SCHARF INVESTMENTS

Scharf Sustainable Value Strategy

MONTHLY COMMENTARY

- U.S. stock returns were strong again in November.
- The Scharf Sustainable Value Strategy returned 4.31% (net of fees).
- The investment team remains focused on earnings resilience at a discount.

MARKET REVIEW

U.S. stocks were broadly up again in November despite deteriorating leading economic indicators and earnings estimates. Value stocks outperformed growth stocks. Materials, IT and Communication Services sectors led, while Energy was the laggard, up just 1% as oil prices declined and sector investors ponder the potential for negative profit growth in 2023.

PORTFOLIO REVIEW

For the month, the Strategy returned 4.31% (net of fees) vs. 6.25% for the Russell 1000 Value Index. At the stock level, the top attribution contributors were Novartis, Comcast, Booking Holdings, Baidu, and Markel. The largest detractors were Advance Auto Parts, McKesson, Lockheed Martin, MillerKnoll, and Cognizant Technologies.

A stock's Favorability Ratio, or our % upside return estimate divided by our % downside return estimate, is a primary driver to portfolio decision making. We seek a 3-to-1 ratio at purchase. In the month of November, we trimmed and added to existing positions based on relative Favorability Ratios. We trimmed Lockheed Martin, our second-best performer year to date (up nearly 40% through November), back to an equal-weight portfolio position. While the company offers low long-term earnings volatility given its advanced R&D and multi-decade government contracts, the Favorability Ratio has meaningfully declined this year given the stock's outperformance.

We nearly doubled the Booking Holdings' weighting given the stock's lagging performance (down approximately 15% year-to-date through November), strong operating performance and resultant expanded Favorability Ratio. The stock trades at approximately 14x 2023 estimated EPS, not only a significant discount from its 20-year median high P/E of 30x, but even its median low P/E of 18x. Q3 gross bookings, sales, and adjusted EPS (up 41% YoY) were all ahead of sell-side expectations.

OUTLOOK

Booking Holdings offers an attractive contrast to the general U.S. equity market. The pandemic abnormally compressed the travel company's margins, EPS and P/E multiple. Thus, we believe any economic slowdown's impact to Booking Holdings will be somewhat mitigated by the normalization of post-pandemic behavior. Conversely, the pandemic actually expanded general U.S. equity margins, EPS and P/E multiples. Post-covid normalization and/or an economic slowdown is likely to present relatively more downside risk for a broad market index and typical U.S. stock. Stock selection will be crucial.

A risk: We believe investors are not fully discounting the risks of earnings deterioration in 2023. S&P 500 net margins assumptions for 2022-23 are > 12% versus a post millennium average of 7.75%. **An opportunity:** However, P/E dispersion, on par with levels last seen during the 2000 tech bubble, presents a compelling investment opportunity for value stocks. The S&P 500 top quintile P/E minus the bottom quintile P/E (valuation spread) is 15.3 turns vs. a 25-year average of 11.5. Meanwhile, quality value (low EPS volatility) should mitigate the risk of traditional value stocks' (e.g., Energy, Financials, Materials) high operating leverage in a slowing 2023 global economy.

All data as of November 30, 2022.

Past performance is not indicative of future results. The securities identified and described do not represent all of the securities purchased, sold, or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.