

## Time for Value?

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In our last market letter, we showed that once a major rally breaks the back of a long bear market, a new up period begins, marked by an irrational speculative phase for stocks. History shows that panicky short covering and get-rich-quick trading become the main drivers of the market. In fact, early in the rally we saw that speculation became so extreme that stocks selling for less than five dollars a share with no earnings and no dividends outperformed the average stock in the S&P by 400%.

As the rally continues, speculation remains the primary driver of the market. A recent *Barron's* article pointed out that the high frequency trading operations of hedge funds, brokerages and others account for 73% of all trading done in the market. In this environment momentum is the key and valuations are irrelevant.

The question becomes: **How long will the speculative phase last?** Stock market history shows that after underperforming for a period of six to nine months, value stocks, i.e. stocks with earnings and dividends, begin to outperform the S&P. The chart below shows that we may have seen the worst for the relative performance of value stocks. And while we have not yet seen the turn, **the stage seems to be set for a rebound.**



## Ditto for Dividends

A virtually identical situation can be seen in the relative performance of dividend paying stocks.



## The Casino is Still Open

In the past, the market on average has come back to value after less than a year of speculative excess. It has taken longer this time mainly because the companies deemed too big to fail and bailed out by the government are still trading in the market. In past recessions, the companies that were most leveraged – the conglomerates in the 1960s, brokerage firms in the 1970s and the S&L's in the 1980s – all went through formal or informal liquidation and were not major factors in the market recovery that followed.

**But this time government bail-out stocks have had a huge impact on the market. In the year since the March 6, 2009 lows, Bank of America is up 433%, AIG is up 300%, Wells Fargo is up 241%, Citibank is up 240% and Fannie Mae is up 180% -- all of them three to four times more than the market.**



## Irrational Markets: How to Cope

The legendary Ben Graham stressed that one key to successful investing is to understand that the market on a one or two year basis is completely unpredictable. As we have seen, extraordinary periods that feature bubbles, collapses and casino type behavior are constant obstacles to successful investing. Graham's answer was to be disciplined about price (P/E, P/B and dividend yield) and to invest for the long term (5 years). The combination gets the investor through the most irrational periods in the stock market. The table below shows the bottom 20% of the S&P by P/E, on a rolling 5-year basis for all 5-year periods going back to 1968.

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	9.7%	1987-1991	10.5%
1969-1973	0.0%	1988-1992	15.4%
1970-1974	1.1%	1989-1993	14.5%
1971-1975	12.4%	1990-1994	10.1%
1972-1976	17.8%	1991-1995	23.2%
1973-1977	17.0%	1992-1996	17.9%
1974-1978	24.7%	1993-1997	22.0%
1975-1979	34.3%	1994-1998	17.8%
1976-1980	24.7%	1995-1999	18.2%
1977-1981	18.2%	1996-2000	13.9%
1978-1982	22.2%	1997-2001	13.3%
1979-1983	24.5%	1998-2002	4.7%
1980-1984	26.1%	1999-2003	12.1%
1981-1985	26.5%	2000-2004	16.0%
1982-1986	27.6%	2001-2005	15.4%
1983-1987	18.9%	2002-2006	16.0%
1984-1988	18.2%	2003-2007	17.3%
1985-1989	16.3%	2004-2008	-2.6%
1986-1990	6.1%	2005-2009	4.0%

Source: S&P 500/SCCM, 12/31/09

## How to Measure Value

Another way to look at Graham's recommendation is to invert P/E, which gives you earnings yield or return on investment. Right now in the S&P, the bottom 20% of stocks on a P/E basis is trading at roughly 12x earnings. This means that you are getting an 8% return on investment -- one dollar of earnings for every 12 dollars invested. Long term value investors can compare that 8% earnings yield with the 10-year bond to gauge relative returns. **With the 10-year bond at 4.0%, the additional 4.0% premium represents one of the three most attractive levels for value stocks versus bonds in the last 70 years.**

## The Peter Lynch Lesson

Peter Lynch was the best known money manager of the 1980's. His record at Fidelity Magellan was spectacular. For thirteen years, his fund was consistently among the top performers. But a controversial study has it that after Lynch retired he was surprised to learn that the average investor in his fund lost money. This was because investors regularly got in and out of the fund, typically at just the wrong time.

The Lynch lesson teaches us that it is not wise to try to time markets. **But stock market history is clear: disciplined investing for the long term helps avoid the pitfalls created by irrational markets.**

**Jim Cullen**  
**President**

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