SCHARF INVESTMENTS

Mid-Year Review

Worst Half for Stocks Since 1970; 1788 for Bonds

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The Fed has pricked the everything bubble. In a pop heard around the world, the Fed's new-found fervor to squash inflation has hit prices for long-duration assets like growth stocks and long-term bonds where payouts are scheduled far into the future. It was the worst first half for stock market returns since 1970 and since 1788 for bonds. Speculative assets with dodgy or zero cash flows were obliterated.

Investment	2022 First Half Return
Bitcoin	-58.8%
ARK Innovation ETF	-57.8%
Nasdaq Composite Index	-29.2%
S&P 500 Index	-20.0%
Russell 1000 Value Index	-12.9%
S&P US Treasury 10-Year Index	-11.5%
Scharf Sustainable Value (Gross)	**-9.7%**

Sources: Bloomberg, Scharf Investments.

As we did in the aftermath of the tech bubble from 2000-2002 and the global financial crisis from 2007-2009, the Scharf portfolio soundly outperformed relevant equity benchmarks. The portfolio's stocks even outperformed US Treasury 10-year bonds in the first half.

We believe the Scharf portfolio outperformed because we buy companies with sustainable earnings, trading at low valuations. This approach provides two layers of protection during adverse markets. From a sector perspective, our stock selection contributed 415 bps of relative outperformance vs. the Russell 1000 Value Index, more than enough to offset the 272 bps of drag from not owning any Energy or Utilities, the two leading sectors year-to-date (YTD). Both sectors generally fail to meet our long-term quality and resilient earnings investment requirement. Stock selection in Health Care, as well as our overallocation to it, led Scharf portfolio returns.

From an individual stock perspective, McKesson, Lockheed Martin, Markel, Berkshire Hathaway, and Fiserv led positive portfolio attribution vs. the benchmark. MillerKnoll, Liberty Broadband, Masco, Valvoline, and Heineken were the largest performance detractors.

Opportunities Amidst the June Swoon

While a 10% decline in the portfolio in the first half of the year pains us—remember that we are investors in the portfolio alongside our clients—this year's benchmark and peer managers' negative returns remind us of the importance of mitigating losses. A -10% return requires just an 11% rise to roundtrip back to par. The S&P 500's first half -20% return will require a 25% increase to make investors whole. Nasdaq investors require a 41% appreciation. An investor in the ARK Innovation ETF (ARKK) needs a whopping 137% increase to return to this year's opening share price. Investment mistakes can take years to recoup.

This market dislocation, especially in June's accelerated leg down, provided us an opportunity to purchase companies with attractive franchises trading at prices that, we believe, offer more upside than downside.

We added two new partial positions to the portfolio in the second quarter—Activision and Booking Holdings. Booking is

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a global travel lodging reservations juggernaut. The company generates a disproportionate level of profits from a hyper-fragmented industry—small and mid-sized European lodging providers, who lack compelling international distribution. Booking also effectively serves as these businesses' scheduling and billing software platform, thereby further integrating the relationship. We estimate Booking Holdings 2023 P/E to be less than 14x on EPS that could very well be revised higher given consumption and travel trends and subdued consensus company margin expectations.

Activision also sports an interesting risk/reward profile in a market likely to remain volatile given limited visibility for inflation and interest rate levels. Clearly, investors fear anti-trust risk, however, we believe the stock trades at a reasonable and long-term average valuation. Further, if the deal falls through, we expect alternate suitors given the relative lack of concentration in the global gaming industry.

Meanwhile, we sold Masco to 1% and trimmed appreciated McKesson. Masco is a high-quality company that has been growing earnings, but we believe the unexpected doubling in US mortgage rates YTD will impact their paint (e.g., Behr) and plumbing revenues (e.g., Delta). Recent negative read-throughs via early peer reports from Restoration Hardware, Bed Bath & Beyond, and Target contributed to our waning conviction.

Portfolio Positioning

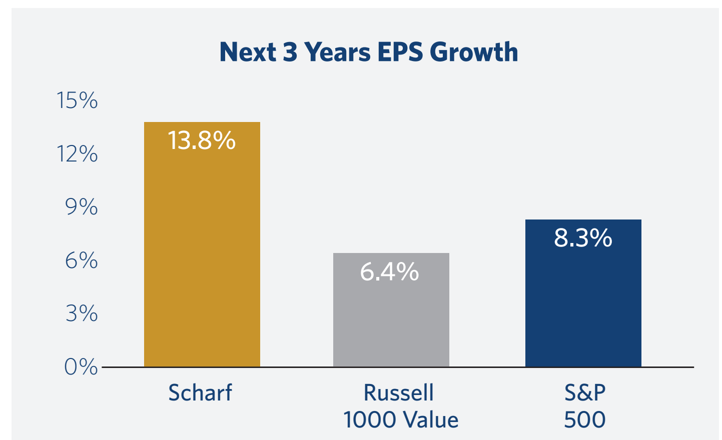
We see more downside risk for market indices and speculative assets. Investors are still unwinding an everything bubble that saw indiscriminate pricing applied to financial assets. The 20-30% equity declines in 2022 have largely been due to P/E compression associated with the Fed's hawkish pivot. The S&P 500's forward P/E has declined from an historically high 21.4x to 15.8x, a level typically associated with normal levels of low, single-digit inflation. If inflation remains elevated or interest rates exceed market expectations, P/E multiples will fall through average levels.

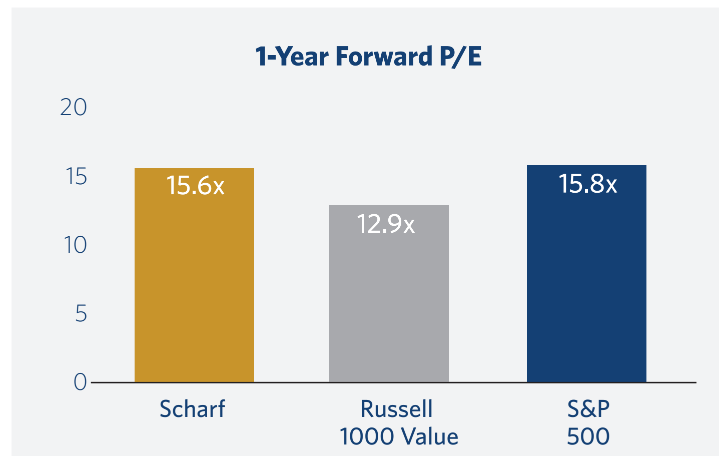
However, the greater concern at this juncture is a decline in earnings estimates. There are two risks here: 1) current sky-high profit margin assumptions, and 2) a slowing economy due to persistent inflation and rising interest rates. Consensus estimates for the S&P 500 continue to assume nearly all-time high net profit margins (> 12%) for '22 and '23, and 10% EPS growth against the backdrop of a slowing economy, higher interest rates, and nearly 9% inflation. Further, given that earnings have only grown 4% through the first half, a calendar-year estimate of 10% growth seems especially suspect. We expect the last few decades' margin tailwinds—globalization, low finance, labor, energy, input, and transportation costs—to remain headwinds for now.

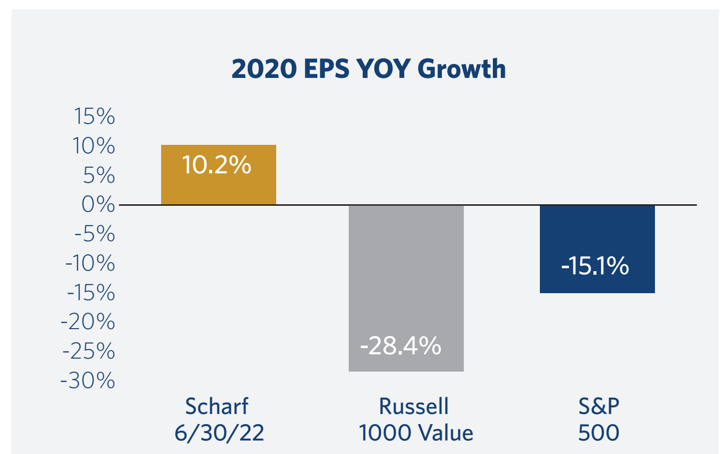
Meanwhile, cyclical sectors are being especially pressured as macro data points to a quickly slowing rate of growth for the US economy. On June 1st, the Atlanta Fed's GDPNow model estimated US Q2 GDP real growth rate to be 1.0%. Incredibly, it now estimates a -2.1% growth rate.

Defensiveness meant more than style classification during the month of June's declines. The Russell 1000 Value Defensive Index outperformed the Russell 1000 Value Dynamic Index by over 700 bps, -5.3% vs. -12.3%. Cyclical sectors like Energy (-16.6%), Materials (-13.7%) and Financials (-11.4%), recent winners until economic growth concerns flared, led June declines. Given these companies' operating leverage, their earnings are especially fragile in a slowing economy.

While we paint a picture of concern for the market and risky assets, we are confident in the portfolio's relative positioning and outlook for returns in the years ahead. In fact, we are excited to find new opportunities provided by the continued volatility. We believe the portfolio is well-constructed given its superior consensus earnings growth estimates, reasonable valuation, and the companies' earnings resilience demonstrated so clearly in the last economic stress test, the inaugural pandemic year in 2020.







Sources: Bloomberg, Scharf Investments.