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July 29, 2016

James P. Cullen
Chairman & CEO

Mid-Year Update

Welcome to the Post Melt-up Market

In our January 2016 market letter, we pointed out that once the back of a melt-up market is finally broken, there eventually follows a long period of outperformance by value stocks. **However, when an extended melt-up ends, speculation and momentum do not suddenly stop. Instead, what happens is a period of extreme volatility and erratic stock market behavior, which usually takes the market to new highs.**

The current post-bubble market is typical in that some of the most popular stocks of the melt-up (biotech, FANG and social media) have started to struggle. For example, the biotech index is down 30% from its high, Twitter is off 60%, Netflix is down 40%, and LinkedIn is off 30% - just to name a few. **Meanwhile, value has been quietly outperforming.**

Our High Dividend Value fund is an example of how value is starting to outperform. **The table below shows that the fund has outperformed the S&P 500 by 7.38% and the average value manager by 11.46% since the end of the melt-up.** Results that make you wonder why the stampede a year ago into passive (S&P 500) investing.

Fund Performance
Since the End of the Melt-up
12-months as of 06/30/16

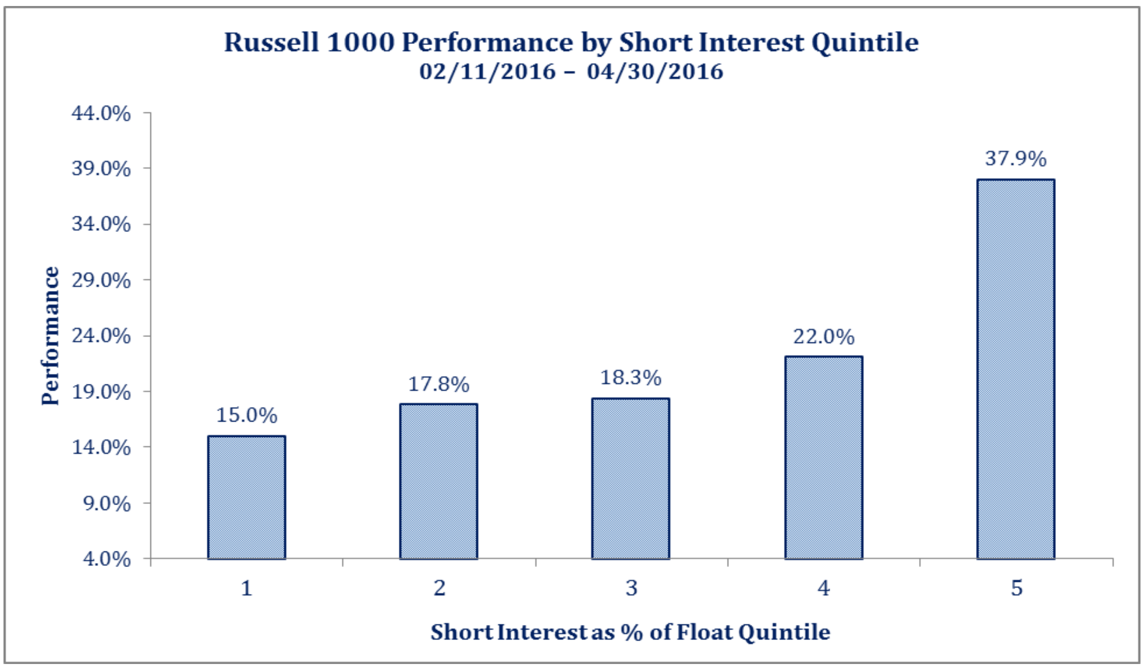
	Performance	Difference
Cullen High Dividend Value Fund (Net)	**+11.37%**	
S&P 500	**+3.99%**	**+7.38**
Average Large Cap Value Fund	**-0.09%**	**+11.46**

Morningstar, June 2016

The Transition Period

The erratic market swings during the transition period occur because the 10% correction was enough of a drop to make investors begin to think that maybe prices wouldn't go straight up forever and that they should start paying attention to valuations. However, to complicate things, hedge funds that were very actively trying to capitalize on a down market are now busy covering their shorts. Finally, investors who had been sitting on cash waiting for a healthy market pull-back began to get nervous and started to chase the market fearing they missed the chance to buy on the dip.

Just how upside down these markets can be is apparent in the chart below. Here we see how the worst companies (most-shorted) have dramatically outperformed the best companies (least-shorted) since the end of the correction.



Strategas, April 2016

Historic Performance

How long transition periods last is hard to predict, but the one we're in now is a year old, which is the about the length of the transition we had in 1999. So rather than trying to time when it ends – an impossible task – it's probably a better idea to focus on the strategy of investing for the long term, i.e. five years. **History shows that investing with a discipline and applying a five-year time horizon is a much underrated and neglected way to achieve downside protection.**

The table on the next page shows all of the rolling five-year periods since 1968 comparing value to growth. We have circled all of the melt-up markets, which were the only periods in which value underperformed growth. **As you can see in each case, there was a long period of value outperformance after market melt-ups.**

S&P 500 Lowest vs. Highest P/E Stocks (1968-2014)

	Rolling 5-Year Periods	Top 20% by P/E (Growth)	Bottom 20% by P/E (Value)	Value Outperforms	Growth Outperforms
Melt-up	1968 - 1972	6.03%	9.66%	+3.62%	
	1969 - 1973	0.29%	0.00%	----- flat* -----	
	1970 - 1974	-4.31%	1.11%	+5.42%	
	1971 - 1975	2.71%	12.44%	+9.73%	
	1972 - 1976	2.44%	17.81%	+15.38%	
	1973 - 1977	-3.27%	17.02%	+20.29%	
	1974 - 1978	1.35%	24.71%	+23.35%	
	1975 - 1979	14.38%	34.30%	+19.91%	
	1976 - 1980	15.37%	24.67%	+9.31%	
	1977 - 1981	9.93%	18.20%	+8.27%	
	1978 - 1982	18.87%	22.18%	+3.31%	
	1979 - 1983	22.54%	24.53%	+1.99%	
	1980 - 1984	15.30%	26.07%	+10.77%	
	1981 - 1985	12.43%	26.46%	+14.03%	
	1982 - 1986	17.23%	27.63%	+10.40%	
	1983 - 1987	12.20%	18.92%	+6.72%	
	1984 - 1988	9.77%	18.22%	+8.45%	
	1985 - 1989	16.75%	16.29%	----- flat* -----	
Melt-up	1986 - 1990	8.57%	6.14%		+2.44%
	1987 - 1991	11.67%	10.53%		+1.14%
	1988 - 1992	11.90%	15.37%	+3.47%	
	1989 - 1993	12.34%	14.54%	+2.20%	
	1990 - 1994	7.09%	10.10%	+3.00%	
	1991 - 1995	14.98%	23.17%	+8.20%	
	1992 - 1996	12.46%	17.92%	+5.47%	
	1993 - 1997	14.35%	22.01%	+7.66%	
	1994 - 1998	16.19%	17.79%	+1.60%	
Melt-up	1995 - 1999	21.84%	18.23%		+3.61%
	1996 - 2000	16.42%	13.91%		+2.51%
	1997 - 2001	8.73%	13.27%	+4.54%	
	1998 - 2002	-0.27%	4.74%	+5.01%	
	1999 - 2003	2.61%	12.15%	+9.53%	
	2000 - 2004	1.52%	16.02%	+14.49%	
	2001 - 2005	2.99%	15.38%	+12.39%	
	2002 - 2006	9.25%	15.97%	+6.73%	
	2003 - 2007	16.35%	17.29%	+0.94%	
	2004 - 2008	-5.01%	-2.31%	+2.70%	
	2005 - 2009	-2.07%	1.98%	+4.05%	
	2006 - 2010	0.96%	2.10%	+1.14%	
	2007 - 2011	-5.51%	-1.51%	+4.00%	
	2008 - 2012	-0.17%	1.99%	+2.15%	
	2009 - 2013	19.61%	24.67%	+5.05%	
Melt-up	2010 - 2014	15.80%	14.45%		+1.35%
		ANNUALIZED RETURNS		AVERAGE OUTPERFORMANCE	
	(47 Years) 1968 - 2014	**8.68%**	**14.80%**	**+7.65%**	**+2.21%**

* Flat = less than 1% difference

Source: S&P Corp/ FactSet Research/ SCCM

“Forget the Euro” – Now versus Then

Markets tend to react to one headline grabbing event after another – the most recent being Brexit. Our first reaction to what happened was to dust off a 2012 Market Letter, one we called “Forget the Euro: Focus on Dividends and Earnings.”

The letter’s conclusion stated that stocks were selling at one of the most attractive levels in the last fifty years. In the subsequent four years, the market went up 1,000 points. **Today, the situation is different because valuations are much more extended, which is typical after a long melt-up period.** Stocks are still cheap relative to bonds, but the S&P 500 needs to see earnings start to catch up to stock prices.

Beware the Black Box

Some things never change – only the way they are packaged. In 19th century America, the stage coach would come to town and a medicine man would jump out and start pitching a special formula to cure any ailment. Life today is no different. **Wall Street always has people coming to town to recommend a special formula, a black box, to cure the market’s two big problems – risk and volatility.** Now, as then, the cure is an expensive one. We list below some of the more notable black boxes once sold on Wall Street.

Tactical Asset Allocation: This was the San Francisco gang’s “tech” black box solution to investing in the late 1970s. The box was a simple formula based on valuations, which would tell an investor when it was the best time to be in bonds, when it was best time to be in stocks, and when to shift the allocation between the two. Pension funds and their boards found the tech box irresistible. The problem at the outset was they were heavily overweighted in bonds at a time when the market was going sharply higher. **After investors grew impatient with the poor relative performance of the strategy, the black box was adjusted to allow for a shift into equities just as the equity market was rolling over.** That was the last we heard of tactical asset allocation.

Portfolio Insurance: In the mid-1980s, the market was going straight up and valuations were getting extremely stretched. Nearly everyone knew that equity prices were too high, but no one wanted to get out of the market. **However, institutions were convinced that if they used a series of derivatives, they could put a stop under their portfolios and not have to worry about valuations.** Portfolio insurance became very popular with nearly all institutions. When the market finally corrected, it blew past all the stops as the market dropped 25% in one day, the steepest in history. We haven’t heard the term ‘portfolio insurance’ since.

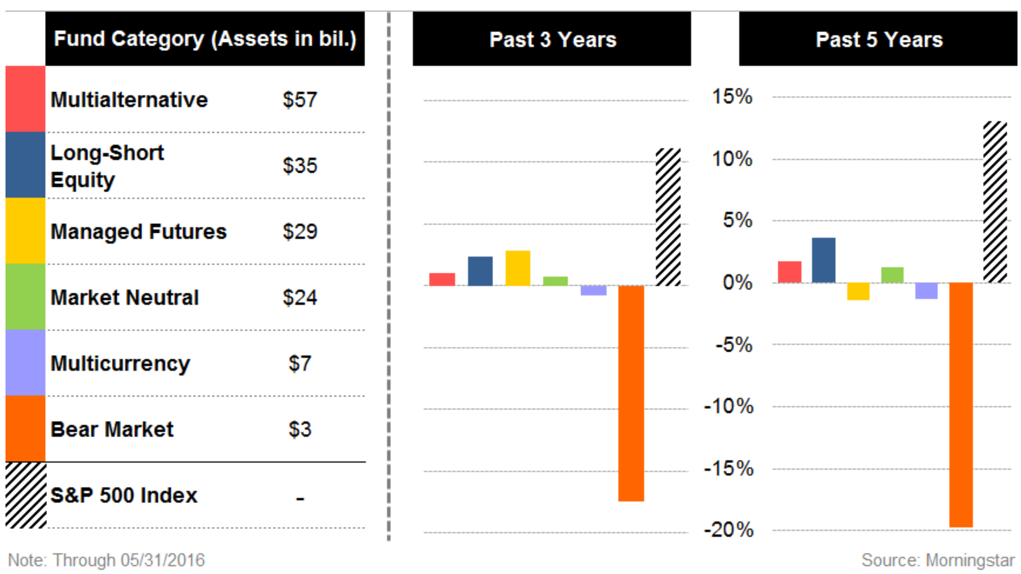
Fund of Funds: During the Tech Bubble, one of the popular areas of investing was a “fund of funds” format where you would pick the smartest, cleverest hedge funds and put them under an umbrella of the best mix of managers. **The fees were high, and when the Tech Bubble burst, performance for the approach was terrible – now little is heard on fund of funds.**

Because some of today’s alternatives to equities have a black box feel to them, we thought it would be worth making a few brief comments about what they purport to do.

Alternatives

Alternatives have recently become very popular with institutions, especially endowment funds. Five years ago, the allocation of funds for endowments was 50% equities, 25% alternatives. Today, they have dramatically shifted to only 35% equities and 51% alternatives. Two years ago, because of the popularity of the category, we tracked the performance of the most popular alternatives. The results were poor. **Because alternatives continue to be popular, we have updated their performance, which is still poor.**

The most popular choice among the alternatives is something called the Multialternative fund, which describes itself as follows: **"These funds will use a combination of alternative strategies, such as taking long and short positions in equity and debt, trading futures, or using convertible arbitrage, among others."** Sounds like a *super* black box.



ETFs

ETFs can be a very good way for investors to get exposure to various specialized areas of the market. They can also help provide portfolio diversification. ETFs have become especially popular with the Millenials, with 80% of all investments made by the group put in the new category. From what we can tell, investors believe that ETFs somehow reduce investment risk and provide a quick and easy way to own stocks. **While ETFs may seem like a good idea in theory, they can be tricky and may eventually set the investor up for major disappointment.**

ETFs are relatively new, but two problems have emerged. First, they are momentum driven and ignore valuations, and second, liquidity is still an unknown factor. Remember the flash crash last year when some of the ETFs went down 30% more than the index that they were supposed to be tracking.

A more serious criticism of ETFs has come from the experienced hand of John Bogle, chairman of Vanguard. He has pointed out that while ETFs are okay in theory, they are being used as trading vehicles; Bogle had estimated that turnover for some ETFs was over 1000% annually. Equally troubling, he said, was that some ETFs were offering exoctic strategies, like using triple leverage. In an interview with *The Financial Times*, Bogle said that while ETFs were a great marketing idea, he didn't think that they would serve an investor well. **After 64 years in the fund industry, Bogle said, "I have learned to beware of investment products, especially when they are new, and even more when they are hot."**

Downside Protection

Investors have spent a lot of money, time and effort trying to hedge against a down market; but what most of these strategies seem to do is limit upside performance.

We believe that the best way to deal with market volatility is to invest with a discipline and approach the market on a five-year basis. We are once more including in this letter the study that compares active versus passive investing. The results show that all of the consecutive five-year periods going back to 1968 smooth performance despite the bear markets and recessions in each five-year period.

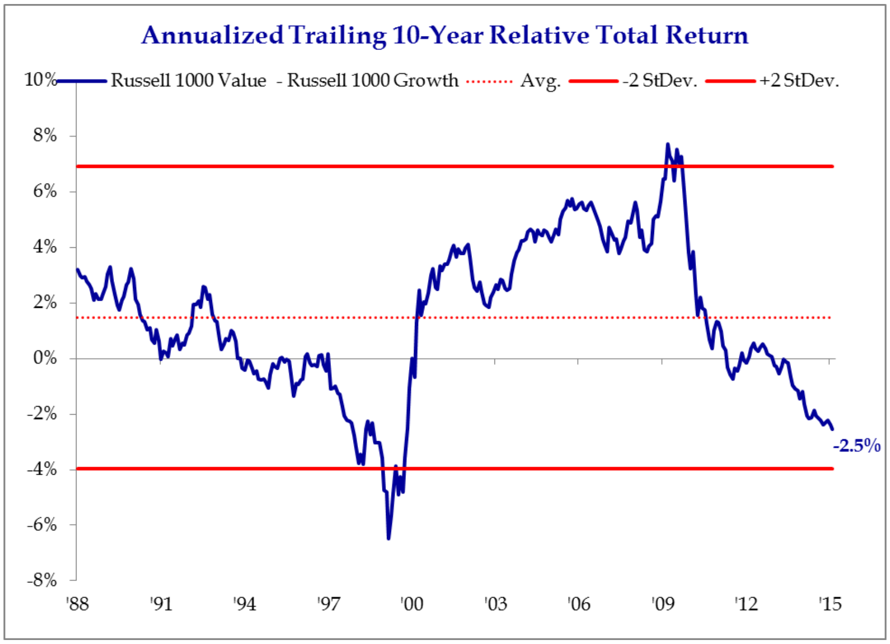
Active vs. Passive

5-Year Performance: 1968 – 2012
Annualized Returns

	Active	Passive		
	Bottom 20% Stocks by P/E	**S&P 500 (Passive)**	**Recessions**	**Bear Markets**
1968 – 1972	**9.7%**	7.5%	1969 – 1970	2/1968 – 05/1970: - 36%
1973 – 1977	**14.2%**	-0.3%	1974 – 1975	1/1973 – 2/1974: - 46%
1978 – 1982	**24.4%**	14.1%	1979 1981 – 1982	4/1981 – 8/1982: - 24%
1983 – 1987	**20.1%**	16.4%		8/1987 – 10/1987: - 33%
1988 – 1992	**18.1%**	15.1%	1990 - 1991	7/1990 – 10/1990: - 20%
1993 – 1997	**22.5%**	20.3%		
1998 – 2002	**7.0%**	-0.6%	2000 - 2001	7/1998 – 8/1998: - 19% 1/2000 – 9/2001: - 34% 3/2002 – 10/2002: - 34%
2003 – 2007	**18.2%**	12.8%		10/2007 – 3/2009: - 56%
2008 - 2012	**5.6%**	1.7%	2008 - 2010	4/2011 – 10/2011: - 19%
Annualized Average:	**15.1%**	9.5%		
1968 – 2012 (Growth of $1 million)	**$570 million**	**$59 million**		

SCCM Research, 2016

A Good Time for Value



Strategas, 2016

As a result of the recent, prolonged melt-up market, that lasted for five years, investors have been bailing out of value and into momentum-driven growth stocks, index funds and other alternatives. **The result is that value has become extremely oversold and would now seem to be especially timely.**

Jim Cullen

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