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Greek Tragedy

As discussed at our annual client event, it is doubtful that any investors in the year 2000 foresaw the many extraordinary events of the decade to come: the 9/11 terror attacks; the housing bubble, the bankruptcies of AIG, Fannie Mae and Freddie Mac; the government takeover of General Motors; etc. Investment success in the “Aughts” was not based on predicting these events at the outset of the decade but in reacting appropriately as events unfolded.

Similarly, the Greek credit crisis was on few radar screens at the beginning of 2010. The initial earthquake has shaken the markets and the aftershocks may go on for years.

To put it briefly, most Western economies – including the U.S. – are running unsustainable budget deficits. The problems are particularly acute in the so-called PIIGS – Portugal, Ireland, Italy, Greece and Spain. Not only are the budget gaps large in these countries, they are all tied to a currency – the Euro – that they cannot print or devalue. As investors flee and interest rates soar, debt payments may become economically and/or politically unbearable.

To date, the healthy members of the European community – primarily France and Germany – have stepped in to backstop Greek debt in an effort to keep the panic from spreading to the other PIIGS. This TARP-like program may or may not succeed. In any case, the Greek situation has focused the attention of governments almost everywhere. Budgets are being cut and/or taxes raised across Europe in an effort to get fiscal houses in order. Even the U.S. seems to have gotten the memo with the latest \$100 billion “stimulus” package stalled in Congress.

These events reinforce our opinion that governments and consumers have spent money “not too wisely, but too well.” Whether it is called the “frugal future” or the “new normal,” economic recovery is likely to be slow and sluggish as spending recedes and savings rates grow. In such an environment, we are sticking to our equity themes. These are: recurring revenues, predictable earnings, emerging market exposure, limited exposure to U.S. consumers, low valuations and high quality.

In the bond portion of balanced accounts, we continue to favor inflation-protected bonds, security of principal, selected municipal bonds and special situations. Many accounts have significant cash-on-hand awaiting better opportunities.

Recent Activity

In response to evolving conditions, we had an unusually active quarter realigning portfolios. We reduced our consumer exposure, our banking exposure and our economically-sensitive exposure. We increased our holdings in food and healthcare-related; added a greatly undervalued special situation conglomerate; and took advantage weakness abroad to add two global multinationals.



The Rule of 18

Price/earnings multiples and inflation have an inverse relationship. When inflation is high, p/e's are low and vice-versa. In 1980, inflation was 13% and the Value Line had a median p/e of 7.5. From 1996 to 1998, inflation averaged 2% and the average median p/e was 16.7. For the period 1973 to date, inflation plus p/e ratio has averaged 18.

For the twelve months ended in May, U.S. consumer prices rose 2%. Thus, the current Value Line p/e of 16.2 is almost exactly in line with historical norms.

The p/e's of our holdings are a different story. At quarter end, our average common stock p/e based on Value Line's 2010 earnings estimates stood at 12.8, our relative valuation at 0.79 compared to a historical average of 1.12, and our median earnings predictability at 95 on a scale where 100 represents the highest predictability. Everything else remaining constant, a return to historical valuations would represent both a 40% gain and 40% outperformance for our holdings. We do not cite these prospective gains as expectations but rather as illustrations of the very favorable risk/reward profile of our holdings.

Parenthetically, inflation plus the p/e of the S&P 500 has added up to 20 over the past 50 years making our stocks severely undervalued by this measure as well.

Summary

While we could be entering an era where p/e's are permanently depressed due to economic uncertainty, we believe the situation is more likely to resolve itself in other ways. Earnings might fall short of estimates. Inflation might accelerate. Or p/e's and stock prices might rise. For our stocks, at least, we believe the third factor will dominate although we are loathe to predict the timing. Even allowing for some discount to historical norms, upside/downside ratios are highly favorable with any movement back toward normal valuations representing worthwhile appreciation from current levels.

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