Clifford
CAPITAL PARTNERS

August 15, 2019

Dear Clients,

We hope that you are all doing well. We are grateful for your support of Clifford Capital Partners. Given the significant volatility over the past several months in both the stock market and our portfolios' results, we wanted to share a few thoughts and opinions. Volatility is uncomfortable and we at Clifford Capital are invested alongside you in our strategies, so we feel the same pain when short-term declines hit our portfolios. However, we have not wavered in our belief that our strategies are very attractive today, despite the uncertainty abounding in the marketplace. We see strong valuation in pockets of the market, areas which have hurt our short-term performance, but for which we believe the long-term rewards are very compelling.

We've clearly been too early in our bullishness on some of our favorite stocks today and our Deep Value stocks have been very out of favor in the recent past. However, our conviction remains strong in the stocks we own, and we will continue to position the portfolio for long-term outperformance, even if it hurts us in the short-term. In short, we're not shying away from the areas that have underperformed; in fact, we believe most of the stocks that have hurt our results in recent times are trading at extremely attractive valuations today and we're more apt to be buyers than sellers, assuming nothing fundamental has changed to our investment thesis.

We liken many of the stocks that we believe are significantly undervalued to a beach ball being held under water – the deeper the proverbial ball goes down, the higher the pressure to move it back towards the surface (fair value). We've seen insiders purchasing stock, companies aggressively buying back shares, and activists swirling around several of the companies we believe are undervalued—all signs that the beach ball will eventually pop back up.

Recession Worries = Volatility

There is a considerable amount of worry today about a possible economic recession. Some of the market's recent volatility can be attributed to a recent buying panic in U.S. government bonds, which has led to long-term interest rates dropping below short-term rates (a "yield curve inversion"). These inversions have historically been a good indicator of upcoming recession, so combining this signal with many other macroeconomic worries around the world—including tariffs and trade wars, middle east tensions, slowing economies, and civil unrest—has contributed to the stock market becoming a bit unhinged.

At Clifford Capital, we look at companies one-by-one on a bottom-up basis, and we do not have strong views about the macro economy. We strive to be "macro aware", but ultimately, we strongly believe in the power of buying individual stocks that are trading at low valuations because of overly negative investor sentiment. Today, we believe many of the individual stocks we own are priced as if they are already in a nasty recession and the odds are in our favor to achieve solid long-term returns.

The Haves and the Have Nots

As economic worries have increased, the market's appetite for "safe havens" has increased significantly. In the stock market, one of these havens has been in lower volatility large cap stocks with seemingly more predictable cash flow streams. These "defensive" stocks are among the "Haves" in today's marketplace and in our opinion, there are very few bargains in this space, and in many cases we believe they are significantly overvalued. In the meantime, the stocks of companies with more economic sensitivity have underperformed, and in many cases are implying a future that we believe is overly pessimistic. In particular, smaller companies that are viewed as being more vulnerable to the economy have underperformed very significantly in the recent past (a phenomenon that has hurt our recent results) and are firmly among the "Have Nots" in today's market.

To illustrate this, the chart below shows the performance of the S&P 500 Low Volatility Index (a good proxy for large cap defensive stocks – the "Haves" in today's market) vs. the Russell 2000 Value (a good proxy for small cap value stocks – among the "Have Nots") over the past one year.

Source: Bloomberg, August 15, 2019

We attribute much of this performance discrepancy to recession worries as well as a flight to safety. In our mind we believe investors have been pressing the proverbial "risk off" button, which has led to a striking valuation disconnect between the Haves and the Have Nots in the marketplace, as shown below.

Small Cap Value Stocks Trading at a Significant Discount to Larger "Defensives"

	P/E	P/Book	Enterprise Value/Sales	Dividend Yield
S&P 500 Low Volatility Index	22.9	2.8	3.7	2.54%
Russell 2000 Value Index	12.7	1.3	1.6	2.57%

Source: Bloomberg, August 15, 2019

Our high-quality Core Value stocks (50-75% of our portfolios) have held up relatively well in this market, while our opportunistic Deep Value stocks—many of which are found in the small cap value universe—have underperformed. We believe both areas are attractive today, but we see tremendous undervaluation in the Deep Value bucket, with our smaller-cap investments trading at very compelling prices. We continue to find much more attractive opportunities in smaller companies and we've recently been selling/avoiding many of the most popular traditional large cap 'safe haven' stocks, which we think have risen to valuation levels that no longer qualify them as "defensives".

Market Anomaly and Opportunity
As we mentioned in our last quarterly commentary, we've observed an anomaly in the stock market relating to several retailer stocks, which we believe has contributed to outsized, and undeserved, stock price declines and provided an investment opportunity. Accounting rules surrounding operating leases—essentially rental contracts for retail stores—changed earlier this year, which produced a new liability on many retailers' balance sheets (as well as an asset for the right to use these properties). This liability was reported as long-term debt at many of the large financial reporting aggregators like Bloomberg and FactSet – services used by investors to assess the financial health of companies. We do not believe these operating lease liabilities are the same as long-term debt (and we note Bloomberg has recently made adjustments to their reporting to clarify this).

Our research has shown that in several cases the stocks of retailers who showed a large increase in this new "debt" were sold aggressively (especially by quantitative, rules-based program traders who are less likely to adjust for new accounting standards) because of the initial confusion around this new accounting treatment and what appeared to be an instantaneous degradation in these companies' financial health. In several cases, we believe this anomaly may have contributed to declines of 20-25% that otherwise wouldn't have occurred and there has been little to no bounce because these companies are so out of favor with most market participants. To be clear, fundamentals of these companies had not changed as a result of this new accounting standard, but it appeared that they did, leading to non-fundamental selling pressure.

While there are other reasons for retail stocks to be down in today's environment (including tariff worries and fundamental changes in how people shop), we think this incremental selling pressure has led to some extremely attractive valuations for retailers that we believe can survive and thrive in the future. Some of these retailers are trading at valuations at or below those of the financial crisis—significantly below what we believe is rational. In each case, we think there are company-specific reasons that these companies' results will exceed what is expected in the marketplace. We believe this accounting anomaly has led to a larger discount and higher future return potential for several of our retail stock investments.

Final Thoughts
We are disappointed with our recent results but remain very positive about the future. We will strive to remain disciplined, stay humble enough to recognize and correct anything that needs correction, and to find new bargains that we believe will lead to attractive long-term results. We are grateful for your support of Clifford Capital and thank you for your investment with us.

We will continue to focus on building long-term wealth through disciplined portfolio management.

Sincerely yours,

Ryan Batchelor, CFA, CPA
Principal and Portfolio Manager
Clifford Capital Partners, LLC

Any return estimates are subject to actual known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those projected. As with any investment strategy, there is potential for profit as well as the possibility of loss. Clifford Capital Partners, LLC does not guarantee any minimum level of investment performance or the success of any index portfolio or investment strategy. All investments involve risk and investment recommendations will not always be profitable. Past performance does not guarantee future results.