

SCHARF INVESTMENTS

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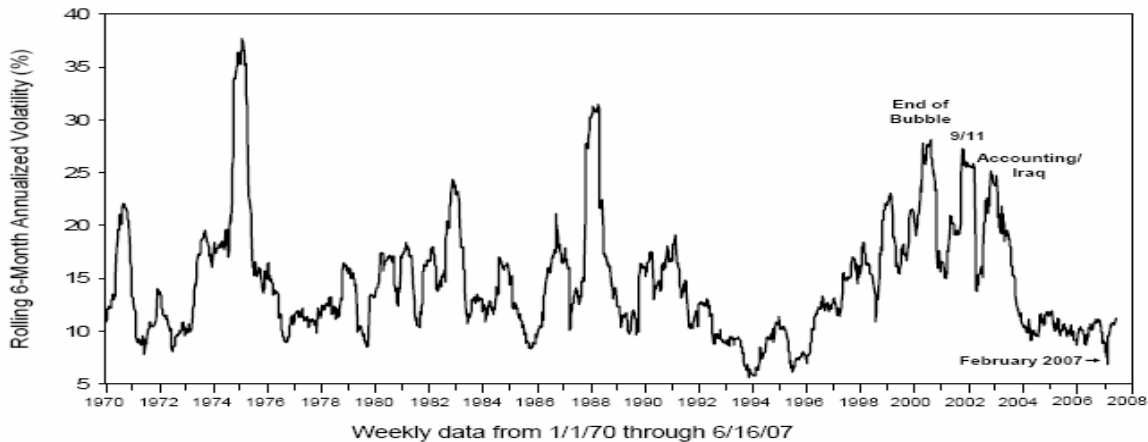
July 5, 2007

While one crocus does not make a spring, the three market aberrations highlighted in our April 2007 letter began to dissipate during the second quarter. (1) Larger cap Russell 1000 stocks finally outperformed smaller cap Russell 2000 stocks. (2) Overly narrow spreads between interest rates and inflation widened. Interest rates on 10-year and 30-year Treasury bonds rose with the value of the bonds falling 8% and 6%, respectively. (3) Interest rate differentials between high quality bonds and low quality bonds expanded. Two Bear Stearns hedge funds betting a reported \$20 billion on sub-prime mortgages are on life support. Numerous tranches of private equity junk bonds were either pulled from the market or sold on terms more onerous than expected.

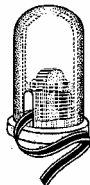
As a July 1 New York Times headline put it, Wall Street is in the midst of “risk aversion therapy.” As it becomes ever more apparent that low quality assets are dangerously overpriced, we believe investment dollars will flow toward the less risky, undervalued assets where our portfolios are concentrated. It has to happen eventually and eventually may be now.

Volatile Behavior

As the chart below indicates, stock prices have been in an unprecedented period of placidity. We believe this low volatility is directly related to an equally long and unprecedented period of better-than-expected corporate earnings. Just as years of rising real estate prices lulled lenders and homebuyers into complacency regarding sub-prime mortgages and overpriced houses, years of positive earnings surprises have lulled lenders and investors into complacency regarding junk bonds, private equity, small-cap stocks, emerging markets and leveraged hedge funds.

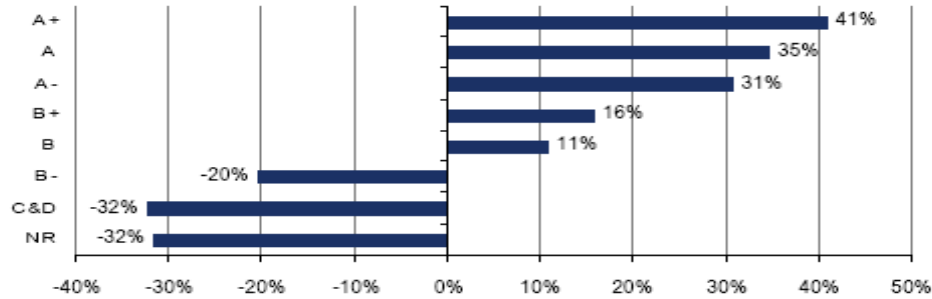


Source: Goldman Sachs Equity Derivatives Research Group.



We believe nap time is over. Corporate earnings will become less predictable as the economy slows, profit margins level out and the negative effects of corporate leverage emerge. More volatile earnings should lead to more volatile prices. As the following chart shows, higher quality assets are likely to outperform when VIX volatility rises.

Chart 9: MLQS Quality Indices 12-Mth Relative Performance Correlation to 12-Mth Chg in CBOE VIX (1986 to 3/2007)



Source: Merrill Lynch Quantitative Strategy

We continue to own very high quality assets. The table below uses the same S&P ratings as the chart above. As the table indicates, 17 of our domestic stocks are rated A- or better. Only one small holding is unrated.

Rating	A+	A	A-	B+	B	NR
Number of Stocks	11	4	2	1	3	1

The probability that our portfolios will benefit from rising volatility is the frosting on the “cake” of undervaluation based on fundamental, historical metrics like price/earnings and price/cash flow ratios.

Personnel Announcements

We are pleased to announce two additions to our staff. Brian Krawez joins us as a Senior Research Analyst. Brian was most recently a partner and head of research for Belden and Associates Investment Counsel. Prior to his work at Belden, Brian worked at Telegraph Hill Investment Counsel, Dodge and Cox, S.C. Fundamental and Smith Barney in areas ranging from investment banking to research to portfolio management. Brian is a CFA and earned an MBA from the Haas School of Business at UC Berkeley. Brian joins Jerry Beyke, Eric Lynch and me on our investment policy committee. Jan Erbe joins us as an administrative assistant. Jan is a Santa Cruz native with a 22-year background in the finance industry, having worked in customer service and trust departments. Jan earned a B.A. from UC Santa Barbara.

Jeffrey R. Scharf
President

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