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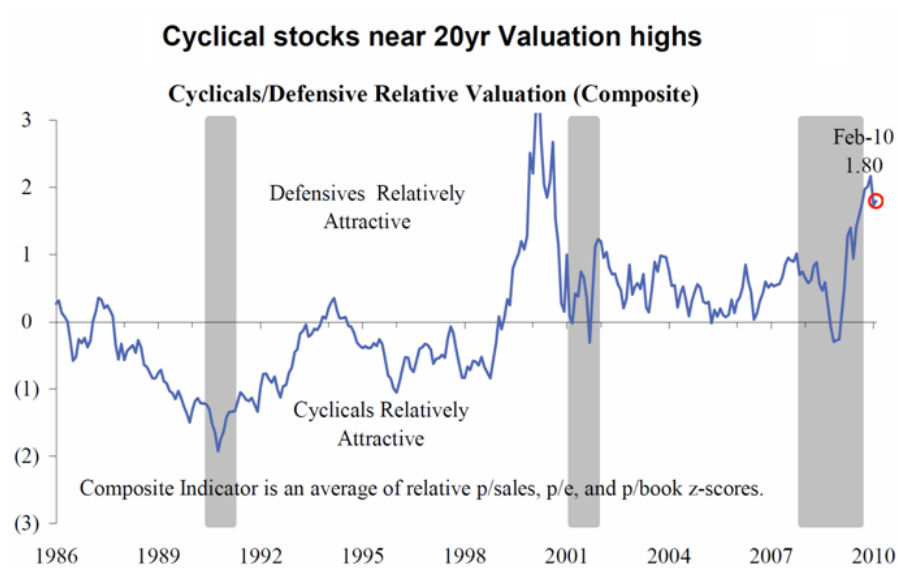
Scharf Investments' annual client appreciation events attracted full houses in Cupertino and Santa Cruz. We look forward next year's events.

Distant Replay

The stock market advanced nicely in the first quarter with the S&P 500 and Lipper Balanced Fund indices returning 5.4% and 3.8%, respectively. However, neither index has fully recovered from the losses incurred in 2008. The S&P needs a further advance of 19% to get back to January 1, 2008 levels while the Lipper needs an additional 6.5% advance.

Looking below the surface, investor behavior in the first quarter echoes the behavior of the good old days of 2003-2007. The VIX Index, which is a proxy for uncertainty, has fallen from 89 at the height of last year's panic to 16. The spread between interest rates and inflation is extremely narrow as are spreads between Treasury debt and corporate debt. The riskiest stocks, as epitomized by the Merrill Lynch C&D Universe, are advancing the most. Groups sensitive to economic growth – industrials, consumer discretionary and financials – rose more than 10% in the first quarter compared to gains of less than 5% for stocks least dependent on growth like consumer staples and health care. As the chart below indicates, the valuation gap between cyclical stocks and "defensives" is unusually wide.



Source: Factset, Morgan Stanley Research

This behavior tells us that investors believe prosperity in the form of a V-shaped economic recovery is just around the corner. We believe the economy has been stabilized by government-administered "methadone" but is far from healthy. Following in the footsteps of Japan, the U.S. government is propping up asset prices by suppressing interest rates, discouraging foreclosures, offering 3.5% down-payment mortgages and providing temporary home buying incentives. We are keeping zombie financial organizations including Fannie Mae and Freddie Mac alive while creating a potential new zombie at the FHA. We are spending billions of dollars on non-stimulating stimulus. We cut taxes on one hand – can you say "Cash for Clunkers?" - and raise them on the other.

In Japan, policies like these have produced paltry real economic growth of 0.7% per year since their twin real estate and stock market bubbles burst in 1989. Because the U.S. has better demographics, we expect better growth here. But we would not be surprised to see a prolonged period of sub-par economic malaise.

Covering the Bases

Given the attractive valuations of defensive stocks and our subdued economic outlook, our portfolios are weighted toward companies whose fortunes are not dependent on robust domestic growth. Companies with recurring revenues – particularly if a significant percentage comes from faster-growing emerging markets – are our majority focus. Other desirable characteristics include predictable and growing earnings, low valuation, low-risk business models and overall financial strength.

As a hedge against other outcomes, we own energy stocks in case oil prices climb; gold as protection against an outbreak of inflation or a run on paper currencies; and a smattering of industrial and consumer cyclicals in case the V-shaped recovery materializes.

Balancing Act

The Federal Reserve has been suppressing interest rates for the better part of a year. Even with rates touching multi-decade lows, investors poured money into bond mutual funds. Since April 2009, $417 billion has gone into bond funds vs. $59 billion into stock funds. This is not a good sign for bonds as mutual fund investors typically exhibit terrible timing, buying high and selling low.

If interest rate spreads normalize, as we think they will, bond investors may experience an unpleasant decline in the value of their holdings. While we retain some traditional bonds in case rates and spreads stay low longer than we expect, our largest bond holdings are inflation-adjusted Treasuries. We also retain considerable uninvested cash awaiting better opportunities.

Summary

Wee Willie Keeler, one of the greatest hitters in baseball history, explained his success this way: "I hit 'em where they ain't." Investing is much the same. The object is to find value where other investors "ain't" and wait for them to arrive.

In today's market, investors "ain't" in the steady defensive stocks that historically sell at premium valuations but currently sell at discounts. In the bond market, investors "ain't" waiting for spreads relative to inflation and quality to normalize.

While we remain open to contrary evidence, we believe that attractively valued non-cyclical stocks and conservatively positioned bonds are the areas to emphasize.

Jeffrey R. Scharf
President