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So far, 2005 is developing as we expected. The market averages began the year with limited upside since they were already at the upper end of historical norms based on 2005 expectations for corporate profits and inflation. Meanwhile, we believed our portfolios were invested in issues with considerable scope for appreciation.

Looking toward 2006, the market averages seem to be trading near historical norms. The stocks which we prefer to invest in – established companies with a history of predictably growing earnings – seem to be trading at unusual discounts to their individual historical valuations, their valuations relative to the market or both. As a result, our holdings appear to have very favorable risk/reward ratios.

Hurricanes

The most newsworthy events during the quarter were hurricanes Katrina and Rita. Beyond the lamentable human costs, the primary economic effect was to further boost oil, gasoline and natural gas prices. Louisiana and Texas are major centers of U.S. production of all three products.

Oil production is the least affected by the hurricanes. Shortfalls in U.S. production can be offset by additional imports or releases from the Strategic Petroleum Reserve. This is not true of gasoline or natural gas. Shortfalls cannot be made up with imports and both will be in short supply until hurricane damaged capacity is back on line. Our energy exposure is primarily in natural gas with some exposure to oil. We have very little exposure in Texas or Louisiana.

While rising energy prices may be good for the energy-related portion of our portfolios, they feed into our twin concerns regarding the economy – inflation and consumer spending. Although "core" inflation – which excludes "volatile" food and energy prices remains tame – actual inflation has registered a 3.6% increase over the 12 months ended in August. Investors in short-term U.S. government securities have lost purchasing power over the past year and investors in U.S. government notes and bonds have done little better than keep up with inflation. The narrow spread between interest rates and inflation is a "conundrum" according to Fed Chairman Alan Greenspan. We believe the conundrum will be resolved with interest rates rising and bond prices falling.

Higher interest rates and higher energy prices should crimp consumer spending. Housing is particularly sensitive to higher rates and the reckless lending of the past few years will eventually come home to roost. Rising rates will make new home purchases more expensive. Refinancing will become unattractive as rates rise. Cash out re-fi's will grind to a halt. The housing bubble in California and other overheated markets will burst. The question for investors is how far the ripple effects will carry. We don't have the answer but we have limited our exposure by eliminating homebuilders, home lenders and home loan guarantors from our portfolios.

Scharf Investments Update

We are pleased to announce that Scharf Investments surpassed the $500 million milestone and ended the quarter with $530 million in assets under management. It has been a long journey from a single $7,000 account in 1984. We are especially pleased that our growth has been achieved the right way. Unlike the many advisors and mutual fund managers who destroy value by underperforming relevant benchmarks, we have fulfilled our mission of adding measurable net value to client accounts. As the performance graphs on this website illustrate, our net equity account returns have been more than double those of the S&P 500 and more than triple those of the average equity mutual fund. Since 1989, balanced account returns have more than tripled those of the average balanced mutual fund.[i] According to the Mobius database of advisors and mutual funds, the gross returns of Scharf Investments' equity accounts rank 36th out of 2975 "products" in our category for the 15 years ended June 30. Gross returns of balanced accounts rank 2nd out of 377 products .[ii]

Even better, we have achieved these above-average returns with below-average risk. Our favorite statistic in this regard is upside/downside capture. According to Mobius data covering the last 15 years, equity accounts have captured 104% of the gains of the S&P 500 when it has been rising but lost only 38% as much when it has fallen. This confirms our long-held belief that less risk and more reward go together.

Finally, we have been able to grow and perform because our clients understand that investing is a marathon, not a sprint, and good performance is the result of a disciplined, long-term strategy. Clients did not heed the siren song of the Internet bubble, have not run for the hills during various market panics and have not succumbed to the tyranny of style boxes or a myopic focus on inappropriate short-term performance comparisons. These may seem like easy and sensible investment decisions but we know that they are not.

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Disclosures: [i] No guarantee can be made that the Scharf Investments' 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. Performance reflects the reinvestment of dividends and other earnings from 1986 onward and the deduction of costs and management fees for all periods. Results were generated using an investment philosophy and methodology similar to that described herein and that Scharf Investments expects to continue 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 described. 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 Lipper All Equity Fund Average tracks total return performance of funds within equity categories – at 12/23/2004, 10,032 funds with $3.8 trillion in assets. The Lipper Balanced Fund Average tracks total return performance of funds within the balanced category – at 12/23/2004, 651 funds with $287 billion of assets. The comparison of performance to the market indices shown is inappropriate because the indices are more diversified than the portfolios generating such performance and, in the case of the S&P 500 Index, represent only unmanaged results. Due to these differences, potential investors are cautioned that no market index is directly comparable to the performance shown above.

[ii] The Mobius database includes the equity investment managers tracked by Mobius in the "domestic equity" category and the balanced investment managers tracked by Mobius in the "domestic balanced" category. The Mobius data is provided by CheckFree Investment Services, which is not affiliated with Scharf Investments.