SCHAFER CULLEN

CAPITAL MANAGEMENT

James P. Cullen
President

Forget the Euro
Focus on
Earnings and Dividends

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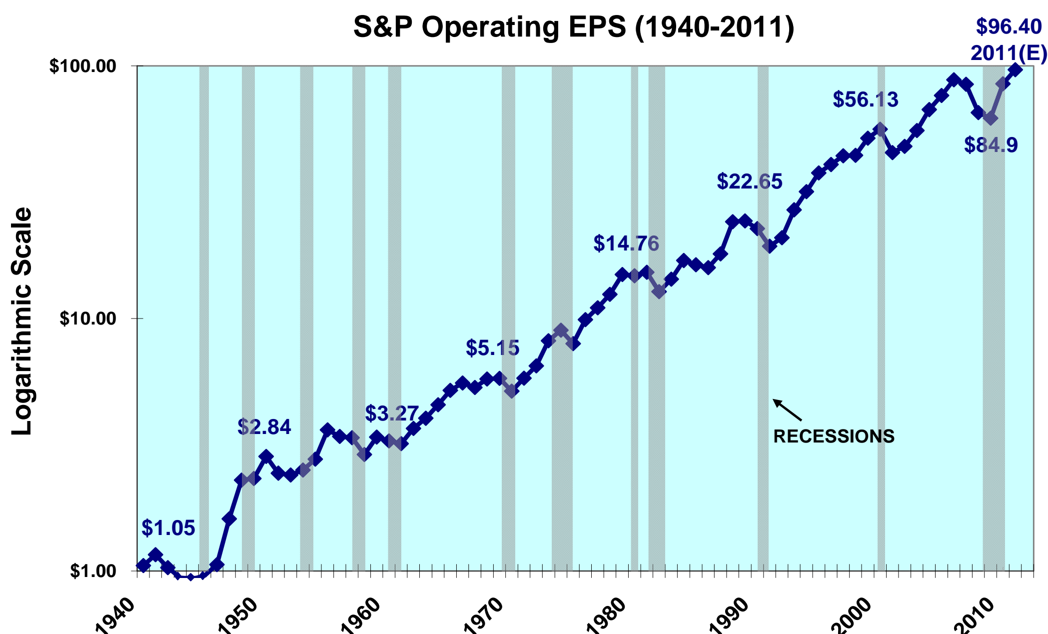
Investors continue to agonize about the European debt crisis and its possible impact on the global economy. But stock market history shows that long term investors would be better advised to think instead about earnings and dividends. To summarize Benjamin Graham's advice after 50 years in the investment business: **"Forget everything else and just invest with two simple principles"**. Which were, as we have said before, first, be disciplined as to the price you pay for stocks (P/E, P/B and dividend yield); and second, because the market is completely unpredictable on a one to two year basis, focus instead on the long term or five-year investment time span. **The advantage of combining the two principles can be seen in the academic studies which are at the end of this report.**

Because we are exposed to an ever increasing amount of information every day, we often forget the main reason stocks go up over time, and that is because their earnings and dividends go up over time. **The chart below illustrates that despite all the catastrophic headlines of the last 50 years, corporate earnings have steadily worked their way higher**. In fact, as you can see, earnings have usually doubled about every ten years.



Source: Robert Shiller, Ned Davis Research, Standard & Poors, and Morgan Stanley Research, December 2011

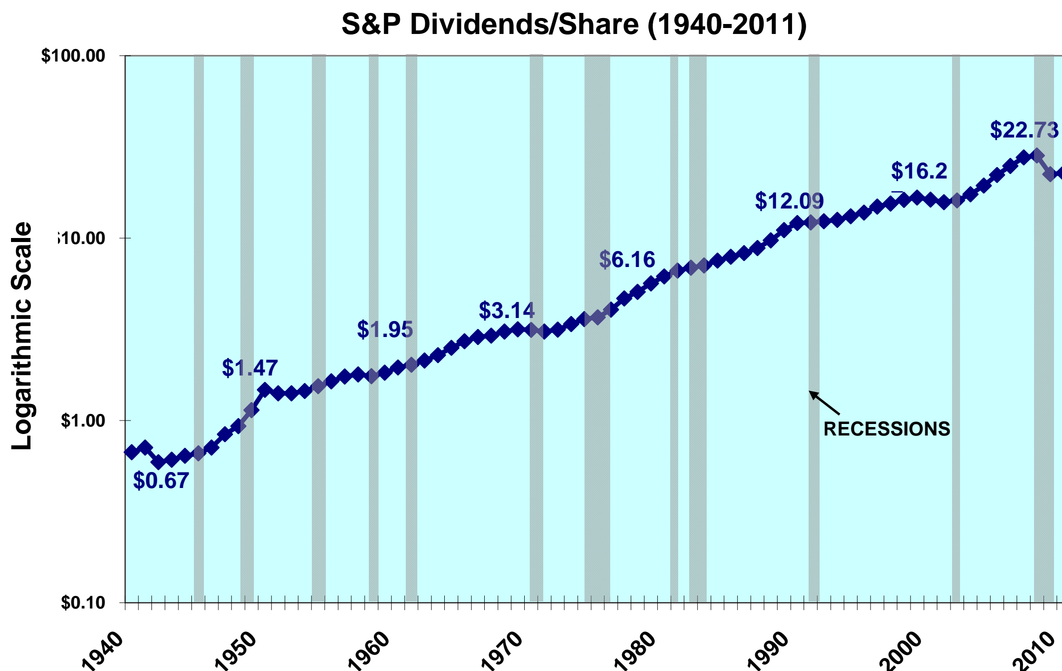
Historical Perspective

Graham's advice is worth listening to. His career spanned the 50 years from 1920 to 1970, a time when the markets were even more volatile and chaotic than they have been over the past few years. His career started during the speculative boom of the "Roaring Twenties" when stock prices went to outrageous levels. The boom ended with the crash of 1929 and the long depression that followed. Then during the latter stages of the massive downturn, there was the growing fear about the possibility of another bout of armed conflict, followed of course by Pearl Harbor and World War II.

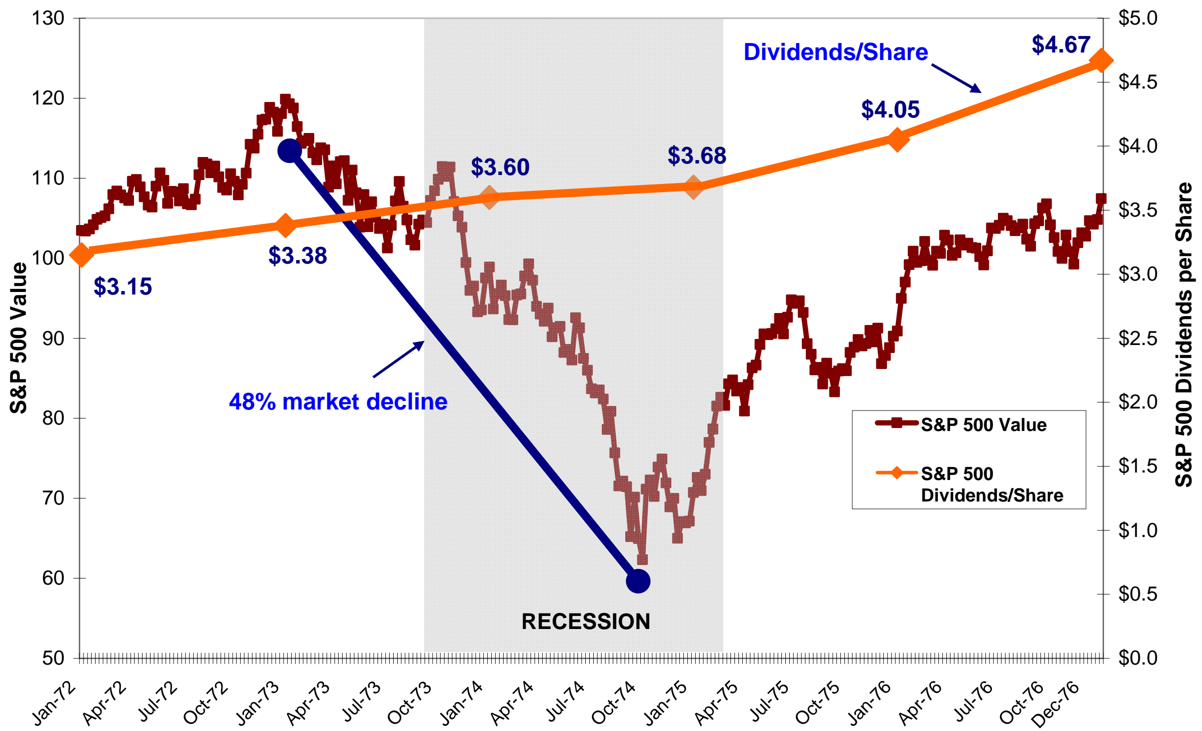
During this period, the stock market was regarded as a place dominated by market manipulators and unsavory speculators -- too dangerous and unsuitable for the average investor. **But despite all the market's extreme volatility and worldwide chaos, Graham concluded in his famous book, *The Intelligent Investor* (1949), that it paid to forget everything but his two principles. If you did, you would have probably outperformed everybody else in the market including the unsavory speculators.**

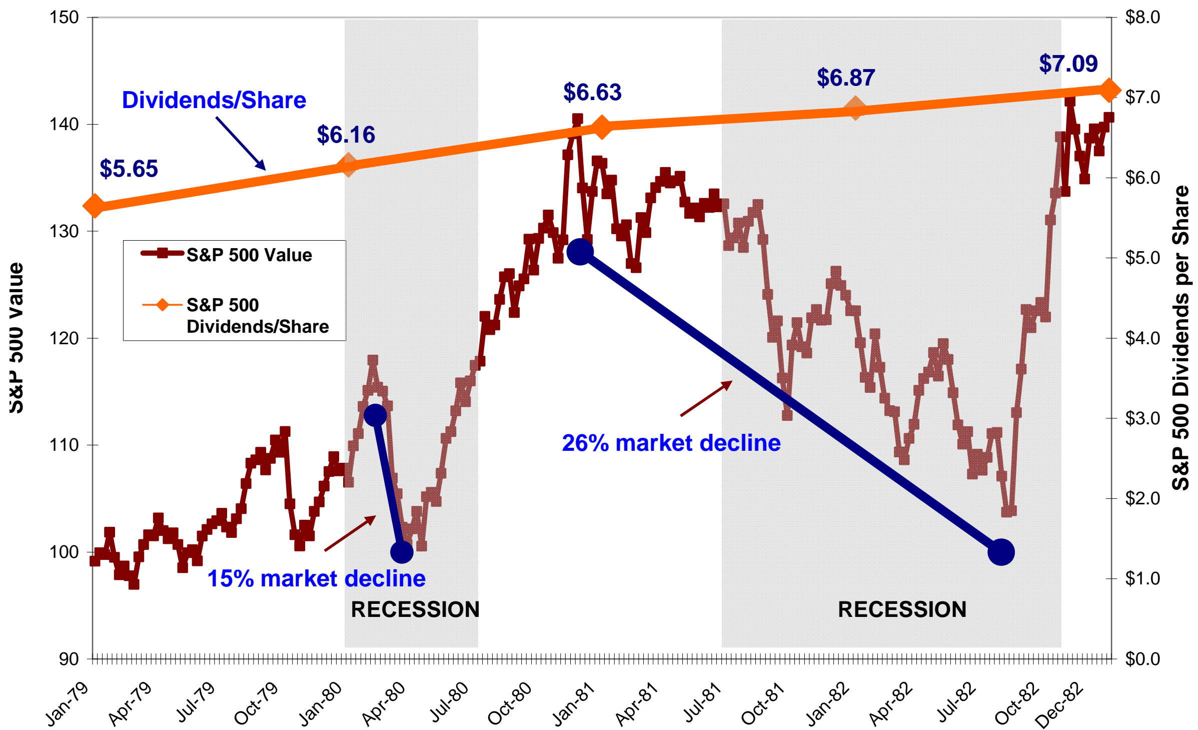
Dividend Growth

While we were doing the work on earnings growth, we began to wonder about what happened to dividends during the same period. **What surprised us was that the track record for dividend growth was even more impressive than earnings growth.** As you can see below, during the last 50 years there has been almost no downturn in dividend growth despite 12 recessions. In fact, as the two charts show on the next page, dividend growth was surprisingly strong even when stock prices were collapsing like they did in 1974 and in the early 1980's.



Source: Robert Shiller, Ned Davis Research, Standard & Poors, and Morgan Stanley Research, December 2011


S&P 500 Index and Dividends/Share (1972-1976)
Dividends/Share
$4.67
$4.05
$3.68
$3.60
$3.38
$3.15
48% market decline
RECESSION
S&P 500 Value
S&P 500 Dividends/Share
S&P 500 Value
S&P 500 Dividends per Share
Source: Bloomberg, December 2011


S&P 500 Index and Dividends/Share (1979-1982)
Dividends/Share
$5.65
$6.16
$6.63
$6.87
$7.09
S&P 500 Value
S&P 500 Dividends/Share
15% market decline
26% market decline
RECESSION
RECESSION
S&P 500 Value
S&P 500 Dividends per Share
Source: Bloomberg, December 2011

The Election Cycle Strategy: It Didn’t Work

The pre-election year has historically been the best year for stocks of the four year election cycle because the sitting president knows that to get re-elected he needs a strong economy. And he knows he needs to get started early, which is why the pre-election year performance dwarfs the other three years. Last year the strategy didn’t work, but we can’t blame President Obama for not trying. The day after his election in 2008 he said that we had some problems that could take two presidential terms to correct. And so he hit the ground running with the largest stimulus package in history, and followed it with a highly-publicized stimulus effort number 2. Even today there is talk of stimulus package number 3. And from the monetary side, the Federal Reserve has pushed interest rates down near zero. **But despite everything, the economy as measured by GDP is producing the slowest growth of any recovery in the last fifty years**.

Not Business’ Fault

While GDP growth is sluggish, corporate earnings are showing the strongest growth in any recovery in the last fifty years. This shows that American corporations are doing their job for the economy. But business in general is taking the blame for Washington’s sloppily executed bail-out of Wall Street.

Major Market Worries

While we say it is key to focus on earnings and dividends and to ignore everything else, we also think it’s worth commenting on the biggest worries of the day and some of the misconceptions they have produced.

- Dead Decades, 1970-1980 and 2000-2010
- Endless and Growing US Budget Deficits
- A Japanese Style 20-year Bear Market

Dead Decades

Much has been said and written about how the decade of 2000-2010 was just like the dead decade for stocks of 1970-1980. Some of the strategists we most admire have been saying both decades went nowhere so often that the assertion has become an established fact.

However, their blanket conclusion is very misleading. What we find for the decade of the 1970s is that earnings for the S&P 500 went up 200%, from **$5** to **$15**. What was actually flat during the period was the Dow Jones Industrial Average, which had been inflated by "The Nifty Fifty" craze of the 1960's. But what would have happened if you instead bought the bottom 20% of stocks with the lowest P/E in the S&P 500 at the beginning of the decade and re-balanced for the same stocks at the end of each year? The answer: **Rather than no return for the decade, the cumulative return for the lowest P/E stocks of the S&P 500 was actually up by a staggering 570%.**

Even in the most recent and presumptive Dead Decade of 2000-2010, earnings went from **$44** to **$88** over the ten years, and while it was a difficult period for most stocks, our large cap funds using the value strategy almost doubled over the same period.

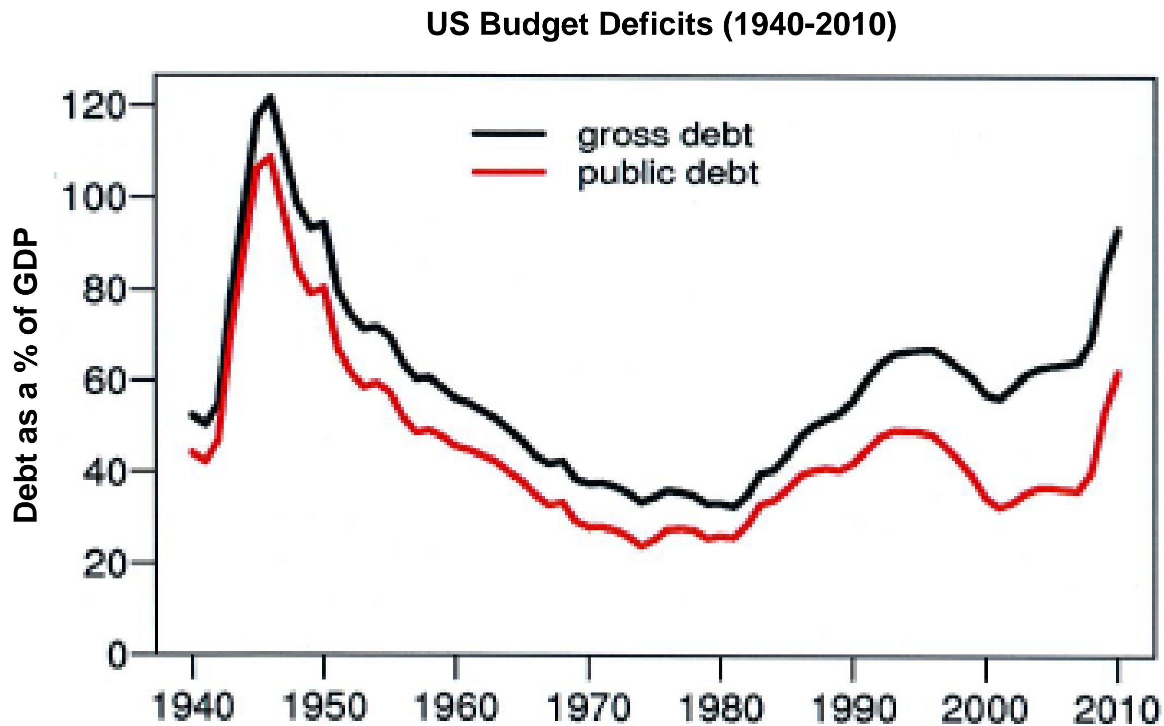
Cumulative Returns 2000-2010	
Pioneer Cullen Value Fund	**+87.9%**
SCCM High Dividend	**+89.8%**
S&P 500 Index	- 9.1%

Source: S&P 500/SCCM, December 2011

Endless, Growing US Budget Deficits

The concern over the size and direction of the budget deficit is serious but it has been worse. This can be seen in the chart below showing how bad the deficit was in 1945. **Even so, instead of the time just after World War II being a bad time to buy stocks, it presented instead one of the great buying opportunities of the century**.

This may have come from the pent-up domestic demand for goods and services postponed by World War II. The same is not true today for the US, but there is a similar kind of pent-up demand in the global market place. The number of people who are moving into the middle class around the world dwarfs what was going on in the United States during the 1940's.



Source: The United States Department of the Treasury, Bureau of Public Debt, December 2010

Japanese-Style, 20-Year Bear Market

The difference between the Japanese stock market in 1990 and our market today is valuation. In 1990, the Japanese market was selling at over 100x earnings; today our market is selling at 12x earnings, one of the cheapest levels in the last 50 years. A look at the 20-year bear market in Japan shows that earnings actually held up fairly well. The big drop has come from a contraction in multiples.

Conclusion

The message for long term investors is to ignore the sensational headlines of the day and focus instead on how earnings and dividends grow over time and on the need to be disciplined about the price one pays for those earnings and dividends – advice especially pertinent today when valuations are at one of the cheapest levels since the 1980s.

Jim Cullen, President

POTENTIAL OFFERED BY A DISCIPLINED VALUE APPROACH

Comparative Rates of Return

Year	Overall Return S&P 500	Return Using Selection Criteria on S&P 500		
		BOTTOM 20%		TOP 20%
		By P/E	By P/BK	By YIELD
1968	11.1	30.5	37.3	26.5
1969	-8.5	-17.5	-20.5	-15.6
1970	4.0	7.8	4.3	11.7
1971	14.3	19.0	19.9	12.5
1972	18.9	14.8	14.3	13.0
1973	-14.7	-17.7	-10.6	-10.9
1974	-26.5	-12.8	-12.1	-10.8
1975	37.2	83.3	94.8	65.4
1976	23.9	50.3	57.3	44.6
1977	-7.2	11.0	8.4	4.1
1978	6.6	13.1	7.5	1.6
1979	18.4	26.3	30.5	19.5
1980	32.4	26.4	18.5	17.6
1981	-4.9	15.1	13.5	17.1
1982	21.4	31.0	37.0	29.4
1983	22.5	24.4	41.2	28.2
1984	6.3	34.3	1.0	10.2
1985	32.2	28.4	19.1	29.5
1986	18.5	20.5	9.3	19.5
1987	5.2	-8.0	10.5	-1.5
1988	16.8	20.8	24.7	20.5
1989	31.7	23.7	15.1	26.4
1990	-3.1	-18.7	-25.2	-17.4
1991	30.5	47.6	55.2	45.3
1992	7.7	14.0	27.9	15.8
1993	10.1	16.5	18.4	16.8
1994	1.3	1.5	3.1	1.4
1995	37.6	42.5	42.1	30.2
1996	23.0	18.7	16.4	14.5
1997	33.4	35.2	25.4	28.9
1998	28.6	-2.3	11.5	7.0
1999	21.0	3.4	5.9	-8.4
2000	-9.2	18.3	21.1	15.0
2001	-11.9	15.4	14.6	12.7
2002	-22.2	-8.6	-17.6	-7.8
2003	28.6	37.5	56.9	31.3
2004	10.9	22.5	23.8	15.9
2005	4.9	15.1	12.5	4.4
2006	15.8	18.4	20.2	21.4
2007	5.5	-3.3	-13.7	-4.8
2008	-37.0	-44.9	-48.0	-39.9
2009	26.5	70.4	65.5	40.9
2010	15.1	15.8	21.5	20.0
COMPOUND ANNUALIZED RETURNS				
(43 Years) 1968-2010	9.5	14.8	14.8	12.3

Source: Standard & Poor's / SCCM 12/31/10
Past performance is no guarantee of future results.

CASE FOR DEEP VALUE FUNDS

Rolling 5-Year Performance – Compound Annualized Returns

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	**-2.3%**
1986-1990	**6.1%**	2005-2009	**4.3%**
		2006-2010	**4.5%**

Source: Standard & Poors 12/31/10

Past performance is no guarantee of future results. The Standard & Poor's 500 Stock Index (the S&P 500) is a commonly used measure of the broad U.S. stock market. Indices are unmanaged and their returns assume re-investment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

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