

SCHARF INVESTMENTS LLC

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Scharf Investments held its first annual meetings last month. These were a terrific opportunity for clients to meet everyone at Scharf Investments and for us to speak with clients. Each meeting featured a presentation and question and answer session. The portion of the presentation discussing the general market outlook and the positioning of our portfolios for 2006 and beyond is updated below.

TRADING PLACES

Value Line and Standard & Poor's measure the stock market in distinct ways. The Value Line composite consists of 1700 equally weighted stocks. These 1700 stocks come in all sizes from large cap to small cap and are both foreign and domestic. ("Cap" or capitalization equals the market value of all the shares outstanding.) The geometric composite gauges the performance of the median stock among the 1700 while the arithmetic composite gauges the performance of the average stock.

The S&P consists of 500 large-cap U.S. based companies representing 71% of the total value of the U.S. stock market. S&P stocks are weighted by market cap and the index is designed to measure the change in value of the stock market as a whole. ExxonMobil, for example, accounts for 3.1% of the S&P but only 1/1700th of the Value Line. The largest 50 stocks account for about 50% of the S&P but only 3% of the Value Line.

Due to these differences, the Value Line composites can be used as a proxy for the performance of smaller and mid-cap stocks while the S&P represents the performance of large cap stocks.

As the table below indicates, the valuations of these sectors have traded places over the past six years. The P/E ratio of the S&P has fallen from 28.8 to 16.7 while the P/E of the Value Line has jumped from 14.3 to 19.1. At current levels, the Value Line is near the top of its historical range. Applying historical precedent to Value Line's own estimate of appreciation potential, the average stock should experience flat returns over the next five years.

Date	S&P 500 P/E at Year End	Value Line Composite P/E at Year End
12/31/1999	28.8	14.3
12/31/2000	25.0	14.7
12/31/2001	34.4	19.1
12/31/2002	20.9	15.6
12/31/2003	20.5	18.8
12/31/2004	18.7	19.3
12/31/2005	17.3	18.3
3/31/2006	16.7	19.1

S&P estimates provided by Goldman Sachs

Figures for 2005 and 2006 include \$3 of options compensation expense

Value Line figures computed by the Value Line Investment Survey



The S&P, on the other hand, is undervalued relative to earnings estimates and inflation. The S&P would be expected to trade at 17-18 times earnings if inflation in 2006 ranges between 3.5% and 4.5%. The expected P/E would rise to 18-19 times earnings if inflation ranges between 2.5% and 3.5%. Assuming inflation remains under control, the S&P is likely to appreciate at the rate of future earnings growth with “kickers” from dividend payments and valuation improvement. First Call consensus currently predicts five-year earnings growth of 7%.

BOTTOMS UP

The “top down” conclusion from the data above is interesting – larger cap stocks are likely to outperform smaller cap stocks in the years ahead. However, we construct portfolios from the “bottom up.” We screen the Value Line universe weekly for individual stocks that meet our criteria regardless of market cap. In theory, our stock-by-stock analysis should lead us to undervalued stocks and sectors. In practice, this seems to be happening. The stocks we have been buying generally have larger market caps than the stocks we have sold.

More importantly, the valuations of our holdings seem very attractive. The table below shows the P/E and estimated growth rates of all our stocks relative to both indices. Please note that these estimates come from different sources and cover slightly different time periods. Nevertheless, the message is the same – our stocks collectively have higher growth rates and lower valuations than the benchmarks.

This is neither logical nor normal. Above-average growth should be accompanied by above-average valuations. Indeed, this has historically been the case. While statistics relative to the S&P are not available, our stocks have historically sold at 119% of the Value Line’s P/E multiple compared to 87% today.

SCHARF INVESTMENTS VS.	Value Line Composite	S&P 500
Scharf Investments Estimated P/E	16.6	15.9
Index Estimated P/E	19.1	16.4
Scharf Investments Est. EPS Growth Rate	12.4%	12.8%
Index Estimated EPS Growth Rate	8.5%	7%
Scharf Investments Historical Relative P/E	119%	not available
Scharf Investments Current Relative P/E	87%	not available

S&P P/E estimates thru 12/31/06. EPS growth estimates for next five years. Data from First Call.

Scharf Investments data represents the unweighted average of current holdings.

Value Line P/E estimates thru 9/30/06. EPS growth estimates for 3-5 years vs. Value Line Industrial Composite

SUMMARY

The six-year trend of smaller stocks outperforming larger stocks accelerated in the first quarter of 2006 but valuations of smaller stocks are near a historical extreme. As with any long-running trend, it is easier to predict that “the end is near” than “the end is here.” Smaller stocks may continue to outperform and valuation disparities may widen further. Nevertheless, our holdings – which are mostly large-cap “growth stocks at value prices” - seem doubly discounted – undervalued stocks in an undervalued sector. We believe this bodes well for long-term performance in the year or years ahead.