SCHAFER CULLEN

CAPITAL MANAGEMENT

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Chairman & CEO

Dealing with a

"Melt-up Market"

As investment managers, we spend most of our careers coping with negatives such as recessions, inflation, wars, government shutdowns, etc. The opposite is much less common – a melt-up market – which is what we have now. A melt-up market is one that moves up for at least 500 days without a 10% correction. **Such a market tends to develop in periods like we have been examining in recent market letters, where we noted that one of the most powerful long-term drivers of stock prices is a massive shift of money from bonds and cash into stocks after stocks reach record low levels of ownership.**

In a melt-up market, the most conservative strategies tend to trail the indices. This can be seen in our U.S. portfolios where the highest beta strategy, U.S. Small Cap, is +31% for the year; our conservative, low P/E, Value strategy is +28%; and our even more conservative High Dividend portfolio is +21%. **The danger in a melt-up market is the temptation to be lured into chasing performance and taking on more risk.**

The chart below lists all of the melt-up markets of the last 70 years.

Periods More Than 500 Days Without a 10% Correction

Date Range	Number of Days
1990 – 1997	1,767 days
2003 – 2007	1,154 days
1962 – 1966	830 days
1982 – 1987	780 days
1950 – 1953	681 days
1943 – 1945	639 days
2011 –	**543 days**
1953 – 1955	510 days

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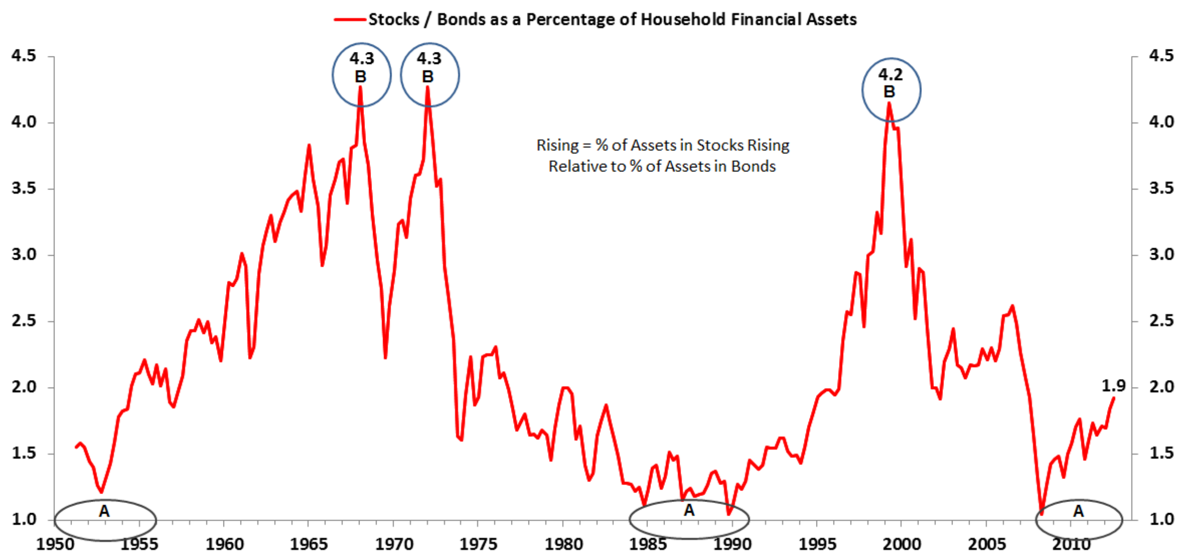
In this letter we examine what melt-up markets look like graphically, the risks such markets pose and the implications for our conservative High Dividend strategy. These points, taken together, should provide some insight into the tricky market we have now.

A Four-Point Analysis

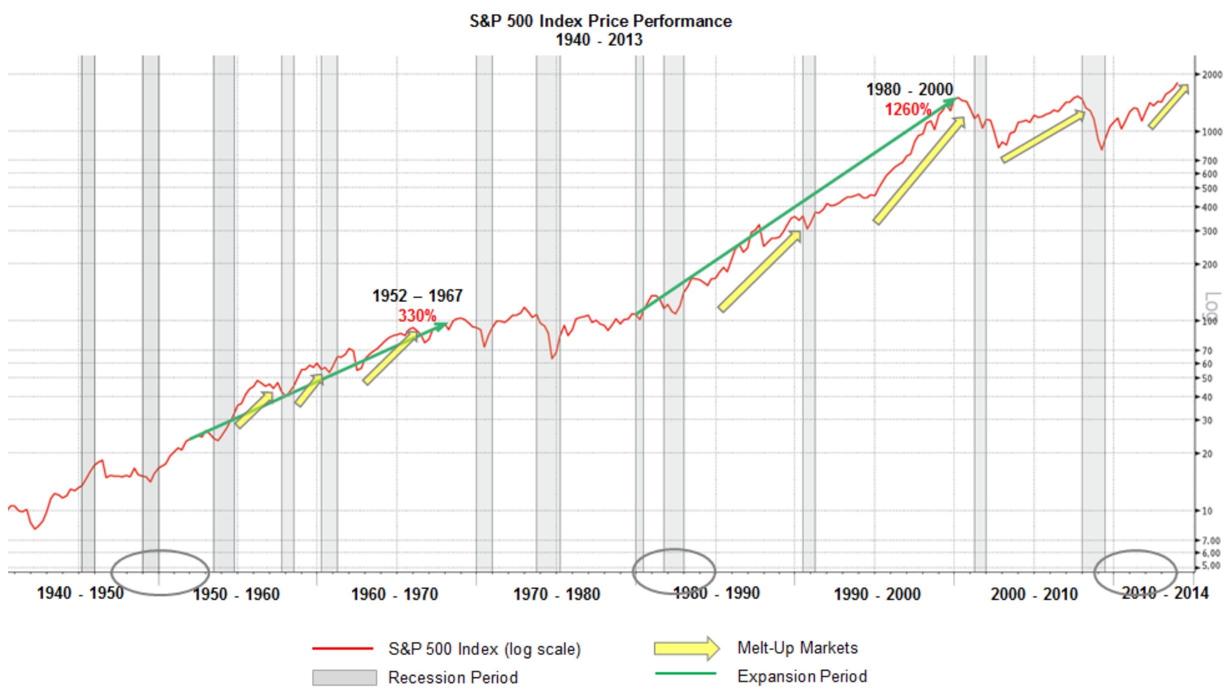
In our 2013 Market Outlook, we first used the two charts below to point out that markets show prolonged upward moves after investors start to move back to stocks following extremely low levels of ownership – like after the 1950s (+330%) and the 1980s (+1,260%). We can also see from Chart 1 that we're now back to those same low levels of equity ownership today (see the circled "A's").

Chart 1



Ned Davis Group/SCCM, 2013

Chart 2



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The second point we made six months later in our Mid-Year 2013 Market Comments where we measured the impact recessions had on these strong advances of the market. We can see from Chart 2 that there were three recessions during both major advances. **The conclusion to be drawn for the long-term investor: the power of money flows tends to override recessions.**

New Data

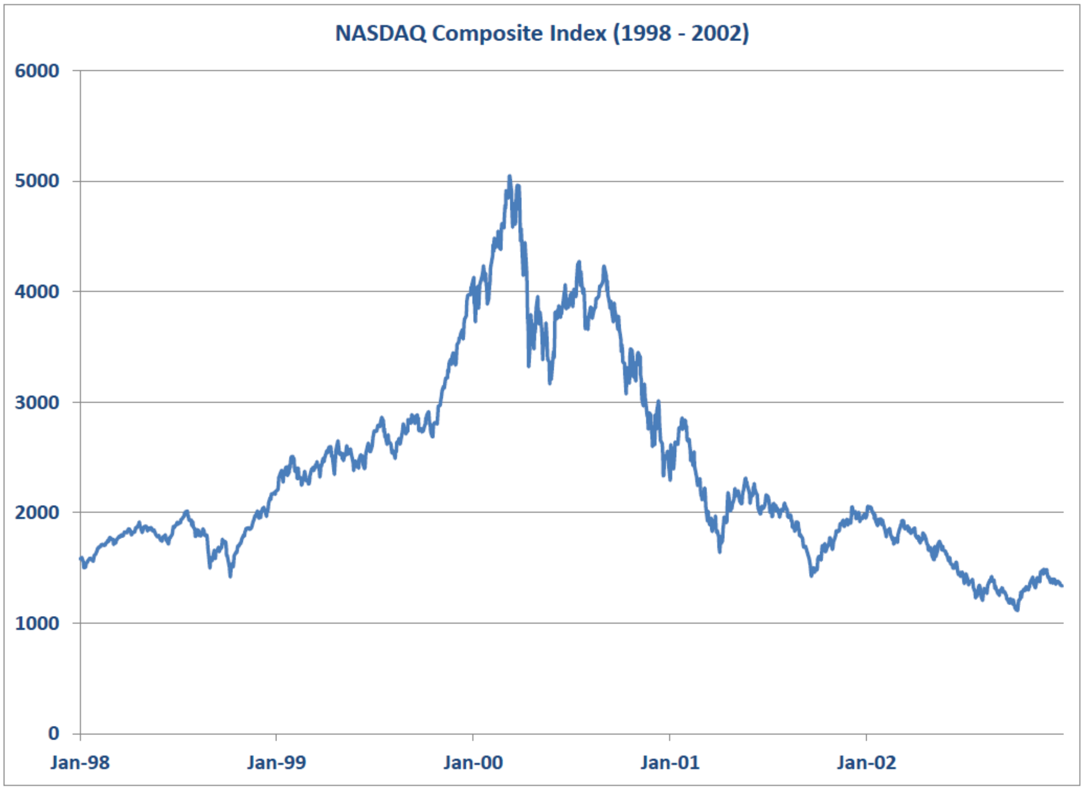
In the current letter, we want to introduce two new analytical points. First, on Chart 2, we superimpose all of the melt-up periods on the market. **What this makes clear is that melt-up markets can last a surprisingly long time, but when they end, a difficult market environment usually follows.** The second new point is that the biggest risk for investors occurs when the popularity of stocks reach extreme levels, which is what happened during the 1970s and in 2000. This is represented by the "B's" circled in Chart 1, the stock/bond chart. **It can be seen that, at the present time, we're a long way from these extremes.**

Taking on More Risk

One danger of a melt-up market is the temptation for investors to start reaching for performance by taking on more risk. A recent *Wall Street Journal* article quoted a portfolio strategist saying that he was finally getting comfortable with the market and was liquidating his low-volatility strategy in favor of investments in biotech ETFs and solar panel stocks, which are among the highest P/E stocks in the market. **The decision might pan out if the market continues to melt up, but – look out below – because once the melt-up comes to an end, valuations quickly come back into play.**

It appears to us that most investors are still in a low-risk frame of mind, but after watching CNBC for the last couple of weeks, you can see how speculative fervor has started to creep back into the market. **For instance, much of the network's air time is given over to social media stocks like Facebook, Twitter and LinkedIn, which is reminiscent of the coverage the dot com stocks received during the Tech Bubble.**

Because of the market's short term memory, I thought it might be a good idea to revisit what happened to NASDAQ, which was the index that featured the high-tech, high P/E stocks of the bubble. Three years later it was down 78%.



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Passive/Indexing Strategies

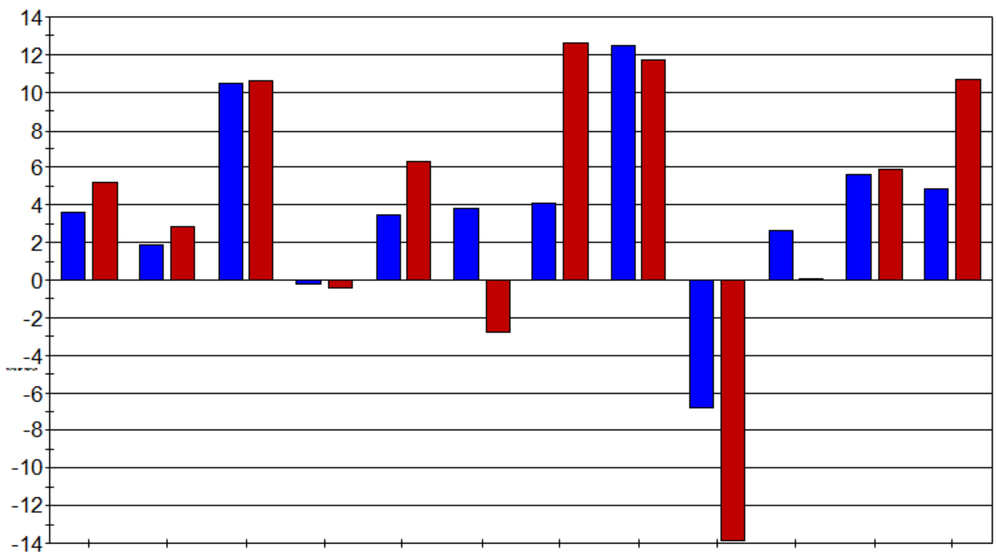
Another risk is that in melt-up markets, most lower-risk portfolios tend to lag the broad market and indexing becomes popular. During the Tech Bubble of the 1990s, the most aggressive investors used the NASDAQ index, QQQ, but investors today should be reminded that in the melt-up market of the 1990s the most popular investment strategy was the use of S&P 500 index funds. The problem was that as the market went ever higher, the valuation of the indices reached unrealistic levels. Then when the market broke in 2000, the index funds underperformed just about everything over the next five years, during which time almost everyone bailed out. By the end of the decade, the index story was more or less forgotten.

Today, a new twist to indexing is an oxymoron called “active ETFs.” These resemble a ghost from the past called Tactical Asset Allocation. During the 1980s, this was a popular strategy driven by a “black box” that signaled shifts between stocks and bonds. Tactical Asset Allocation blew up in the late 1980s and we haven’t heard much about it since.

The High Dividend Strategy in a Melt-up Market

One of the main strengths of our High Dividend strategy is its strong performance in down markets. What we can see in the graph below is that in the last three years, there have only been two meaningful down quarters for the market and the High Dividend strategy dramatically outperformed the market in both by approximately 7%.

PERFORMANCE BAR
PERIODS ENDING SEPTEMBER 30, 2013



	6/2013-9/2013	3/2013-6/2013	12/2012-3/2013	9/2012-12/2012	6/2012-9/2012	3/2012-6/2012	12/2011-3/2012	9/2011-12/2011	6/2011-9/2011	3/2011-6/2011	12/2010-3/2011	9/2010-12/2010
Schafer Cullen HDV	3.58	1.95	10.55	-0.25	3.46	3.78	4.08	12.57	-6.80	2.61	5.61	4.87
Standard & Poor's 500	5.24	2.91	10.61	-0.38	6.35	-2.75	12.59	11.82	-13.87	0.10	5.92	10.76

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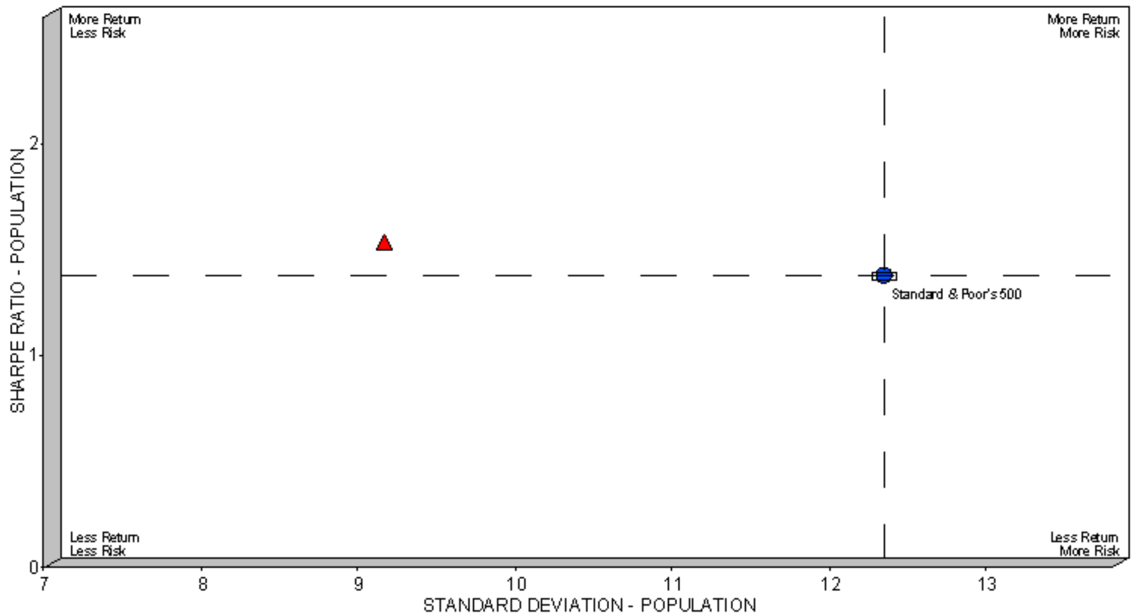
Measuring Risk

While valuation disciplines like P/E, price/book and dividend yield are important in controlling risk, they are often forgotten in melt-up markets. As a way to measure risk, the chart on the following page shows the risk-adjusted performance of the High Dividend strategy during the recent challenging three-year period.

CULLEN HIGH DIVIDEND EQUITY FUND
XY ANALYSIS
OCTOBER 31, 2010 TO OCTOBER 31, 2013



	ROR	Std Dev Pop	Alpha	Beta	R-Squared	Sharpe Ratio Pop	Info Ratio Pop	Tracking Error Pop	Downside Cap Ratio	Upside Cap Ratio
▲ Cullen High Dividend Equity Retail	13.68	9.11	2.83	0.65	0.76	1.49	-0.47	6.19	55.94	67.08
● Standard & Poors 500	16.56	12.29	0.00	1.00	1.00	1.34	0.00	0.00	100.00	100.00

RISK BENCHMARK USED FOR THIS ANALYSIS: STANDARD & POORS 500

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Conclusion

We have often quoted Ben Graham saying, “It is important to remember that markets are completely unpredictable on a one, two or even three-year basis.” This means that the melt-up market could end tomorrow or last another year or two. **But the strategy of applying a discipline and investing for the long term – a minimum of five years – goes a long way to reduce the risk of investing in equities, no matter where we are in the market cycle.**

In the long run, stocks should continue to benefit from institutional and individual investors coming back into equities, but with the market up 100% over the last five years, and now selling at 17 – 18 times earnings, it would seem prudent for investors to stick with disciplined value investing.

Jim Cullen

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