

# SCHARF INVESTMENTS LLC

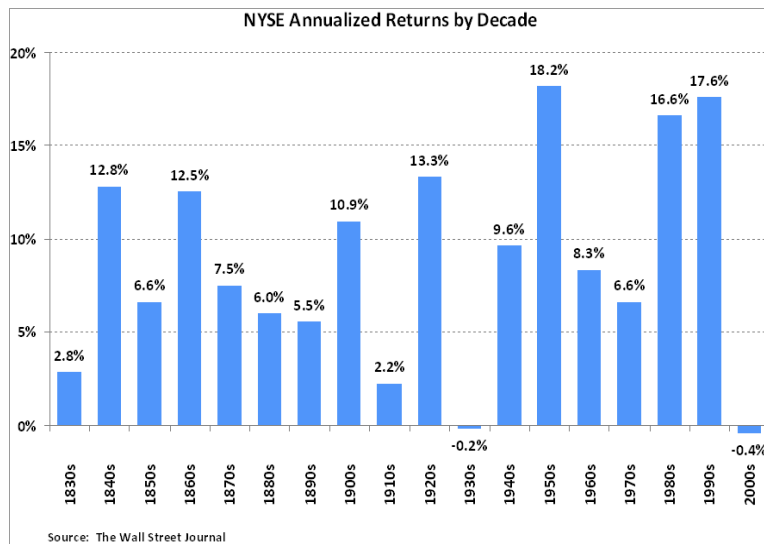
REGISTERED INVESTMENT ADVISOR

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Dear Clients:

The “aughts” were for naught. As the chart below shows, the ten years just ended were the worst calendar decade ever for U.S. stocks. Issues traded on the New York Stock Exchange *lost* approximately 0.4% per year compounded. These results were even worse when adjusted for inflation, as NYSE stocks lost an average of 3.2% per year in the aughts compared to the previous record 1.4% per year inflation-adjusted loss of the 1970’s.



These returns would have been much worse without the 73.95% huge rally that took the NYSE composite from down -26.09% on March 9<sup>th</sup> to up 28.57% for the year.

## 2010 Outlook

As the market described above indicates, a signal feature of 2009 was the wide range of potential market outcomes. A “fat-tail” event like a second Depression became a real possibility. While the most extreme risks appear to be mitigated going forward, the range of potential outcomes remains enormous. The economy could experience anything from a Japanese-style “lost decade” to a typically robust post-World War II expansion. We could have anything from mild deflation to 1970’s inflation. The dollar could recover or collapse. Interest rates could remain low for years or take off as investors rebel against U.S. fiscal irresponsibility.

In short, these are the times when we, like Harry Truman, yearn for a one-armed economist who would not say, “On one hand, GDP is growing again. On the other hand, much of the growth is dependent on government bailouts and incentives.” Alas, today’s economist needs to be an octopus to encompass all the possibilities.



We, as portfolio managers, need to be octopi as well. We need a base case scenario where we place the bulk of your assets along with placeholders that benefit from alternate outcomes.

Our base case is this:

- 1) The U.S. follows the path of Japan in the 1990's. We squander stimulus dollars, raise taxes, keep zombie financial institutions alive, prop up asset prices artificially and engage in a series of "now you see them, now you don't" economic incentive programs
- 2) International – particularly non-European – economic growth is faster than ours
- 3) The dollar loses stature
- 4) U.S. consumers save more and spend less

Thus, our base case equity investments emphasize companies with:

- 1) Global exposure
- 2) Non-cyclical, recurring revenues
- 3) Limited reliance on U.S. discretionary consumer spending
- 4) Predictable earnings
- 5) High-quality, low-risk business models

As indicated above, our goal in constructing portfolios is not to be precisely right by putting all our chips on one outcome. Our goal is to be prudent. We want to prosper if we are right and muddle through if we are wrong. We hope to emulate Warren Buffett who looked back on 2009 and said, "We didn't do all the smartest things [but] we didn't do anything really dumb." As such, we continue to have some exposure to consumer discretionary spending and industrial recovery in case the economy turns out to be stronger than we expect.

For balanced accounts, our base case bond investments emphasize:

- 1) High quality
- 2) Inflation-protection
- 3) Tax-free income
- 4) Special situations

#### Risk vs. Reward

We are more confident in our stocks than we are in the market as a whole. On average, our stocks have historically had a median high P/E of 23.3 times earnings. Today they sell for 15 times 2010 estimates. They have historically sold at 120% of the multiple of the Value Line Universe. Today, they sell for 85%. Will these gaps narrow? We believe they will. Will the gaps narrow with our stocks going up while the market goes down as happened in 2000 and 2001? Or will the gaps narrow with our stocks going down less than the market as happened in 2002 and 2008? Or will our stocks go up more than the market? Here, our crystal ball grows dark. However, we are confident that our portfolios can continue to meet our objective of meaningfully outperforming relevant benchmarks over the course of a market cycle.

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President