SCHARF INVESTMENTS

THE BIG Picture

Q3 2024

- President's Perspective
- Stock Spotlight: CME Group

1
President's
Perspective

6
Stock Spotlight: CME Group

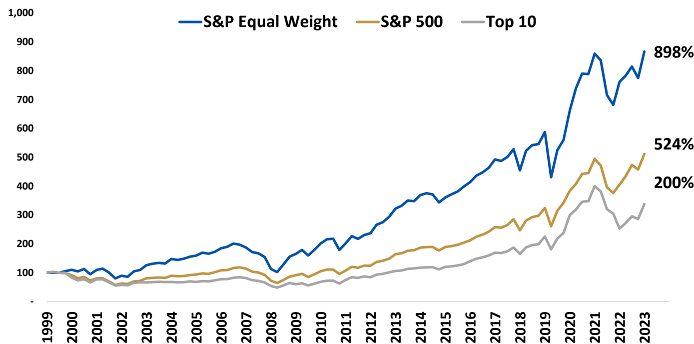
Results were generated using an investment philosophy and methodology that Scharf Investments expects to continue using. However, future investments may be made under different economic conditions and in different securities. Past performance is not indicative of future results.

BRIAN KRAWEZ, CFA®
President, Investment Committee Chairman

To Our Valued Clients:

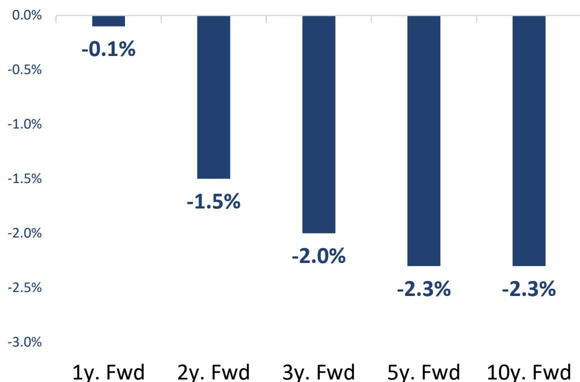
The average stock in the S&P 500 typically outperforms both the market capitalization weighted S&P 500 and the top 10 largest stocks (see chart below). This is due in part to the faster growth of smaller companies as it is increasingly more difficult to grow as a company becomes larger. As shown in the chart below, since 1980, this has meant the top 10 market capitalization companies in the S&P 500 typically underperform over all time periods. In addition, as a direct result of this faster growth, the average company in the S&P 500 generally trades at a premium to the S&P 500. At the end of last year, we highlighted a potential theme for 2024 that we dubbed "revenge of the average stock". We believed the average stock was poised to outperform because the S&P equal weight had become historically cheap relative to the S&P 500.

Performance: Average S&P Stock > S&P 500 Total Return (indexed to 100)



Source: Bloomberg, Scharf Investments. Data as of 9/30/2024

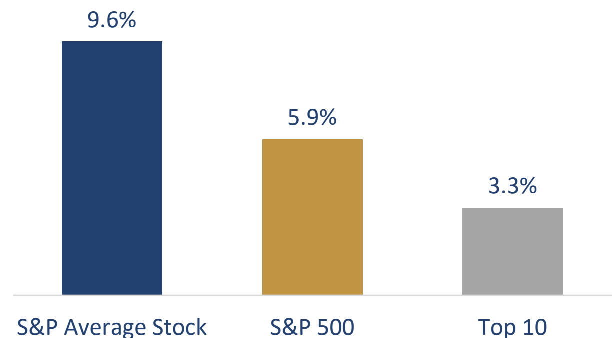
Average Relative Return: US Top 10 Companies Since 1980



Source: Bloomberg, Scharf Investments. Data as of 9/30/2024

Through the first half of 2024, larger companies continued to lead. Were we early or just wrong? Time will tell, but last quarter this theme finally began to work. The S&P equal weighted index (i.e., 'the average stock') outperformed not only the market capitalization weighted S&P 500 Index, but also the 10 largest stocks in the S&P 500 for the first time in 18 months. Despite the broadening out of returns last quarter, this is still the most concentrated U.S. stock market in recent history. The top 10 stocks hit a record 39% of the S&P 500, compared with a peak of less than 27% during the internet bubble.

Total Returns Q3 2024

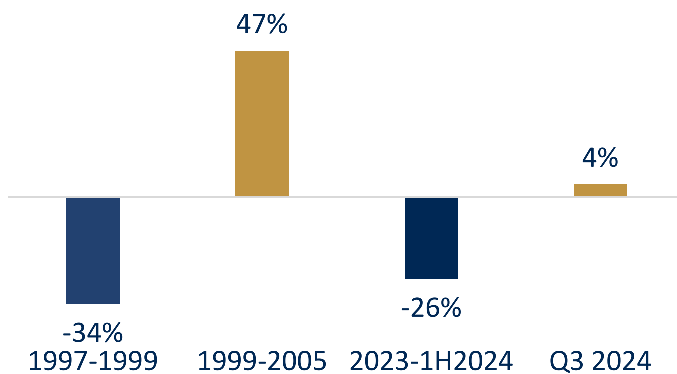


The S&P Average Stock refers to the S&P 500 Equal Weighted Index. Top 10 refers to the 10 largest stocks in the S&P500 by weight as of 9/30/2024. Source: Bloomberg, Scharf Investments. Data as of 9/30/2024

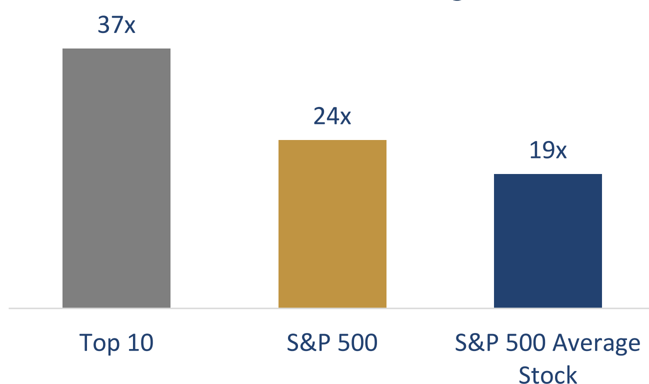
Highly Concentrated Market

Source: Charles Schwab, Bloomberg, as of 8/16/2024. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. Past performance is no guarantee of future results.

From Jan 1, 2023 to the end of last quarter, the average stock underperformed the S&P by around 26%. The largest companies in the S&P 500 led the way. The last time the average stock underperformed by this magnitude was during the internet bubble. As shown in the chart below, what followed was a period of strong outperformance by the average stock. If history is any guide, we believe the broadening theme that started last quarter is more likely than not to continue. Our conviction is further strengthened by the fact that, while the average stock has typically traded at a premium to the market capitalization weighted S&P 500, today it trades at more than a 20% discount.



The Average S&P Stock is represented by the S&P Equal Weighted Index. Source: Bloomberg, Scharf Investments. Data as of 9/30/2024.



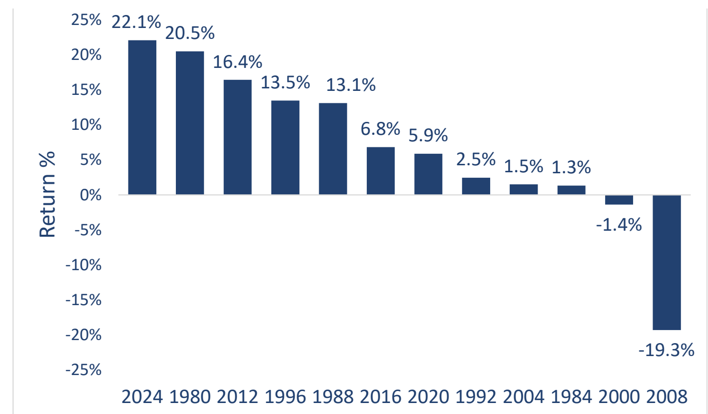
The S&P Average Stock refers to the S&P 500 Equal Weighted Index. Top 10 refers to the 10 largest stocks in the S&P500 by weight as of 9/30/2024. Source: Bloomberg, Scharf Investments. Data as of 9/30/2024.

Elevated Recession, Geopolitical, and Policy Risks

In September, the U.S. Federal Reserve Board reduced its benchmark interest rate 50 basis points to 4.75 - 5% from 5.25 - 5.50% beginning an easing cycle that many investors expect to continue over the next several quarters. This has helped drive up investor optimism to peak levels. In fact, we have had one of the best rallies in the first 9 months of any presidential election year as investors have now priced in a soft landing.

With earnings growth of only 7%, the strong stock performance has elevated the S&P 500's valuation to nosebleed levels. At 24 times this year's earnings, the S&P is now in the top 10th percentile in terms of expensiveness. Despite this investor optimism, we see heightened recession, geopolitical, and political risks which warrant some degree of caution.

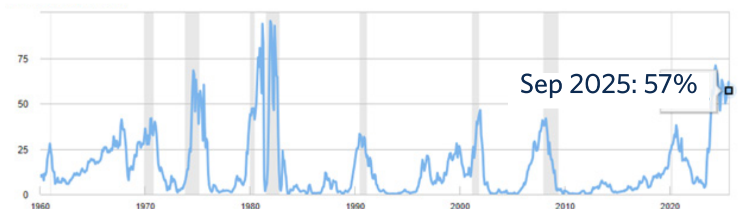
S&P 500 Presidential Election Year Return % through 9/30



Source: Bloomberg. Data as of 9/30/2024.

While investors seem to be convinced the Fed has engineered a soft landing, history shows this rarely happens. In fact, of the 12 times the U.S. Federal Reserve executed a 50 basis point rate cut to begin an easing cycle, a recession followed in all but two of those cycles. In other words, the chances of a soft landing are low. The current Treasury spread indicator is pointing to a 57% chance of a recession in the next 12 months. As shown in the chart below, every time this indicator has been over 50%, the U.S. economy was either in a recession or about to have one.

Probability of U.S. Recession, Twelve Months Ahead of Term Spread Readings *Percent (monthly average)*



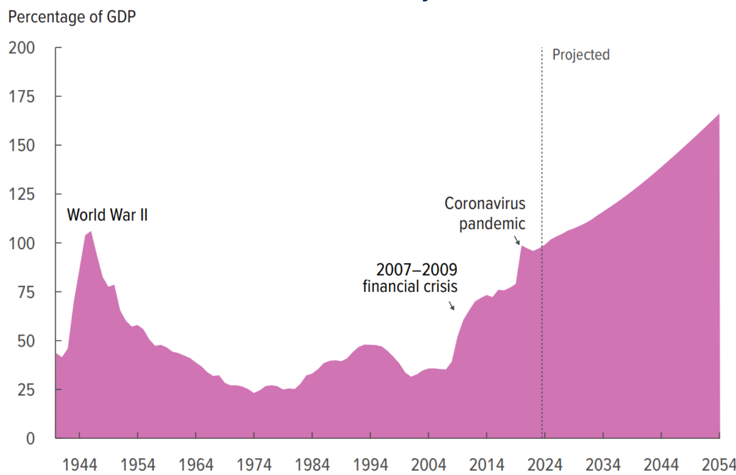
Source: Board of Governors of the Federal Reserve System

With wars raging in Ukraine and the Middle East, it goes without saying that geopolitical risk is also at elevated levels. This could lead to disruptions in supply chains, global trade, and investment, as well as potentially reduce consumer spending. Importantly, conflict is also generally inflationary – which could derail the Fed's efforts to cut rates and ultimately pressure stocks if forward rate expectations rise.

No matter who wins, the next president is going to have to contend with rising deficits and expiring tax cuts.

Political risk for investors is also heightened due to policy uncertainty. No matter who wins, the next president is going to have to contend with rising deficits and expiring tax cuts. According to the Congressional Budget Office, the U.S. is currently running a budget deficit of 7% of GDP. If there are no changes to current laws, the public debt to gross domestic product ratio is projected to reach 122% 10 years from now (by 2034), surpassing the post-second world war record high of 106%.

Federal Debt Held by the Public

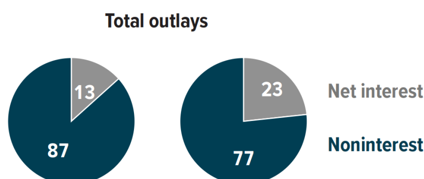


Source: Congressional Budget Office, Long-Term Budget Outlook 2024 - 2054

As shown in the chart, this increased debt pressures the budget through higher interest costs. Importantly, the CBO analysis assumes the 2017 tax cuts expire, which is unlikely given both candidates have pledged to keep at least some of the tax cuts in place. Expiration of the tax cuts will certainly lead to a reduction in consumer spending and a reduction in GDP, while an extension of them would lead to increased debt and ultimately higher interest costs. There are no easy answers and the current proposals (higher corporate taxes, tariffs, taxes on unrealized gains, no taxes on tips, etc.) would potentially all lead to negative economic consequences and stock market volatility.

Composition of Outlays, 2024 and 2054

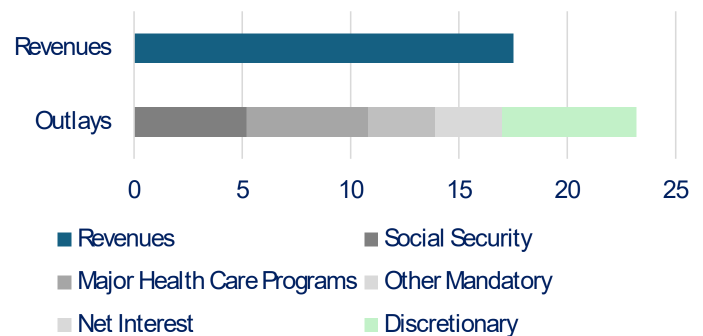
Percent



Source: Congressional Budget Office, Long-Term Budget Outlook 2024 - 2054

So why not cut spending? As shown in the chart below, mandatory spending (including entitlement programs and interest) essentially matches total revenue. In other words, the government would need to cut all discretionary spending to balance the budget. This is clearly impossible and even more so given rising geopolitical tensions that have increased the importance of defense spending for both political parties. Sadly, the problem is only going to get worse. Per the CBO, the number of Social Security beneficiaries is projected to increase to 80 million (22% percent of the population) by 2034. As a result, net federal spending on entitlement programs, such as Medicare and Social Security, is projected to dramatically increase.

U.S. Federal Government Budget 2024: % of GDP



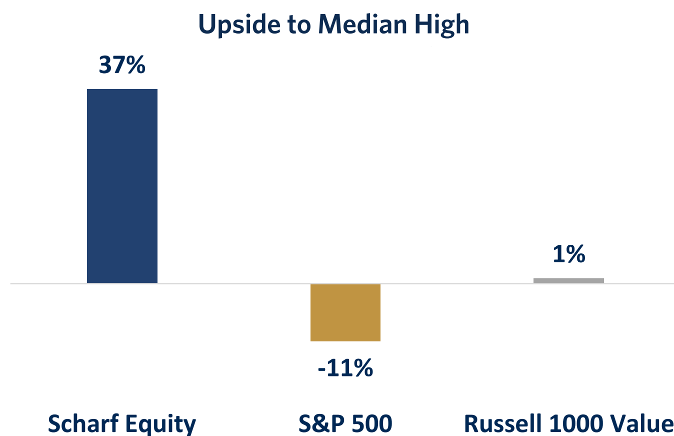
Source: Congressional Budget Office, Long-Term Budget Outlook 2024 - 2054

It is against this backdrop – regardless of who wins the November 2024 presidential election - that we think investors should curb their enthusiasm and focus on companies best positioned to do well regardless of what lies ahead.

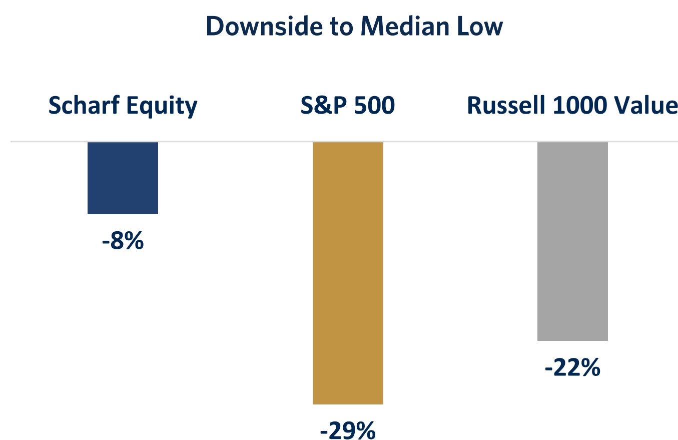
Portfolio Positioning

Our strategy remains focused on 'Quality' and 'Value' – which means identifying undervalued companies with predictable earnings trading at compelling valuations relative to their trading history. We seek to buy stocks with 30% plus upside to their median high trading ranges and limited downside to their median lows if our investment thesis proves incorrect. We use this upside vs. downside calculation to create a stock's Favorability Ratio. We believe this valuation support should provide downside protection while offering upside potential if multiples revert to their historical ranges. As shown in the charts on page 4, the Scharf Quality Value portfolio offers better favorability, meaning it has better upside potential to its median high with significantly less downside to its median low relative to

the S&P 500 and the Russell 1000 Value.



Source: Capital IQ, Scharf Investments. Data as of 9/30/2024.



Source: Capital IQ, Scharf Investments. Data as of 9/30/2024.

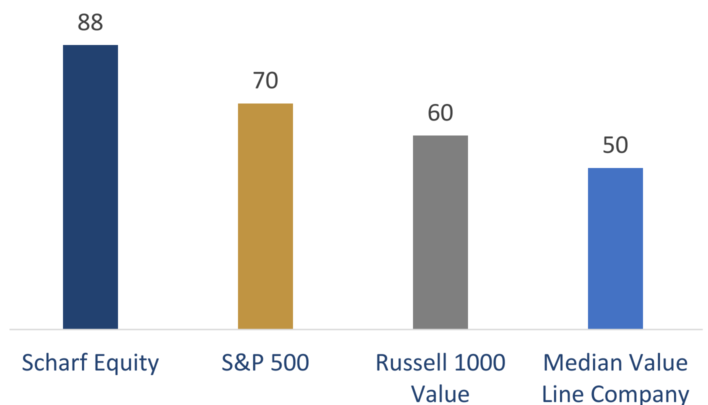
Despite better favorability, the Scharf Quality Value portfolio also has shown better historical earnings growth and predictability. The median company in the portfolio had 2024 and 10-year historical earnings growth of 8% and 11%, respectively. As shown in the table below, this is better than both indexes.

Earnings Growth

	2024 Projected Earnings Growth	10-Year Trailing EPS Growth Rate
Scharf Equity	8%	11%
S&P 500	7%	7%
Russell 1000 Value	-4%	4%

Source: Value Line, Bloomberg, Capital IQ, Scharf Investments. Data as of 9/30/2024.

Another important hallmark of Scharf equity is the earnings predictability of the companies in the portfolio. We seek companies that are much more predictable than the averages or peers as companies with less sensitivity to the business cycle typically outperform in adverse markets. In addition, as shown in the 10-year earnings data below, companies with superior earnings consistency tend to deliver better earnings growth over the full cycle. The median stock within the Scharf Quality Value portfolio has an earnings predictability ranking of 88, compared to 70, 60, and 50 for the S&P 500, Russell 1000 Value, and median company in the ValueLine universe, respectively.



Source: Value Line, Scharf Investments. Data as of 9/30/2024.The Value Line universe of 1,700 stocks accounts for approximately 90% of the market capitalization of all stocks traded on the U.S. exchanges.

Staying the Course

In sum, we see evidence that the valuation disparity between growth and the average stocks is starting to converge – and if the past period is any guide, the trend has much further to run.

Over the past 40 plus years, we have seen recessions, credit crises, wars, stock bubbles, pandemics, etc. During this time, we have utilized the same investment process. History has shown that investors would be wise to stay the course as prudent investors have been well rewarded. In fact, an investor that had the foresight to invest a million dollars with Scharf Investments at the end of 1983 would have $144,414,102 today, for a compounded return of over 14,000%.

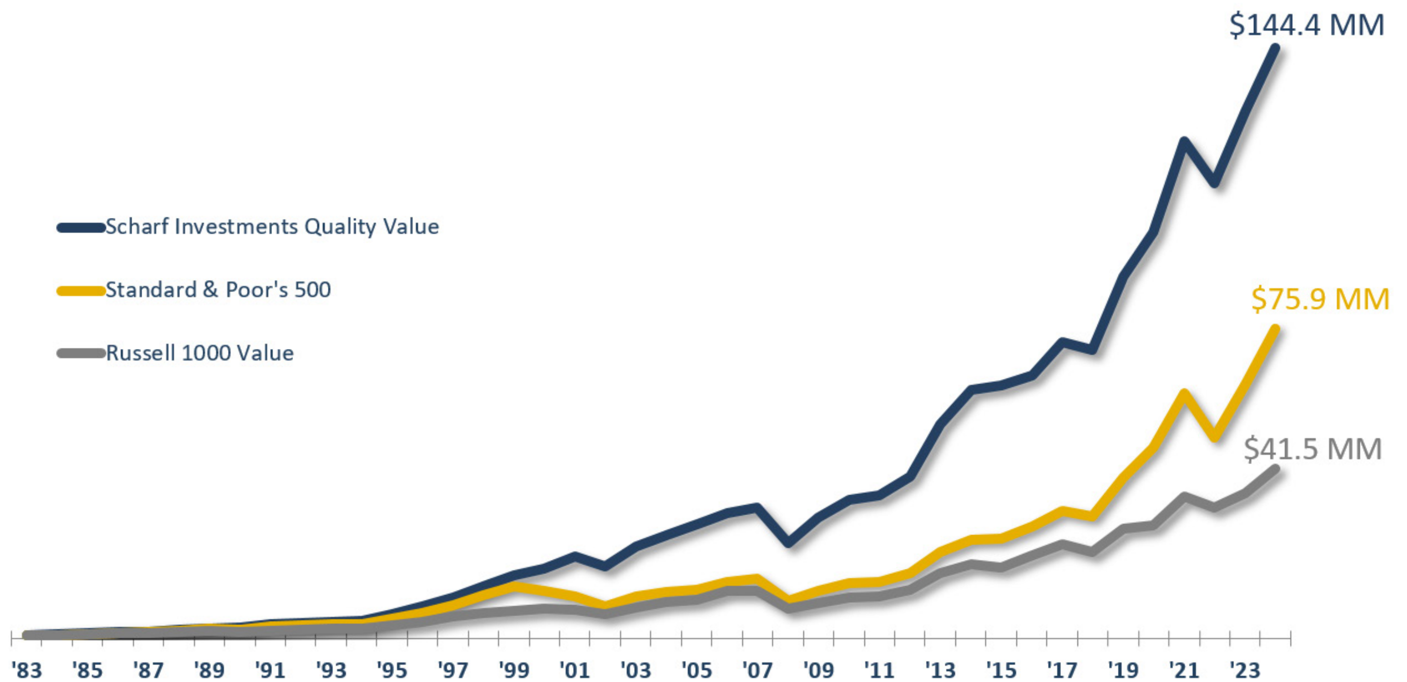
We are proud of the “mountain chart” shown below and believe it demonstrates the power of our simple, yet effective approach to investing. We thank you for the confidence and trust you have placed in us, and we welcome your questions.

Best regards,

Brian Krawez

Scharf Quality Value: Growth of a $1,000,000 Investment

12/31/1983 - 9/30/2024 (Net of Fees)



Sources: Bloomberg, Scharf Investments, as of 09/30/2024.
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.
Past performance is no guarantee of future results, and different periods and market conditions may result in significantly different outcomes. Performance for 1989 through 1996 includes all fee-paying, fully discretionary equity accounts open for the entire calendar year. The performance for each year beginning with 1997 includes all fee-paying, fully discretionary equity accounts from their first full quarter under management through their last full quarter under management. Performance for all years reflects the reinvestment of dividends and other earnings, along with the deduction of trading commissions and other costs including management fees. No guarantee can be made that the composite performance is the statistically accurate presentation representing performance of any specific account, as specific account performance depends on investment timing, account specific guidelines, and other factors that vary from account to account. Results were generated using an investment philosophy and methodology similar to that described herein and that Scharf Investments, LLC expects to ontinue to use, but future investments will be made under different economic conditions and in different securities. Further, the results do not reflect performance in all different economic cycles. It should not be assumed that investors will experience returns, if any, comparable to those shown above. The Standard & Poor’s 500 Index contains 500 industrial, transportation, utility and financial companies regarded as generally representative of the large capitalization U.S. stock market. The comparison of performance to the market index shown is inappropriate because the index is more diversified than the portfolios generating such performance and represents only unmanaged results. Due to these differences, potential investors are cautioned that no market index is directly comparable to the performance shown above.

JORDAN COREY, CFA
Research Analyst

CME Group operates the largest futures exchange in the United States and is among the largest financial infrastructure entities in the world. The company's subsidiaries include the Chicago Mercantile Exchange [commodities], the Chicago Board of Trade [rates], the New York Mercantile Exchange [energy], and COMEX [metals]. CME products include interest rate futures and derivatives based on major U.S. stock indexes such as the S&P 500, Russell 2000, and the NASDAQ-100. CME also offers contracts on most major foreign currencies and commodities, including WTI crude oil, natural gas, cattle, lean hogs and lumber. We believe the scale and scope of CME's market position in the United States is significant. In 2023, CME clearinghouses acted as a counterparty for approximately 90% of all futures and options trades executed on a regulated U.S. domiciled exchange.

Core business highly profitable and driven by transaction volumes: CME's operating margins have averaged 60% and earnings have compounded +12% annually over the past 10 years. The core exchange business is driven by transaction volumes, which tend to increase during periods of market volatility and decline when markets are more benign. Within the exchange business, stock exchanges are relatively mature. Hence, absent an increase in the number of public companies or capital committed, there are few growth drivers in the stock exchange business. We believe the growth opportunities for exchanges are primarily in the options and futures markets, where CME is a leader. We believe CME is the leading exchange, by far, for U.S. interest-rate futures, which account for just over 30% of its total revenues. The company is also the leader in trading futures contracts on the major U.S. stock indexes such as the S&P 500, Russell 2000, and NASDAQ-100 – this equity derivatives segment accounts for 28% of total company revenue. Commodities – including crude oil and agriculture – represent about 20% of revenue, and foreign exchange contracts account for about 5% of revenue. In aggregate, transaction volumes at CME have grown at a +6.8% compound annual growth rate (CAGR) the past 10 years.

Volume growth at CME is being driven by retail and institutional investors. Many of these investors, especially large institutions such as insured banks or pension funds, use CME products to manage interest rate risk or establish downside protection on stock portfolios. These activities are sometimes referred to as 'portfolio insurance.' As you likely know, generally the best time to purchase insurance is when a risk event has not occurred recently and is not expected anytime

soon. Conversely, perhaps the worst time for insurance pricing for a buyer is immediately following a risk event, such as a hurricane or forest fire. In the early summer of 2024, financial markets were unusually calm; inflation had moderated, stocks were up big, the job market was robust, and geopolitical risk, while elevated, had yet to inflect higher. And as a result, the benchmark volatility index (VIX) was at 12 compared to longer term average of 20, and the outlook for volume and associated earnings growth at CME was muted. This translated to a low price to earnings multiple for CME relative to its trading history.

Competitor threat offers an attractive entry point. In addition, concerns about a well-financed new entrant (FMX) in the interest rate derivatives market weighed on CME shares in 1H24. FMX is a new futures exchange set up by Howard Lutnick, the CEO of a large brokerage firm named Cantor Fitzgerald, L.P. The new exchange is backed by several Wall Street banks, including Bank of America, JP Morgan, and Goldman Sachs. The goal of the new entity is to compete with CME in interest rate derivatives/Treasury products – which represent 20% of CME's earnings. With 90+% market share, we believe CME currently operates as effective monopoly in the U.S. interest rate derivatives. The network effects that CME has, in which traders often aggregate toward where the trading volume is highest to get better pricing, we believe is a significant barrier to entry. FMX started trading on September 24, 2024 – we will await to see market share data over the coming quarters. Concurrently, in September 2024, CME posted record trading volume in its interest rate derivatives/ Treasury products subsidiary, with average daily volume up +25%. Our base case is that CME continues to be the dominant interest rate future exchange, and its diversified additional platforms in equity, commodities, and FX trading position the company for continued earnings growth.

A beneficiary or rising volatility: CME earnings tend to grow in periods of financial stress. As a result, CME has outstanding prior downside capture that averages 63%. The 2008 period is the only time in the past 40 years when the stock declined more than the S&P, due to the derivative-centric nature of the 2008 market decline.

High dividend payout: CME pays a 4.4% annual dividend (including the variable dividend at year-end) and has consistently paid out this variable dividend since 2012 as a way to return excess cash to shareholders. Even if earnings growth is muted, we see the company continuing to pay out around 5% in annual dividends for the next several years.

In sum, CME Group is the largest futures exchange in the world and has oligopoly type market share in the structurally important U.S. futures and options market. In addition, the company has a rich dividend payout and unique earnings profile that provides some measured downside protection. If volatility increases and the competitor threat is muted, we expect shares to outperform.

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.

16450 Los Gatos Boulevard, Suite 207
Los Gatos, CA 95032
831.429.6513
info@scharfinvestments.com

scharfinvestments.com