

# SCHARF INVESTMENTS

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Since the beginning of 2000, P/E ratios for larger-cap stocks as represented by the S&P 500 have been falling while P/E ratios for mid- and smaller-cap stocks as represented by the Value Line Composite have been rising. In our January and April letters, we said this trend had reached the point where the S&P seemed undervalued by historical standards while the Value Line seemed ready to begin five years of stagnation.

The turning point in larger-cap vs. smaller-cap performance may have arrived. The Value Line Composite, which gained 10.9% compared to 6.3% for the S&P from year-end through early May, underperformed significantly during the late quarter sell-off. The situation appears analogous to the trend reversal in March 2000 when investors began to turn away from tech stocks.

## Anticipation

Hockey great Wayne Gretzky said, "I skate to where the puck is going to be, not where it has been." In our view, larger-cap stocks with predictable long-term earnings growth are where the investment puck is headed. Although these stocks should – and usually have – sold at premium valuations, many now sell at market multiples or less. Our portfolios are concentrated in these issues. Our collective holdings have above-average 3-5 year estimated earnings growth and below-average historical valuations. Risk/reward ratios are extremely favorable. If earnings come through and valuations improve, we will see double-barreled gains. Meanwhile, waiting for the puck is a test of patience just as it was back in 2000.

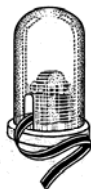
## The Big E

Better-than-expected earnings have been the main driver of stock market appreciation over the past 3½ years. Our basic strategy calls for buying stocks with high levels of earnings predictability. For the ten years we have been tracking this metric through Value Line, our portfolios have consistently registered 85 to 90 out of a possible 100 for median earnings predictability. Thus, we have not benefited as much as others from positive earnings surprises.

However, the era of positive surprises may be coming to an end. The Federal Reserve Board raised interest rates for the seventeenth time last week. The Fed reiterated its willingness to do what it takes to slow the economy and tamp down inflation. The question is whether the landing will be soft – with economic growth remaining positive – or hard – with the economy lurching into recession. Either way, we believe overall corporate earnings are more likely to surprise on the downside than the upside. If this happens, the predictability built into our portfolios should be a plus as earnings for our stocks are less likely to disappoint. Money should flow toward our stocks as investors again perceive predictability as a valuable attribute.

## Whither Go CPI?

If potential earnings shortfalls are the Scylla endangering the stock market averages, higher inflation is the Charybdis. According to Goldman Sachs data covering the period 1950-2004, the P/E ratio of the S&P averages 18.2 when inflation is less than 3.5% but falls to 13.0 when inflation is between 3.5% and 5.5%.



Over the 12 months ended May 2006, the Consumer Price Index rose 4.2%. If the CPI remains at this level and average valuations prevail, the S&P is 15% overvalued based on Goldman's 2007 earnings estimate. If inflation falls below 3.5%, the S&P is 22% undervalued.

In our view, the Fed is likely to bring inflation below 3.5%. In the event the Fed fails and P/E ratios fall, we believe the low valuations currently accorded our stocks mitigate our risk.

### Capture the Moment

Risk management is a large part of our strategy. We seek to reduce earnings risk by investing in companies with predictable profits. We seek to reduce valuation risk by buying at the lower end of historical norms. Combining these two factors, we hope to add measurable net value to your accounts over the course of a market cycle by doing somewhat better than the S&P when it advances while losing less than half as much as the index when it declines. This is an extremely important point since, mathematically, losses weigh more heavily than gains. It takes a 50% gain to recover from a 33% loss, a 100% gain to recover from a 50% loss, etc.

Historically, we have exceeded our objective. According to the Mobius database, we have "captured" 104% of the S&P's gains during market advances while losing only 34% as much during declines.<sup>1</sup>

### Summary

The six-year trend of mid- and smaller-cap stocks outperforming larger-cap stocks may have ended in May. With or without a change in trend, our stocks, which are generally larger cap, should benefit from expected improvements in valuations and earnings. Risks to the market averages include the possibility of earnings shortfalls in a slower economy and/or declining valuations if inflation remains elevated. Our portfolios are not immune to these or other risks although favorable valuations and relatively predictable earnings should be significant mitigations.

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President

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<sup>1</sup> Data comes from the Mobius database for the date range 3/31/1991 through 3/31/2006. Mobius data is provided by Informa Investment Solutions, which is not affiliated with Scharf Investments. Past performance does not guarantee future success.