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July 7, 2008

The Long and the Short of It

The stock market averages are now nine months away from their October 2007 peak and below levels prevailing at the end of 2006. While it is never pleasant to go backward, we believe it is important to distinguish between investment losses caused by changes in investor psychology and losses caused by economic impairment.

Our portfolios continue to be concentrated on high-quality stocks with predictable earnings and lower-than-usual valuations. We continue to emphasize investments with international exposure and de-emphasize investments dependent on stressed U.S. consumers. With one exception, we believe our current holdings[i] have increased in economic value over the past 18 months. We expect economic value to increase further over the course of our investment horizon which now extends through the end of 2009.

While economic value and stock market value should converge in the long run, the short-term is less predictable. The table below shows that the higher earnings power of our current holdings has been accompanied by falling price/earnings valuations. At the end of 2006, our current holdings had an average P/E of 16.2 times 2007 earnings. Now the average P/E is 12.4 times 2009 estimates. (Please note that we have not owned all of our current holdings for the entire 18 months and some previously owned holdings have been sold. No representation is made or implied as to portfolio returns for the period shown.)

Current Holdings	Change in Earnings 2006 Reported to 2009 Estimate	12/31/06 P/E on 2007 EPS	6/30/08 P/E on 2009 est. EPS
Portfolio Average[ii]	41%	16.2	12.4

Put another way, our portfolios will be much higher by year-end 2008 if earnings estimates remain intact and P/E multiples return to 12/31/06 levels. Gains would be even greater if multiples reached median highs.

Triple Threat

Why have price/earnings multiples declined? We believe there are three primary reasons.

First, earnings estimates for 2009 may be too high. If so, P/E's are not as low as they appear. As we have written many times, our holdings have excellent earnings predictability. Our median predictability is currently in the 85th percentile of the Value Line Universe.

Second, risk aversion has grown. Investors are understandably nervous about the housing crisis, the oil bubble and the prospect of a prolonged recession. The question is not whether these concerns are legitimate. The question is whether too much or too little risk is priced into the market.

The chart below is reprised from our April letter. The underlying data shows that investors are willing to accept 4.5% per year interest on a 30-year Treasury bond with no possibility of additional gain rather than take a chance on the 6.4% earnings yield of the median stock with the overwhelming probability of future growth. This level of aversion is comparable to or greater than that seen during the depths of the 1982 recession, after the stock market crash in October 1987, at the height of the savings and loan crisis in 1990, in the midst of the Asian currency meltdown in 1998 or at the end of the bursting stock market bubble in 2003.

While aversion could become more extreme, investors holding out for 1980 levels might never own stocks. As it is, stocks advanced after seven of the eight dates shown with twelve months gains averaging 21%.

Third and last, price/earnings multiples fall as inflation rises. When inflation is above 3.5%, multiples tend to be in the 12-14 range. When inflation is below 3.5%, multiples tend to be in the 17-19 range.

Currently, the Consumer Price Index has increased 4.2% over the past twelve months while the "core" rate excluding food and energy has increased 2.3%.

We believe the reported rate is likely to fall back below 3.5%. Although prices of food and energy - which make up 17% of CPI - capture daily attention, they are less important than items like housing and autos which make up 37% of CPI. In addition, unit labor costs are basically flat as productivity increases offset modestly higher wages. Finally, there is a strong historical tendency for inflation to peak during recessions and then decline.

Investment Summary

We believe higher earnings and stagnant stock prices have improved the risk/reward characteristics of our portfolios over the past 18 months. Now valued at 12.4 times relatively predictable 2009 earnings estimates, our aggregate holdings are trading well below historical norms relative to their own histories and stocks in general. We believe our prospective earnings yield of 8% is exceptionally attractive compared to the yield on 30-year Treasury bonds. While risks remain – primarily in the form of lower than expected earnings or higher than expected inflation – we believe potential gains are much greater than potential losses.

The timing of gains, if any, is uncertain. Risk aversion seems to grow daily even as lower prices mitigate actual risk. This counterproductive behavior was summed up by legendary investor John Templeton who said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."

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President

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[i] Current holdings include all equities purchased and held in managed accounts with a period ending market value greater than $1 million. Client accounts are individually managed. Every account does not own every holding. Some current holdings were purchased after 12/31/06

[ii] Sources: Earnings estimates: Value Line Investment Survey, Sanford Bernstein
Reported Earnings: Value Line Investment Survey, company reports. Earnings and p/e multiples are not adjusted for spin-offs.