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The continuing rally off the March 2009 lows left the benchmark Standard & Poor's 500 Index at nearly the exact same level as *September 30, 1999.* After ten years and two bursting bubbles – the Internet/Nifty Fifty bubble of 2000 and the real estate bubble of 2005-2006 – investors should at least be richer in experience, if not in wealth.

Lessons Learned

"One month trading stocks is worth two years at Harvard Business School."- Wall Street aphorism

If this is true, anyone buying or selling stocks over the past twenty-one months more than qualifies for a Ph.D. Here are a few lessons that investors should find valuable going forward:

1. To thine own self be true: Investors need to understand their own tolerance for risk and develop an investment program that is financially suitable and psychologically sustainable. It does no good to have a sound financial plan that is overturned in the midst of adverse market conditions. If the events of the past two years have shown anything, they have shown the importance of re-assessing risk tolerance and adjusting asset allocation pro-actively rather than reactively. Given the recovery in stock prices and relative calm in the market, this appears to be a particularly good time for a financial re-examination. We can help.

2. Losing small is more important than winning big: We believe a key to investment success is losing less than the market during declines. This has two positive effects. First, controlling losses makes recovery easier. It takes a 100% gain to recover from a 50% loss. It takes a 25% gain to recover from a 20% loss. Second, controlling losses makes it easier to remain invested. An investor who loses 25% is more likely to be around for the recovery than the investor who loses 50%.

3. Investors are not rational: Stocks represent financial interests in corporations. These financial interests have a value that is independent of the stock price on any particular day. That value is based on the long-term earnings and dividend-paying power of the company. When investor psychology drives prices irrationally above long-term value as happened with technology stocks in 2000 or irrationally below long-term value as happened to most stocks in March 2009, the successful investor must resist giving in to herd mentality.

4. Less risk = more reward: Too many investors take chances for which they are not compensated. Given our long history of outperformance while owning stocks with below-average earnings risk and below-average price volatility, we think we know whereof we speak.

Lessons Ignored

The primary characteristic of the 2003-2007 bull market was insensitivity to risk. At the market peak, the riskiest stocks were generally selling at the highest multiples of earnings as investors bet on a never-ending continuation of debt-induced economic growth.

One would have thought that the horrific decline of 2008 would have killed off the appetite for risk. But no-o-o. Like Freddy Kreuger, risk-taking is back. Over the past six months, C and D-rated stocks in the Merrill Lynch universe have returned 105% compared to the 38% return of A+-rated stocks. Within the S&P 500, the best performing groups have been financials, industrials, consumer discretionary and materials. The price/earnings ratio of the median stock in the Value Line Universe has risen from 10.3 in March to 17.5 while estimated 3-5 year appreciation potential has fallen from 185% to 55%.

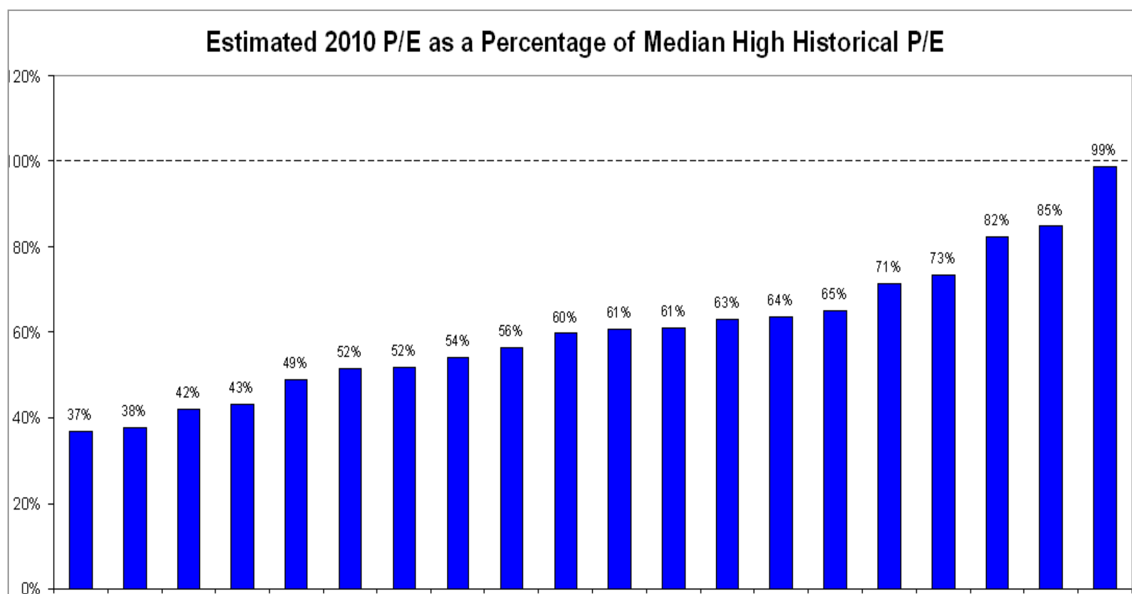
The remarkable recovery in economically-sensitive stocks has been driven by earnings expectations that we view as wildly optimistic. For example, 2010 earnings for the Value Industrial Composite are estimated to be only 9% lower than earnings in 2007. Given Value Line's own projections that unemployment will average 10% in 2010 versus 4.6% in 2007, auto sales will total 10.9 million units versus 16.1 million units, and housing starts will total 860,000 versus 1.34 million, even Maxwell Smart would find this hard to believe. Earnings estimates for the S&P 500 seem similarly implausible.

Perhaps investors paying high multiples for economically-sensitive stocks are right in proclaiming "Happy Days are Here Again." But we doubt it.

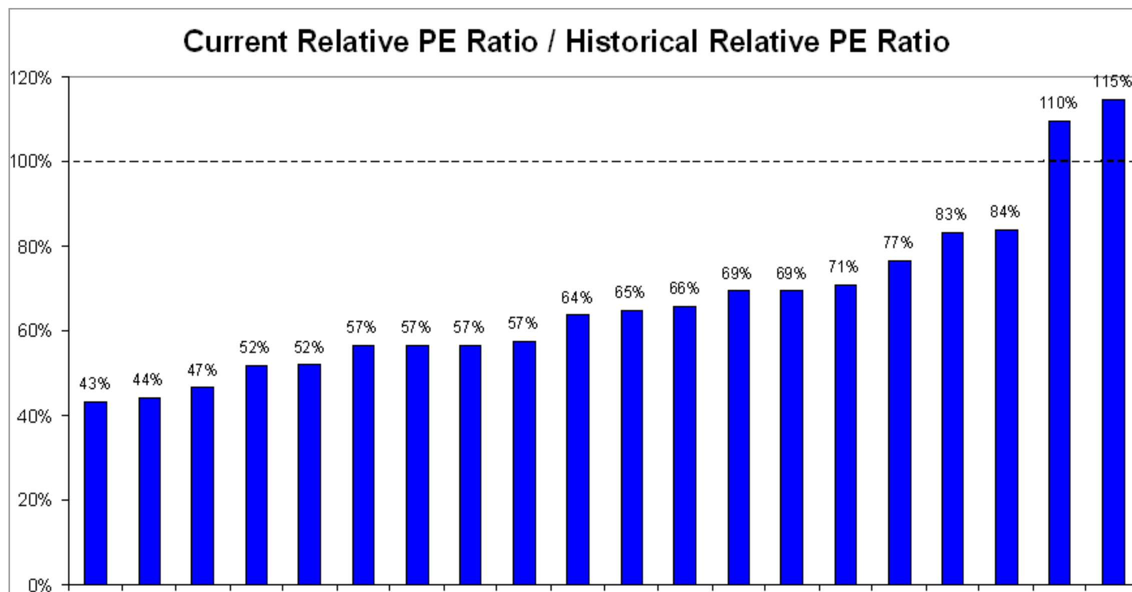
Our Portfolios

The economic developments of the past three months have not changed our view that the U.S. economy is in for a prolonged period of malaise. "Cash for clunkers" and tax credits for new home purchases have pulled demand for cars and houses forward. This has put the economy on a "sugar high" that will soon wear off. Investors paying high multiples of expected earnings for companies dependent on a V-shaped economic recovery are likely in for severe disappointment.

At the same time, high-quality companies with recurring revenues and global footprints – or, to put it more baldly, our portfolios – are selling at discounted valuations on relatively predictable earnings. We look at these discounts in several ways. First, we compare the estimated 2010 P/E of each stock to its own historical median high P/E. As the table below indicates, only one stock – which is the subject of a takeover offer - looks fully valued. Our other holdings are selling for 38% to 85% of their historical high P/Es. If earnings come through and median high P/Es prevail, appreciation potential ranges from 20% to 150%. Although we do not expect this best case scenario to play out, we believe risk/reward ratios remain very favorable.



We also look at the valuations of our holdings compared to the 1700 stock Value Line Composite. This statistical series uses the past six months of reported earnings and six months of projected earnings. On a relative basis, all but two of our stocks are selling at significant discounts to their usual valuations. Again, appreciation potential is large and risk/reward favorable.



Finally, we compare the earnings yield of our stocks to risk-free returns. Our average P/E is 13.8 times 2010 earnings estimates. Our 7.3% earnings yield is very attractive compared to a return of 3.3% on 10-year Treasuries.

Can our stocks go up while other sectors of the market tread water or sink? In the long run, we are confident the answer is, "Yes." In the short run, we don't know. In 2000 and 2001, our stocks went up even as the tech bubble imploded. In 2008, we did much better than the market but still suffered losses.

A Word About Balance

Volatility in the stock market is a fact of life. The extra returns that have historically accrued to stockholders versus bond investors are the reward for putting up with events like those of the past two years. For investors who can live with volatility, we believe the right stocks will outperform bonds in the years ahead.

On the other hand, the twin 50% declines in the S&P during the past decade may be sufficient reason for investors who do not need extra return and want a lower degree of volatility to lower their commitment to stocks. Adding a bond component to a portfolio provides an anchor that should reduce fluctuations upward and downward. Our balanced accounts are designed with this goal in mind.

As one might expect, the bond component of our balanced accounts is risk-averse. Bond market risk comes from three main sources: interest-rate risk, credit risk and reinvestment risk. We generally concentrate on shorter maturities and inflation-adjusted issues to ameliorate interest-rate risk; government and highly-rated securities to ameliorate credit risk; and staggered maturities to ameliorate reinvestment risk. The equity portion of a balanced account is the place to seek high returns. The bond portion is the place to seek security and preservation of principal. When the opportunities to buy bonds on attractive terms are present, we are aggressive buyers. When opportunities are not present, we are content to preserve capital in cash and wait.

Scharf Investments Update

We continue to add staff to keep up with our growing client base. To this end, we are pleased to announce that Alex Herring has joined Scharf Investments as a research associate. In addition to providing research assistance, Alex regularly performs duties in sales and operations. Alex earned a Bachelor of Science in Economics from the Wharton School of the University in Pennsylvania in May 2009 with concentrations in Finance and Operations & Information Management.

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