SCHARF INVESTMENTS

THE BIG Picture

SPRING 2022

Finding Opportunities

- War, What Is It Good For?
- Eulogy for the Fed Put
- Women & Retirement

FEATURED CONTENT SPRING 2022

ALSO IN THIS ISSUE

War, What Is It Good For?

BRIAN KRAWEZ, CFA®
President, Investment Committee Chairman

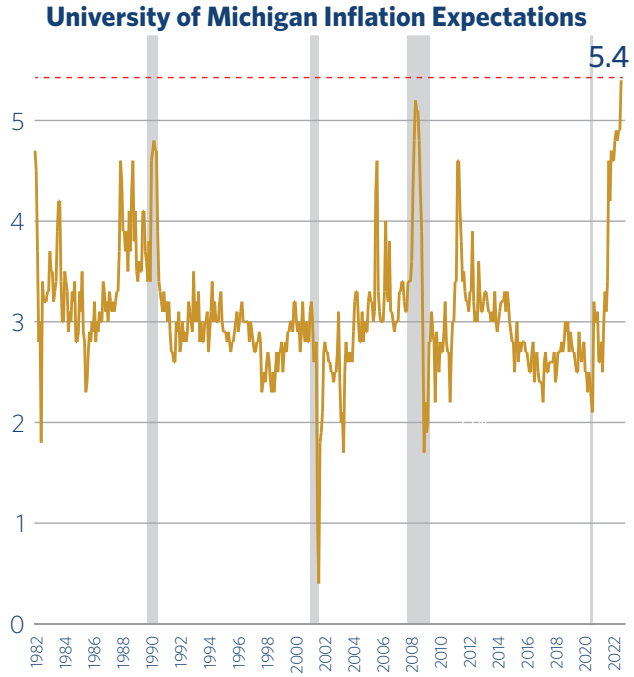
We want to start by acknowledging what is currently taking place in Ukraine. Like most people, we are horrified to see what is going on in the news. A recent headline, "Russian Troops Have Left Zhytomyr Highway Littered with Shot-Up Cars and Dead Bodies of People Who Tried to Escape the War," particularly hits home for me as part of my family was originally from Zhytomyr. We can all hope for a quick resolution to the situation. To do our part, Scharf Investments is donating $5,000 to World Central Kitchen to help the children affected by this war.

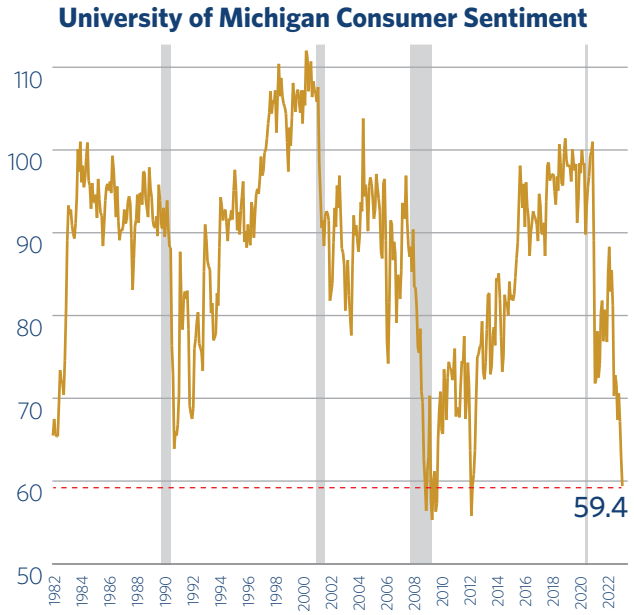
For investors, it has been a tumultuous quarter. From the beginning of the quarter until March 14, the Nasdaq plummeted 19.5%, the S&P 500 fell 12.2%, the MSCI ACWI Index fell 12.5%, while the Russell 1000 Value Index dropped 5.7%. The high-quality nature of our portfolio showed its resilience with your equity accounts down 5.3% over the same time period, which is less than the four benchmarks.

Stocks rallied in the last few weeks to finish the quarter down 8.9%, down 4.6%, down 5.3% and down 0.7% for the Nasdaq, S&P 500, MSCI ACWI Index and Russell 1000 Value indexes, respectively. By comparison, our equity composite was down roughly 1.1% net of fees. Bonds had one of their worst quarters in over a decade with the Bloomberg Aggregate Bond Index down 5.9% and the Lipper Balanced Index down 5.0%. Our balanced composite was down approximately 1.7% net of fees on the quarter.

Inflation Up, Consumer Sentiment Down

There is a lot of noise out there right now. Investors are faced with war, lockdowns in China, rising inflation, continued supply chain problems, falling consumer sentiment, rising gas prices, to name just a few things. One concerning data point comes from the University of Michigan consumer sentiment index, which sank to its lowest level since 2011. Falling real incomes and surging





Source: University of Michigan. Shaded areas indicate U.S. recessions.

fuel prices were key drivers of the pessimism with the expected year-ahead inflation rate at 5.4%, the highest since November 1981. More consumers mentioned reduced living standards due to rising inflation than any other time except during the two worst recessions in the past 50 years. Nearly one-third of all consumers expect their overall financial position to worsen in the year ahead, the highest recorded level since the surveys started in the mid-1940s. Given these data points, it seems clear that the Federal Reserve is going to need to act on the inflation front.

Fed Late to Take the Punch Bowl Away?

Bill Dudley, a former Federal Reserve Board Member, thinks the Fed has waited too long to raise rates. He believes the Fed will need to increase rates sharply, which will likely trigger a recession. The graph below helps to show one reason why. With official inflation levels around 7.9% year-over-year, the U.S. federal funds rate is the furthest it has been below CPI since 1951. This has led to the increased inflation expectations and falling consumer sentiment shown on the previous page.

In today's hot labor market, seasonally adjusted unemployment has fallen to 3.6%. To bring down inflation, Dudley believes the Fed will need to increase unemployment at least back to the "natural" rate of unemployment of roughly 4.4%. Said another way, the Fed will need to trigger the ***loss*** of 1.3 million jobs just to bring the labor market back to "equilibrium" in order to bring down inflation expectations. Dudley also points out that over the past 75 years, whenever the unemployment rate has increased by 0.5 percentage points vs. the prior 12-month low level, a recession is either already underway or about to start.

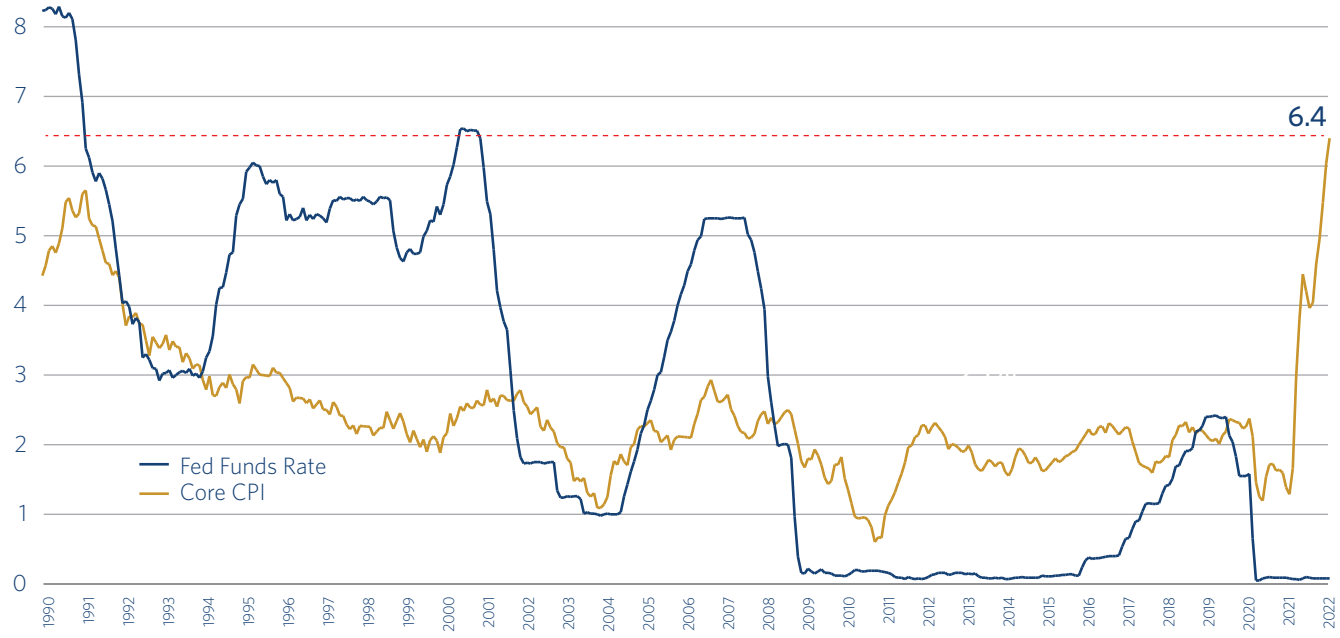
With unemployment already so low (3.6%) and inflation already so high (7.9%), the Fed is in a tough spot and engineering a "soft landing" won't be easy. The fact that the Fed doubled its balance sheet in response to the pandemic certainly complicates things as does the war in Ukraine.

Yield Curve Flashes Warning Signals

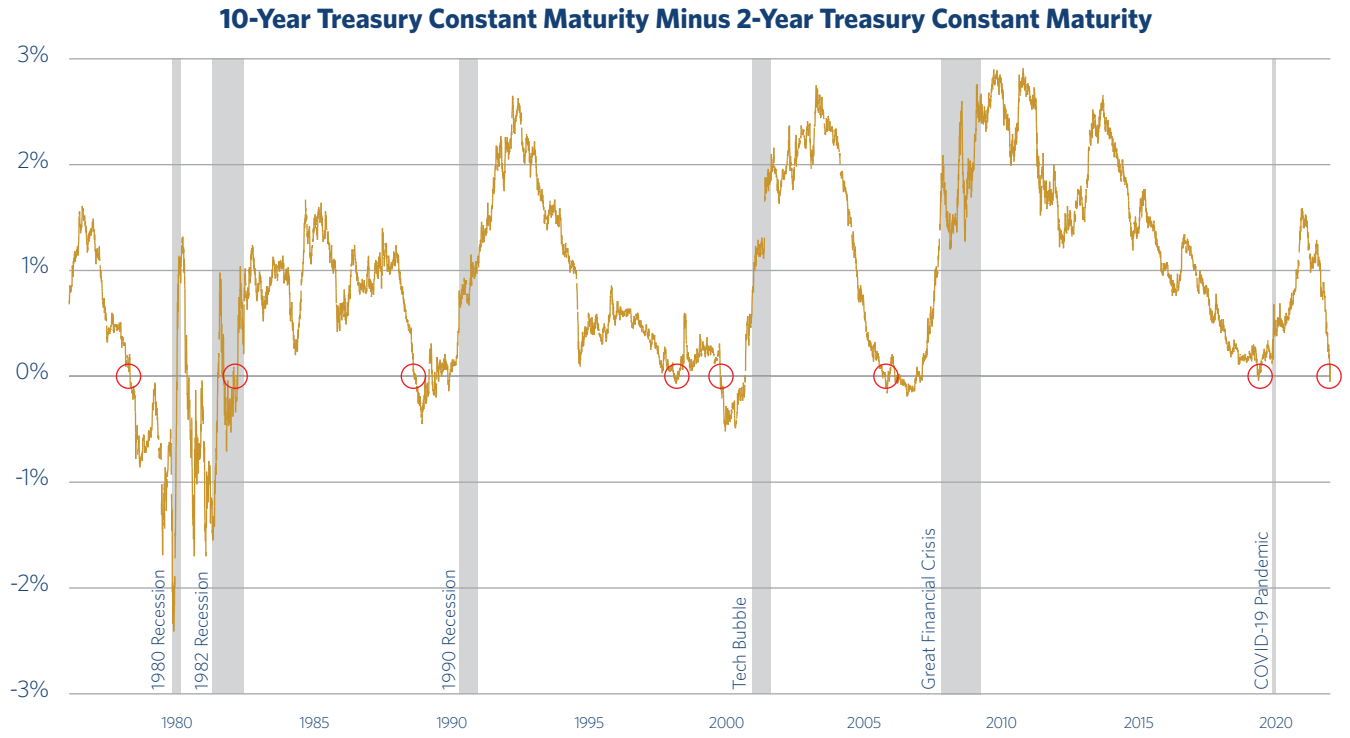
One market indicator that agrees with Mr. Dudley is the recent inversion of the yield curve. Historically, this has been one of the best warning signals of future recessions. What is the yield curve and what does it mean to be inverted? The yield curve is a graph showing the relationship between short-term and long-term interest rates of U.S. Treasury notes. To compensate for the extra risk that investors are taking by lending for a longer period of time, long-term rates are usually higher than short-term ones.

The graph on the following page shows the difference between the 10-year and 2-year Treasury yields. When the line shown in the graph is below zero it means 2-year yields are above 10-year yields. In Wall Street speak, the curve has "inverted". Today's inversion of the yield curve is a reflection of market expectations that the Federal Reserve needs to tighten monetary policy by aggressively raising short-term

Inflation and Fed Funds Rate



Source: Federal Reserve Bank of St. Louis.

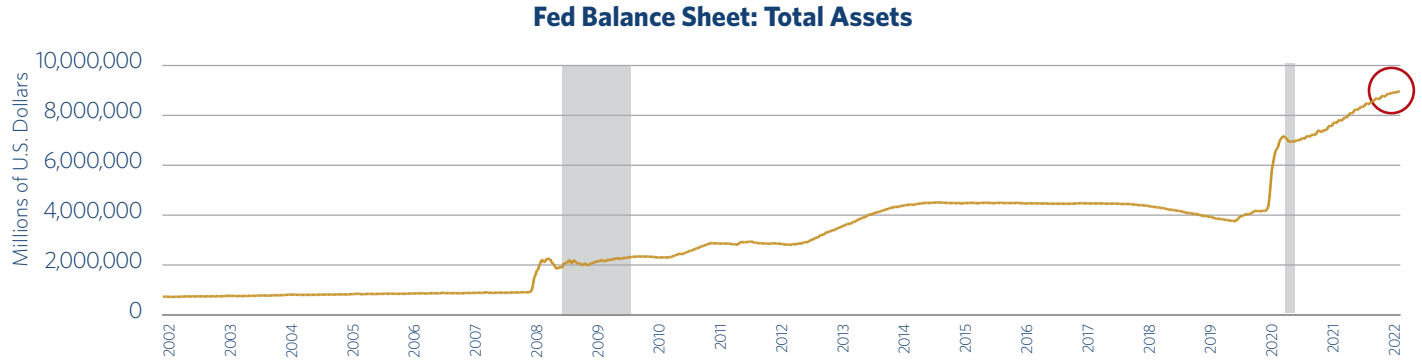


Source: Board of Governors of the Federal Reserve System (U.S.). Shaded areas indicate U.S. recessions.

interest rates. The Fed needs to do this in order to slow down an "overheated" economy in which inflation has been running persistently high. This bond market phenomenon has been a reliable recession indicator as inversions of that part of the curve have preceded nearly every recession over the past 40 years. The graph above illustrates this point.

On a more positive note, some market pros believe the 3-month yield to the 10-year yield is a more accurate recession forecaster, and that curve has not flattened. That spread has actually widened, a signal for better economic growth. In addition, after the five instances where the 2-year and 10-year yields inverted since 1988, the S&P 500 had a median return of 15.8% over the next 12 months.

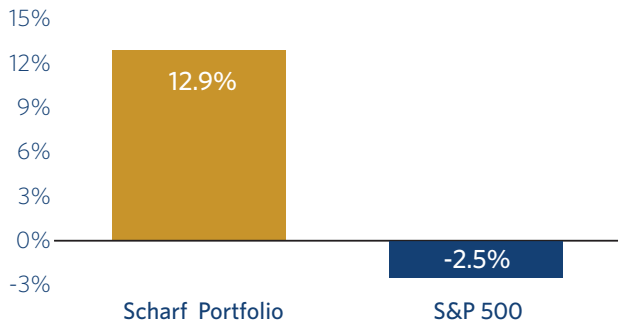
Regardless, an inverted yield curve should be taken as a sign that the Federal Reserve's efforts to counter inflation by raising short-term interest rates may be nearing a tipping point which could result in slower economic growth over the next 12-24 months. For stock market investors, the emergence of an inverted yield curve is akin to seeing dark clouds on the horizon. It is a time to be prepared for a possible change in the weather. Our expectation is that the growth rate of the economy is most likely to decelerate in the year ahead, and there is a greater chance of a recession in the next year or two. We cannot forecast when it is going to happen, but we can strive to own very high-quality businesses with consistent earnings power and strong balance sheets. Owning high-quality businesses with pricing power is one of the best ways to keep up with inflation, and our experience has been that owning high-quality businesses also provides resilience when storms eventually arrive.



Source: Board of Governors of the Federal Reserve System (U.S.). Shaded areas indicate U.S. recessions.

In fact, since 1988, the median return for the S&P 500 in the first 3 calendar years after an inversion was ***negative*** 2.5% annualized compared with a median ***positive*** 12.9% annualized return net of fees for our equity accounts over the same time periods.

Median Return Three Years After Inversion



Sources: Bloomberg, Scharf Investments. 1988-2022.

A Final Word on Valuation

An old rule on Wall Street is the "rule of 20". This says the market is fairly valued when the price-to-earnings ratio (or "P/E") equals 20 minus the inflation rate. With CPI inflation expectations near 6%, the implied "fair" P/E for the S&P 500 is roughly 14 times (20-6) compared to the current P/E of roughly 20 times. This would imply the current P/E is still too high despite the recent decline in stocks. Even if the Fed manages to bring inflation expectations down to 4%, that still implies a "fair" multiple of roughly 16 times, or 20% below where it is today. That says nothing of the risk that S&P 500 earnings would decline if the Fed were to inadvertently cause a recession. During the last 4 profit recessions, S&P earnings fell by roughly 25% from peak to trough. Thus, the S&P could have around 40% downside in a Fed-induced recession. By comparison, our portfolio already trades at a P/E of under 16 times with a much more resilient earnings profile.

The war further complicates the Fed's task of engineering a soft landing as it will increase inflation expectations and cause further supply chain issues. We believe investors would do well to remain cautious and de-risk their portfolio if they are still holding any speculative darlings of the past. For our part, we continue to emphasize high-quality companies with strong balance sheets trading with good favorability ratios. This has served us well in the past and should serve us well in the future. As the late Edwin Starr would say, "War, what is it good for? Absolutely nothing." Say it again, Edwin, say it again.

> "Owning high-quality businesses with pricing power is one of the best ways to keep up with inflation, and our experience has been that owning high-quality businesses also provides resilience when storms eventually arrive.

Eulogy for the Fed Put

ERIC LYNCH
Managing Director

The Fed Put was always there when we needed him. When the markets hiccupped over the Asian financial crisis in 1998, he cut the fed funds rate even though U.S. unemployment was just 4.5%. As the ensuing tech bubble deflated from 2000-2003, our caped hero intervened, introducing investors to the new millennium's sub 1% fed funds rate era. When the subsequent real estate bubble popped and Global Financial Crisis raged from 2007-2009, he summoned a zero-interest rate policy and tripled the Fed's balance sheet via purchases of U.S. Treasuries and mortgage-backed securities. Like Atlas, he kept holding those trillions of extra bonds in response to the bond market's 2013 taper tantrum. Finally, when the pandemic threatened in 2020, he bravely doubled the Fed's bond holdings to $9 trillion and slashed interest rates to a negative rate adjusted for inflation.

A whole generation of new investors can be forgiven for recency bias—"Buy the dip!"—since our hero delivered so much for so long. Over the past 14 years, he has brought us an average fed funds rate of just 0.51%. His free money made even unworthy assets worthy.

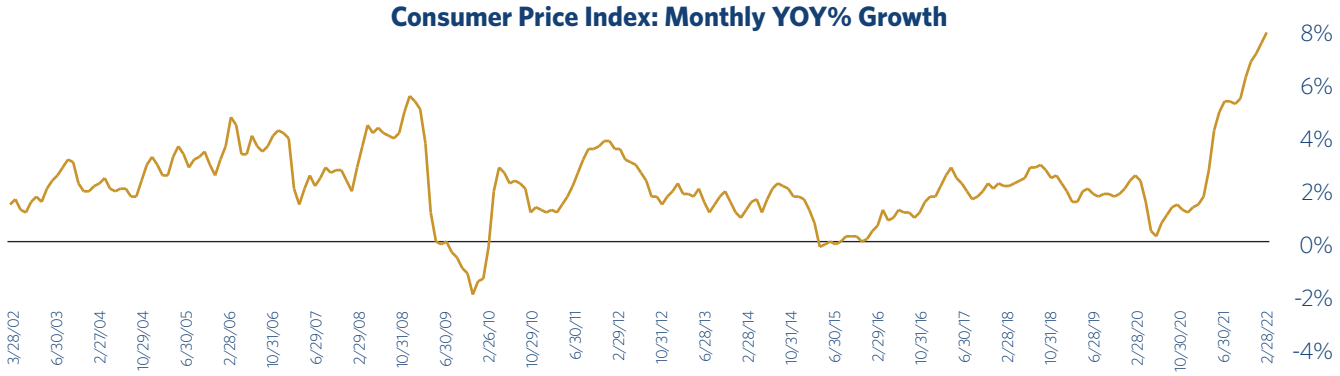
Recently, he unfortunately flew into his kryptonite meteor shower—the highest inflation rates (February CPI of 7.9%) since the 1980s. For decades he enforced one half of the Fed's dual mandate—maintaining full employment—with impunity. There was no fear his prodigious actions could impact the prices consumers and businesses paid for things. However, with supply chain-driven inflation now embedded in more persistent and large areas of the economy, like wages and housing, Federal Reserve Chairman Jerome Powell and company must shift their focus to the Federal Reserve's other mandate—price stability. Our hero, the Fed Put, can no longer patrol the skies, neutralizing threats to economic growth and the stock market. May he rest in peace...for now.

Late-Cycle Positioning without a Fed Put: Earnings Sustainability and Value

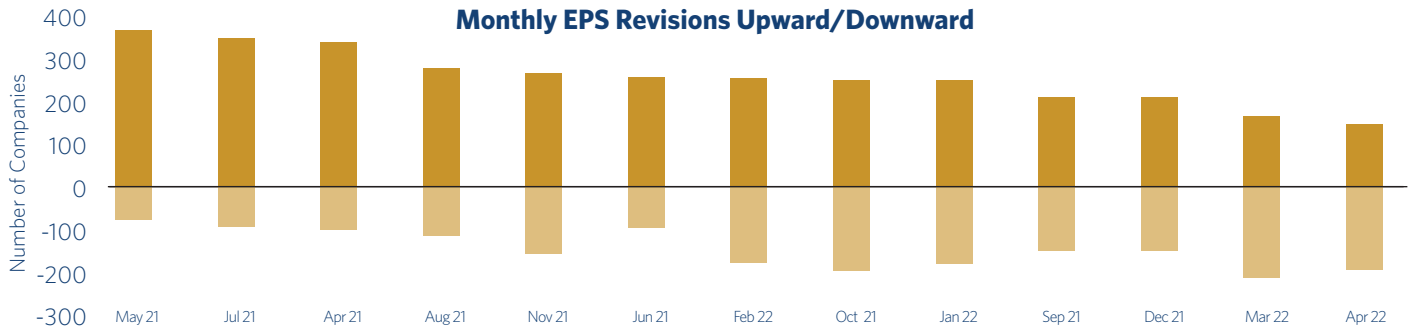
The unprecedented amount of U.S. government pandemic stimulus, over 50% of GDP, supercharged the speed of the current economic and market cycle. While we are only two years removed from the 2020 recession, the briefest on record, we have already witnessed classic late-cycle signals. Corporate earnings, profit margins and GDP growth peaked in 2021 as did leading economic indicators like the ISM survey. With the Fed's hawkish pivot towards controlling inflation, it is clear the Fed's intent is to slow economic growth.

After 2021 operating margins for the S&P 500 exceeded 13%, their highest on record and nearly double their long-term average, it is not surprising that inflationary pressures and poor consumer sentiment stand poised to erode profit margins. The earnings upward to downward revisions ratio has notably deteriorated over the past 12 months.

Consumer Price Index: Monthly YOY% Growth

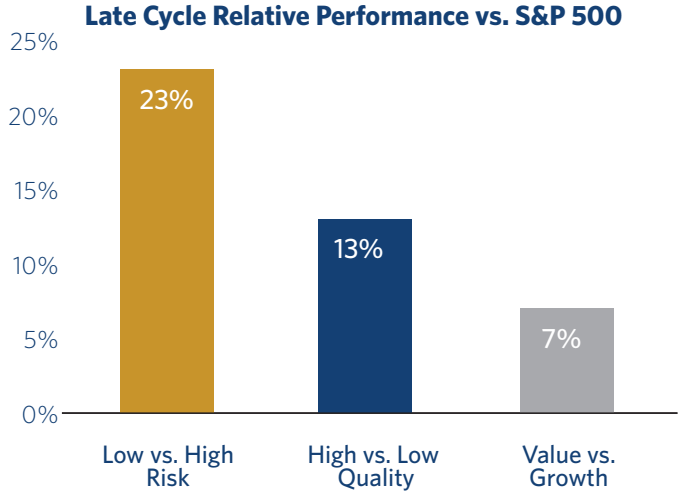


Sources: Bloomberg, Scharf Investments.



Sources: Factset, Scharf Investments. Universe reflects companies in the S&P 500.

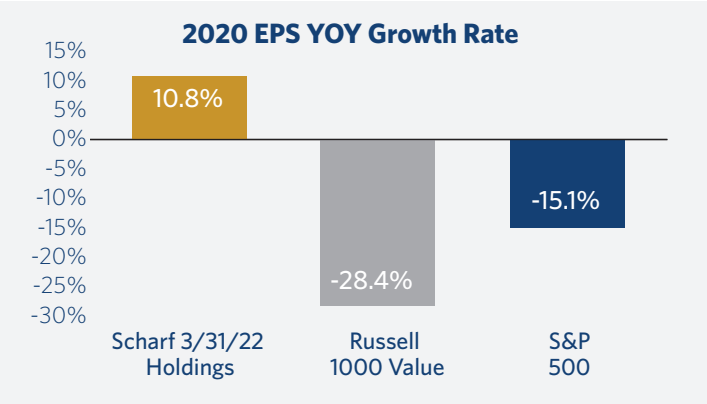
The good news is that there are always investment opportunities, even in volatile markets. Investors who de-risked their portfolios of high-flying tech names before the tech bubble burst in 2000 went on to experience solid returns the following decade. When we look at several historical market cycles, the successful playbook for outperforming in a late-cycle environment has been to allocate towards low risk vs. high risk, high quality vs. low quality, and value vs. growth factors.

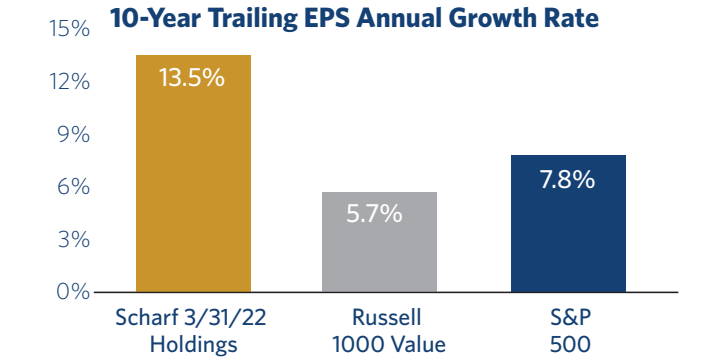


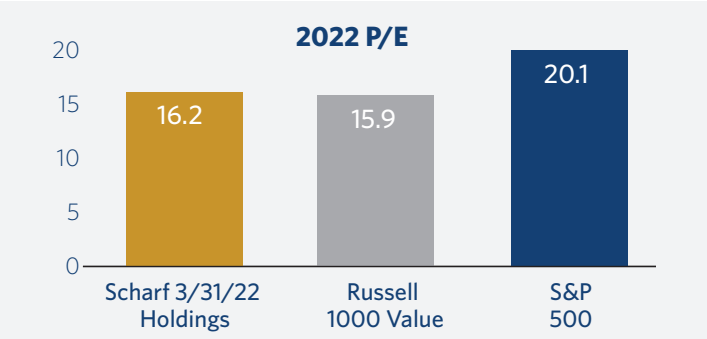
Sources: BofA, Scharf Investments. Style returns relative to equal weighted index during historical late cycle phases.

We believe the Scharf Portfolio is well-positioned as the Fed attempts to thread the needle between price stability and full employment. The high-quality and low-risk health care sector remains the portfolio's largest overweight and has already smoothed returns during the market's recent volatility. Our exacting investment process emphasizes companies with sustainable earnings trading at compelling discounts to fair value. We seek to buy stocks with 30%+ upside to our price targets and limited downside. Historically, this long-tested investment process has helped us add value for investors during adverse markets.

Our current portfolio holdings' earnings have been highly resilient, as most notably displayed in 2020 when the world literally stopped.







Sources: Bloomberg, Scharf Investments.

Over the last 10 years, the current holdings have grown EPS at an annual rate of 13.5%, far outpacing relevant market indices. We model continued double-digit portfolio EPS growth over the next three years and consider the valuations to be attractive for such earnings sustainability.

While the Fed Put is kaput, investing in quality businesses at reduced valuations remains the order of the day.

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.

Women & Retirement

DEBBIE ROBINSON
Director of Wealth Management

Like so many women, are you constantly juggling family, professional, and personal responsibilities? I know I am. No wonder retirement planning seems to always get shuffled to the bottom of your "to do" list. But, procrastination is not the answer. Putting it off will only increase your risk of becoming one of a growing number of women who will spend their golden years struggling to make ends meet.

With the right planning, you may be able to avoid that situation. Saving enough for a comfortable retirement can be difficult for most Americans, and it can be especially challenging for women who may, when compared with men, earn less, spend fewer years working, and live longer. Retirement income concerns are often more acute for women who are divorced, widowed, or otherwise single, as well as for those who have spent all or a significant portion of their adult years caring for children and other family members.

Most women will need to build their own retirement savings to maintain their current standard of living in retirement. Here are some strategies you can use to get started:

Plan for Retirement

If your current employer does not offer a retirement plan, consider your options for securing better benefits. While companies with defined benefit plans that replace a percentage of income (based on your salary and years of service) are becoming increasingly rare, consider the long-term consequences of working at a firm that does not at least match contributions to a 401(k) or other defined contribution plan. To put this into perspective, assume you invest $5,000 a year at a 10% return. Over 30 years, that would equate to roughly $900,000 in retirement savings. With a $5,000 company match, however, that nest egg would double to $1.8 million. So, if you do only one thing, be sure to MAXIMIZE your company match. If you are employed by a company with a traditional pension plan, find out what your benefit is likely to be and at what age you can collect the maximum benefit.

Plan for Less Taxes

Take advantage of the tax benefits of qualified retirement plans and traditional Individual Retirement Accounts. Depending on your financial situation, you may find that making pre-tax contributions to a retirement account will not significantly reduce your net income. Nevertheless, contributions may decrease your current taxable income (and, consequently, your ultimate tax bill), and potential earnings are tax deferred. Taxes will be due when you begin taking distributions. If you withdraw money too early, a 10% Federal tax penalty may be due, in addition to income taxes, unless a qualified exception applies.

Look at Roth IRAs

Consider the role a Roth IRA (or a Roth 401k if that option is available to you) may play in your long-term plan. Contributions to Roth IRAs must be made with after-tax dollars, but potential earnings grow tax deferred. Qualified distributions made after a certain age are income tax free, provided the account has been owned for at least five years. Certain income limits apply. If your company offers a Roth 401(k) option, you should strongly consider it as Roth contributions typically allow for greater retirement savings because the money can be taken out tax-free at retirement!

Consider Working Longer

Plan to work longer if needed. A few extra years spent working may enable you to save more for retirement. You may want to consider working until you qualify for full Social Security benefits. Also, your health care costs may be lower if you postpone retiring until you qualify for full Medicare benefits.

Pay Off Debt

Arrange to pay off your mortgage and other debt as quickly as possible. Owning a house outright in retirement not only ensures that you will have a place to live, but it can also serve as a valuable source of equity, should you need it. To give yourself an incentive to pay off your credit cards, resolve to turn your monthly credit card payments into retirement account contributions, when the debt is paid.

In Your Name

If you are married, assess the capacity of your husband's retirement benefits to meet your future needs. Given the possibilities of divorce and widowhood, it is essential that you plan for a time when you may have to manage independently. If you are staying at home while your spouse is working, set up an IRA in your own name. Also, determine your rights regarding your spouse's pension in the case of death or divorce, and research the effects of divorce and remarriage on your Social Security benefits.

Invest More

If your family budget allows, evaluate the benefits of putting extra funds into your own IRA or 401(k) versus putting money into a savings account for your children's college education. Your children may qualify for financial aid or low-interest loans to help pay for college, but remember, there are no grants or scholarships for retirement. Also, some funds may be withdrawn from a retirement account penalty free, if used for qualified education expenses.

Make Retirement Your Business

If you own a business, consider implementing a retirement plan for yourself and your employees. A retirement plan may help you accumulate funds to live more comfortably in your retirement years, and it may also be fully deductible, thereby reducing your business's current tax liability. If you already have a retirement plan for your business, review it with your professional advisors periodically to make sure you are taking advantage of all potential tax benefits.

Consider Deferred Comp

If you are an executive and your company offers you the chance to participate in a non-qualified deferred compensation plan, consider the opportunity. Again, it will decrease your current income tax liability while providing you with an additional pool of money for your retirement.

Take Good Care of Yourself, Too

Prioritize saving for your own financial future, even when there are bills to pay, along with the wants and needs of your children and other family members. While taking care of others is important, you can take good care of yourself by preparing for your retirement.

Women's issues are important to me and my team at Scharf Investments. Please contact us today to answer your questions and address your financial planning needs.

Hospice of Santa Cruz County

The last two years have taught us many things. Perhaps among the most important are to value our health and our relationships...and that we can't plan for everything. But when it comes to our health and our healthcare needs – now and in the future – having a plan and talking with the important people in our lives can bring us closer together. At Hospice of Santa Cruz County, we'd like to help you plan for your future healthcare needs, prepare for having conversations with those who are close to you, and document your wishes.

Often, healthcare providers see the anguish that families face when making a healthcare decision for someone who can no longer speak for themselves. Are we making the right decision? Is this what my parent/spouse/friend would have wanted? Healthcare conversations help make what we think and how we feel as clear as possible, but these conversations can be difficult to have. Hospice of Santa Cruz County has many resources that can prepare you for having these conversations. As part of our commitment to community education, we are available to meet with you (in-person or on Zoom) to help you document your healthcare wishes. The resources listed below can help get you started.

Studies have shown that hospice care is most effective when patients are with their hospice care teams for months, rather than days. This time allows the team to guide the family as their loved one's needs change. It also allows the patient to fully participate in decisions about their care.

Not All Hospices are the Same

As a community-based nonprofit, Hospice of Santa Cruz County's services are available to people of all ages. Hospice of Santa Cruz County is proud to have the highest quality ratings and caregiver satisfaction scores of any other hospice provider serving our community. Medicare, Medi-Cal, and most private insurances cover our core hospice services and we are committed to serving all members of our community.

> Hospice gave me the opportunity to strengthen relationships, to share time with each and both of my parents. It is a priceless gift. After a death, hospice offers a chance to heal, smile again, and focus on memories, not so much on the loss.
>
> — Irma Vega, Hospice Grief Support Volunteer

We rely on the generosity of donors to support additional programs like grief support for the entire community, Camp Erin youth grief camp, music therapy, and pediatric programs for seriously ill children. **We appreciate the generosity we've received over the years from many Scharf Investments clients.**

RESOURCES

- Advance Healthcare Planning and tools to help you have the conversation: www.hospicesantacruz.org/community-education-events/preparing-for-the-future
- Compare hospices in the area: www.medicare.gov/care-compare

EVENTS AT SCHARF INVESTMENTS

Wednesday, April 20, 2022
Q2 2022 Investment Insights webinar
2:00pm PT / 5:00pm ET

Please join us for this live webinar. You'll hear from members of our Investment Committee and Wealth Management team. They will discuss the current state of the markets and economy, review current portfolio performance and positioning, and share key considerations for you to be aware of in the year ahead. We will also have our friends from Sempervirens Fund speak about upcoming events and their Earth Day Hug-a-Tree Challenge. A question-and-answer period will follow. A replay of the webinar will be available upon request.

Call your Wealth Advisor at **831.429.6513** to register or email us at **marketing@scharfinvestments.com**

Focused On Your Goals. Invested In Your Success.

Helping you achieve your goals is our passion. When you choose Scharf Investments, you gain a partner committed to working with you to provide individualized financial planning, strategic investment management, and superior service. Building a relationship with you is our privilege and our responsibility—because our efforts on your behalf have real-life consequences. By thoroughly understanding your needs, we can assist you decisively and responsively today and over the long term.

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