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President

Some Concerns

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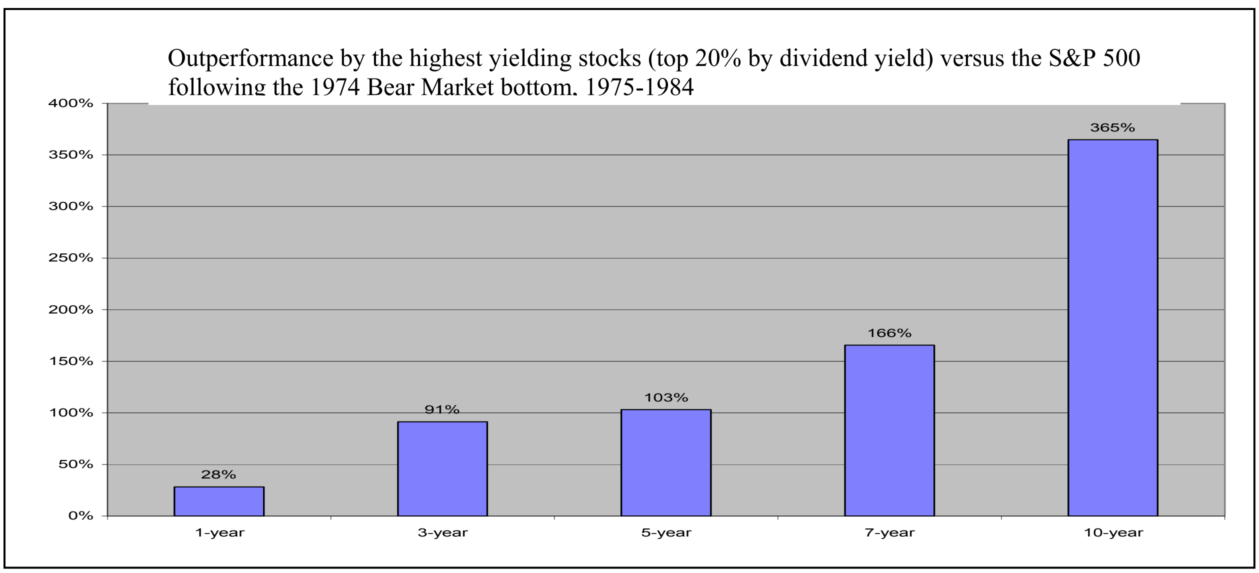
The one constant in my 45 years in the investment business is that there is always something to worry about. In this letter we want to speak to concerns that investors have raised during recent meetings. First, not a day goes by that we don't get the question, the high dividend strategy has become so popular maybe it is overdone? Maybe, but not for the long term investor.

History shows that high dividend stocks have had long periods of powerful performance following bear markets. This is especially true after severe bear markets like we had in the 1930's and 1970's. After the Great Depression of the 1930's, 90% of all the performance came from dividends. Again, in the 1970's as you can see in the chart below, the dividend paying stocks dramatically outperformed the market (S&P 500) over the one, three, five, seven and ten year periods following the 1974 bear market low.

We include the chart of the 1970's because we believe it is most like the recent severe recession. We have studied all the recessions of the last 100 years and the results were similar in every case. Even following the 1990's recession, the high dividend stocks outperformed over the one, three, five and seven year periods. It was only in the last 3 years of the 10, at the height of the "tech bubble" that the high dividend stocks trailed.



Source: SCCM, S&P

The Real Worry About ETF'S: No Price Discipline

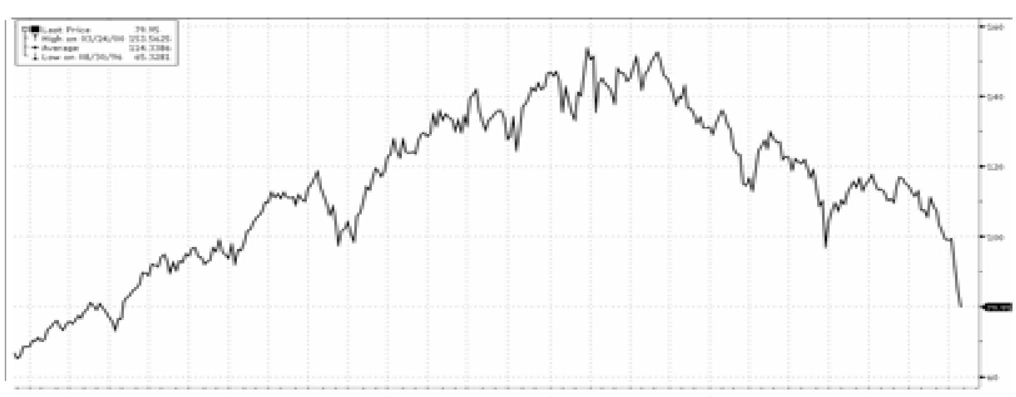
Danger

The fastest growing area of the mutual fund world has been the ETF's, which are basically index funds for specialized areas in the market. Many firms have created new ETF's that specialize in the high dividend strategy. They have become popular because they are new vehicles for the short-term trading crowd, making it easy for them to flip in and out of one hot area of the market to another.

ETF's make sense in theory because they enable investors to participate in a specialized area of the market. But they can become dangerous if the area becomes too popular. **Money then rushes into the hot area of specialized focus with no consideration given to valuation. The result is that investors wind up with a portfolio of very popular but very overpriced stocks.** In contrast, what we emphasize in our actively managed Schafer Cullen High Dividend strategy is a strict P/E discipline, as well as high dividend yield and dividend growth.

An instructive example of how an ETF can play out is what happened to the popular S&P 500 index funds in the 1990s. During the bull market of that decade, index funds became an extremely popular way for both individual and institutional investors to get immediate and broad exposure to the market. They became so popular that by 2000 the Vanguard 500 Index Fund had replaced the venerable Magellan fund as the largest fund in America. **Meanwhile, people who administered the S&P 500 found themselves frantically scrambling to add the newest, hot high tech stocks to the S&P 500 index to make it represent "the market", completely ignoring valuation**. The result was at the market top in 2000, the S&P 500 index was selling at the highest valuation level in modern market history. The Vanguard Fund, which tracked the Index, obviously became equally overvalued. Over the next three years the Index and the Vanguard Fund lost 50% (see below) and showed poor relative performance for years after.

S&P 500 Index - Price Performance



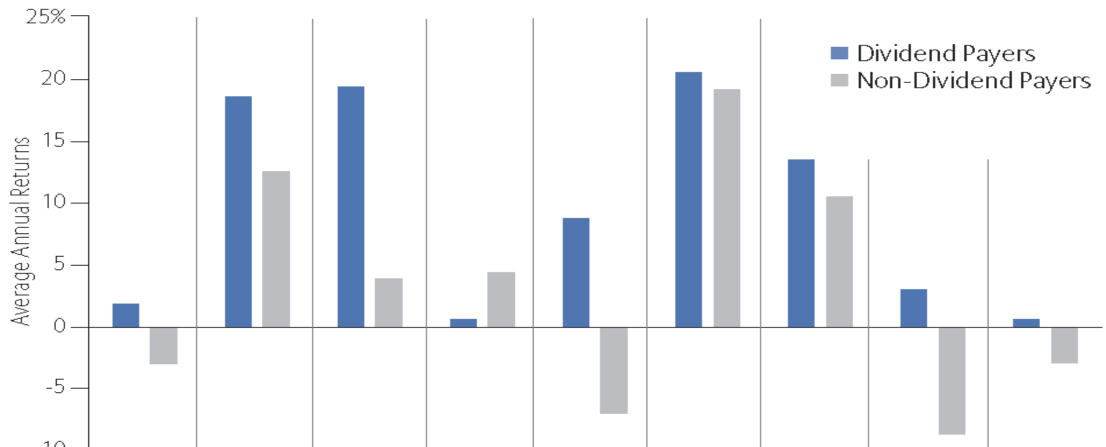
Source: Bloomberg

Tax Increase

Another concern for investors is the possibility of a higher tax on dividends. In the near future, the tax rate on dividends is probably going to go up. The questions is, by how much? Initially, it appeared the Obama Administration was going to propose a tax increase on dividends from 15 to 20%. But then as the presidential campaign heated up and the 1% became a political target, the President signaled that he wanted to move the rate much higher. We won't get much clarity on the issue until after the election, but some Senate Democrats want a smaller tax hike on dividends. They are getting a lot of heat from their constituents in the 99% who are retirees trying to make ends meet on dividend income.

But the bigger question is: how do high dividend stocks perform if they are taxed at a much higher rate? **The table below tracks all the tax rate environments from 1972 to the present. The results are very surprising and consistently favor the dividend payers over non-dividend payers**.

History has shown that dividend-paying stocks have outperformed in a wide variety of tax environments



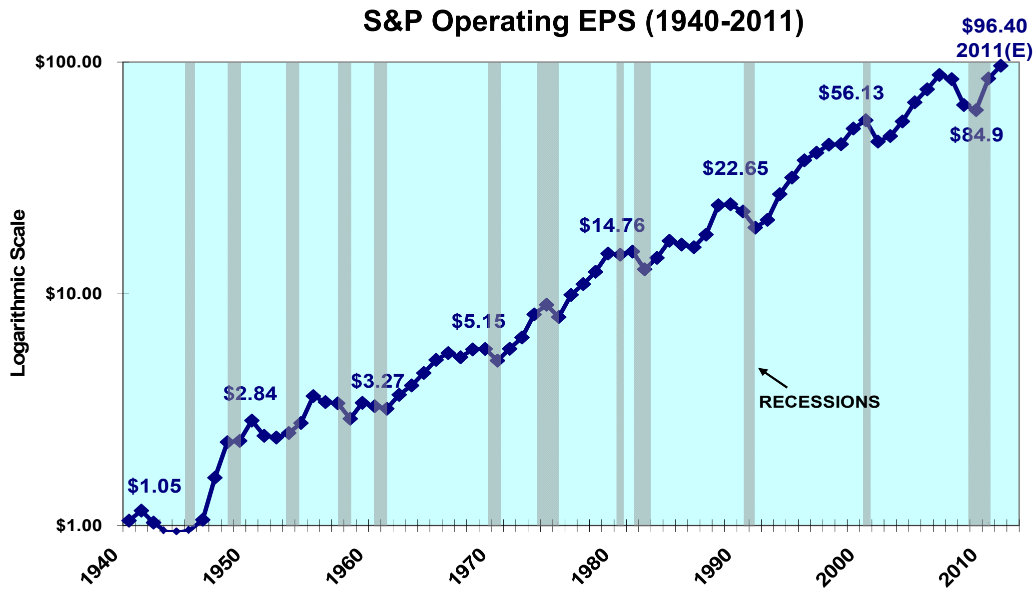
	1972–'78	1979–'81*	1982–'86**	1987	1988–'90	1991–'92	1993–'96	1997–'02	2003–'10***
Dividends Tax Rate	70.0%	70.0%	50.0%	38.5%	28.0%	31.0%	39.6%	38.6–39.6%	15.0%
Cap Gains Tax Rate	36.5%–39.9%	23.7%–28%	20.0%	28.0%	28.0%	28.0%	28.0%	20.0%	15.0%
Spread	30.1%–35.5%	42%–46.3%	30.0%	10.5%	0.0%	3.0%	3.0%	19.1%–19.6%	0.0%

Source: Ned Davis, Tax Foundation.org. Data based on S&P 500 Index.
*First $100 of dividend income exempt and then taxed at ordinary income rate.
**For years 1982–1986 up to $750 of reinvested dividends of public utilities companies exempt.
***Data through 3/31/10.

The Recession Worry

Europe is in a recession, China's economy is slowing and weak economic data in the US might be pointing to another recession here. In earlier market letters, we have used the chart below to show how earnings going up over time drive stock market performance. **Because of the worry about another recession on the horizon, we show the chart again to make clear how earnings have gone up despite 12 recessions since 1940.**

Experience and history show that trying to time the market to get out of the market before a recession tends to be the silent killer of long term performance. This is because the market usually has had a considerable correction well before the time a recession sets in. The real challenge is trying to get back into the market once a bear market and recession have run their course.



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

Summary

Investing is a constant challenge. But since we started our firm 28 years ago, the market (S&P 500) despite all the obstacles, is up almost +1,800%. And during that same time, the strategy of investing with a discipline has performed dramatically better than that.

In a worrisome global environment, adhering to a value and yield discipline should continue to provide strong relative performance.

Jim Cullen, President

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