger Management, Old-Economy Advocate, Is Closing* MARCH 31, 2000

In a 1976 interview, Ben Graham said, "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook "Graham and Dodd" was first published; but the situation has changed a great deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost." (*The Rediscovered Benjamin Graham,* Janet Lowe). As shown in the chart below, value went on to meaningfully outperform growth in the five plus years following both 2000 and 1976.

Value Rebounds After Underperformance



Source: FactSet

There are not very many "true" value managers left today. An analysis of 49 managers (with an average of 55 stock holdings each) classified as "value" by *InsiderScore* shows the average top ten holdings include a sampling of FAANGs and 20/20 Club stocks with an average current P/E of 27.5 and 2022 P/E of 17.9. We would love to own most of these companies at the right price (we do own Comcast and sold Alphabet recently after over 5 years of strong compounding off of a low price), but today's high prices matter greatly for future returns. Conversely, we do not think that the banks are high quality enough to buy, in spite of their low P/E.

Top 10 Holdings of Other "Value" Managers

	Price-to-Earnings		Held in # of	Average % of
Company Name	**2021**	**2022**	**Funds**	**Portfolio**
Alphabet	29.0x	24.8x	23	1.9
Berkshire Hathaway	21.5x	19.6x	18	2.6
Facebook	26.6x	21.3x	14	0.7
Comcast	18.0x	14.3x	14	0.5
Microsoft	31.8x	28.8x	13	0.4
Mastercard	40.9x	33.0x	12	1.6
Visa	38.6x	31.0x	12	1.1
Bank of America	13.7x	10.8x	12	5.5
Charles Schwab	23.1x	22.0x	11	0.4
Wells Fargo	14.3x	8.8x	11	0.9
Average	***25.8x***	***21.4x***		

The valuation rules for the current market favorites are not new and different because they have a lot of "intangible assets" or because they "scale easily" or any other buzzwords that are variations on similar thinking from the '90s, the '70s, the '20s and even back to some of the canal, railroad and telegraph favorites of the 1800s. Low nominal bond rates do not guarantee permanently high P/E multiples - look at Japan over the last 20 years. Size still often loses to competition, regulation and the law of large numbers. We have owned and will own again great businesses with significant intangible asset value like Abbott Labs, adidas and Mondelez/Nabisco. The same goes for fee-based scalers like Yum Brands, McDonald's, Marriott, Sonic and Wendy's. Former growth favorites like Discovery Communications and NCR's Teradata that we have also owned are a reminder that consensus great businesses don't always remain consensus great.

Outlook

Value works if you are able to take the temporary mental pain necessary to find bargains on under-recognized quality investments until fundamentals are properly weighed. We emphasize that, with our own capital on the line, we demand high quality, which we define as competitively advantaged businesses that will produce more free cash flow in the near future and will earn above average returns on invested capital. However, we will not pay the high prices commanded by quality that is extremely obvious to see or screen. We have pursued a proven long-term, concentrated, engaged value investment approach for over 45 years, and we have remained disciplined throughout multiple market downturns and challenging periods for our style. Our portfolios look meaningfully different than the index and our value peers. Today, we are ahead of the value index on a trailing one-year basis across our four Funds. We believe value is primed to return to market leadership, and most importantly our portfolios are positioned to deliver absolute returns and outperform our (dwindling) value peer group.

See following pages for important information.

Information in this letter regarding market or economic trends, or the factors influencing historical or future performance, reflects the opinions of management as of the date of this report. These statements should not be relied upon for any other purpose. Past performance is no guarantee of future results, and there is no guarantee that the market forecasts discussed will be realized. There is no assurance the investment process discussed will consistently lead to successful investing. There is no assurance the Fund objectives will be met.

Average Annual Total Returns as of September 30, 2020

Partners Fund: Since Inception (4/8/87): 9.13%, Ten Year: 5.23%, Five Year: 4.52%, One Year: -1.81%. S&P500: Since Inception (4/8/87): 9.99%; Ten Year: 13.74%; Five Year: 14.15%, One Year: 15.15%. S&P 500 Value: Since Inception (4/8/87): 9.27%, Ten Year: 9.95%, Five Year: 7.65%, One Year -5.03%.

Small-Cap Fund: Since Inception (2/21/89): 9.98%, Ten Year: 9.71%, Five Year: 6.84%, One Year: -3.16%. Russell 2000: Since Inception (2/21/89): 8.98%, Ten Year: 9.85%, Five Year: 8.00%, One Year: 0.39%. Russell 2000 Value: Since Inception (2/21/89): 9.23%, Ten Year: 7.40%; Five Year: 4.11%; One Year: -14.88%.

International Fund: Since Inception (10/26/98): 6.34%, Ten Year: 2.70%, Five Year: 5.37%, One Year: -10.02%. MSCI EAFE: Since Inception (10/26/98): 4.22%, Ten Year: 4.62%, Five Year: 5.26%, One Year 0.50%. MSCI EAFE Value: Since Inception (10/26/98): 4.31%, Ten Year: 2.10%, Five Year: 1.14%, One Year: -11.93%.

Global Fund: Since Inception (12/27/12): 4.52%, Ten Year: na, Five Year: 7.51%, One Year: -3.15%. MSCI World: Since Inception (12/27/12): 9.76%, Ten Year: na; Five Year: 10.48%, One Year: 10.41%. MSCI World Value: Since Inception (12/27/12): 5.59%, Ten Year: na, Five Year: 5.01%, One Year: -8.35%

One Year/Since Inception Total Returns as of November 30, 2020 (since inception is annualized)

Partners Fund: 9.81% / 9.63%	**International Fund: -2.87% / 6.97%**
S&P 500: 17.46% / 10.19%	**MSCI EAFE: 6.37% / 4.68%**
S&P 500 Value: 0.99% / 9.10%	**MSCI EAFE Value: -3.35% / 4.91%**
Small Cap Fund: 3.72% / 10.33%	**Global Fund: 4.17% / 6.25%**
Russell 2000: 13.59% / 9.58%	**MSCI World: 14.52% / 10.78%**
Russell 2000 Value: 0.35% / 9.95%	**MSCI World Value: -1.65% / 6.96%**

Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting southeasternasset.com. The prospectus expense ratio before waivers for the Partners Fund is 1.00%. The expense ratio is subject to a fee waiver to the extent normal operating expenses exceed 0.79% of average net assets. This agreement is in effect through at least April 30, 2021 and may not be terminated before that date without Board approval. The total expense ratio for the SmallCap Fund is 0.93%. The total expense ratio for the Longleaf Partners International Fund is 1.17% (gross) and 1.15% (net). The expense ratio is subject to fee waiver to the extent normal annual operating expenses exceed 1.15% of average annual net assets. The total expense ratio for the Global Fund is 1.32% (gross) and 1.15% (net). The expense ratio is subject to fee waiver to the extent normal annual operating expenses exceed 1.15% of average annual net assets. These agreements are in effect through at least May 1, 2021 and may not be terminated before that date without Board approval.

Before investing in any Longleaf Partners fund, you should carefully consider the Fund's investment objectives, risks, charges, and expenses. For a current Prospectus and Summary Prospectus, which contain this and other important information, visit southeasternasset.com/account-resources. Please read the prospectus and summary prospectus carefully before investing.

RISKS

The Longleaf Partners Funds are subject to stock market risk, meaning stocks in the Funds may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Funds generally invest in 15 to 25 companies, share value could fluctuate more than if a greater number of securities were held. Mid-cap stocks held may be more volatile than those of larger companies. With respect to the Small-Cap Fund, smaller company stocks may be more volatile with less financial resources than those of larger companies. With respect to the International and Global Funds, investing in non-U.S. securities may entail risk due to non-US economic and political developments, exposure to non-US currencies, and different accounting and financial standards. These risks may be higher when investing in emerging markets.

The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. S&P 500 Value Index constituents are drawn from the S&P 500 and are based on three factors: the ratios of book value, earnings, and sales to price. An index cannot be invested indirectly.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3,000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell 2000 Value Index is drawn from the constituents of the Russell 2000 based on book-to-price (B/P) ratio. An index cannot be invested in directly.

MSCI EAFE Index (Europe, Australasia, Far East) is a broad based, unmanaged equity market index designed to measure the equity market performance of 22 developed markets, excluding the US & Canada. The MSCI EAFE Value Index captures large and mid-cap securities exhibiting overall value style characteristics across Developed Markets countries around the world, excluding the US and Canada. An index cannot be invested in directly.

MSCI World Index is a broad-based, unmanaged equity market index designed to measure the equity market performance of 24 developed markets, including the United States. The MSCI World Value Index captures large and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries. An index cannot be invested in directly.

Price / Earnings (P/E) is the ratio of a company's share price compared to its earnings per share.

Earnings per share (EPS) is the portion of a company's net income allocated to each share of common stock.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Nifty Fifty refers to a group of fifty growth stocks identified by Morgan Guarantee Trust in the 1960's and 1970's that were regarded as "buy and hold" stocks.

FAANG refers to the stocks of technology companies Facebook, Amazon, Apple, Netflix,
and Alphabet (formerly Google).

As of September 30, 2020 the top ten holdings for the Longleaf Partners Funds are:

Longleaf Partners Fund: Lumen (CenturyLink), 10.1%; Mattel, 6.9%; FedEx, 5.5%; Comcast, 5.2%; CNH Industrial, 5.1%; LafargeHolcim, 5.1%; CNX Resources, 5.1%; Affiliated Managers Group, 4.8%; Fairfax Financial, 4.7%, GE 4.7%.

Longleaf Partners Small-Cap Fund: Lumen (CentruyLink), 10.9%, Kodak, 10.0%; Mattel, 8.4%; Lazard, 7.1%; CNX Resources, 6.5%; Graham Holdings, 4.9%; Lanxess, 4.7%: Realogy Holdings, 4.4%; Empire State Realty, 4.3%; Univar, 4.1%.

Longleaf Partners International Fund: EXOR, 8.3%; Domino's Pizza Group (UK), 7.7%; Melco, 6.6%; Prosus, 5.9%, Lazard, 5.4%; LANXESS, 5.0%; Fairfax Financial, 5.0%; Accor, 4.9%; Millicom, 4.6%; Baidu, 4.6%.

Longleaf Partners Global Fund: Lumen (CenturyLink) 8.1%; EXOR, 7.9%; FedEx, 5.5%; Melco, 5.0%; Comcast, 5.0%; Prosus, 4.9%; CK Hutchison, 4.7%; Fairfax Financial, 4.7%; CNX Resources, 4.6%; Williams, 4.5%.

Fund holdings are subject to change and holding discussions are not recommendations to buy or sell any security. Current and future holdings are subject to risk.

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