

No Surprises

Successful investing is often more about losing small than it is winning big, says Scharf Investment's Brian Krawez, who has the track record to back that up.

INVESTOR INSIGHT



Brian Krawez
Scharf Investments

Investment Focus: Seeks companies with relatively predictable earnings when their stocks are trading at the very low end of their historical valuation ranges.

Before he hired Brian Krawez in 2007 to take the portfolio reins of the investment firm he founded 25 years earlier, Jeffrey Scharf asked to see every trade Krawez had made since 1995. "The overlap in how we invested was pretty impressive," says Krawez.

With a clear preference for predictability over panache, Krawez is finding opportunity in a wide variety of areas, including auto parts, pharmaceuticals, precious metals, DNA testing and defense. [See page 11](#)

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THE SCHARF FUND

NASDAQ: LOGIX

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TOP TEN EQUITY HOLDINGS AS OF 03/31/12*

APPLE, INC.	5.10%
NOVARTIS AG - ADR	4.99%
BARRICK GOLD CORP.	4.96%
MICROSOFT CORP.	4.95%
VODAFONE GROUP PLC - ADR	4.94%
ADVANCE AUTO PARTS, INC	4.87%
TOTAL SA - ADR	4.85%
MCKESSON CORP.	4.46%
CHEVRON CORP.	4.00%
SANOFI - ADR	3.89%

* Percentage of Fund net assets

Investor Insight: Brian Krawez

Scharf Investments' Brian Krawez and Loren Kinczel explain the two key metrics on which they focus to limit downside, the primary reason they walk away from demonstrably cheap stocks, when they'll override their screens to buy something, and why they believe Advance Auto Parts, Novartis, Life Technologies and Lockheed Martin are mispriced.

-You put a lot of emphasis on the valuation screening you do to identify ideas. What specifically are you looking for?

Brian Krawez: If you think about the components of a stock's return, you've got three: dividends, earnings and the multiple put on those earnings. Dividends are more or less known, so there's not a lot of work to do there. That leaves us focused in our research on prospective earnings and multiples.

Since we're trying first and foremost to limit our downside, our valuation screening is centered on where a stock is trading relative to its own history. We look at various measures, but we basically go back as far as we can and calculate for each calendar year the high multiple of cash flow, say, and the low multiple of cash flow at which the stock traded. (The cash flow number we use is for that entire calendar year.) From that, we determine the median high multiple over the entire history and the median low.

We'll then look at the upside to that high and the downside to that low from today's multiple on current-year estimated cash flow and calculate what we call a "favorability" ratio. We want to do further work only on companies where the favorability ratio is at least 3:1, meaning the upside to the median-high valuation level is at least 3x the downside to the low. In other words, for the multiple part of the return equation, we want the odds in our favor.

For example, in mid-2009 Advance Auto Parts [AAP], the auto-parts retailer, was trading at 8.1x cash flow. That was very near its median low annual cash flow multiple since it started trading in 2001 of 7.9x. The median-high multiple was 11.8x. So just from a valuation perspective, this implied roughly 45% upside to the historical high and 3% downside to the historical low, a 15:1

ratio. Those are the types of situations that get our attention.

The second primary aspect of our screening focuses on earnings predictability. *Value Line* actually calculates a measure of that by looking at historical earnings volatility over the past eight years, giving each company it covers a score from zero to 100. Companies rated with high earnings predictability – scoring say 90 and above – tend to have profits that progress in a more or less stair-step pattern.

We haven't yet done our fundamental research at this point, but we believe we'll be better able to predict future earnings of companies that have had more predictable earnings in the past. Back again to the components of a stock's return, we want to improve our chances that we get the earnings piece right. We think this emphasis on predictability also protects us on the downside.

Once you've culled the herd, where does your research focus?

BK: Companies rarely get cheap without a reason, so we're first and foremost trying to understand what the issues are. That requires a full understanding of the industry, the competitive set, the cycle, the business model, the strategy and management. Once we've identified the reasons it's cheap, we have to be able to argue why the concerns aren't valid or are overstated.

CVS Caremark [CVS], which we still own, is a good example. The market had gotten more or less fed up with the company in mid-2010 because the promised benefits of combining CVS's drugstore business and Caremark's pharmacy benefits management [PBM] business didn't appear to be panning out. In particular at the time, Caremark was losing some large PBM contracts, which had people wor-



Brian Krawez

Basic Training

The best-known training ground for successful investors is probably Julian Robertson's Tiger Management, whose "Tiger Cubs" include such luminaries as John Griffin, Stephen Mandel and Lee Ainslie. Far less known but similarly prolific, however, was Siegler, Coltery & Co., where Scharf Investments' Brian Krawez first learned investing after starting his career as an investment banker. Among other SC alumni: Greenlight Capital's David Einhorn, Ivory Capital's Curtis Macnguyen, Yale Fergang of Royal Capital and Scott Bommer of SAB Capital.

The secret to SC's being a great place to learn? "The principals had worked at Dillon, Read and for Carl Icahn and focused on the deep fundamental research you'd do on a company if you were looking to own all of it," says Krawez. Einhorn elaborates in his book, *Fooling Some of the People All of the Time*: After presenting his research file on a company to co-founder Peter Coltery, "The next morning he returned to work having read everything and made a detailed list of questions that I wished I had asked," writes Einhorn. "When I started, I would not know answers to any of them; after a couple of years, I usually could answer about half."

ried about earnings. It also wasn't a great time to be connected to healthcare, given all the uncertainties about healthcare reform. As the shares fell it began screening very cheap to us, even though it had a 95 earnings-predictability rating and had for a long time been producing double-digit earnings gains.

Our conclusion was there was nothing fundamentally wrong with the integrated model that management was pursuing and that both sides of the business would benefit from a variety of secular tailwinds, from the aging population, to increased sales of more-profitable generics, to increased insurance coverage if health reform went forward. Given the valuation level and the fact that earnings had been so predictable and were still growing, we thought we were getting all that potential upside with very little risk. [Note: CVS shares currently trade around \$42, from below \$30 in late 2010.]

Are catalysts at all important to your investment cases?

BK: They can be in certain special situations, but not so much for our more traditional ideas. In general, we think it's very hard to predict when the market is going to get excited about things, or even what exactly the market reaction will be when a catalyst does occur.

We're blessed with very patient clients, but many of them have asked me why we own Microsoft [MSFT], usually saying something like, "Don't you know it hasn't gone anywhere in 12 years?" But if you look at the company's earnings over that time, except for a hiccup in 2009, the stair-step function is almost perfect. We believe this will continue because of the strength and entrenched nature of its commercial businesses, which are significantly more important to the company than the consumer side that everybody seems so worried about.

At today's valuation, we believe we have a lot of free options on good news on Windows 8, success in mobile, and even breakthroughs on the consumer side. Almost no one is talking about it, but we're impressed so far with Microsoft's retail-store concept and it

appears to be off to a good start. But those free options aren't why we own the stock. We own it because it's cheap and because we think earnings are predictable and growing. If we're right, we'll eventually get rewarded.

You mentioned special situations – what do those tend to be?

BK: It's not the majority of what we do, but we will invest in companies that don't pass our screens if we believe there is significant asset value that the market is just missing. A current example of that is Vodafone [VOD], the global wireless services company that owns 45% of Verizon Wireless. (Verizon owns the

ON SPECIAL SITUATIONS:

We'll invest in companies that don't pass our screens if we believe there's asset value that the market is just missing.

other 55%.) What jumped out at us was the fact that the shareholders of Verizon appear to be ascribing to Verizon Wireless more than double the value for it that is implied in Vodafone's current valuation.

Here we do see a few catalysts. We believe the temporary dividend Verizon Wireless just paid to its owners – of a total of \$10 billion – will be made permanent. We think that dividend will continue to grow, given the competitive strength of Verizon Wireless in a vibrant services market in the U.S. The company also has been unlocking value by selling off smaller assets, and after very recently winning a tax case in India, is likely to take its subsidiary there public. This could bring in as much as £3 billion and the company would still own 70% or so of what would then be a publicly traded subsidiary whose full value Vodafone doesn't currently get credit for. Any of these things would likely be good news for the shares [which now trade at around \$27].

We're guessing something like miner Barrick Gold [ABX] is a special situation as well.

BK: Yes – it's not one that screens well on earnings predictability. But it is extremely attractive on valuation. Assuming flat gold prices, it has roughly 140% upside [from today's \$49 share price] even to trade at its median-low historical cash flow multiple. One reason that's happening is because of the gold ETF, GLD, which is clearly drawing investor interest away from gold miners. To correct for that, we also looked at the upside for Barrick if it permanently traded at the lower historical multiples of other non-gold miners, such as Freeport-McMoRan. Barrick would still have over 120% upside to Freeport's median-high multiple and only 7% downside to its median-low, resulting in a great favorability ratio.

We also own the gold-miner ETF, GDX, because gold-miner shares in general are trading at rock-bottom valuations relative to the price of gold. In fact, if you look historically at those times when miners have been this cheap relative to the gold price, 100% of the time the miners outperformed the metal over the following 12 months, and 98% of the time the miners outperformed the S&P 500. Only 2% of the time did you lose money. If you're constructive on gold as a hedge against inflation and global economic instability – as we are – we believe now is an opportune time to own companies that mine it.

What are typical reasons stocks that screen well end up not passing muster?

BK: The primary reason is that we don't have adequate conviction that whatever the problems are will end up being transitory. You're never going to have 100% confidence, but with a concentrated portfolio with only 25-35 positions, we're very comfortable walking away when we don't consider the probabilities sufficiently in our favor.

An example where our judgment so far appears to have been wrong: we passed last year on MasterCard [MA] and Visa [V]. We just couldn't get comfortable

with the impact the Durbin amendment, which regulated certain card fees, might have. We were also concerned about how evolving electronic-payments methods might impact the business.

One we were right to wait on was Goldman Sachs [GS] at around \$150. The valuation looked great and it had always been a very profitable business, but we couldn't get comfortable that the regulatory environment wasn't really going to damage their franchise.

Loren Kinzel: We recently looked into Archer Daniels Midland [ADM] and concluded that too much of its business, particularly corn-based ethanol, was propped up by governmental subsidies that don't necessarily make sense. Ethanol's price tends to go up with the price of oil, so it was hard for us to see it somehow being more competitive if oil prices rise. That's especially true if the subsidies go away.

BK: One other thing we've done over the past three years – reflecting one of our primary macroeconomic views – is to put an even higher valuation hurdle on more-cyclical businesses, from industrials to financials. With debt-to-GDP ratios in the developed world where they are, we think it's hard to come up with a scenario where the U.S. and other developed markets see GDP growth above trend. Given that, we've made it harder for companies more reliant on overall economic growth to make it into the portfolio.

How do you arrive at fair value for the stocks you're considering for purchase?

BK: We ascribe a price target, typically based on our earnings or cash flow estimate 12 months out and the company's historical median-high multiple, adjusted as necessary for things like changes in the industry, the company's potential growth and overall market multiples. There's nothing magic about looking a year out, other than we believe we can have more confidence in our estimates over a shorter time period and because using that over time has worked. We won't buy unless the

current price is at least 30% below the target and, as I mentioned, the favorability ratio is at least 3:1.

Describe your investment case for core holding Advance Auto Parts [AAP].

BK: Given that we remain somewhat bearish on the economy long-term, we like that the company actually benefits in a couple of ways from economic headwinds. People only delay maintenance on their cars for so long, but they can delay purchases of new cars much longer. More older cars on the roads – the average vehicle age in the U.S. is 10.8 years, up from

8.8 a decade ago – means higher auto-parts sales. Another key tailwind is that with fewer new-car sales, dealers close, causing more people to either fix their cars themselves or go to smaller independent mechanics for repairs. In both cases, the parts needed are more likely to come from retailers like Advance Auto, AutoZone and O'Reilly Automotive.

Advance started out serving primarily the retail do-it-yourself market, but has been steadily expanding its sales to independent mechanics as well. That business has traditionally been more about parts availability and speed of delivery, but as customers get more cost-conscious, it's

INVESTMENT SNAPSHOT

Advance Auto Parts
(NYSE: AAP)

Business: Third-largest U.S. auto-parts retailer, serving both individual and commercial customers through 3,500 stores primarily in the eastern half of the country.

Share Information
(@1/30/12):

Price	76.57
52-Week Range	49.50 – 76.97
Dividend Yield	0.3%
Market Cap	\$5.62 billion

Financials (TTM):

Revenue	\$6.11 billion
Operating Profit Margin	10.4%
Net Profit Margin	6.2%

Valuation Metrics

(@1/30/12):

	AAP	S&P 500
Trailing P/E	16.3	15.1
Forward P/E Est.	13.6	12.5

Largest Institutional Owners

(@9/30/11):

Company	% Owned
Fidelity Mgmt & Research	17.5%
Ruane, Cunniff & Goldfarb	9.9%
Merchants' Gate Capital	5.0%
Massachusetts Fin Serv	4.9%
Vanguard Group	4.8%

Short Interest (as of 1/13/12):

Shares Short/Float	8.9%
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AAP PRICE HISTORY



THE BOTTOM LINE

The company should benefit from the sluggish economic environment he expects in the U.S., says Brian Krawez, and its expansion in serving commercial customers is paying off in higher profitability. Assuming the shares reach median-high historical P/E levels, which he considers reasonable, they would trade at 35% above today's price.

Sources: Company reports, other publicly available information

also putting a higher premium on keeping parts prices down, which companies like Advance have the scale to do. Over the past five years the company's share of revenues from commercial customers has increased from roughly 27% to 37%, with the goal of eventually getting to 50%. All of the big retailers are taking share from mom-and-pop jobbers, a trend we expect to continue.

That's important because growth of the commercial business positively impacts sales per square foot, margins and returns on invested capital. Those incremental sales require some new investment in warehouse space and delivery infrastructure, but not a lot. ROIC was 18.8% in the most recent quarter, up from 15.1% two years ago. That has resulted in higher free cash flow, which they've used to buy back a lot of stock.

Is store growth important here?

BK: Advance is currently #3 in the industry, with more than 3,500 stores. It isn't #3 in all markets, however, as the vast majority of its stores are east of the Mississippi, while O'Reilly, for example, is far more established in the western U.S. Overall, Advance plans to increase square-footage by maybe 3% this year, so it's not an add-a-lot-of-stores story.

How susceptible is Advance to competition from mass retailers and the Internet?

BK: It's a tough business for a Wal-Mart or Costco. You need to have a lot of specialized parts, inventory turns aren't so high, and there's a level of technical knowledge expected from your workforce that they're unlikely to provide.

The Internet is both a threat and an opportunity. It hasn't happened yet, but it's possible an Internet competitor could get big enough to heavily discount and take margin out of the incumbent businesses. We consider that fairly unlikely, given the importance of both service and, on the commercial side, parts availability at the local level. That's not something easily provided through UPS. We believe it's more likely that Advance and its com-

petitors provide much of the Internet presence for the industry, offering the added benefit of being able to pick up ordered parts at stores.

We assume the valuation is less attractive than it was in 2009. How are you looking at upside from today's \$76.60 price?

BK: The historical median-high P/E multiple is 18-19x, which on our 2012 EPS estimate of around \$5.50 gives us a target upside of roughly 35%. The median low is around 12x, resulting in 12% downside. So the favorability ratio clearly isn't as good as it was, but it's still attractive. If

the industry and company-specific tailwinds hold, there will be additional upside as earnings grow. We think this story is still more in the middle innings than at the end.

Describe your thesis for life-sciences company Life Technologies [LIFE].

LK: The company is the product of a 2008 merger between Invitrogen and Applied Biosystems and is a leader in supporting cellular, biological and genetic research. It makes the machines and consumables that researchers use in a wide variety of life-sciences applications,

INVESTMENT SNAPSHOT

Life Technologies

(Nasdaq: LIFE)

Business: Global provider of genetics-based systems, consumables and services used in academic, governmental and commercial scientific research.

Share Information

(@1/30/12):

Price	48.56
52-Week Range	35.30 – 56.71
Dividend Yield	0.0%
Market Cap	\$8.65 billion

Financials (TTM):

Revenue	\$3.70 billion
Operating Profit Margin	19.2%
Net Profit Margin	9.6%

Valuation Metrics

(@1/30/12):

	LIFE	S&P 500
Trailing P/E	25.5	15.1
Forward P/E Est.	12.0	12.5

Largest Institutional Owners

(@9/30/11):

Company	% Owned
Glenview Capital	7.9%
Primecap Mgmt	6.1%
Vanguard Group	5.4%
Paulson & Co	4.1%
State Street Corp	3.7%

Short Interest (as of 1/13/12):

Shares Short/Float	3.3%
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LIFE PRICE HISTORY



THE BOTTOM LINE

Brian Krawez believes temporary headwinds are obscuring the company's growth potential as genetic-based testing moves beyond sophisticated research labs and into clinics serving individual patients. If the shares traded at their median-high historical multiple on 2012's estimated cash flow, he says, they would be at double today's price.

Sources: Company reports, other publicly available information

including pure research, drug development, diagnostic testing, food safety and forensic analysis. The business has all the characteristics we like in terms of stability: steady growth in demand, high recurring revenues – 80% of sales come from consumables – and consistently high margins.

We got interested in the stock last year when it traded down due to a variety of things, including supply-chain disruptions due to the Japanese earthquake, an announced restructuring in the Chinese operation, and fears that academic and government budgets for biological research were vulnerable. The operating issues were fixable, and we very much believe the science supported by Life Tech's products will be a research-spending priority for some time at the academic and governmental level, and even more so in the private sector. Not to be overly dramatic, but you're talking about understanding the keys to life here.

We also believe there's tremendous optionality on the upside as genetic testing moves beyond the lab into clinics serving individual patients. Life Tech recently announced that it will by the end of this year introduce a machine that can map a person's entire genetic code within one day for \$1,000. At that price point and below, there's potential for a dramatic increase in demand as doctors use the information in diagnosis, prevention and increasingly individualized treatment of disease and illness. We're not counting on this having a material impact for some time, but it's a potentially massive wave that the company is well-positioned to ride.

The shares popped last week after Roche's unsolicited bid for primary competitor Illumina. At \$48.60, how favorable does the risk/reward look from here?

BK: We estimate this year's cash flow – defined as earnings plus depreciation and amortization – at about \$5 per share. So the stock currently trades at 9.7x cash flow, which is actually below the historical median-low multiple of 10x. On that metric, we see no downside. On the

upside, the median-high multiple is 19-20x cash flow, which would result in a doubling of the share price from today. Put that multiple on the much higher level of cash flow we'd expect in the next few years, and it's that much more interesting.

Elsewhere in healthcare, what attracted you to Novartis [NVS]?

BK: A key attraction is that it didn't follow the U.S.-company model of spinning off ancillary businesses to focus just on branded pharmaceuticals. It has a big presence there, but also has extensive operations in generics (from Sandoz),

vaccines (from Chiron), eyecare (from Alcon), diagnostics and consumer products. That all makes for a more stable and predictable business, and one much less susceptible to the patent cliffs other big players like Merck and Pfizer are struggling with.

Even in the branded pharmaceutical business the story is brighter. Novartis has some key drugs going off patent – including this year its highest-revenue drug, Diovan – but it has a much better lineup of about-to-be-approved or newly approved drugs to potentially pick up the slack. Among those are Gilenya for multiple sclerosis, Arcapta for respiratory dis-

INVESTMENT SNAPSHOT

Novartis
(NYSE: NVS)

Business: Diversified provider of health-care products, including branded pharmaceuticals, generic drugs, diagnostics, vaccines and branded consumer goods.

Share Information
(@1/30/12):

Price	54.30
52-Week Range	51.60 – 64.82
Dividend Yield	3.7%
Market Cap	\$131.34 billion

Financials (TTM):

Revenue	\$58.84 billion
Operating Profit Margin	22.8%
Net Profit Margin	17.2%

Valuation Metrics

(@1/30/12):

	NVS	S&P 500
Trailing P/E	12.8	15.1
Forward P/E Est.	9.6	12.5

Largest Institutional Owners

(@9/30/11):

Company	% Owned
Dodge & Cox	2.1%
Primecap Mgmt	1.3%
Clearbridge Adv	0.3%
Brown Brothers Harriman	0.3%
Wells Fargo	0.2%

Short Interest (as of 1/13/12):

Shares Short/Float	n/a
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NVS PRICE HISTORY



THE BOTTOM LINE

Its diverse revenue streams, cost-cutting potential, and strong lineup of new or about-to-be-approved drugs sets the company apart from its competition, says Brian Krawez. He believes the stock deserves at least a normalized S&P 500 multiple, which on his \$5.75 per share 2012 earnings estimate would result in a share price above \$85.

Sources: Company reports, other publicly available information

ease, Galvus for diabetes, and Afinitor and Tasigna for cancer.

One other attraction is that the company has thus far been slower than peers in cutting SG&A and headcount to reflect competitive realities in the pharmaceutical business. We believe that's changing and will result in margin upside going forward.

How big a threat is pricing pressure from healthcare reform?

BK: It's more an issue in the U.S., which pays dramatically more for its healthcare – even relative to the quality of care received – than other countries around the world. That a smaller percentage of its profitability comes from the U.S. is a good thing for Novartis in this regard.

The more important global trend is that literally billions of people, as a result of rising incomes and standards of living in developing countries, are entering healthcare markets in which they've never been able to participate. Novartis doesn't have the absolute highest exposure to emerging markets in the industry, but it is among the highest.

How inexpensive do you consider the shares, now at \$54.30?

BK: This is a case where looking at history isn't completely illustrative. The median-high P/E is 21.5x, while the low is 17.5x. But Novartis stock trades now at less than 10x our 2012 EPS number of \$5.75. That's off-the-charts low, but clearly the pharmaceutical business isn't what it once was. That makes valuation here a bit more art than science.

Our basic view is that Novartis is a better, more-stable business with a comparable growth profile and higher dividend compared to the S&P 500. That means it deserves at least a normalized S&P multiple, which is 15-17x. At 15x, the stock would trade above \$85.

Key risks?

BK: We certainly don't see downside from multiple compression. Where risk could

come from is if new drugs like Gilenya blow up and you have to take them out of your model. [Note: Novartis shares on January 23rd fell more than \$3 per share on news that Europe's drug regulator was reviewing approval of Gilenya, following reported heart problems in certain patients taking the drug in treatment.] One drug is not going to make a big difference, but if a few go wrong, that could be a risk.

Another risk is if intense reimbursement pressure reverses the operating-margin improvement we expect. My basic feeling is that we've so far experienced most of the bad stuff from healthcare reform, without

any of the good stuff like more people getting coverage. The whole area is obviously something to watch closely.

We're guessing defense contractors are showing up on your screens – why did Lockheed Martin [LMT] make it into the portfolio?

LK: Lockheed is the biggest U.S. defense contractor, with a fairly balanced portfolio of businesses – including those not tied to defense – that it segments into aeronautics, electronics systems, information systems and global services, and space systems.

INVESTMENT SNAPSHOT

Lockheed Martin
(NYSE: LMT)

Business: U.S. defense contractor operating in four market segments: Aeronautics, Electronic Systems, Information Systems & Services and Space Systems.

Share Information
(@1/30/12):

Price	82.01
52-Week Range	66.36 – 83.71
Dividend Yield	4.9%
Market Cap	\$26.33 billion

Financials (TTM):

Revenue	\$46.50 billion
Operating Profit Margin	8.6%
Net Profit Margin	5.7%

Valuation Metrics

(@1/30/12):

	LMT	S&P 500
Trailing P/E	10.5	15.1
Forward P/E Est.	9.7	12.5

Largest Institutional Owners

(@9/30/11):

Company	% Owned
State Street Corp	20.2%
Capital World Inv	13.1%
Massachusetts Fin Serv	5.7%
Capital Research Global	4.4%
Vanguard Group	3.5%

Short Interest (as of 1/13/12):

Shares Short/Float	7.0%
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LMT PRICE HISTORY



THE BOTTOM LINE

The market is understandably still concerned about the effect on the company of potential defense-spending cuts, says Loren Kinzel, but he believes the fears exceed what is actually going to happen. Valuing its F-35 fighter-jet program and the rest of the business separately, he arrives at a share-price fair value of close to \$110.

Sources: Company reports, other publicly available information

The potential negatives here are fairly well known. There are federal-government budget pressures on defense spending, exacerbated by the automatic spending cuts in play after the failure of the congressional super-committee. There have also been high-profile schedule and cost-overrun problems with Lockheed's giant F-35 fighter-jet program, leading to rhetoric in Washington that the project should be severely curtailed or even shut down.

Our view is that fears over defense-spending cuts impacting Lockheed exceed what is actually going to happen. For one, the automatic spending cuts proposed seem almost impossible to implement, so we expect those to be renegotiated in a way that relies less on reducing defense spending.

More broadly, if you look at the political rhetoric, President Obama is talking about holding the defense budget steady, while Mitt Romney has said he'd look to increase the defense budget – currently well below post-war averages relative to GDP – to around 4% of GDP. Neither of those strikes us as the type of dovish posture that would translate into deep spending cuts. The reductions that do come are much more likely to be in the operations and maintenance side of the defense budget, rather than the investment side where most of Lockheed's projects are.

As for the F-35 program, we just consider it inevitable. The goal of the program is to create a common fighter-jet platform across the Air Force, Navy and Marines, which will improve interoper-

ability and reduce maintenance costs. The differences between fourth-generation aircraft and this fifth-generation one revolve around stealth, computer systems, and the ability to process data to rapidly make decisions. With China rolling out its own fifth-generation fighter and Russia in the process of a giant military modernization program, there's no way we and our allies are going to make do without the F-35. There will be challenges along the way in any program of this size – the total cost over time is pushing \$400 billion – but it's definitely not going to go away.

How does Lockheed rate in terms of historical earnings predictability?

LK: The core businesses have actually been quite stable. It's a diverse company which is best-of-breed in a lot of segments. It's been the top information technology provider to the U.S. government for 17 years running and it continues to win big contracts outside of the military. Last month, for example, it won a multi-year contract worth up to \$2 billion from the National Science Foundation to support an extensive U.S. research presence in Antarctica. Those types of things help smooth out bumps in the defense business.

The shares, now around \$82, have done well since tanking last summer. How attractive are they now?

LK: We value the F-35 business separately from the rest of the company. For the

F-35, to be conservative we've modeled estimated cash flows below consensus expectations, arriving at a DCF value of about \$7.5 billion, just under \$25 per share.

For the rest of the business we're using a multiple of 7.5x estimated 2012 earnings before interest and taxes of approximately \$4 billion. This values the core business at \$30 billion, or around \$95 per share. After backing out net debt of a little under \$3 billion, we arrive at a fair value for the company of close to \$110 per share. We like that you can pay a reasonable price for the core business, receive a nearly 5% dividend, and essentially get the entire F-35 program for free.

On a price-to-cash-flow basis the favorability ratio is also very attractive: The stock has roughly 70% upside to its historical median high multiple of 11.6x, while it trades currently at its median low of less than 7x.

You seem to be in the camp of those who believe that defense is the best offense as an investor. Do you expect that to be particularly true in the market environment we have today.

BK: Given the macroeconomic headwinds, we don't think the market is in for a smooth ride. Our strategy is really built for that. We truly believe the key to investment success is losing less than the market during declines – losing small is more important than winning big. The math works and it keeps you in the game when you should be. **VII**

SCHARF FUND

Disclosures

Definitions:

Standard & Poor's 500 Index: The Standard & Poor's 500 Index ("S&P 500") contains 500 industrial, transportation, utility and financial companies regarded as generally representative of the large capitalization U.S. stock market.

Downside Capture Ratio: Downside Capture measures the manager's performance in down markets relative to the performance of the S&P 500. A down market is defined as any period (month or quarter) where the market's return is less than zero.

Upside Capture Ratio: Upside Capture measures a manager's performance in up markets relative to the performance of the S&P 500. An up market is defined as any period (month or quarter) where the market's return is greater than or equal to zero.

Earnings Predictability: Earnings Predictability as measured by the Value Line provides a measure of the reliability of an earnings forecast. Predictability is based upon the stability of year-to-year comparisons, with recent years being weighted more heavily than earlier ones. The most reliable forecasts tend to be those with the highest rating (100); the least reliable will usually get the lowest (5). The earnings stability is derived from the standard deviation of percentage changes in quarterly earnings over an eight-year period. Special adjustments are made for comparisons around zero and from plus to minus.

Price to Earnings Ratio: The Price to Earnings Ratio ("P/E") is a valuation ratio of a company's current share price compared to its per-share earnings.

Trailing P/E: Trailing P/E is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.

Forward P/E: Forward P/E is a measure of the price-to-earnings ratio ("P/E") using forecasted earnings for the P/E calculation. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

Price to Cash Flow Ratio: Price to Cash Flow Ratio ("P/CF") is a measure of the market's expectations of a firm's future financial health. Because this measure deals with cash flow, the effects of depreciation and other non-cash factors are removed. Similar to the price-earnings ratio, P/CF provides an indication of relative value.

Earnings Per Share: Earnings Per Share ("EPS") is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability.

Valuation: Valuation is the process of determining the current value of an asset or company. There are many techniques that can be used to determine value, some are subjective and others are objective.

Shares Short as a Percentage of Float: Shares Short as a Percentage of Float measures the percentage of shares sold short relative to the number of shares that make up a stock's float.

Market Capitalization: The Market Capitalization ("Market Cap") is the total dollar market value of all of a company's outstanding shares. Market capitalization is calculated by multiplying a company's shares outstanding by the current market price of one share.

Operating Margin: Operating Margin measures a company's operating income as a percentage of revenue.

Net Profit Margin: Net Profit Margin measures a company's net income as a percentage of revenue.

Dividend Yield: A company's Dividend Yield is calculated by dividing the most recent full-year dividend by the current share price.

Earnings Growth and Forward P/E (price to earnings): Estimates are not measures of the Fund's future performance.

References to other mutual fund products should not be interpreted as an offer of these securities.

Opinions expressed as those of the fund, are subject to change, are not guaranteed and should not be considered investment advice.

Past performance is not a guarantee of future results.

Fund Holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

The Scharf Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contains this and other important information about the investment company, and it may be obtained by calling 1-866-5SCHARF (1-866-572-4273) or by visiting www.scharffunds.com. The prospectus should be read carefully before you invest or send money.

Mutual fund investing involves risk. Principal loss is possible. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to volatility than a diversified fund. The Fund may invest in securities representing equity or debt. These securities may be issued by small- and medium-sized companies, which involve additional risks such as limited liquidity and greater volatility. The Fund may invest in foreign securities which involve greater volatility; political, economic and currency risks; and differences in accounting methods. The Fund may invest in ETFs or mutual funds, the risks of owning either generally reflecting the risks of owning the underlying securities held by the ETF or mutual fund. The Fund follows an investment style that favors relatively low valuations. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated, non-rated and distressed securities presents a greater risk of loss to principal and interest than higher-rated securities.

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