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A 36% rally off the March lows brought the benchmark Standard & Poor's 500 Index into positive territory for the first half of 2009. Even so, the stocks in our portfolios are selling for an average P/E of just 13.6 times estimated 2009 earnings. This is low by historical standards. Our earnings yield of 7.4% is very attractive compared to the 3.6% risk-free yield on 10-year Treasury bonds. Between further improvement in valuations and expected earnings growth, significant appreciation potential remains despite the concerns described below.

Executive Summary

It would be an understatement to say that the past eighteen months have been traumatic. It has taken great fortitude for investors to persist to this point and reap the benefits of the market's recovery from the panic lows in March.

We believe the future is much clearer than it was during the Lehman Brothers meltdown last September. For the U.S. consumer, the frugal future is here. Consumption is out. Saving is in. Therefore, we are concentrating our equity investments in high-quality companies with recurring revenue streams and international exposure. As noted above, our stocks are selling at attractive valuations and should have earnings growth despite the sluggish U.S. outlook. Risk/reward ratios remain highly favorable.

As for government policy, the U.S. has chosen the Japanese model of propping up the bankrupt thereby setting the stage for a prolonged period of domestic economic malaise. We expect a W-shaped recovery that moves in fits and starts as government tries to unwind its numerous interventions. This is likely to be accompanied by start-and-stop financial markets which offer opportunities to sell selected stocks at full value without necessarily presenting simultaneous buying opportunities. Thus, we expect cash to fluctuate more than it has in recent years.

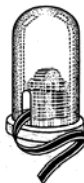
In balanced accounts, we remain wary of long-term bonds due to the risk of a dollar crisis that raises interest rates above current levels.

Looking for Love in All the Wrong Places

As gratifying as the blast-off from the March lows has been, we believe many investors are riding for a fall. Parsing the rally by sector, the table below shows that financials, industrials, materials and consumer discretionary were market leaders. These same groups were the primary beneficiaries of the hot house economy of 2003-2007. That five-year run was fueled by financial legerdemain, rampant real estate speculation and overconsumption funded with mortgage-equity withdrawals. The table also shows that less economically sensitive groups like consumer staples and health care stocks were laggards in the recent advance.

Price change from March 9, 2009-June 30, 2009:	
S&P 500	35.9%
Financials	91.9%
Industrials	44.0%
Materials	42.0%
Consumer Discretionary	44.9%
Consumer Staples	19.2%
Health Care	21.0%

Source: Standard & Poor's



It seems obvious to us that investors betting on a 2003-2007 re-run have it all wrong. The economy is not, as the introduction to the Lone Ranger put it, going to return to “the thrilling days of yesteryear.” In the U.S., 12% of home mortgages are delinquent. One can hardly pick up a copy of the New York Times or Wall Street Journal without reading a story about an unfortunate soul like Eileen Ulery. Ms. Ulery bought a condo in Phoenix for \$77,500 in 1997. She re-financed several times and now owes \$143,000. She lost her \$26,000 per year job and cannot make her \$1,000 per month house payment. The key point – and one repeated millions of times over – is that Ms. Ulery used her house as an ATM to spend an average of \$6,000 more per year than she was earning. For consumers as a whole, mortgage equity extraction peaked at nearly 8% of disposable personal income from mid-2005 to mid-2006.

Such overspending is history. The frugal future is here and businesses will be fighting consumer spending restraint for a long time. U.S. housing starts averaged 1.95 million per year from 2004-2006 versus a current run rate of 400,000. New light vehicle sales averaged 16.7 million per year from 2004-2007 versus a current run rate of 10 million. Value Line’s 5-year forecast for the U.S. economy predicts a return to boom levels in 2013 assuming a national savings rate of 2%. The savings rate has already risen from the 4% shown on the chart to 6% and we believe these or higher rates are more likely to constitute the “new normal.” Higher savings rates would further delay a return to peak production. As for financial companies, 2003-2007 profitability was mostly smoke and mirrors. Whether we or Value Line are right on the timing, it will be years before cyclical and financial companies return to their 2006-2007 sales and profit heydays.



So why should investors pay 14 times what Merrill Lynch’s analyst hopes a well-regarded cyclical stock will earn in 2011 when they can buy a household-name diversified health care company for 12 times what it is nearly certain to earn in 2009? We can’t imagine. We regard the cyclical stock rally as a huge “do-over” opportunity. We have been taking advantage by selling economically sensitive holdings at generous multiples in order to buy stable growth companies at attractive valuations.

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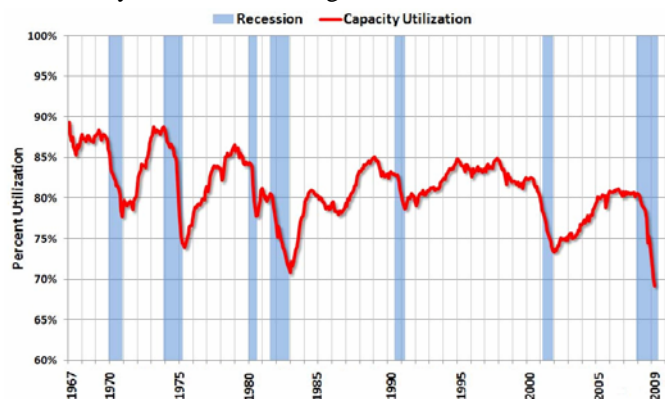
The Shape of Things to Come

The economic recovery predicted by Value Line might be described as U-shaped with six years elapsing before housing and autos return to prior peaks. The rapid recovery in cyclical stocks implies that investors believe a vibrant V-shaped turnaround is at hand.

Other possibilities include an L-shaped bottom where the economy scrapes along at a low level indefinitely or a saw-toothed “W” marked by intermittent bouts of growth and relapse. For reasons described below, we believe a V-shaped recovery is the least likely outcome.

In the typical post-WW II recession, the Federal Reserve raises interest rates to tame inflation. Borrowers shy away from big ticket purchases of cars and autos. Recession ensues. Weak companies fail. The Fed cuts interest rates. Pent-up demand for autos and houses is unleashed. The economy revives. Surviving businesses flourish.

Today, there is little pent-up demand for cars or houses. With their credit restricted and net worth plunging, American consumers are saving money at the highest rate in 16 years. In the business sector, commercial real estate is in a downturn. Factory utilization, as illustrated by the chart, is less than 70% of capacity reducing the need for capital expenditures. Conditions for a V-shaped rebound are nowhere to be seen.



Meanwhile, the government refuses to let economic nature prevail. Bankrupt insurers, auto companies and mortgage intermediaries operate under government ownership. Insolvent banks are propped up. Delinquent homeowners are kept in their overpriced houses. Instead of the two to three year “cold turkey” workout chosen by Sweden in the 1990’s, policymakers have adopted the “methadone” treatment of the Japanese. The result is a malaise that is likely to last longer and spread further than necessary.

In the normal course of events, the housing market would fall of its own weight. Overleveraged borrowers – many of whom have little or no equity in their houses – would go swiftly into foreclosure. These borrowers would exchange their high mortgage payments for lower rents. New home buyers would purchase affordable, inexpensive dwellings. The money that both groups would save in housing costs would give them more disposable income to spend on other items. Those at the epicenter of the problem – homebuilders, lenders, mortgage guarantors, etc. – would suffer grievously. But the shock waves affecting those outside the epicenter would be attenuated.

Alas, the course of events has been anything but normal. The government is propping up the housing market by expanding conforming loan limits, offering tax credits to new home buyers, extending 125% re-financing through various agencies, intervening in the bond market to keep interest rates low, bailing out lenders with TARP, TALF and PPIP, and launching mitigation programs. As a result, troubled homeowners and lenders resist property sales at market-clearing levels while prospective homebuyers sit on their wallets for fear prices will plummet once government support is removed. Ms. Ulery, from the New York Times story cited above, should have exchanged her \$1,000 per month mortgage payment for a \$600 per month rent payment long ago.

By keeping Ms. Ulery and others in their homes, the government transmits losses that would have been borne by the real estate sector into losses spread throughout the economy. Banks and bankers suffer less. The rest of the economy suffers more.

The “rescues” of two Detroit automakers are similarly wrong-headed. The superior financial claims of bond holders were sublimated to the interests of the United Auto Workers union. This will make it harder to attract distress financing in the future. With the U.S. taxpayer now owning 60% of its shares, largest U.S. automaker will be subjected to constant political meddling. Like Conrail, Amtrak and the GSE’s before them, these auto companies are sinkholes for taxpayers that siphon customers and jobs away from non-socialized competitors. Excess capacity lives.

These and other government interventions like “cash for clunkers,” tax rebates and pork barrel stimulus merely postpone the day when the economy can stand on its own. No prop can be withdrawn without the risk of relapse. The likely consequence is a start-and-stop economy similar to Japan’s. This would be consistent with a start-and-stop stock market.

Thus, stock prices are likely to meander through a wide trading range rather than make steady upward progress. This type of market is likely to present opportunities to sell selected stocks at full value without necessarily presenting simultaneous buying opportunities. This may result in cash positions that are bigger and fluctuate more than in past market cycles. It may also result in occasional purchases of non-equity investments like bonds or preferred stocks in equity accounts. This would occur if we believe the alternatives have the potential for equity-like returns. This trading range theme is added to our previous investment themes.

Current Themes

As a reminder, these other themes are:

- High quality: Companies with good balance sheets and business models should be better able to navigate through difficult circumstances
- Recurring revenue: Products that are consumed or services that function like subscriptions are likely to generate steady revenue through good times and bad
- Global footprint: Developing economies are likely to grow faster than the domestic economy and provide currency diversification
- Purchasing-power protection: See below

Stocks, Bonds, Inflation

Ronald Reagan supposedly said, “Deficits don’t matter.” When domestic savings finance government borrowing, this is largely true. It is total government spending, whether out of cash or out of borrowing, that matters.

Unfortunately, a Blanche DuBois economy that relies on the kindness of strangers is different. We depend on the Chinese and other foreigners to finance our profligacy. They may get tired of buying our debt causing the dollar to fall and interest rates to rise. Or we may get tired of paying them and decide to inflate away the value of our debt.

Without policy changes, we are confident that one or both of these things will happen although we don’t know when. We believe gold represents a dollar and inflation hedge. Our multinational and non-U.S. companies give us further protection against trouble at home. Finally, many of our stocks have pricing power that should help them navigate through inflation. This pricing power should produce earnings increases that ameliorate the lower price/earnings multiples associated with higher interest rates and inflation.

In balanced accounts, our long-term debt is limited to an amount consistent with providing diversification in case inflation stays low for a long time. Our long-term exposure was generally unchanged during the quarter as we substituted other issues for our mortgage-backed securities fund.

We have a significant amount of unallocated fixed-income cash in some balanced accounts. Spreads on our preferred investment vehicle are too narrow to warrant a full new purchase commitment. We believe we will be able to buy on more attractive terms at a later date. While it is frustrating to hold cash that pays next to nothing, we would rather be frustrated than put principal at risk by overpaying.

Scharf Investments Update

We are pleased to announce that Loren Kinczel has joined Scharf Investments as a Director of Client Relations. Before joining us, Loren performed equity research for Farallon Capital Management L.L.C., a leading multi-billion dollar hedge fund, and Belden and Associates Investment Counsel. Prior to that, Loren worked with a venture capitalist on new enterprises serving the financial services industry. He has invested privately since 1994.

Loren graduated with honors from Harvard University with a Bachelor of Arts Degree and earned an M.B.A. from the Haas School of Business at UC Berkeley.

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President