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The first quarter of 2008 was the worst quarter for stocks since 2002. The benchmark Standard & Poor's 500 Index lost 9.5% while the median stock as measured by the Value Line Composite declined 11.3%.

While any investor would rather advance than fall back, stock prices historically decline about 30% of the time. During these periods, our goal is to lose significantly less than the market averages. We believe that superior down market performance is key to outperforming the averages over time.

Back to Basics

In trying times, it helps to step back and review the big picture. From 1926 through 2007, one dollar invested in S&P equivalent stocks grew to \$3189. That same dollar invested in 20-year Treasury bonds grew to \$83 while one dollar in cash-equivalent Treasury bills became \$20. These outsized stock market returns occurred despite the Depression, World War II, Korea, Vietnam, the 1973-74 oil embargo, 21% interest rates, the 1987 stock market crash, the savings and loan crisis, the Internet bubble and 9/11. Declines related to these events did not last forever and neither will the current decline.

Current conditions echo the 1990-1991 savings and loan crisis and 2000-2002 aftermath of the stock market bubble. In 1990-1991, banks and savings and loans made reckless real estate investments with federally insured deposits. The end result was \$177 billion of loan losses. A 20% decline in the value of residential real estate today would produce comparable loan losses as a percentage of GDP. Coincidentally, that same 20% decline would result in \$4 trillion of lost residential real estate equity – an amount equal to the stock market losses after the bubble burst in 2000.

While today's losses may eventually exceed those of 1990-1991 or 2000-2002, we do not believe they will be as deep or as widespread as apocalyptic headlines suggest. We believe many securities outside the trouble spots are unduly depressed as fearful investors throw the baby out with the bathwater.

Bad Day at Bear Stearns

Today's economic distress has one primary cause: too many people and institutions borrowed too much for too long to buy too many assets of questionable value. Sub-prime mortgage lenders and borrowers were the worst offenders but the problem is spreading to Alt-A and prime mortgages, commercial lending and other types of credit.

Now the chickens have come home to roost. Increasing numbers of homeowners are failing to make their loan payments. Mortgages and mortgage-backed securities are declining in value. Institutions that borrowed huge amounts of short-term money to buy mortgages are receiving margin calls. To meet the margin calls, they are dumping whatever they can onto the market at fire-sale prices. Because much of the recent mortgage activity took place outside the banking system and was packaged into poorly disclosed asset pools, derivatives and other opaque instruments, nobody knows where the next shoe will drop.



This has led to a justifiable aversion to non-guaranteed mortgages and mortgage industry participants as well as highly leveraged mortgage investors such as banks, brokers and hedge funds. Bear Stearns, for example, bought \$33 of assets with each dollar of equity. This is like a homeowner buying a million dollar house with a \$30,000 down payment. A 3% decline in asset value causes a 100% equity wipe-out. Unlike homeowners with 30 years to repay Bear Stearns financed many of its purchases with overnight money. When lenders refused to roll over the overnight loans, Bear was cooked. Despite a book value of more than \$80 per share, Bear was “taken under” for \$10.

For better or worse, justifiable aversion has expanded to unjustifiable aversion. Many tax-free municipal bonds have been yielding more than taxable Treasury bonds. Under normal conditions, municipal bonds have lower yields than Treasuries. We believe these elevated yields are due to exceptional and largely unwarranted fears of municipal default. Federally-guaranteed mortgages have been selling at historically wide premiums to Treasury bonds with the same guarantee.

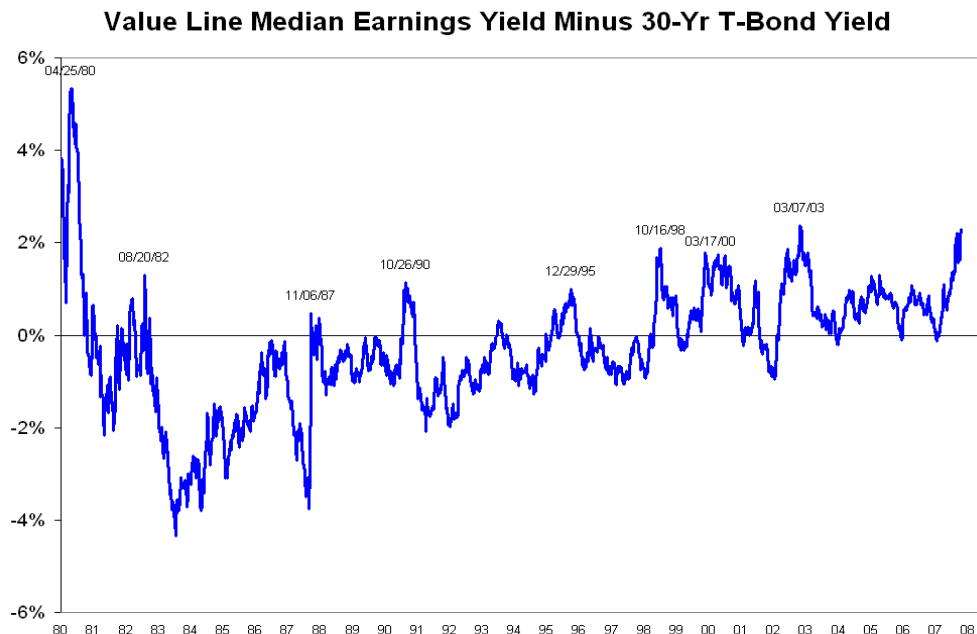
Going to Extremes

The exaggerated risk aversion afflicting the bond market has infected the stock market. One measure of this aversion is the spread between the earnings yield on stocks and the yield on 30-year Treasury bonds.

Earnings yield is the earnings/price ratio of stocks. A stock with \$1 in earnings and a \$10 price is effectively “yielding” 10% on an investor’s money. Since stocks compete with bonds for investors’ attention, yields tend to move in the same direction: stocks have higher earnings yields when interest rates are high and lower earnings yields when interest rates are low.

As the chart below shows, earnings yields are often less than bond yields. This is perfectly logical. Since the economy tends to grow over time and corporate earnings tend to grow with the economy, companies can be expected to earn more ten years from now than they earn today. Meanwhile, bonds pay the same interest year in and year out. A stock which yields 6% on today’s original cost might yield 12% on original cost ten years from now. A bond which yields 7% at today’s cost will be yielding the same 7% in ten years.

Occasionally, investors become so worried about the future that earnings yields exceed bond yields. This is one of those times. The earnings yield of the Value Line Composite is 6.4%. The yield on 30-year Treasury bonds is 4.4%.



Over the past 27 years, spikes similar to today’s represented outstanding buying opportunities. Following the dates shown on the chart, stock prices advanced 7 out of 8 times with an average one-year gain of 21% for the S&P and 28% for the Value Line Composite. The sole decline occurred after March 2000 when the deflating Internet bubble obscured the gains available elsewhere.

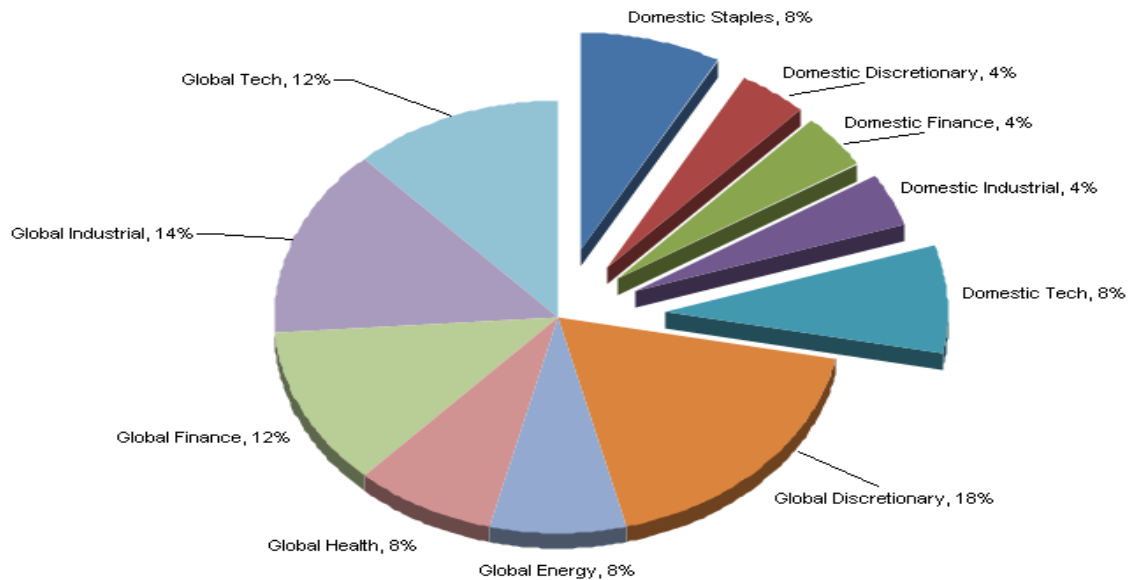
The earnings yield differential is one of many harbingers of better times ahead. Others include the historical tendency of stocks to rise in the six and twelve months following multiple Fed rate cuts, the historical record of major bankruptcies/restructurings like Bear Stearns occurring near market bottoms, a high level of insider purchases and the extremely favorable risk/reward ratios uncovered in our stock screening process.

Ready and Waiting

Our concern, of course, is not for the market averages but for our portfolios. Here, we continue to emphasize:

1. Predictable growth: Warren Buffett told CNBC that he did not worry about stock prices as long as his holdings were adding to their intrinsic value. We share his feeling. Our current holdings increased their earnings per share by an average 15% in 2007 and we expect 5% to 10% growth this year. Our median earnings predictability compared to the Value Line Universe remains in the 85th percentile (100 is highest). Meanwhile, S&P 500 earnings declined 3.7% last year and may be flat to down this year.
2. International exposure: More than 40% of portfolio revenues come from outside the U.S. giving us geographical diversification and a currency hedge.
3. A safe distance from U.S. housing and consumers: Consumer spending in the U.S. recently hit 70% of GDP compared to a more normal 65%. We believe overextended consumers will be spending less and saving more. As for housing, prices and inventory remain far above normal levels.
4. High quality: High quality stocks tend to outperform in decelerating profit cycles. Eighteen of our 21 stocks with S&P quality ratings are A-, A or A+.
5. Low valuations: Our collective portfolio historically sells at 118% of the valuation of Value Line Composite but currently sells for 94%.

The chart below shows the approximate weighting of our portfolios by industry and geography.



Summary

A successful investment advisory relationship combines skilled decision-making on the part of the advisor with patience and realistic expectations on the part of the client. Every day, we look for situations where the probability of winning is greater than the probability of losing and the magnitude of potential gain is greater than the magnitude of potential loss. While no time period or investment is free from risk, there are periods like the present where long-term risk/reward ratios appear extremely favorable. This does not mean that long-term losses are impossible, only that we consider them unlikely.

The rewards we expect will not be achieved overnight. The market may get worse before it gets better. Patience and realism are needed to persist through adversity and recognize that markets go down as well as up.