

# SCHARF INVESTMENTS LLC

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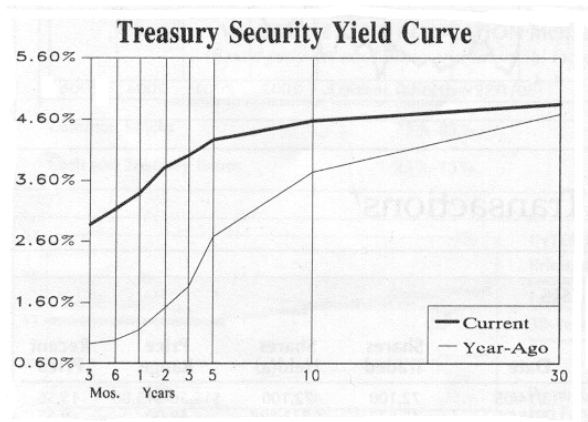
April 5, 2005

We believe the stock market averages entered 2005 with more downside risk than upside potential. Three factors contributed to this view. First, valuations were high relative to inflation. Second, interest rates were likely to move up. Third, the positive earnings surprises that triggered the gains of the past two years were likely to abate. All three factors came into play in the first quarter with the Standard & Poor's 500 Index falling 2.2% and the median stock as measured by the Value Line Composite Index declining 4.3%. While the risk/reward equation still appears negative for the balance of the year, the outlook brightens in 2006 as better earnings and today's prices create more attractive valuations.

Meanwhile, we believe our holdings have reasonable upside potential this year and next. We have been pruning back positions with diminishing potential to recycle the proceeds into situations with more favorable characteristics. If favorable opportunities are not available, we are holding cash.

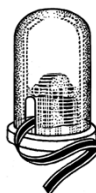
## The Acid Test

In March, the Federal Reserve Board raised short-term interest rates for the seventh time in nine months. The federal funds rate stands at 2.75% vs. 1% last June. As the graph below indicates, longer-term interest rates have moved up less than short-term rates. With further increases likely all along the yield curve, the economy and the markets will finally confront the valuation and economic risks posed by rising rates.



Our primary area of concern centers on housing and the consumer. Lower interest rates and easy credit have sparked a marked increase in housing prices. According to one 25-year study of the historical relationship between monthly mortgage payments and household income, housing prices in 75% of the country appear normal. Prices in the other 25% of the country – including most of California – are 20% to 40% above normal.

As interest rates rise, prices in "bubblicious" markets are likely to decline. Markets that were fairly valued at low interest rates may tip into overvalued territory. Recent buyers – many of whom put little or no equity into their purchase – may walk if property values fall below loan balances. Lenders who were relying on appreciation to mitigate default risk may lose money. Credit standards could be tightened and an ugly downward spiral could get underway.



Beyond this, the role of mortgage refinancing in bolstering consumer spending will finally be revealed. As rates rise and property values stop appreciating, the re-fi boom will end. As the saying goes, “You never know what’s on the beach until the tide goes out.”

In our view, fears that a “housing bubble” will burst and sink the entire economy are too dire. These fears are similar to the fears that the bursting of the U.S. stock market bubble in 2000 would sink the entire U.S. economy or that the bursting of the Japanese stock and real estate bubbles in 1989 would sink the world economy. These bubbles were not broad enough in their reach to have the feared impact. To the extent that a housing bubble exists, we believe it, too, is limited in its reach.

This is not to say a bursting bubble will have no effect. Some participants in irrationally priced markets - speculators, aggressive lenders, overleveraged borrowers, buyers with little or no equity and others - will suffer grievous losses. On the periphery, there will be some “wealth effect” as the seventy percent of Americans who own their homes have less access to home equity credit, feel less prosperous and reduce their spending.

We have been monitoring our holdings and prospective purchases for their exposure to the fallout from a housing decline. For example, we have been very profitably overweighted in the homebuilding industry from almost the moment of our entry in 2000 until we cut long-term holdings back to a normal position size last month.

#### Summary

With interest rates rising, the stock market is beginning to confront the twin risks of high valuations and economic slowdown. While more bad things than good things can happen to the market averages in 2005, we believe our holdings have favorable risk/reward characteristics based on predictably growing earnings and valuations below historic medians. Opportunities that meet our hurdle rate for new purchases remain in short supply. If opportunities are not present, we prefer to hold cash rather than risk capital in marginal situations. We believe interest rates are likely to rise further and continue to maintain liquidity in the bond portion of balanced accounts.

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