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The following is excerpted from our client letter of this date.

October 5, 2007

Going Our Way

The market turbulence experienced in third quarter was very much in keeping with our July prediction that volatility would be increasing and “nap time [for investors] is over.” Recent market developments are very much in line with our expectations.

1. The July-August decline appears to have been a correction rather than the beginning of a bear market. From July 13 to the intra-day low on August 16, the Dow Jones Industrial Average fell 10.8%, the S&P 500 lost 11.9% and the Value Line Composite swooned 14.8%. As we noted in our special client letter dated August 17, further losses were likely to be small since none of the three conditions historically associated with bear market declines of more than 15% was present.
2. The U.S. housing meltdown continues apace. The Case-Shiller 20-City index of repeat sales prices showed a 3.9% decrease from July 2006 to July 2007. The declines are accelerating in 16 of the 20 cities
3. Credit spreads are widening. The interest rate spread between the Merrill Lynch High Yield 100 and Treasuries stands at 342 basis points vs. 192 basis points at its narrowest. Spreads on CCC bonds stand at 698 basis points vs. 422 basis points at their narrowest.
4. Larger cap stocks are outperforming smaller cap stocks. Since March 31, the S&P 500 has advanced 8.4% while the Value Line Composite has barely budged.
5. The boom in outsized private equity takeovers has come to an end. The days of low-interest, covenant-lite loans are over. Investment bankers are in no mood to issue new loans while they are holding the bag on previous commitments estimated at \$300 billion.
6. Weaker U.S. home prices will lead to weaker consumer spending. Mortgage equity withdrawal peaked at nearly \$250 billion in the second quarter of 2005. It has fallen steadily, hitting \$84 billion in the first quarter of 2007.
7. Money is flowing out of the many hedge funds which have been charging extravagant fees for mediocre or worse performance. Some of this money is likely to migrate toward the undervalued, large cap equities that make up the bulk of our current holdings.

We have not changed any of these expectations. It seems likely that the intra-day lows reached on August 16 will hold. The factors associated with bear markets are still absent while the factors associated with bull markets are now present. These factors include the two reductions in interest rates by the Federal Reserve Board, trends in consumer credit and favorable stock price momentum.

House prices should fall further. According to InvestorsInsight, interest rates on \$684 billion worth of adjustable rate mortgages will reset higher over the next nine months. These resets will likely cause hundreds of thousands of defaults and foreclosures. An added supply of houses for sale combined with a shrunken pool of qualifying buyers can only result in further downward pressure on prices. While we would like to return to homebuilding stocks someday, the time does not seem right.



Junk bond spreads should widen until they reach or exceed historical norms.

The rotation to large cap stocks from smaller cap stocks should continue. These rotations tend to run for years. The five-year trend of large cap outperformance from 1995-1999 gave way to the seven-year trend of smaller cap outperformance from 2000-2006.

Private equity is in full retreat. Not only are new deals not getting done, several existing deals have been pulled. More deals may be pulled. Many of the deals which have been or are about to be completed will turn out to be stinkers.

Summary

We have concentrated our investments in what we believe are the right areas – large cap, multi-national companies with rational valuations. We have little direct exposure to the housing bubble and limited exposure to U.S. consumers. The two interest rate reductions by the Federal Reserve Board bode well for stocks. Favorable seasonality is at hand as stock prices are historically strong from December through the first quarter.

We should caution that probabilities are not certainties. Risk has not disappeared. The ripple effects of the bursting housing bubble could spread further than we expect. The economy could fall into recession. Interest rate reductions do not always lead to good outcomes. The market averages fell in 2001 and 2002 despite numerous rate reductions. Seasonality does not always work. For example, the S&P gained 3.7% this September which is historically the worst month of the year.

Scharf Investments Update

We are pleased to announce that Justin Walker has joined Scharf Investments as a Client Relationship Manager. Prior to joining Scharf Investments, Justin was at Wells Fargo where he was in charge of developing comprehensive, multi-generational financial strategies for the bank's high net worth clients in the Central Coast and Fresno regions. Justin graduated from the University of San Francisco with a B.A. in Politics with an emphasis in Economics and earned an MBA from the University of California at Davis. Justin's initial focus is to augment client service and outreach.

We are also pleased to announce that the excellent performance of client accounts has driven total assets under management to a new record of more than \$700 million.

Jeffrey R. Scharf
President