Scharf Sustainable Value Strategy

MONTHLY COMMENTARY

- July saw a ferocious return of the "risk-on" trade as investors perceived a potential dovish Fed pivot in 2023.
- The Scharf Sustainable Value Strategy, focused on earnings resilience through economic cycles, returned 5.35% net of fees.
- Cyclical stocks outperformed defensive stocks by a wide margin despite signs of a slowing U.S. economy.

MARKET REVIEW

Growth stock and cyclical stock investors cheered early signs of a slowing U.S. economy in the hope the Fed would begin cutting interest rates earlier than expected. The 10-2 year U.S. Treasury spread went solidly negative and finished the month at -0.22%.

In July, the Russell 1000 Growth Index returned 12.0% vs. 6.63% for the Russell 1000 Value Index. Bitcoin was up 19%. S&P 500 sectors, consumer discretionary and information technology, leading laggards year-to-date, rocketed up 18.9% and 13.5%, respectively.

With a 9.1% CPI YOY increase reported for June, Fed presidents like San Francisco's Mary Daly are making comments ("Nowhere near almost done"), which is pushing back on market exuberance.

PORTFOLIO REVIEW

For the month, the Strategy returned 5.35% net of fees vs. 6.63% for the Russell 1000 Value Index and 9.22% for the S&P 500 Index. The top sector attribution contributors were stock selection in Health Care, Consumer Staples, and Materials. The largest sector detractors were overexposure to underperforming Communication Services, a zero allocation to the leading Energy sector, and overexposure to underperforming Health Care.

At the stock level, the top attribution contributors were Centene, Valvoline, Fiserv, MillerKnoll, and McKesson. The top detractors were Lockheed Martin, Markel, Cognizant, Baidu, and Liberty Broadband.

We continued to add Booking Holdings. We estimate Booking Holdings 2023 P/E to be approximately 14x on EPS that could very well be revised higher given 2022 travel trends and subdued margin expectations. Marriott and Delta provided positive read throughs in their Q2 earnings calls.

We exited Masco. Masco is a high-quality company, but we believe the unexpected doubling in U.S. mortgage rates year-to-date will impact their paint (e.g., Behr) and plumbing revenues (e.g., Delta Faucets) as 2022 progresses. The housing market has quickly cooled. In June, U.S. pending home sales declined 8.6% vs. expectations for a 1% drop. While Masco's largely residential housing renovation and maintenance business is less cyclical than new building construction, revenues are still correlated with the number of homes sold.

OUTLOOK

As concerns about slowing growth accelerate, we are confident in the Strategy's sustainable earnings profile. For a stress test, holdings as of the close of Q1 grew their weighted averages EPS 10.2% YoY in the initial year of the pandemic, in calendar 2020. This compares to -28.4% YoY EPS growth for the Russell 1000 Value Index and -15.1% EPS growth for the S&P 500. Health Care remains the Strategy's largest sector overweight and has continued to produce strong relative returns and limit volatility. We believe investors are irrationally exuberant about the probability of a soft landing.

All data as of July 31, 2022.

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