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The Long and the Short of It

It could have been worse. A late-year rally lifted stock market indices about 20% above their November 20 lows. Nevertheless, the 37% loss in the benchmark Standard & Poor's 500 Index represented its worst calendar year decline since 1937. The cumulative loss from its October 2007 high to its November 2008 low represented the biggest decline since World War II. At year-end, the dividend-adjusted S&P stood at levels first seen in June 1997.

Given the magnitude of the decline and the 11-year price drought, it is not surprising that the longer term indicators which we follow are exceptionally favorable. At the November low, the 3 to 5 year estimated appreciation potential of the median stock in the Value Line Universe stood at 175%, the highest level since 1982. The price/earnings ratio stood at 10.2, a reading last seen at the depths of the savings and loan crisis in 1990 and, before that, in 1985 when the great 1984-2000 bull market was finding its legs. S&P-equivalent returns for 10-year periods following previous 10-year droughts have been strongly positive.

Unfortunately, these long-term indicators tell nothing about the next 3 to 5 days, weeks or months.

Both Sides Now

We believe the biggest challenge facing investors is the extraordinary nature of the current economic distress and the unprecedented government response. The chances of extreme outcomes on both sides of the investment spectrum may be higher today than at any time in U.S. history. At one extreme, deflation is a very real possibility for the first time since the 1930's. A deflationary spiral is one of the most intractable problems in economics. Falling prices cause consumers to put off spending which leads to lower production and more unemployment. More unemployment and lower incomes compound the reluctance to spend. In what is known as the Paradox of Thrift, the more people save, the worse the economy gets.

We do not foresee a replay of the 1930's due to economy-wide income stabilizers like unemployment insurance, Social Security, welfare, food stamps and farm supports. On the other hand, U.S. government responses like bailing out banks, credit card companies, automobile manufacturers, etc. and throwing money at public works projects bears an uncomfortable resemblance to the Japanese policies that led to that country's lost decade of the 1990's.

At the other extreme, government printing presses running non-stop to fund $500 billion of tax rebates and TARP handouts in 2008 with the potential for another $350 billion in TARP funding and $600 billion plus of "economic stimulus" in 2009 may boomerang in the form of virulent inflation and a debased dollar.

Because of these uncertainties, we believe investors need to cover the bases with some holdings that benefit from inflation and others that can survive deflation. Such investments represent insurance against extreme outcomes and, as such, will be unproductive in the same way that fire insurance is unproductive if a house does not burn down. For example, we have maintained a position in oil and oil services. Even at $147 per barrel, worldwide oil production did not increase. The entire decline in oil prices has been driven by reduced demand. Our oil-related holdings are insurance against the possibility that oil will eventually sky-rocket in price as emerging market demand overwhelms stagnant to falling supply. Oil is also a hedge against a falling dollar and generalized inflation. So far, the insurance has been a cost, not a benefit.

Portfolio Construction

We continue to emphasize investments in high quality companies with relatively predictable earnings. In some cases, these predictable earnings stem from recurring revenue streams based on services with high renewal rates. Industries in this category include insurance, data processing and subscription software. In other cases, the companies provide or distribute consumable necessities like food and medicine. Replacement auto and industrial parts are near cousins to consumable necessities.

While our companies are not immune to earnings disappointments, we believe earnings will come closer to expectations than those of stocks in general. As indicated above, price/earnings multiples are at multi-decade lows. Stable to rising earnings combined with higher p/e multiples are a potent combination for stock price appreciation.

Balancing Act

As we noted in our past few letters, successful asset allocation must be financially sensible and psychologically sustainable. While we believe that stocks will return much more than bonds or cash over the next 5 to 10 years, the small but elevated possibility of deflation may argue for a more conservative allocation than in prior years. For those who do not need to maximize returns, a reduced exposure to stocks may make financial or psychological sense. In such cases, a balanced account combining stocks and bonds may be appropriate.

Please let us know if you have an interest in a balanced account.

Bernie Madoff

Given the financial carnage wrought by the alleged $50 billion Ponzi scheme operated by Bernie Madoff, investors may reasonably wonder if placing all or most of their investments with a single manager is wise.

We cannot speak for others but we have operational safeguards built into our relationships that make a fraud like that perpetrated by Madoff impossible.

As we understand it, Madoff's direct clients deposited funds into accounts with Madoff Securities. Indirect clients came through "feeder fund" partnership accounts from fund-of-fund "managers" like Fairfield Greenwich. Some of the indirect clients were never told that management consisted of nothing more than turning money over to Madoff. Madoff Securities apparently supplied bogus account statements and transaction records. Presumably, Madoff Securities also supplied the information about returns. Madoff's firm was audited by a tiny, storefront accountant. There were essentially no outside checks on Madoff's operation.

In contrast, every Scharf Investments client – direct and indirect – has an investment management agreement with us. Assets under our management are not farmed out (except for fully disclosed purchases of money-market or other mutual funds) or commingled. Client funds and securities are deposited into accounts held by reputable, well-known custodians who are completely independent of Scharf Investments. All subsequent activity settles in these accounts. We do not have access to the assets in client accounts other than to place trades, deduct fees and, where authorized, direct the custodian to disburse funds to the owner of record at the address of record or to bank accounts through electronic funds transfers which clients choose to set up. The custodian sends it own monthly statements, trade confirmations and 1099 tax documents. Clients generally have, if they want it, 24/7 on-line access to account information.

We send quarterly statements of account holdings, annual statements of realized capital gains and losses (for taxable accounts only) and performance reports. These reports are strictly supplemental and can be readily checked against the official records provided by the custodian. For additional protection, performance figures dating back to the beginning of 1997 have been audited by Ashland Partners, a leader in its field.

There are many things to worry about in the current investment climate but the reality behind the financial reports provided by an advisor should not be one of them.

Scharf Investments LLC

On a related topic, investors might also wonder about the health of their advisor given the bankruptcy of Lehman Brothers, the shotgun weddings of Bear Stearns and Merrill Lynch and the closures of hundreds, if not thousands, of hedge funds.

Insofar as Scharf Investments LLC is concerned, the news is reassuring. While assets under management declined in 2008, most of the decrease was due to market depreciation. Account retention remains strong and we continue to attract new clients. We remain profitable and stable. We have no plans to reduce personnel or cut services.

Business-related accomplishments in 2008 include: converting from a sole proprietorship to an LLC; re-emphasizing our balanced account offering with good acceptance; appointing a new COO Brian Krawez and new Chief Compliance Officer Nancy Gregg; and further penetrating the institutional marketplace to give the company a more diversified asset base.

We also completed our first full year with our four-person investment policy committee. Working together, Jerry Beyke, Brian Krawez, Eric Lynch and I are able to investigate more investment ideas and bring more experience to bear on the decision-making process.

Summary

2008 was the most difficult and traumatic year since I have been investing. The twin possibilities of deflation and inflation have driven risk aversion to extreme, although not completely unjustified, levels. Valuations in many markets – from stocks to municipal bonds – are exceptionally attractive compared to historical norms and should provide excellent returns if and when the chances of extreme outcomes fade. In the meantime, investors should consider owning positions at both ends of the deflation/inflation spectrum as insurance against the extremes. While the short-term outlook remains uncertain, we believe 3 to 5 year risk/reward ratios are extremely favorable.

Jeffrey R. Scharf
President

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