S C H A F E R   C U L L E N

C A P I T A L   M A N A G E M E N T

January 26, 2015

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Strategy 2015

The Nature of the Beast

In the interview that summarized his 60 years in the investment business, Ben Graham was asked for his opinion of the professionals on Wall Street. His answer was that **"Most of the stockbrokers, financial analysts, and investment advisors, etc. are above-average in intelligence, business honesty and sincerity. But they lack adequate experience with all types of security markets and an overall understanding of common stocks."** He called this **"the nature of the beast,"** which is the natural, emotionally-driven instinct to buy high and sell low.

Graham went on to point out that Wall Streeters tend to take the market, and themselves, too seriously, **spending too much of their time valiantly trying to do things such as forecasting short- and long-term changes in the economy and determining the short-term price levels of common stocks.** A pretty negative assessment coming from the Father of Security Analysis. **But what Graham is telling us is that investing is difficult even for experienced investors and focusing on the short term does not add much value.**

Tackling the Beast

Graham recommended two ways to deal with "the nature of the beast." **First, as we have emphasized many times, invest with a discipline (P/E, P/Book, and dividend yield) and, second, invest for the long-term, that is, with at least a five-year time horizon.** This tends to be enough time for earnings and fundamentals to drive stock performance, as opposed to the short-term which is often driven by speculation and momentum.

A subtle, but equally important message is to be aware that the market is completely unpredictable on a one-, two- or even three-year basis. It's hard to believe that the recessions, bear markets, and crises like 9/11 are really not significant to the long-term investor. The reason: history shows that in the long run, companies and the market do a good job of adjusting to disruptions seemingly catastrophic when they occur.

Long-term Investing

In our recent market letters, we showed how disciplined investing for the long-term can produce phenomenal results.

Type of Strategy	1968	2013
S&P 500 (Passive)	$1 million	**$79 million**
S&P 500 (Bottom 20% by P/E)	$1 million	**$578 million**

SCCM Research 2013

Further, in a study covering the period from 1968 to 2013, we showed how consecutive five-year periods provided consistently strong results even while almost every single five-year period included a serious bear market.

5-Year Performance: 1968 – 2013
Annualized Returns

	Bottom 20% Stocks by P/E	S&P 500	Recessions	Bear Markets
1968 – 1972	9.7%	4.1%	1969 – 1970	12/1968 – 05/1970: - 36%
1973 – 1977	17.0%	-0.2%	1974 – 1975	1/1973 – 2/1974: - 46%
1978 – 1982	22.2%	14.1%	1979 1981 – 1982	4/1981 – 8/1982: - 24%
1983 – 1987	18.9%	16.5%		8/1987 – 10/1987: - 33%
1988 – 1992	15.4%	15.8%	1990 - 1991	7/1990 – 10/1990: - 20%
1993 – 1997	22.0%	20.2%		
1998 – 2002	4.7%	-0.6%	2000 - 2001	7/1998 – 8/1998: - 19% 1/2000 – 9/2001: - 34% 3/2002 – 10/2002: - 34%
2003 – 2007	17.3%	12.8%		10/2007 – 3/2009: - 56%
2008 - 2012	2.0%	1.7%	2008 - 2010	4/2011 – 10/2011: - 19%

SCCM Research, 2014

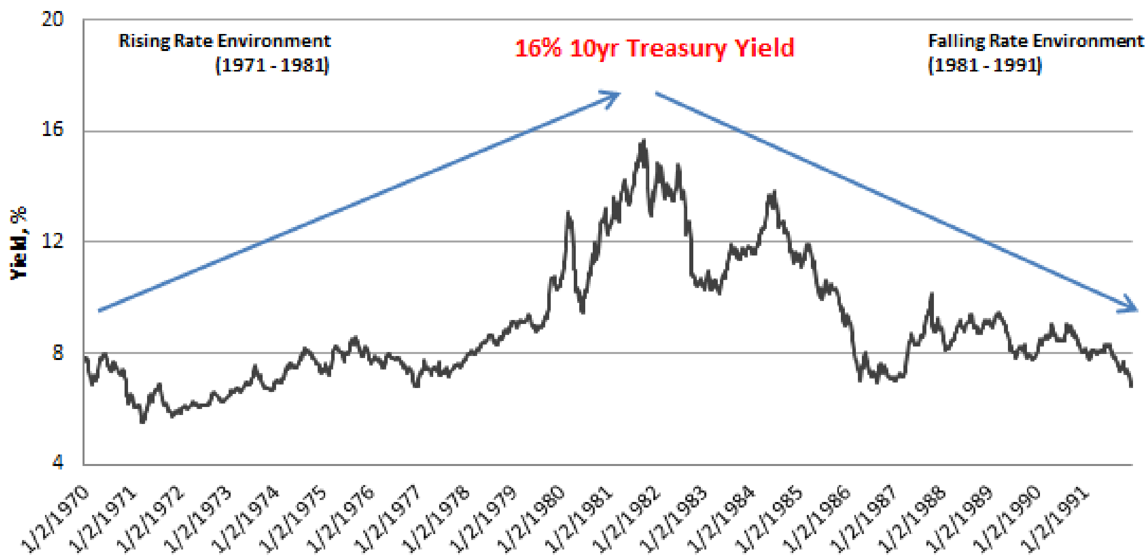
Popularity of Alternative and Passive Investing

Investors have been traumatized by the devastating experiences of the last 15 years, which included the collapse of the tech bubble and the financial crisis. As a result, downside protection has become the focus for many investors. **However, what we are seeing is that popular alternative investments are not generating competitive returns, only putting a lid on performance.**

Today, because investors are starting to have more confidence in the market and because most active strategies have not worked, record amounts of funds are being placed in the 'easy-decision,' S&P 500 index. Last year $400 million was redeemed from stock mutual funds and $1 billion went into index funds. **While indexing can be an easy way to get invested, an important negative is that it completely ignores any price discipline.** Historically, the absence of a price discipline has led to problems when indexing became too popular and valuations got too high. This is what contributed to the "Nifty-Fifty" bubble of the 1970s and the "Tech" bubble of 2000. After both collapsed, value investing dramatically outperformed the index for a long period of time.

P/E & Dividend Yield in a Rising-Rate Environment

A frequently-asked question is, how do the High Dividend and Value disciplines work in a rising rate environment? To answer the question, we did a study covering the last cycle when rates had a major move (5% to almost 20%). **What we found was that on a rolling five-year basis, the highest-yielding and lowest P/E stocks dramatically outperformed the S&P 500 during this period.**



RISING RATES		
5-Year Periods	Top 20% by Yield	Bottom 20% by P/E
1971 - 1975	8.30%	12.44%
1972 - 1976	13.30%	17.81%
1973 - 1977	10.30%	17.02%
1974 - 1978	14.10%	24.71%
1975 - 1979	22.00%	34.30%
1976 - 1980	12.50%	25.67%
1977 - 1981	8.20%	18.20%
Average Return	12.67%	21.31%
S&P Avg. Return	6.92%	

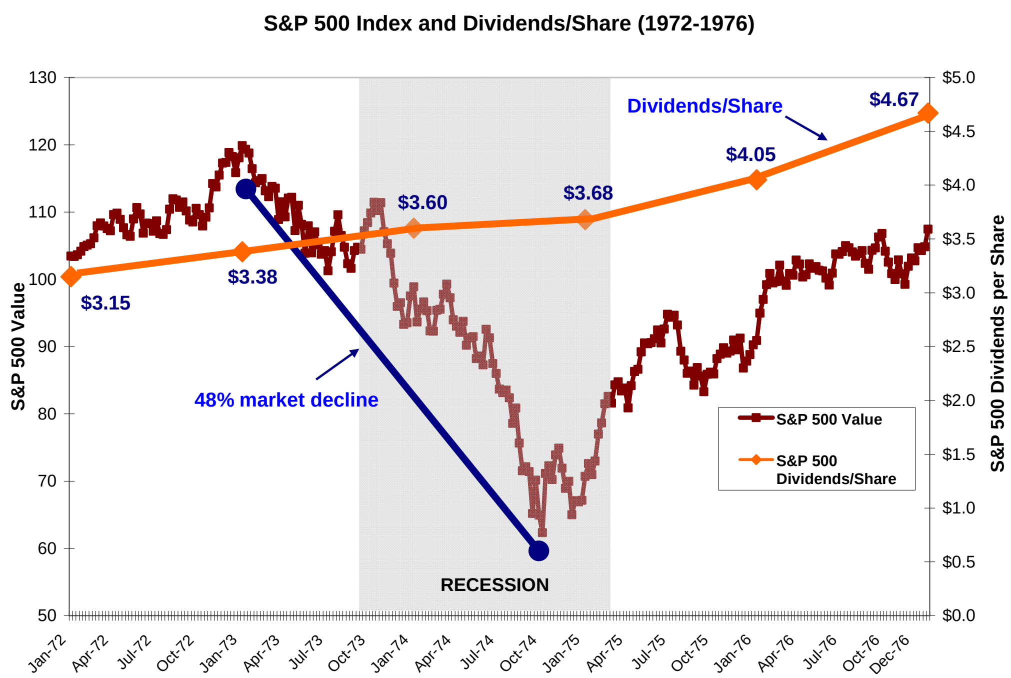
FALLING RATES		
5-Year Periods	Top 20% by Yield	Bottom 20% by P/E
1981 - 1985	21.00%	26.46%
1982 - 1986	23.20%	27.63%
1983 - 1987	19.10%	18.82%
1984 - 1988	18.40%	18.22%
1985 - 1989	21.40%	16.29%
1986 - 1990	13.50%	6.14%
1987 - 1991	14.90%	10.53%
Average Return	18.79%	17.73%
S&P Avg. Return	15.96%	

SCCM Research, 2013

Dividends for Extra Cushion

It may come as a shock to many investors to learn that dividends for the market (S&P 500) over the last 70 years have gone up during all of the recessions except one – even though earnings experienced a sharp drop in all of the downturns. The only exception was the dividend decline during the 2008 recession, when the government under TARP forced financial companies to cut them. Today, dividends for the S&P 500 are at back to all-time highs, up dramatically from their peak before financial crisis.

A classic example of how dividends hold up in a recession, and the first one I experienced, was the period from 1972 to 1976 – up to then, the worst collapse since 1929. It was a time of extreme chaos: the recession lasted for almost two years, the market dropped 50%, and 75% of all of the brokerage firms went out of business. Earnings were down sharply. So it is a shock to look back and see that dividends moved up steadily over the entire period.



Bloomberg, 2011

Conclusion

There is always the strong emotional urge to buy high and sell low and to try new investment products. However, history shows that we are better off if we just stay focused on investing for the long term and stick with a discipline.

Jim Cullen