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April 5, 2009

Recent events have reinforced our belief in our portfolio themes: low valuation, recurring revenue, high quality, global footprint. To these, we have added inflation protection. Let us look at each in turn.

## Valuation

*“Today's global crisis - a loss on paper of more than \$50 trillion in stocks, real estate, commodities and operational earnings within 15 months - cannot be explained only by the default on a meager 7% of subprime mortgages (worth probably no more than \$1 trillion) that triggered it. The real villain is the lack of trust ... [T]he Bank for International Settlements estimates ... \$1 quadrillion worth of new derivatives (mortgage-backed securities, collateralized debt obligations, and credit default swaps) ... have flooded the market... Nobody knows precisely how many there are, where they are, and who is finally accountable for them. Thus, there is widespread fear that potential borrowers and recipients of capital with too many nonperforming derivatives will be unable to repay their loans.” – Hernando de Soto in the Wall Street Journal, March 25, 2009*

As hard as it is to believe, we are 18 months into the current decline and still don't know how big overall credit losses are or who is holding the bag. Investors have adopted the attitude of the fictional French Inspector Jacques Clouseau – they suspect everyone. Nevertheless, it seems indisputable that aggregate stock market losses greatly exceed any reasonable estimate of actual economic impairment.

Thus, high quality companies with predictable earnings, favorable demographics and sound business models may be purchased with current earnings yields of 8-12% compared to yields in the 3% range for intermediate risk-free Treasury bonds. Current dividends alone often exceed Treasury yields giving investors a free option on retained earnings and future dividend increases. Risk/reward ratios this favorable do not come along often and we believe investors who can take a long-term view will be amply reward for persevering through the current despond.

## Recurring Revenue

In the typical post-WW II economic cycle, the Federal Reserve raises interest rates to keep the economy from overheating and inflation from taking hold. Higher interest rates discourage spending and encourage saving. Sales of debt-financed items like cars and houses are particularly hard hit. Unemployment rises and sales slow further. Recession ensues.

The Fed then lowers interest rates. Pent up demand for housing and autos results in increasing sales and economic activity. The Fed keeps the pedal to the metal too long resulting in overheating and the cycle begins anew.

As the chart below indicates, the low, low, low interest rates of mid-decade fostered a debt bubble of unprecedented proportion relative to GDP. Overconsumption ran rampant. The U.S. savings rate turned negative. We spent more than we earned using houses as ATMs to finance life-styles we could not afford. This could not go on and, as economist Herbert Stein once quipped, “Things that cannot last forever stop.”





This usual remedy of reduced interest rates will not cure today's economic woes because there is no pent up demand and will not be for quite a while. Americans need to focus on paying off debt, not taking on new debt. We have more houses than households; more cars than drivers; more "stuff" than savings.

For this reason, we continue to emphasize investments in companies with recurring revenue streams at a remove from domestic discretionary spending. Data processing and software licensing are two such businesses. Insurance, food, health care and phone service are others.

### High Quality

The predominant feature of the financial markets prior to the recent turmoil was insouciance toward risk. Abundant, inexpensive financing enabled highly-leveraged companies dependent on external borrowing to flourish. That model is broken. As debt-ridden competitors cut back or close their doors, customers will necessarily flock to the high-quality survivors.

### Global Footprint

Where the U.S. has a spending problem, developing countries like China have a savings problem. The Chinese save an estimated 40% of income. As Chinese exports to the U.S. diminish, growth will slow unless internal consumption picks up the slack. We believe this will happen. Because countries like China are starting at low levels of income and consumption, their growth should be faster than ours even after recovery begins in the U.S.

Another reason for global investing is the risk of a run on the U.S. dollar. It pains us to observe that the Federal Reserve's bail-out efforts and quantitative easing have expanded its balance sheet by \$1.3 trillion dollars with greater increases looming. Meanwhile, the federal budget deficit is spiraling out of sight with a \$410 billion spending bill and \$787 billion "stimulus" package signed into law since January. The U.S. government is hooked on debt and our foreign suppliers are growing restive.

U.S. government intervention in our domestic economy is another negative. As U.S. consumers kick their borrowing habit, the government could allow the economy to go “cold turkey” providing only critically needed support in the form of deposit guarantees and income maintenance. Instead, the government has been administering economic “methadone” in the form of ad hoc, temporary programs designed to ameliorate the symptoms of overindebtedness without eliminating debt. It supports overleveraged financial institutions at huge expense. It keeps house prices above market-clearing levels by minimizing down-payments and suppressing interest rates. It offers temporary tax credits for new home purchases and temporarily raises the ceiling for Fannie Mae/Freddie Mac conforming loans. It keeps auto companies on life support and may enact temporary tax incentives for the purchase of new cars. It uses TARP to “encourage” banks to lend as if more borrowing is the way out of the mess. Not only do these interventions add to uncertainty as to who the government will save and who it will not, it keeps the economy in an economic netherworld awaiting the indeterminate moment when government support is withdrawn. Although last week’s rhetorical dose of tough love directed at two of the Detroit automakers was encouraging, actions will speak louder than words. We believe ending intervention will take more time rather than less. It will be a stop-and-go process and the economy will not be truly healthy until artificial supports are removed.

### Inflation Protection

We have long believed that avoiding a repeat of the 1930’s is the bedrock economic policy of the United States. All the steps taken in the past year confirm our view. From bailouts to quantitative easing, the goal is to reflate the economy. Possible side effects of flooding the markets with dollars include inflation or a dollar crisis or both.

Although we have owned the occasional diversified mining stock, we made our first foray more directly into gold last quarter. Historically, gold offers protection against inflation, a weaker U.S. dollar, global instability and, surprisingly, deflation. Although gold is stereotypically viewed as the province of survivalists and other doomsayers, Jerry Beyke, our senior analyst who researched this topic, believes gold stands a good chance of becoming an accepted mainstream investment with significant upside potential. Portions of Jerry’s analysis follow:

Before he became Federal Reserve Chairman, Ben Bernanke gave a very revealing and, as it turns out, prophetic speech in 2002 entitled “*Deflation: Making Sure It Doesn’t Happen Here.*” In that speech, Bernanke made it abundantly clear that, if a severe debt-deflation cycle took hold in the U.S., he would see it as his solemn duty to be our nation’s fireman doing *whatever it took* to put the fire out. Bernanke clearly said that it is appropriate and necessary for the Federal Reserve to *err on the side of inflation* rather than sit idly by in the midst of a 1930’s-style deflationary spiral. What Bernanke specifically said was [and we have highlighted some parts for emphasis]:

Under a fiat (that is, paper) money system, a government should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero... U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, **under a paper-money system, a determined government can always generate higher spending and hence positive inflation.**

The effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities. A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. **A money-financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money...** Of course, in lieu of tax cuts or increases in transfers the government could increase spending on current goods and services or even acquire existing real or financial assets. If the Treasury issued debt to purchase private assets **and the Fed then purchased an equal amount of Treasury debt**

**with newly created money**, the whole operation would be the economic equivalent of direct open-market operations in private assets.

In our view, the more the government uses its printing press, the more investors are likely to take a shine to gold as an asset class. At a Financial Analyst's Society meeting in San Francisco entitled "*The Strategic Case for Investing in Gold*," we were surprised to learn that only 20% of the annual demand for gold from 2004-2008 was investment-related. In fact, 68% of the demand came from jewelry and 12% from industrial uses. Looking back, however, we know that *investment*-related demand for gold accelerates when investors become worried about inflation. About 30 years ago, apprehension about inflation ran so high that investment-related demand accounted for more than 50% of annual demand. For perspective, gold now trades at about \$900 per ounce while the peak price for gold in 1980 was roughly equal to \$2,300 per ounce in today's dollars. Without knowing when this will happen, it would not surprise us if history were to repeat resulting in a significant increase in investment-related demand for gold.

### Summary

Stock market valuations remain favorable where earnings conviction remains high. We believe that conviction comes most easily in self-financing companies with recurring revenues or consumable products. We believe global exposure is a benefit as the world economy may recover sooner and grow faster than the U.S. economy. Global exposure also offers protection against a weaker U.S. dollar. While we believe the threat of a 1930's style Depression – which was small to begin with - has receded, the risk of a return to 1970's style inflation has increased significantly. While stocks at current levels offer meaningful inflation protection – earnings would probably increase fast enough to offset lower p/e multiples – exposure to gold seems warranted.

Within the bond market, we believe municipal bonds remain very attractive. Spreads on Inflation-protected Treasuries and GNMA's have moved into neutral territory. Gold is particularly important as a hedge against the damage that inflation could do to fixed-rate holdings.

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President