# SCHARF INVESTMENTS

REGISTERED INVESTMENT ADVISOR

641 Escalona Drive
Santa Cruz, CA 95060
(831) 429-6513

October 4, 2006

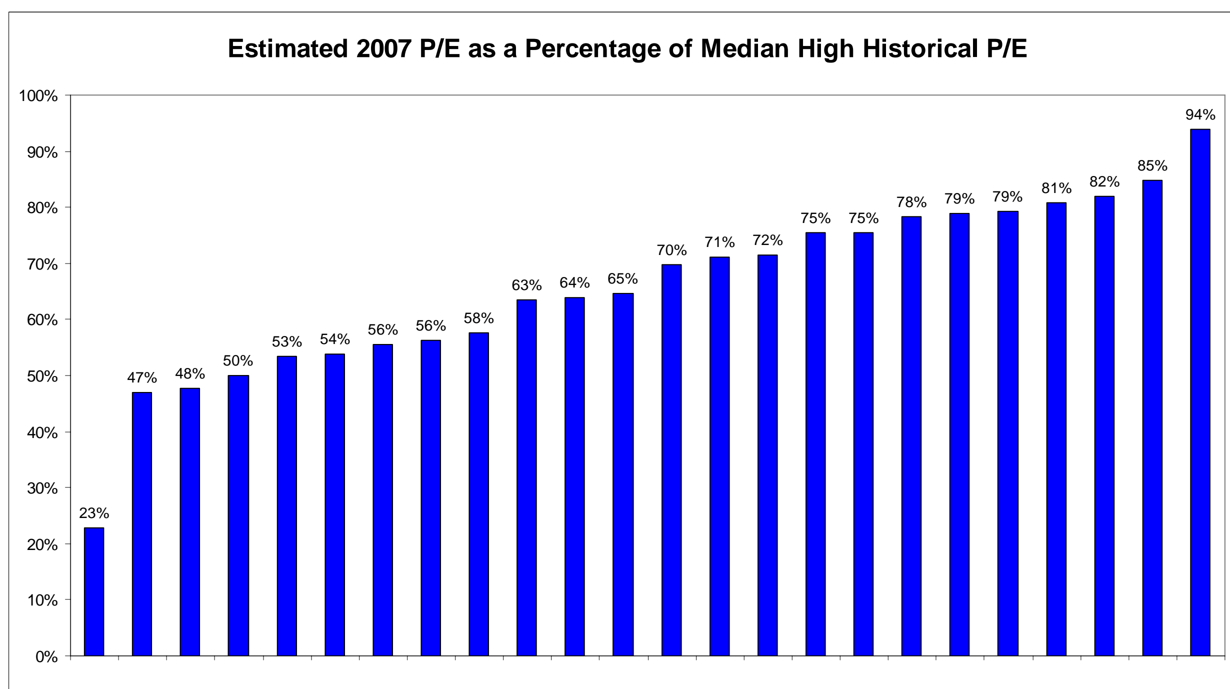
On September 28, 2006, the Dow Jones Industrial Average momentarily exceeded its record closing level of 11,723 set on January 11, 2000. Of the three best known market indicators, the DJIA is alone in achieving this feat. The benchmark Standard & Poor's 500 Index stood 188 points or 12% below its closing high of 1,527. The NASDAQ Composite closed at 2,270, less than half its peak of 5,048. Including dividends, the DJIA has advanced 2% per year over the period while the S&P is flat and NASDAQ is a disaster.

The new high in the Dow confirms our belief that larger-cap stocks are undervalued compared to small-cap stocks and quality stocks are undervalued compared to more speculative issues. For the reasons described below, we believe our portfolios are well-positioned. We remain optimistic about our prospects for relative and absolute performance.

## Absolutely Fabulous

In previous letters, we described the comparative undervaluation of our holdings relative to the market as a whole. Historically, our collective holdings have sold at a price/earnings multiple greater than that of the Value Line Composite. Currently, our holdings sell at a P/E below that of the Value Line.

The chart below makes the case that our holdings are "absolutely" undervalued compared to their own individual histories.



The chart shows estimated 2007 price/earnings ratio for each relevant quarter-end holding[1] as a percentage of its own median peak P/E. Using Value Line data and estimates, all the stocks shown are selling below their historic median high valuations. In most cases, appreciation potential to the median high is extremely large and, we believe, far greater than the potential of the market averages.

We believe these low valuations are anomalies that will eventually be rectified. While we cannot predict when this will happen, we can echo the ethos of "Zen and the Art of Motorcycle Maintenance" – namely, "Patience furthers."

## Out of the Frying Pan

The stock market has been threatened by the twin dangers of inflation and economic slowdown. Given the recent declines in commodity prices and spreading downturn in housing prices, the threat of higher inflation is receding.

Economic deceleration is underway. Gross Domestic Product grew 5.6% in the first quarter of 2006 but only 2.6% in the second quarter. With the housing market worsening by the day, the economic impetus provided by housing construction and "cash-out" refinancings is diminishing. Even where property owners did not extract money from their holdings, the wealth effect of higher real estate values may have raised consumption spending. Our negative national savings rate may have been triggered by the notion that retirement security was "on the house."

We believe the fallout from the deflating real estate bubble is in its early stages. Homebuilders, mortgage originators, real estate brokers, lenders, leveraged property owners and mortgage guarantors are all at risk. The unanswerable question is whether the ripple effects will extend beyond those directly involved. Recent bubbles – from the oil patch in the late 1970's to the Japanese stock and real estate bubbles of the late 1980's to the Internet bubble of the late 1990's – had few indirect effects.

For our part, we have drastically reduced our direct exposure to residential real estate. As noted above, our current portfolio appears historically undervalued. We believe this undervaluation, combined with high earnings predictability, gives us both a margin of safety in an economic downturn and a margin of reward if earnings for our companies materialize as expected.

## Summary

Our expectations regarding inflation have improved but the outlook for earnings remains clouded. The stock market indices appear slightly undervalued based on current 2007 earnings estimates and estimated inflation below 3 1/2%. However, earnings may prove disappointing as the economy slows.

Our stocks have relatively predictable earnings and historically low valuations. If earnings hold up and valuations return to normal, appreciation potential is substantial. In the meantime, we have a wide margin of safety for mitigating adverse events.

---

[1] Holdings which are not covered by Value Line, which typically trade on book value rather than earnings or which represent less than $200,000 of assets under management are excluded from the chart.