

SCHARF INVESTMENTS LLC

REGISTERED INVESTMENT ADVISOR

5619 Scotts Valley Drive, Suite 140
Scotts Valley, CA 95066
831.429.6513

February 22, 2009

Weighing In

In the short run, the stock market is a voting machine. In the long run, it is a weighing machine.
– Benjamin Graham, the father of value investing.

There are three components to stock market returns – earnings, dividends and valuations. In the long run, stocks are “weighed” by their earnings. One very well-known household name, for example, increased its earnings per share 2800% between 1984 and 2008. Its stock price also increased 2800%. Its earnings and stock price did not advance in unison, however. Sometimes investors “voted” for a higher price/earnings valuation; sometimes they voted for a lower valuation.

The table below compares the recent earnings, dividend and valuation progress, or lack thereof, of our current holdings to the S&P 500. (Please note that the stocks we own today are not identical to those owned at the end of 2006. Data for all charts and tables as of 2/18/09.) As you can see, our companies are expected to show an earnings increase of 17% from 2006 to 2009 compared to 45% decline for the S&P 500. Dividends for our stocks were 51% higher in 2008 than in 2006 while S&P dividends were flat. While the earnings performance of our stocks has fallen short of our initial expectations for 30-40% earnings growth over three years, any growth is spectacularly good in the current environment.

| 2006-2009 Change in: | Average Stock in <i>current</i> Scharf Portfolio | S&P 500 |
|---------------------------------|---|--------------------|
| Earnings | 16.9% | -45.1% |
| Dividends | 51.2% | 1.4% |
| Price | -31.6% | -44.4% |
| Valuation (P/E) | 19.6 → 11.7 | 16.2 → 16.4 |

Despite manifestly superior business fundamentals, the price/earnings valuations accorded our stocks have fallen markedly while the p/e of the S&P 500 has risen slightly. Our stocks would be 40% higher if they were selling for a market multiple. They would be 59% higher if they sold for the 18.6 p/e that the S&P has averaged between 1950-2006 when inflation was at current levels.

Why are investors “voting” against stocks with better earnings and dividend growth? As Isaac Newton said after losing a fortune in the South Sea bubble, “I can calculate the motions of heavenly bodies but not the madness of people.”

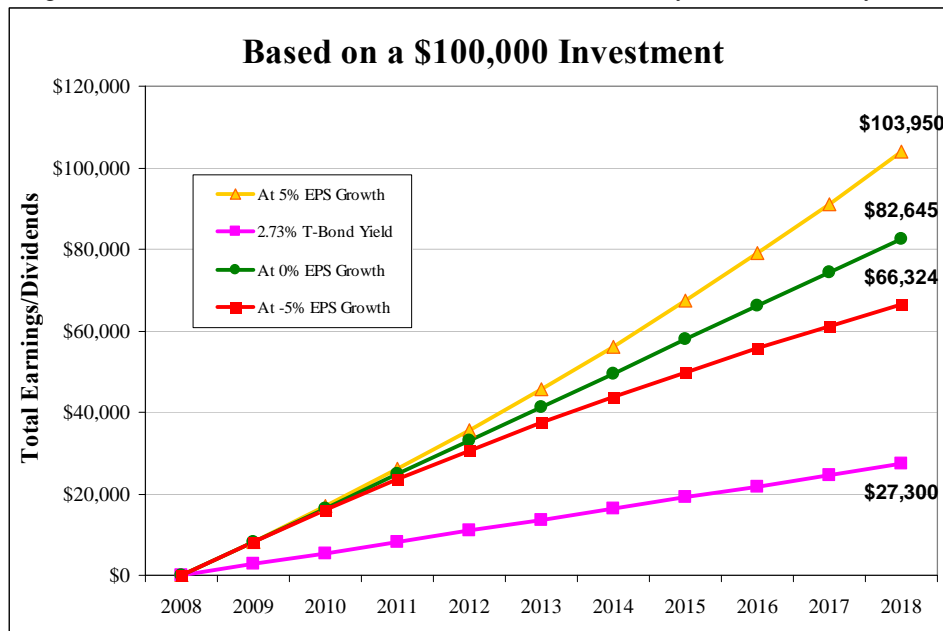
Doing the Math

*I have always thought that if... even in the very presence of dizzily spiraling [stock] prices, we had all continuously repeated, “two and two still make four” much of the evil might have been averted. – Bernard Baruch, preface to *Extraordinary Popular Delusions and the Madness of Crowds*, October 1932.*



During the 1999-2000 stock market mania, the arithmetic behind Internet investing was incredibly poor yet investors were overwhelmingly optimistic. Today, the arithmetic seems incredibly favorable yet investors are overwhelmingly pessimistic.

The chart below compares the long run value of our portfolio to the risk-free return on Treasury bonds. In the best of the scenarios shown, our stocks compound their earnings at 5% per year for the next ten years. Assuming 5% GDP growth – which could be 2% real, 3% inflation, or 1% real, 4% inflation, etc. – and commensurate growth in earnings, our companies would earn a cumulative \$103,950 for each \$100,000 invested. At zero growth, they would earn \$82,465. If earnings declined 5% per year for each of the next ten years, they would earn \$66,234. All of these figures are much greater than the \$27,300 that will be earned in risk-free 10-year U.S. Treasury bonds.



For dividend paying stocks, the situation is even more favorable. At a 35% payout rate, dividends in the three scenarios above would range from \$23,000 to \$36,000. Not only are these dividends nearly equal to or greater than Treasury interest, dividends currently receive preferential tax treatment.

Is it any wonder Warren Buffett wrote this in the October 16, 2008, New York Times?

Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Deal or No Deal?

If the math is so blindingly favorable for stocks, why are investors racing for the exits? Imagine that there are two suitcases containing \$1 million total. You can buy a suitcase for \$400,000.

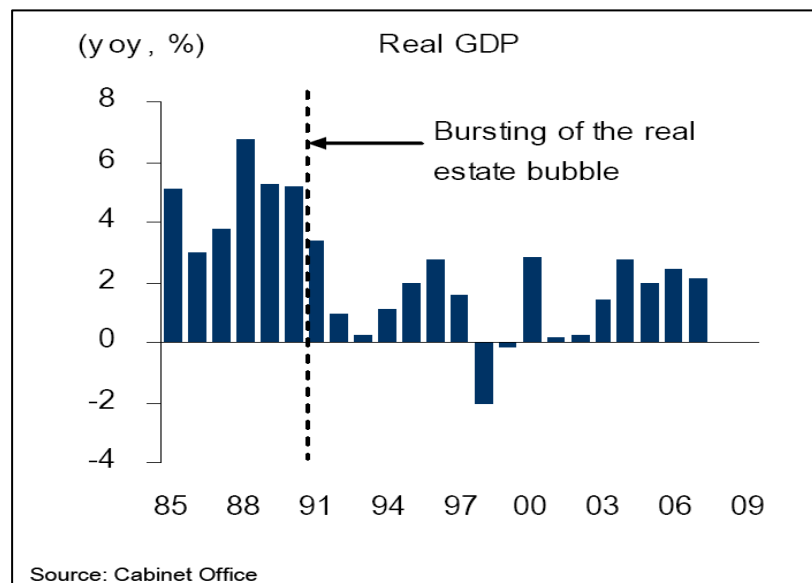
If you are told that each suitcase contains \$500,000, are you buying? Absolutely. One suitcase contains \$400,000 and the other \$600,000? Buy, buy, buy. One has \$350,000, the other \$650,000? Maybe, maybe not. One has \$1,000,000 and the other zero? Take the \$400,000 and run.

This example shows that investors become more reticent as outcomes become more volatile. Today's low valuations reflect the fear that we could be entering a 1929-style depression and the investment "suitcase" really might be empty.

For reasons stated in previous letters, we believe this is an extremely remote possibility, though not as remote as it was 18 months ago. The differences between 1929 and today are stark. We have deposit insurance to prevent bank runs. We have income stabilizers like unemployment insurance, welfare, food stamps, farm supports and Social Security. We do not have the Dust Bowl devastating 25% of the economy. Nor do we have (at least not yet), higher taxes and Smoot-Hawley trade barriers.

A less extreme but more reasonable fear is that the U.S. is entering a “lost decade” similar to the Japanese economy in the 1990’s. This may not happen – the U.S. has better demographics and has responded to the crisis more quickly – but even if it does, the lost decade was not actually that bad.

As the chart below indicates, the Japanese economy showed sluggish but generally positive GDP growth following the bursting bubble. A U.S. economy with a similar growth pattern would be perfectly consistent with the +/- 5% earnings growth scenarios portrayed above.



Personal Finance

Investors need an investment strategy that is financially reasonable and psychologically sustainable. An investor with more money than he or she will ever spend can bury the money in the backyard. An investor who needs a 10% annual return to reach his or her financial goals will not get there buying Treasury bonds yielding 2.75%.

Suggested strategies are:

1. Reduce leverage by reducing debt. It's hard to go broke if you don't owe money.
2. Use an appropriate time horizon. The scary part of buying the “Deal or No Deal” suitcase is getting one 50/50 chance to win. Given ten chances, the odds of breaking even or winning rise to 83%. With 100 chances, the odds of winning rise to 98.3%. In the stock market, the odds of winning over ten minutes or ten days or ten months are much smaller than the odds of winning over ten years. Short-term money does not belong in the stock market. Long-term money – whether it is for you, your children or your grandchildren – may.
3. Reduce your commitment. Instead of putting \$400,000 at risk to buy a suitcase, put \$300,000 or \$200,000 at risk. Although this is likely to reduce future gains, it may provide the psychological comfort needed to remain invested. It is better to make a sound decision with 50% of your money than an emotional mistake with 100%.
4. Look at all assets through the same lens. Do not apply one set of standards to stocks and another to assets like real estate. In our discussions, we have talked to investors who are committed to keeping their rental houses earning 2% per year based on estimated market value. Meanwhile, these same investors are worrying themselves sick about their phone company stock paying a cash dividend of 7%. In our opinion, they are focusing on the wrong asset. A world where masses of consumers are so strapped that they abandon all phone service is not a world of rising rents and \$700,000 houses.
5. Achieve a balance. We re-opened our balanced account product last year. Balanced clients choose an asset allocation, usually 60-70% stocks, 30-40% fixed income and cash. Our fixed income philosophy is very conservative – preservation of principal is paramount.

Summing Up: Back to the Future

We were asked whether we were being overly optimistic about the future. Let us say that valuations make us optimistic because they work using pessimistic economic assumptions. “Two and two still make four” and our stocks appear to be more attractive than Treasury bonds even if earnings decline 5% per year compounded for the next ten years.

As the table below shows, the market has come full circle since Scharf Investments got going in 1984. P/E ratios are similar. Value Line’s estimated 3-5 year appreciation potential is higher. Interest rates and inflation are much more favorable. Coming out of the brutal 1981 recession and a long period of stagnant markets, stocks produced years of above-average returns. Once the current turmoil ends, we believe another era of above-average returns awaits.

| | January 1, 1984 | February 18, 2009 |
|-----------------------------------|------------------------|--------------------------|
| Value Line P/E | 11.4 | 11.7 |
| Value Line appreciation potential | 85% | 140% |
| 10-year Treasury Yield | 11.7% | 2.7% |
| Inflation (YOY) | 3.9% | 0.1% |

© 2009 by Jeffrey R. Scharf