SCHAFER CULLEN

CAPITAL MANAGEMENT

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Investment Strategy

Melt-up Market: Update

The current melt-up market is now 650 days old – i.e. 650 days without a 10% correction – making it one of the most powerful and long lasting equity run-ups in the last 70 years. Feeding the frenzy have been headlines reading "…Market at New Highs…" appearing an amazing 70 times in the last 12 months. In such an environment, investing with a price discipline is ignored if not completely forgotten. As a result, stocks like Facebook and Twitter have become market darlings, despite having meager or no earnings. What we have is reminiscent of the melt-up markets of the 1920s, the 1970s, and the late 1990s, in which it became ever more difficult for disciplined investors to outperform the market. Even the legendary Warren Buffet has failed to outperform the market over the last five years for the first time in his long career.

Because investors are feeling the pressure to get into the market, today's new winner, besides the most speculative stocks, is passive investing – the new name for indexing and ETFs (exchange traded funds). The indexed portfolios represent a quick and easy way to get into equities without having to deal with the burden of stock selection. Both types of funds can help to diversify a portfolio, but because there is no price discipline in stock selection, the danger, once the indices become too popular, is that the investor winds up owning a portfolio of very popular and very overpriced stocks. **With the market having advanced for five years and selling at 19x earnings, it would seem to be a good time to be more disciplined about price rather than less.**

In our opinion, the best advice for long-term investors, especially now, is to look at a study done of the last 45 years that shows that if you had invested $1 million in the market (S&P 500) in 1968, it would have grown to $79 million today. **However, if one had invested $1 million with a value discipline (that is, the bottom 20% of stocks by P/E), and readjusted for the bottom 20% each year, the result would have been a staggering $578 million, not $79 million. So much for passive investing and the efficient market crowd.**

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

SCCM Research 2013

The History of Indexing

During the last 45 years, there were two other periods when indexing also became extremely popular. What those periods had in common was that they were both products of melt-up markets like the one we now have. The first was the "Nifty Fifty" era of the 1970s in which nearly all of the institutions were buying the same high quality stocks. The result was that the popular index of the day, the Dow Jones, came to represent the Nifty Fifty stocks. The index topped out in 1974, and the once popular stocks, despite their strong fundamentals, underperformed almost everything else for the next ten years.

The second period of indexing – the "Tech Bubble" of the late 1990s – is still fresh in the minds of most investors and was characterized by the huge run-up in technology stocks in the popular S&P 500 index. When the market collapsed in 2000, the S&P underperformed most everything for years.

Why Not Value?

Looking at market history and the advantages of investing with a P/E discipline, the obvious question is: "Why doesn't everybody invest this way?" To find out, we did a study in 2006 of the prior 20-year period from 1985 through 2004. The study showed that foreign stocks were the best performers in six of the years and the worst for seven, and small cap stocks were the best for six years and worst for six. **Meanwhile, large cap value was the best over the entire 20-year period; however, during that time, it was the best only twice. Nearly always another group was luring investors by making the most alluring headlines.**

Ranked by Performance 1985-2004	Annual Performance	Number of Years **Best**	**Worst**
# 1 Large Cap Value	**+ 14.5%**	**2**	**0**
# 2 Foreign Stocks	+ 11.8%	6	7
# 3 Small Cap Stocks	+ 11.3%	6	6
# 4 Large Cap Growth	+ 11.1%	4	1
# 5 Bonds	+ 8.8%	2	6

Large Cap Value:	Bottom 20% of stocks in the S&P 500 by P/E
Foreign Stocks:	Morgan Stanley EAFE
Small Cap:	Russell 2000 Small Cap Index
Large Cap Growth:	Top 20% of stocks in the S&P 500 by P/E
Bonds:	Lehman Brothers Aggregate Bond Index

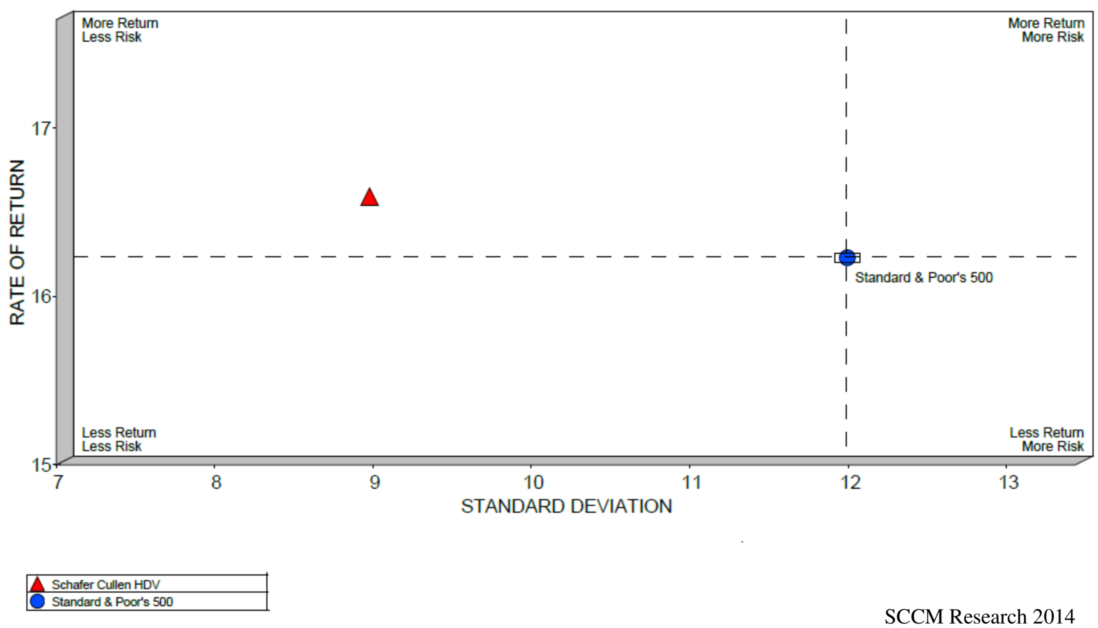
SCCM Research 2006

Risk-Adjusted Performance

As the market has moved up from its 2009 lows, there has been a gradual drift to taking on more risk. Last year our most aggressive strategy, the Small Cap Value accounts were +37.9% and our Value accounts, which are less volatile, were +31.9%, while our most risk-adverse, High Dividend accounts, were up only +24.9% versus 32.4% for the S&P 500. **However, if you factor in risk, you get a different picture – as you can see from the chart below.** Here we chart the last three years of the recovery. The vertical axis shows performance and the horizontal axis shows standard deviation, which is a measure of risk, with lower risk being farther to the left.

TOTAL RISK REWARD

DECEMBER 31, 2010 TO DECEMBER 31, 2013



SCCM Research 2014

Dealing with Recessions

After a strong 5-year advance from the oversold markets of 2009, some investors have begun to worry about the onset of the next recession. The key to dealing with recessions is found in our investment approach, which has two tenets: 1) invest with a discipline (P/E, price/book, and dividend yield) and 2) invest for the long-term – at least five years. Combining these features dramatically reduces the volatility of performance and absorbs the inevitable, periodic recessions. Evidence of this can be seen in the 45-year study that we feature in this letter. **What it shows is that despite the strong performance over the entire time frame, investors had to wrestle with a bear market and/or recession in every single one of the 5-year periods.**

Conclusion

We believe that the best investment strategy for long-term investors is: be in equities, but be in for the long term, be disciplined as to price and, for some extra downside protection, add dividends.

Jim Cullen

The Case for Disciplined Value Funds

Rolling 5-Year Performance: Bottom 20% of the S&P 500 by P/E & Top 20% by Yield

Period	S&P 500 Bottom 20% by P/E	S&P 500 Top 20% by Yield	Period	S&P 500 Bottom 20% by P/E	S&P 500 Top 20% by Yield
1968-1972	9.7%	10.7%	1989-1993	14.5%	15.5%
1969-1973	0.0%	2.2%	1990-1994	10.1%	9.2%
1970-1974	1.1%	0.0%	1991-1995	23.2%	19.1%
1971-1975	12.4%	8.3%	1992-1996	17.9%	16.5%
1972-1976	17.8%	13.3%	1993-1997	22.0%	21.3%
1973-1977	17.0%	10.3%	1994-1998	17.8%	22.0%
1974-1978	24.7%	14.1%	1995-1999	18.2%	20.7%
1975-1979	34.3%	22.0%	1996-2000	13.9%	16.8%
1976-1980	24.7%	12.5%	1997-2001	13.3%	14.9%
1977-1981	18.2%	8.2%	1998-2002	4.7%	6.1%
1978-1982	22.2%	12.1%	1999-2003	12.1%	7.4%
1979-1983	24.5%	17.1%	2000-2004	16.0%	12.4%
1980-1984	26.1%	18.5%	2001-2005	15.4%	8.4%
1981-1985	26.5%	20.9%	2002-2006	16.0%	10.7%
1982-1986	27.6%	23.2%	2003-2007	17.3%	12.1%
1983-1987	18.9%	19.1%	2004-2008	-2.3%	-3.0%
1984-1988	18.2%	18.4%	2005-2009	2.0%	-3.6%
1985-1989	16.3%	21.4%	2006-2010	2.1%	-1.1%
1986-1990	6.1%	13.5%	2007-2011	-1.5%	-2.5%
1987-1991	10.5%	14.9%	2008-2012	2.0%	0.8%
1988-1992	15.4%	16.4%	2009-2013	24.7%	16.7%

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