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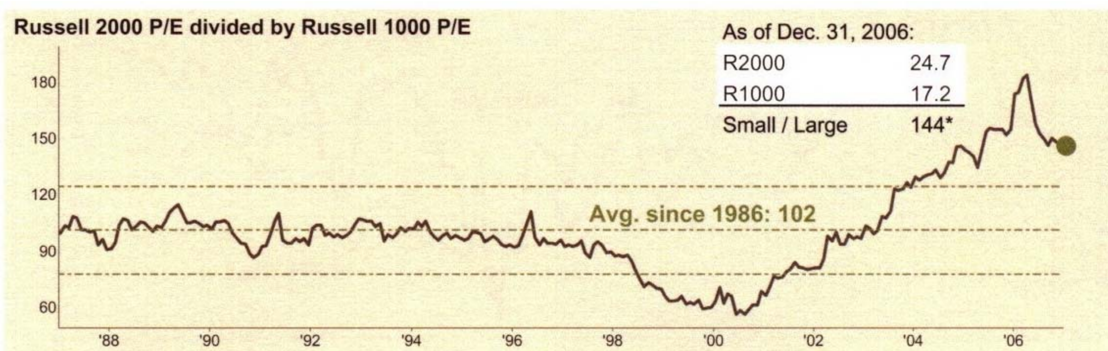
April 5, 2007

The financial markets seem as out of whack today as they were back in 1999-2000. Back then, the Internet/technology bubble and Nifty Fifty bubble were in full swing. Venture capital hedge funds were all the rage. Financing for the flimsiest internet-related business model was cheap and abundant. Meanwhile, price/earnings ratios of the megacap members of the Standard & Poor's 500 Index were astronomic compared to the rest of the market.

Today's excesses center around venture capital private equity hedge funds and smaller cap stocks. Financing for the flimsiest private equity takeover is cheap and abundant. Price/earnings ratios of the non-megacap sectors of the market are astronomic compared to the rest of the market.

The chart below compares the P/E ratio of the Russell 1000 with that of the Russell 2000. The Russell 1000 represents the thousand largest U.S. stocks by market value. The Russell 2000 represents the next two thousand. The Russell 1000 encompasses 92% of total market value in the U.S. with the majority of that value in the 100 largest companies.

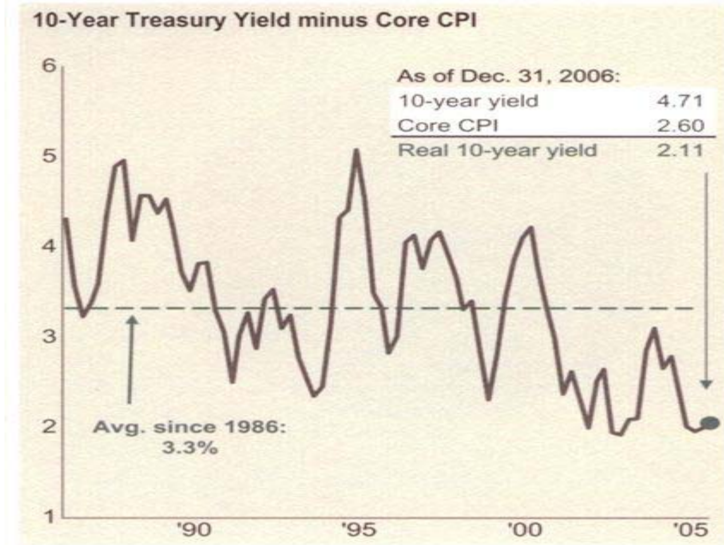


Source: Russell Investment Group, FactSet, JPMorgan

As the chart indicates, P/E ratios for the 1000 and 2000 more or less tracked each other from 1986 through early 1998. In 1998, they parted company as the Internet and Nifty Fifty bubbles got under way. For the next two years, the P/E of the large-cap 1000 eclipsed that of the small-cap 2000 by increasingly aberrant margins. This out-of-pattern trend lasted more than two years before reversing.

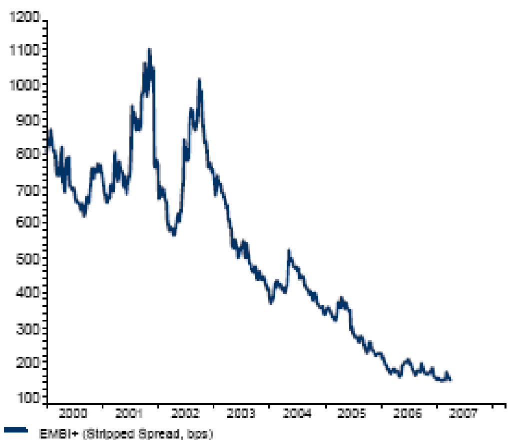
Today, the opposite situation prevails. The P/E of the 2000 broke above previous boundaries in 2003 and trended higher for about three years before its recent reversal. We believe this reversal will continue until normality is restored but only time will tell.

The stock market is not alone in exhibiting peculiar behavior. The bond market is aberrant in almost every respect. To begin with, 10-year Treasury bonds are far below their average level compared to inflation. Since 1986, the interest rate on T-bonds has averaged inflation plus 3.3%. Currently, T-bond interest equals inflation plus 2.2%. If interest rates rose to the historical average of 5.9%, T-bonds would lose 13% of their value.



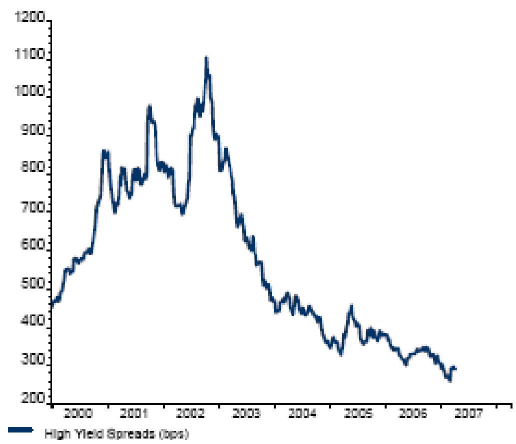
The spread between T-bond rates and rates on much riskier bonds is unusually compressed. The charts below compare interest rates on Treasury bonds to interest rates on both emerging market bonds and high-yield "junk" bonds. Longer-term charts would show that these spreads are near historic lows. The 2% to 3% current interest rate premiums are a fraction of the 11% premiums demanded just a few years ago.

Chart 30: EM Sovereign Debt Spreads



Source: Thomson DataStream

Chart 31: U.S. High Yield Spreads



Source: Thomson DataStream

Combine low baseline interest rates on Treasuries with narrow spreads and you have doubly overvalued emerging market and junk debt. Instead of yielding the normalized Treasury yield of 5.9% plus a 500 point spread for a total of 10.9%, these bonds are yielding a bit more than 7%.

The thread that ties these stock and bond market examples together is insouciance toward risk. Stock market investors are complacent about the additional risk in small, low-quality stocks vs. large, high-quality stocks. Treasury bond investors are complacent about the risk of higher inflation. Emerging market and high-yield investors – including subprime lenders - are complacent about inflation and credit risk.

In our view, the distinguishing characteristic of markets today is the systemic overpricing of riskier assets and the systemic underpricing of less risky assets.

Nobody's Fool

"If you can keep your head while all around you are losing theirs, you obviously don't understand the situation."

Faced with systemic irrationality, we have two choices. We can join the party and hope to profit if things become even more irrational. This is the "greater fool theory." Or we can do the rational thing and position ourselves to profit when the irrationality ends. Today, the rational thing appears to be investing in the high-quality, large cap stocks that have been ignored in the hullabaloo surrounding private equity and smaller cap stocks.

Going against the tide can be a frustrating and lonely endeavor. It was not easy to go resist the Internet and Nifty Fifty bubbles in 1999 and early 2000 but we did. It was not easy to sell homebuilders or avoid mortgage-related stocks at the height of the 2005 housing bubble but we did.

It is has not been easy to sit with high-quality assets in a 2006-2007 market that overvalues low-quality but we are.

We believe that rationality will return to the financial markets. The sub-prime mortgage debacle should be a wake-up call to every sentient investor that risky assets are overpriced.

What Happens in Subprime…

We believe there is a misplaced belief that what happens in subprime lending, stays in subprime lending. By way of background, subprime mortgage originators made a huge number of loans with low teaser rates to uncreditworthy borrowers. In theory, housing prices would appreciate after the loans were made but before built-in interest rate escalators kicked in. This would enable borrowers to either refinance or sell at a profit. The very presence of these borrowers as homebuyers drove housing prices upward creating the illusion of perpetual motion. The loans were packaged and sold to hedge funds and other credulous "investors." Now the loans are going bad. Credit has been cut off. Losses will be staggering.

The private equity boom has parallel characteristics. Junk bond loans with extremely low interest rates are being made to highly-leveraged borrowers. These borrowers use the money to take public companies private. In theory, the borrowers will be able to refinance at equally low interest rates when the loans come due or sell part of the company back to the public to repay debt. The presence of private equity buyers is driving prices higher in the non-megacap sectors of the market where privatization is feasible. The profitability of early private equity deals is pulling more and more investors into the game. More money is being allocated to private equity purchases and private equity lending creating the illusion of perpetual motion

Someday, the illusion will end. Refinancing on easy terms will not be available. The public markets will not welcome new offerings. Interest rates on junk loans will rise. The debt will not be serviced. Private equity funds and other credulous investors will suffer losses. Credit will be cut off as investors and lenders flee the sector. Losses will be staggering.

Where will the money go and who will benefit? We believe money will flow back to high-quality companies with strong balance sheets, growing earnings and attractive valuations. Just as the demise of the Nifty Fifty and Internet bubbles allowed neglected market sectors to flourish from 2000 to 2002, we believe the demise of today's low-quality gold rush may have a similar effect.

Summary

We have been tracking the risk characteristics of our holdings on a regular basis since 1996. These figures come from Value Line and include of measures of financial strength, stock price stability, earnings predictability and earnings growth persistence. During this time, we have never had a portfolio with an overall safety ranking as high as we have had over the past few months. We did not come to this portfolio by chance. Our valuation work indicates that high-quality stocks are historically undervalued. Eventually – a word which we are beginning to despise – these out-of-favor assets should increase in price.

Personnel Update

In our continuing effort to build a firm of lasting excellence, we are adding depth to our organization. Eric Lynch joined us on April 1. Eric earned an MBA from the University of North Carolina. His past experience includes roles as co-COO, Research Analyst and Portfolio Manager at Polen Capital Management, an East Coast firm with a highly regarded track record. Eric joins Jerry Beyke and me on our research and investment team. Jerry, our Senior Investment Analyst, has been working with me since 2002. Jerry is a CFA with more 20 years of experience including roles at Wallace R. Weitz & Co., Carson Wealth Management and Beyke Partners.

In addition to his analytical role, Eric will be contributing to our institutional sales effort.

Jeffrey R. Scharf
President