SCHARF INVESTMENTS

THE BIG Picture

SUMMER 2022

Summer Breeze

- Where Have All the Bond Vigilantes Gone?
- The Worst Half for Stocks Since 1970; For Bonds Since 1788
- Maintaining Perspective During Market Volatility

FEATURED CONTENT SUMMER 2022

ALSO IN THIS ISSUE

Where Have All the Bond Vigilantes Gone?

BRIAN KRAWEZ, CFA®
President, Investment Committee Chairman

In the January 2019 President's letter, we warned investors:
...The tax cuts have not only stimulated the economy, but also brought with them a massive government budget deficit. At some point, if the Fed fails to act, inflation will return.

It's worth remembering that the worst stock performance of the 1970s came not when inflation peaked, but when it first spiked. From 1972 to 1973, inflation doubled to more than 6% and the S&P 500 declined by a combined 40%. To avoid this, sooner or later QT will need to return. Either way, the era of simply buying an index and riding the wave of liquidity is over. As Warren Buffett likes to say, 'when the tide goes out you see who is swimming naked.' It is a good thing we brought our swim trunks!

	H1 2022	Q2 2022
Barclays Bloomberg US Aggregate Bond	-10.3%	-4.7%
Russell 1000 Value	-12.9%	-12.2%
Lipper Balanced	-15.3%	-10.8%
Russell 2000	-17.3%	-15.3%
S&P 500	-20.0%	-16.1%
MSCI ACWI	-20.0%	-15.5%
NASDAQ	-29.2%	-22.3%
Scharf Sustainable Value (Gross)	**-9.7%**	**-8.9%**
Scharf Multi-Asset (Gross)	**-8.5%**	**-7.2%**
Scharf Hedged (Gross)	**0.3%**	**-1.3%**

Sources: Bloomberg, Scharf Investments.

The Fed initially started to curtail its balance sheet to control inflation, but then had to slowly reverse course in late 2019 as the economy began to weaken. Next came COVID-19. In response, the Fed doubled its balance sheet. Similar to the 1972-73 period, inflation roughly doubled from 2.4% in 2018 to 4.7% in 2021 and, right on cue, both bonds and stocks had their worst performance to start the year since the 1970s.

The Nasdaq was hit especially hard, losing over 29% in the first half alone. Many ex-darlings fared even worse, with former high flyers Amazon, NXP, and Facebook-parent Meta down 37%, 35% and 53%, respectively. While the Nasdaq came in last, the table above demonstrates that there was nowhere to hide with everything from the smaller company Russell 2000 index (-17%) to the globally-oriented ACWI (-20%) to Bonds (-10%) down significantly. As promised, our "swim trunks" helped as the high-quality nature of our portfolios proved much more resilient than the markets.

Bring Back Bell Bottoms?

The pandemic that literally shut down the world was met with unprecedented fiscal and monetary stimulus. A June 2020 McKinsey report calculated that an unprecedented $10 trillion of stimulus was announced worldwide in just the first two months of the pandemic. This was many multiples of what was done in response to the financial crisis. For example, Western European countries alone allocated nearly $4 trillion. McKinsey estimates this to be almost 30 times larger than the value (in today's dollars) of the Marshall plan that was put in place to rebuild Europe after World War II. IMF estimated that US stimulus was more than 4 times the amount used in response to the great recession of 2008-2009.

This extraordinary fiscal stimulus was fully accommodated as central banks dramatically expanded their balance sheets

around the world. In the US, for example, the Fed nearly doubled its balance sheet in a matter of months in 2020 and it has only grown since. Far from acting to slow down inflation as we had warned, the Fed and other central banks poured gasoline on the fire.

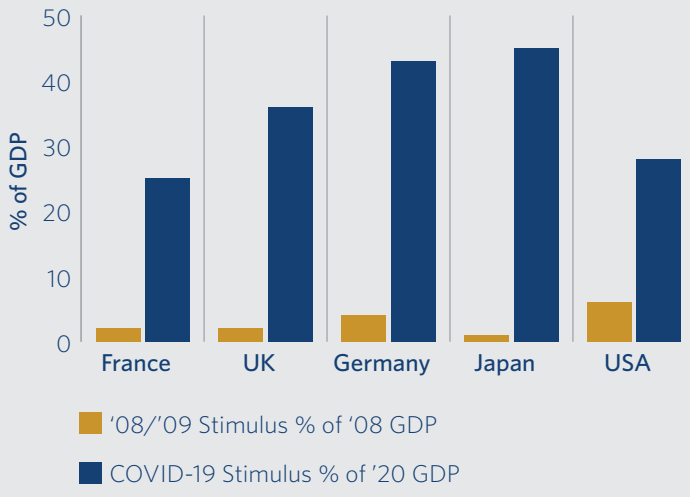
To be sure, in 2020, the Federal Reserve and other central banks had good reason to do what they did. Today, however, bloated central bank balance sheets remain, but lockdowns have faded and consumers are busy catching up for lower spending during the COVID years. Yet, supply chains have not fully recovered. For example, airlines have been surprised at how fast demand has grown with airports like London's Heathrow asking airlines to cut back flights during the critical summer season because the airport was not yet set up to handle the substantially increased demand. The Ukraine war further exacerbated the problem by reducing the supply of critical food and energy to the market. The result has been the perfect storm of surging demand meeting an inelastic supply curve. Given our early warnings, inflation should surprise no one. Despite this, everyone from the Federal Reserve, to politicians, to news reporters seem flummoxed or angry by the current rate of inflation.

Who's Correct? The Mob or the Market?

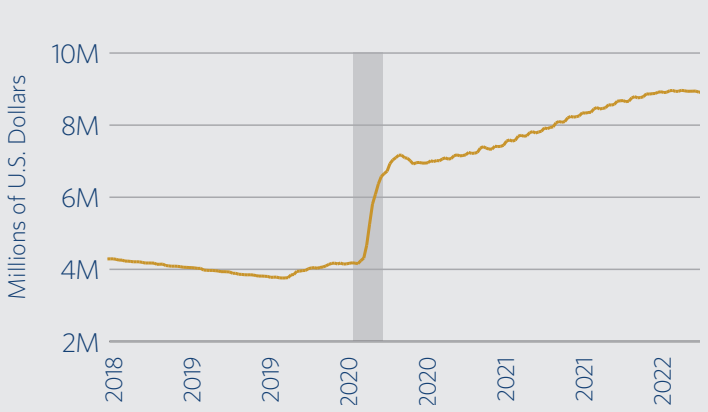
"Inflation, Inflation, Inflation!" Speaking of the 1970s, business headlines have recently been dominated by stories about inflation.[1] Inflation coverage has been relentless with daily stories that malign the rising prices of everything from gas to milk.

This anxiety has found its way into consumer sentiment with the widely followed University of Michigan's consumer sentiment index falling to its lowest level since 1978. Close to half of surveyed consumers blamed inflation for eroding their living standards. People are clearly very concerned about inflation. And with a recent CPI of 8.6%, the largest 12-month increase since December 1981, who can blame them?

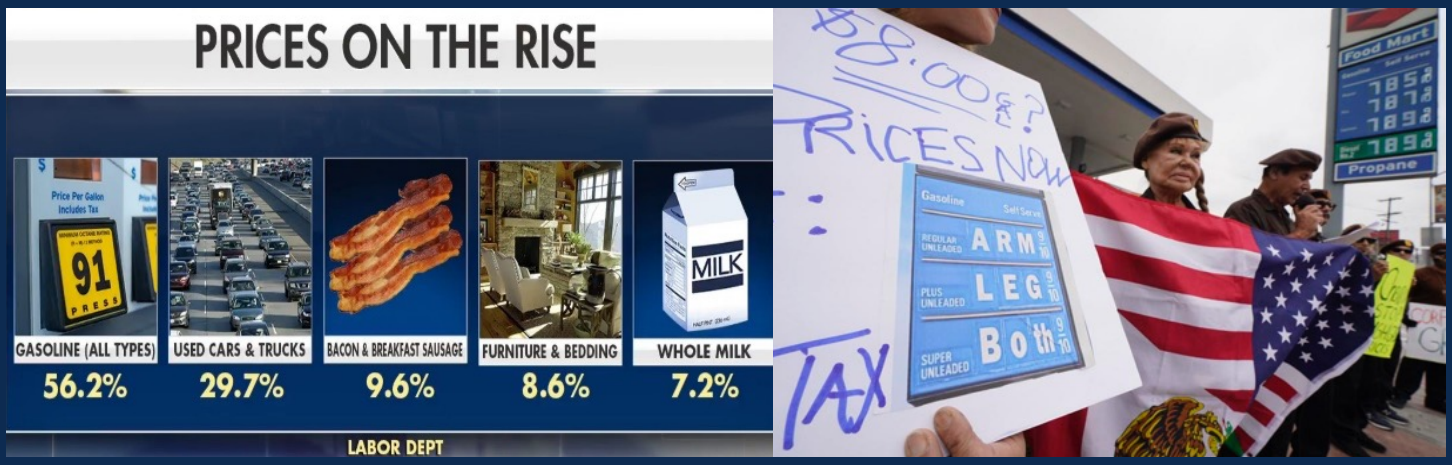
The market on the other hand seems to be pricing in a relatively rapid decline in inflation. For example, the 10-year Treasury currently yields around 3%, which is significantly lower than the 10% average from 1978 to 1982, the last time inflation was this high.[2] Stocks for their part have also not yet priced in anything more than transitory inflation. Despite a 20% decline this year, the S&P is still priced at roughly 17 times trailing earnings (and 16 times forward), a level much more aligned with 3% inflation.[2] By comparison, the S&P averaged roughly 10 times earnings during the mid to late



Source for COVID-19 figures: IMF estimates as of September 27, 2021. Source for 2008/2009 figures: IMF estimates as of April 26 2009. For UK, source is McKinsey report.



Source: Board of Governors of the Federal Reserve System



1970s, while the "rule of 20" would imply a multiple closer to 11 times at current inflation levels.

The part of the market most keenly focused on inflation, Treasury Inflation Protected Securities ("TIPS"), are priced for a rapid decline in inflation. TIPS yields are priced in real terms. For example, an investor that buys TIPS with a real yield of 1%, receives 1% plus inflation. Hence, TIPS can be used as a reliable gauge of investor inflation expectations. For example, despite inflation currently near 9%, TIPS investors' inflation expectations over the next five years peaked at 3.4% in April and have since declined to 2.6%. This implies a rapid decline in inflation. In fact, the price of 5-year TIPS implies a substantial deceleration in inflation is expected over the next 12 months. For example, if inflation over the next year is 5.3%, in-line with expectations from the University of Michigan survey, it implies that investors are pricing inflation of only 1.9% during the following four years. [2]

Can the Fed Complete a Triple Lindy?

The Fed continues to hope the current inflation will be transitory. Fed Chairman Powell has argued that supply disruptions due to COVID and the Ukraine war should subside helping increase supply. The pandemic has created a unique situation and it is plausible that a moderation in supply chain issues will allow the Fed to engineer a soft landing.

To do this, we believe they must moderate consumer demand the exact right amount to bring down prices without causing a recession. Given the level of inflation and unemployment, Former Treasury Secretary Larry Summers is skeptical and believes a hard landing is nearly inevitable. Even Chairman Powell acknowledged during his recent Senate Banking Committee hearing that this would be 'very challenging.' In other words, pulling off a soft landing may be akin to completing a triple lindy (a fictional dive that involves launching off a diving board, then launching off three spring boards, in succession, before entering the water.)

Let's hope that Chairman Powell is as adept as Rodney Dangerfield who pulled off the triple lindy in the movie "Back to School."

Defense Still Wins Championships

In our Q4 2021 letter we warned: *Excesses are never permanent, and investors should temper expectations going forward. Much of this return has been driven by multiple expansion. As a result, the S&P 500's valuation is at extremes not usually seen except at market tops*. Six months later, the S&P's forward multiple has declined 33% from 21 times to 16 times. At 16 times the S&P is near its long-term average of roughly 15-16 times, but is by no means cheap and certainly nowhere near the low double digit multiple typically seen

[1] The recent Supreme Court ruling overturning of Roe vs. Wade has also dominated headlines and is yet another issue in common with the 1970s.
[2] Data sourced from Bloomberg and Scharf Investments.

at market bottoms.[2] In addition, S&P earnings typically fall 25% during a recession. Thus, there could still be downside from both multiple compression and earnings declines for the S&P if investors begin to price in a recession.

Despite the downturn, favorability for the S&P 500 remains unattractive at roughly equal downside and upside. By contrast, our core-weighted portfolio has a better than 4 to 1 favorability with 40% upside to its median high and 7% downside to its median low.[3]

Our expectation remains that the growth rate of the economy is most likely to decelerate in the year ahead, and there is a greater than normal chance of a recession in the next year or two. As such, we remain focused on high quality businesses with more predictable earnings.

Our investment discipline seeks to mitigate capital loss by buying companies with high earnings predictability at prices that already discount risk. We know there will invariably be an unforeseen economic contraction or company-specific issue for any company we purchase. Over the past few years, concerned by the lack of market earnings growth, burgeoning levels of corporate debt and historically high market valuations, we have intentionally sought to increase the defensiveness (high quality earnings and stronger balance sheets) of the equity portfolio even further while remaining disciplined on price.

Equities have started off this year as if they are going to do a repeat performance of the 1970s or the 2000s. While we hope equities will fare better than either of those two periods, we believe our emphasis on capital preservation and risk management will allow us to do well regardless of how the overall market does. In fact, if past is prologue, we would be reasonably pleased if our portfolios had a repeat performance of the 2000s.

“ Our investment discipline seeks to mitigate capital loss by buying companies with high earnings predictability at prices that already discount risk.

[3] Data sourced from Value Line and Scharf Investments.

Mid-Year Review

Worst Half for Stocks Since 1970; 1788 for Bonds

ERIC LYNCH
Managing Director

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.

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.

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 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,

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.

Bed Bath & Beyond, and Target contributed to our waning conviction.

Portfolio Positioning

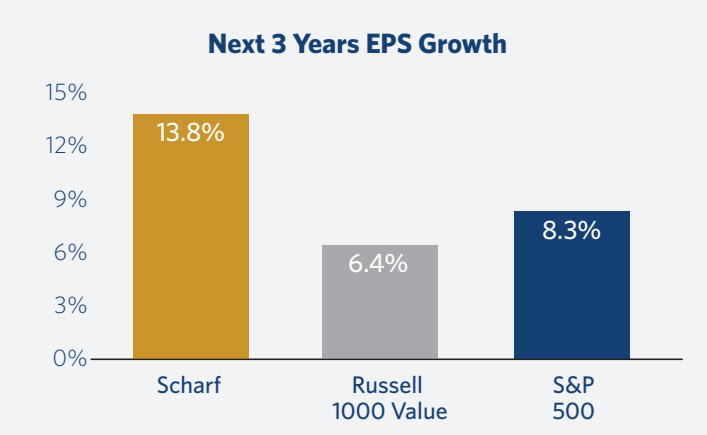
We see more downside risk for market indices and speculative assets. Investors are still unwinding an everything bubble that saw indiscriminate pricing applied to financial assets. The 20-30% equity declines in 2022 have largely been due to P/E compression associated with the Fed's hawkish pivot. The 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.

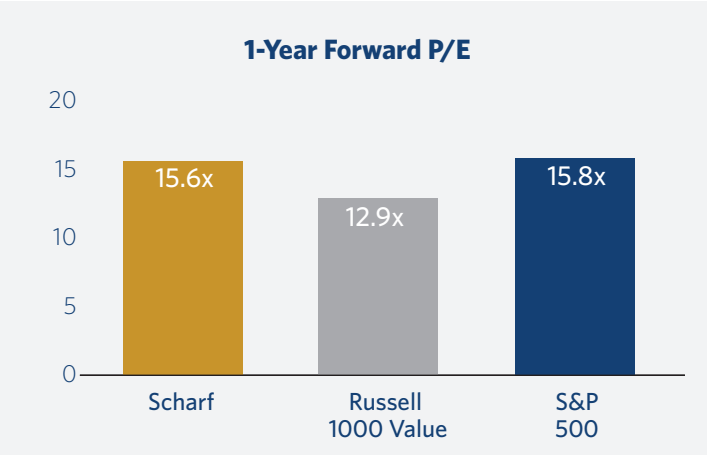
However, the greater concern at this juncture is a decline in earnings estimates. There are two risks here: 1) current sky-high profit margin assumptions, and 2) a slowing economy due to persistent inflation and rising interest rates. Consensus estimates for the S&P 500 continue to assume nearly all-time 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.

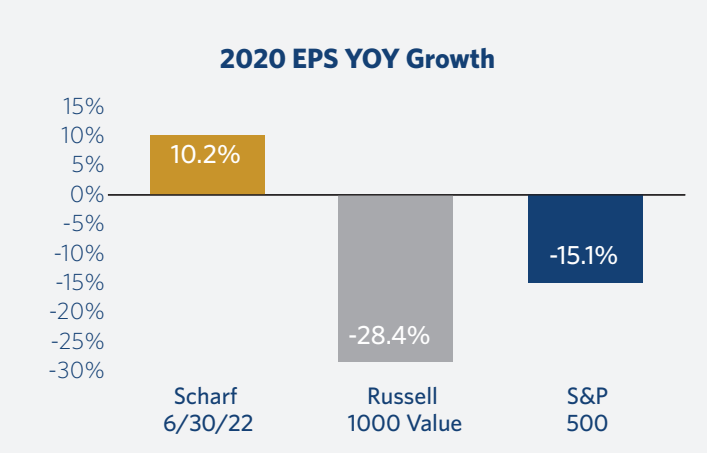
Meanwhile, cyclical sectors are being especially pressured as macro data points to a quickly slowing rate of growth for the US economy. On June 1st, the Atlanta Fed's GDPNow model estimated US Q2 GDP real growth rate to be 1.0%. Incredibly, it now estimates a -2.1% growth rate.

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.

Maintaining Perspective During Market Volatility

KEN VANDER KOOI
Senior Wealth Advisor

"Abnormally good or abnormally bad conditions do not last forever."

~Benjamin Graham

Given the long bull run we have experienced in many areas of the market over the last decade plus, it is not surprising that many investors are feeling anxious and a bit out of sorts in the current environment. It may be helpful to remember that times like these offer an opportunity to reassess the importance of various long-term goals, as well as reinforce valuable lessons regarding risk tolerance and the benefits of a diversified allocation.

Volatility, such as we are seeing in the markets today, can naturally create anxiety and heighten fears for many people. That is a natural reaction and to be expected. In the long run, equities, while more volatile than some other categories, have provided excellent long-term growth. It pays to keep in mind that most every bear market historically has been followed by above-average equity returns during subsequent recovery and expansionary phases of the market.

Investors will often react to periods of increased volatility by contemplating exiting equities altogether, with the intention of "getting back in" when volatility has passed. In our view, the timing of the exit and re-entry is extremely difficult to master and all but impossible to execute on a consistent basis. All too often investors capitulate to fears and sell at inopportune moments, only to miss significant portions of recoveries as they wait for just the right moment to re-enter markets.

Rather than being swept into the emotions of declining markets, we suggest investors should use the opportunity to reflect on the importance of their various long-term goals and review the overall allocation of the portfolio to ensure it aligns with those goals. Don't focus on the daily ups and downs of markets, but instead think about the timing of your expected cash needs and your tolerance for risk in long-term investments. Make sure you have sufficient cash reserves for any near-term needs to avoid having to sell into the teeth of an adverse market to raise cash. For long-term funds, look toward equity markets for growth and reduce overall portfolio risk to levels you can tolerate by bringing in assets not typically correlated to equities (i.e., fixed income).

"In the financial markets, hindsight is forever 20/20, but foresight is legally blind. And thus, for most investors, market timing is a practical and emotional impossibility."

~Benjamin Graham

> "With every new wave of optimism or pessimism, we are ready to abandon history and time-tested principles, but we cling tenaciously and unquestioningly to our prejudices."
>
> ~Benjamin Graham

While conditions constantly change and no two markets are identical, history has repeatedly shown some consistent truths regarding investing for the long term.

1. Just as with periods of rising prices, periods of falling prices are a naturally occurring part of investing.

2. Diversification can serve to reduce company and industry-specific risk, however, excessive diversification can assure a middling of outcomes to your detriment (i.e., you end up owning the best and worst).

3. Long-term value in investing is strongly influenced by fundamentals—profit, revenue growth and predictability of earnings.

4. Tailor your allocation to your needs and risk tolerance. Make these decisions absent your emotions surrounding current markets. Once you develop a plan, trust yourself and stick to the plan.

4. Remember you are investing for the long term. Don't let natural short-term price fluctuations sway you from disciplined investing.

With the volatility displayed across markets this year, it is not unusual for investors to experience anxiety, fear, and concern about the future. If you have concerns about your financial situation in light of the current volatility or would like to review your allocation in relation to your long-term goals, please contact your Scharf Investments wealth advisor. They can assist you with developing a financial plan, reviewing your allocation to ensure it aligns with your goals, and making any needed adjustments as efficiently as possible.

> "Investing isn't about beating others at their game. It's about controlling yourself at your own game."
>
> ~Benjamin Graham

CABRILLO FESTIVAL OF CONTEMPORARY MUSIC

Scharf Investments is proud to be a Community Partner with the Cabrillo Festival and we congratulate them on 60 sound-sational years!

What began in the summer of 1961 as the Sticky Wicket Concert Series today celebrates its 60th anniversary as the Cabrillo Festival of Contemporary Music. Even at a seasoned 60 years old, it is all about the new—the here and now of contemporary works for orchestra. To quote Financial Times music critic Allan Ulrich, "...in the surf mecca of Santa Cruz, 75 miles south of San Francisco, the Cabrillo Festival has made the contemporary repertoire sound urgent, indispensable and even sexy."

In late July and early August each year, audiences are joined by both preeminent and emerging composers, spectacular guest artists, and an orchestra of dedicated professional musicians from across the globe to give voice to works which are rarely more than a year or two old, and sometimes still wet on the page. The opportunity for composers to work with musicians skilled and enthusiastic about bringing these new works to life, in the beautiful, coastal college-town of Santa Cruz, California, makes this an artistic paradise. With a professional training workshop for early career conductors and composers, open rehearsals almost daily, educational programming, and much more, the Cabrillo Festival has dozens of opportunities for meaningful engagement.

In 1991, following the 1989 Loma Prieta earthquake, the Festival made the Santa Cruz Civic Auditorium its home venue and has been an important part of downtown's summertime experience ever since. Since its founding, the Festival has presented 175 world premieres, 78 U.S. premieres, 170 West Coast premieres and countless local premieres, and included the participation of more than 300 composers.

WQXR named Cabrillo Festival "one of the top five incubators of new music" in the world, and The Wall Street Journal described the Festival as "two of the most thoughtful and original summer musical weekends anywhere in America." In 2017, the Festival embarked on a new era of artistic leadership with the appointment of Music Director and Conductor Cristian Macelaru. Following his second season at its helm, The Monterey Herald claimed "Santa Cruz's Cabrillo Festival of Contemporary Music is a national treasure with a strong international identity and importance. The Festival is a bright beacon of creativity and inspiration for living composers and new music lovers throughout the world."

Cabrillo Festival celebrates its 60th anniversary with a return to a live, in-person season with works by 12 American composers, a stunning roster of soloists, three world premiere commissions, and seven West Coast premieres. **Join us in Santa Cruz, July 24 – August 7, for two weeks of concerts, talks, rehearsals and more!**

EVENTS AT SCHARF INVESTMENTS

Thursday, July 14 2022
Q3 2022 Investment Insights webinar
2:00pm PT / 5:00pm ET

Despite the ongoing market volatility, our portfolios have provided the downside protection that our clients have come to expect during adverse market conditions. Please join us for an interesting and informative webinar. Members of our Investment and Wealth Management teams 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 as we move into the second half of the year. A question-and-answer period will follow. A recording of the webinar will be available after the live session and will be distributed to those who register.

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

scharfinvestments.com