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October 13, 2008

After our regular letter of October 3, global financial markets had a 1987-style seizure. Back then, the Dow Jones Industrial Average plunged 22% in a single day. This time, it swooned 18% in a single week.

These are truly the times that try investors' souls and we are gratified to have a client base that has the right temperament for long-term investment success. To summarize the points we will make below, we believe:

1. Global stock market losses are vastly greater than the losses involved in the underlying problem of bad real estate loans.
2. Declines like the present have happened before yet stocks have produced much higher returns than bonds or cash over time.
3. Potential returns are extremely attractive by historical standards.
4. Once recovery comes, it will come quickly. Those who move to the sidelines until things "look better" will probably miss a significant percentage of the rebound.
5. 2008 does not equal 1929.
6. The difference between the economic value of our holdings and the market price of those holdings has gotten wider and the risk/reward ratios more favorable over the past ten days.

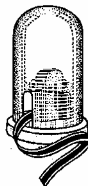
The Underlying Problem

The epicenter of the financial shock wave remains the deflating bubble in U.S. housing prices. Fueled by low interest rates and lax – or more accurately, non-existent – lending standards, housing prices spiraled upward. New purchases were often made with no money down and those with homes began using them as ATMs through cash-out refis. The bubble burst, prices are falling and mortgages are going bad.

Doing the math, the residential real estate market was worth about $21 trillion. Half of all homeowners have no mortgage. Assuming that these paid-off homes are distributed evenly across the spectrum, there are $10.5 trillion of mortgage loans outstanding. Using the extreme assumption that every home was purchased or refinanced with a 100% loan at the market peak and prices fall 35% and every borrower defaults, total loan losses would equal $3.7 trillion. This compares to stock market losses in the U.S. alone of nearly $8.4 trillion since last year's peak. And, believe it or not, the U.S. stock market is one of the best performing markets in the world!

Any way you look at it, we believe the losses in global stock markets exceed any conceivable losses in global lending. So why are markets collapsing?

First, nobody knows exactly how big the losses are or, more importantly, where the losses are. The losses are dispersed through securitizations and further muddied by credit default swaps. Because investors do not know who is holding the bag, they suspect everyone. When institutions like Bear Stearns, Lehman, AIG and Washington Mutual can disappear overnight, investors have reason to be wary. But wariness can easily get out of hand. Investors seem to be ascribing many more losses than are likely and compounding the error by ascribing them to companies and countries where they are unlikely to be found.



This psychological contagion is reminiscent of the 1997-98 Asian currency/Russian ruble crises. When Russia defaulted on its debt, investors yanked money out of developing countries from Asia to Latin America. The U.S. market plunged. The guilt-by-association became so extreme that CNBC began covering the opening of the Hong Kong stock market for the benefit of worried investors in the U.S. Today, CNBC is again covering the opening of the Asian markets.

In the end, what defaulted in Russia stayed in Russia. Today, many developing countries are in a better foreign exchange position than the U.S.

It's Not Unusual

Stock market declines are not unusual. This is the twelfth recession-related decline since 1945. There were severe non-recessionary declines in 1962 during the Cuban missile crisis, during the market crash of 1987 and in the midst of the Long Term Capital Management debacle of 1998. Including all these declines plus the Depression, $1 invested in S&P equivalent stocks in 1926 through October 10 would have been worth approximately $1983 compared to $90 if invested in Treasury bonds or $20 if invested in Treasury bills.

How bad can things get? At the lows on October 10, the S&P 500 and Dow Jones Industrial were down about 46% from their October 2007 peaks. This is comparable to the two worst declines in post-World War II history – 1973-74 and 2000-2002.

Elements of Return

Stock market returns are driven by three factors: earnings, dividends and valuations. Normally, we project earnings 12-18 months forward. In our last two letters, we showed how collapsing valuations – not collapsing earnings – were primarily responsible for losses incurred through September 30. Valuations have collapsed further in the past two weeks and, we believe, more than account for potential shortfalls in earnings over the next 15 months.

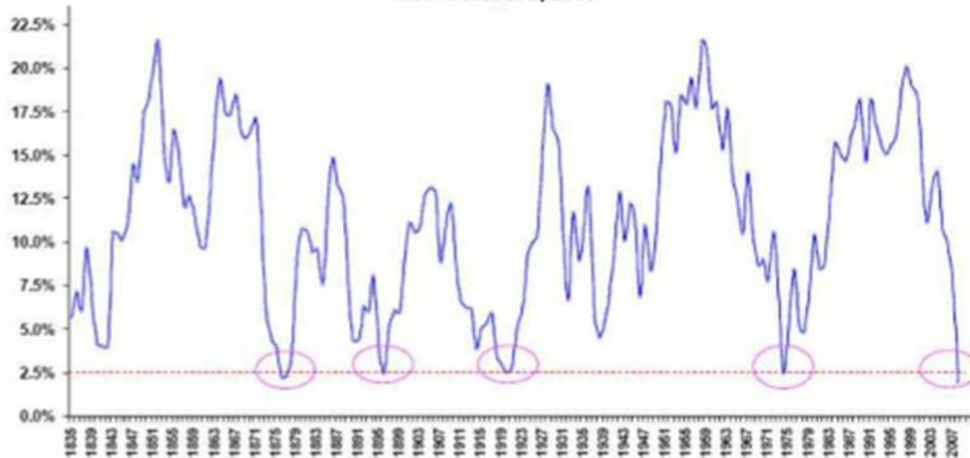
Granting that next year is murkier than usual, let's look at longer time periods. Each week, Value Line estimates the 3-5 year appreciation potential of the median stock. Appreciation potential, based on October 8 prices, reached 135%.

The table below shows that actual 5-year appreciation following initial readings of at least 115% ranged from a low of 28% to a high of 166%. Yes, the current reading could get more extreme. But unless one believes that the current crisis is going to drag on for five more years, the probabilities are very much in favor of remaining invested.

Date	Estimated Appreciation Potential	Subsequent 5-year Return (Including Dividends)
7/17/1970	118%	+ 43%
8/24/1973	115%	+ 28%
11/17/1978	115%	+ 100%
3/14/1980	115%	+ 91%
7/31/1981	120%	+ 133%
6/29/1984	115%	+ 132%
11/6/1987	120%	+ 125%
9/28/1990	115%	+ 159%
10/18/2002	115%	+ 166%
10/17/2008	135%	?

S&P 500 returns prior to 1980; Value Line Arithmetic returns thereafter.

For a really long-term look, the next table shows that the investment return on large-cap stocks for the ten years just ended was comparable to the worst results over the past 180 years. Each previous period was followed by years of higher returns.



Source: Goldman, Sachs

The Waiting Game

When losses mount and panic prevails, the natural urge is to step aside until things look better. Unfortunately, the stock market is a forward-looking mechanism. Just as the market turned down before the current economic distress blossomed, it will probably turn up long before the distress abates. In past recessions, prices bottomed three to nine months ahead of economic recovery.

The table below shows that the S&P advanced an average 27.9% in the year after making a recession-related low. The only decline occurred after 2001. That decline was more severe in stocks coming down from their astronomical Internet/Nifty Fifty bubble highs than for stocks in general.

Recession Onset	S&P 500 Trough Date	Recession Ends	S&P 500 Index Trough	S&P 500 One Year After Trough	One Year % Gain After Trough (w/o dividends)	Months between S&P Trough and Recession End
Feb-45	Mar-45	Oct-45	13.93	17.53	**25.8%**	7
Nov-48	Jun-49	Oct-49	13.97	17.69	**26.6%**	4
Jul-53	Aug-53	May-54	23.32	29.83	**27.9%**	9
Aug-57	Dec-57	Apr-58	39.99	55.21	**38.1%**	4
Apr-60	Oct-60	Feb-61	53.39	68.62	**28.5%**	4
Dec-69	Jun-70	Nov-70	72.72	98.70	**35.7%**	5
Nov-73	Sep-74	Mar-75	63.54	83.87	**32.0%**	6
Jan-80	Mar-80	Jul-80	102.09	136.00	**33.2%**	4
Jul-81	Jul-82	Nov-82	107.09	162.56	**51.8%**	4
Jul-90	Oct-90	Mar-91	304.00	392.45	**29.1%**	5
Mar-01	Sep-01	Nov-01	1040.94	815.28	**-21.7%**	3
Dec-07	?	?	?	?	?	
				Median:	**29.1%**	
				Average:	**27.9%**	

Investors selling stocks today have two choices. They can abandon stocks forever which will probably result in more lost opportunity than short-term savings. Or they must decide when to buy back in. If they miss the turn, they will face one of investing's most difficult decisions – having to buy higher after selling low.

2008 = 1929?

The biggest fear of most investors is a re-run of the 1930's. While we would never say this could not happen, there are multiple mechanisms in place to see that it doesn't. The recession of 1929 was turned into the Depression by a concatenation of policy mistakes and meteorology. Trade was restricted via Smoot Hawley tariffs. When banks failed, depositors lost everything. Taxes were raised. Mortgages were financed with three-to-five year bullet loans. The Dust Bowl devastated 25% of the nation's economy.

Today, we do not let depositors go down with their bank. Most homes are financed with 30-year, non-callable loans. We have automatic income stabilizers such as unemployment insurance, welfare, food stamps, farm supports and Social Security. The Dust Bowl is nowhere to be seen. Whatever one thinks of the current leadership and policies coming out of Washington and elsewhere, it is clear that the central thrust of global policymakers is to avoid a second Depression.

2008 = 2000?

For investors scarred by the Internet bust, we can say that there is little comparison between our portfolios and the tech stocks of 2000. Back then, it was not unusual for stocks with unproven business models to sell for 100 times ephemeral earnings. The technology stocks in the S&P sold for 48 times earnings. The difference between owning the world's most profitable software company today at $22 with estimated earnings of $2.15 and owning it then at $60 with earnings of $0.85 is the difference between night and day.

Staying Power

Notwithstanding our view that the probabilities of attractive returns are extremely high, stock market investing is not for everyone or for all assets. As we said in our last letter, investors must allocate their assets in a way that is financially sensible and psychologically sustainable.

Financially sensible means many things. Please call if you would like to review your particular situation. Psychologically sustainable is something that only investors can know and periods like the present are the acid test. There is no shame in discovering that one is not as risk-tolerant as one imagined. But we urge investors to change allocation sensibly based on any new risk-related insights. Becoming risk averse during market declines and risk tolerant after advances is a formula for selling low and buying high.

Leap of Faith

When all is said and done, when all the historical comparisons are made, when all the known data has been reviewed, investing boils down to a leap of faith that, given an appropriate time horizon, the system works. This is true of any investment – whether a stock, a bond, a house or a bank deposit. In each case, there are no guarantees, only probabilities. Taking everything into account, we believe the probability of favorable returns is greater today than it was two weeks ago.

Jeffrey R. Scharf
President
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