SCHAFER CULLEN

CAPITAL MANAGEMENT

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Market Update:

The Melt-Up Market is Over!
Now What?

The sell-off in the third quarter finally broke the back of the melt-up market. As we have pointed out in recent market letters, the longer a melt-up market lasts, the more speculative it becomes, and this was one of the most extended in the past 70 years.

Besides ending the melt-up market, the recent sell-off resulted in the first down quarter for the overall market in nearly four years. And as we have said previously, once the market corrects, value dramatically outperforms – just as it did after the down quarters in 2011 and 2012. The results of the current down quarter can be seen in the October 5th issue of *Barron's* in which the Cullen High Dividend Equity (CHDVX) was the #1 performing fund out of all the large-cap value funds.

Barron's
3rd Quarter 2015: Best Performers

All U.S. Stock Funds	- 8.43%
Large Cap Value	- 8.91%
Best Performer: Cullen High Dividend Equity	- 5.01%

The question is, now what? **The short answer for the long term investor is that once a melt-up period ends, it opens the door for a very long and dramatic period of outperformance by value.** A recent example of this kind of market behavior is the tech/dot-com melt-up market, which ended in late 1998, made new highs in 1999, and then collapsed in 2000. After which, value returned **16.02%** a year for the next five years versus **1.52%** for growth.

We will talk more about performance history later in the letter, but first we need to look at the present post melt-up transitional stage of the market.

The Transition Period

History shows that once an extended melt-up period ends, the speculation and momentum does not suddenly stop. This is because money is still coming into the market as a result of (1) short covering and (2) steady flows from sidelined cash; **however, there tends to be a definite change in market activity.** To give you an idea of what this is, a few months ago we started tracking the daily performance of five of the most expensive and popular stocks in the market (Facebook, Netflix, Amazon, Tesla and the Biotech ETF). During the melt-up, every day the market went up, all five stocks uniformly went up two or three times more than the S&P 500. Conversely, when the market went down, the five stocks also uniformly held up or went down only a little. Now that the melt-up has ended, the uniformity has stopped.

Performance is always very mixed during transition periods. We can see, for example, in the current market that the Biotech ETF went down three times as much as the market during the correction. Meanwhile, a few growth stocks like Amazon continued to go higher, prompting a cry for investors to buy more on dips. Also, some of the most out of favor groups, like commodities, have been doing better. A big difference is that value has continued its strong performance during the rally. Since the end of the quarter, our High Dividend strategy is in the top 1% of the Morningstar universe: **+9.96%** versus **+7.19%** for the market and **+6.86%** for the average large cap value fund.

How long the current transition period lasts is hard to predict. In the past, momentum has carried high flying stocks to new highs after the melt-up market ended. **However, one thing is clear: when the market eventually becomes less speculative, valuations become more important.**

Historic Performance

The table on the following page illustrates how value has outperformed growth after previous melt-up markets. While there is confusion about how to separate value from growth stocks, we believe a simple definition is categorizing growth as the top 20% of stocks in the S&P 500 on a P/E basis and value being represented by the cheapest 20% on a P/E basis. And since we are talking about long-term investing, we have calculated the numbers on a rolling 5-year basis.

The table highlights all of the melt-up periods (circled) since 1968. It is amazing to see how growth outperformed value only during the melt-up periods, and what is equally clear is that after the melt-up periods end, value dramatically outperforms for a long time.

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

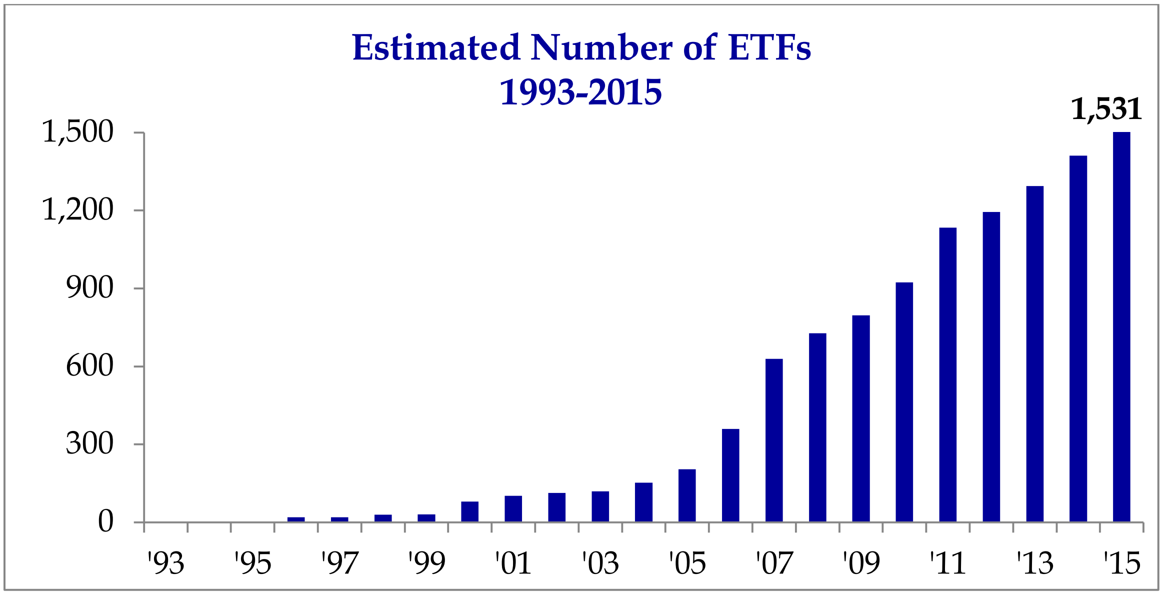
Rolling 5-Year Periods	**Top 20% by P/E (Growth)**	**Bottom 20% by P/E (Value)**	**Value Outperforms**	**Growth Outperforms**
1968 - 1972	6.03%	9.66%	+3.62%	
1969 - 1973	0.29%	0.00%	----- flat* -----	
1970 - 1974	-4.31%	1.11%	+5.42%	
1971 - 1975	2.71%	12.44%	+9.73%	
1972 - 1976	2.44%	17.81%	+15.38%	
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* -----	
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%	
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%	
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

More on ETFs

In past letters, we have warned about the danger of indexing in ETFs when they become too popular. The risk comes from over-valuation. The research firm, Strategas, points out another risk – liquidity. In the top chart below, the firm shows how strong flows have been into the ETF indexes. **In the bottom chart, Strategas shows what happened in the recent market correction when the performance of the ETFs was much worse than the individual stocks they were supposed to be mimicking.** This raises the question of what would happen in a really serious market sell-off.



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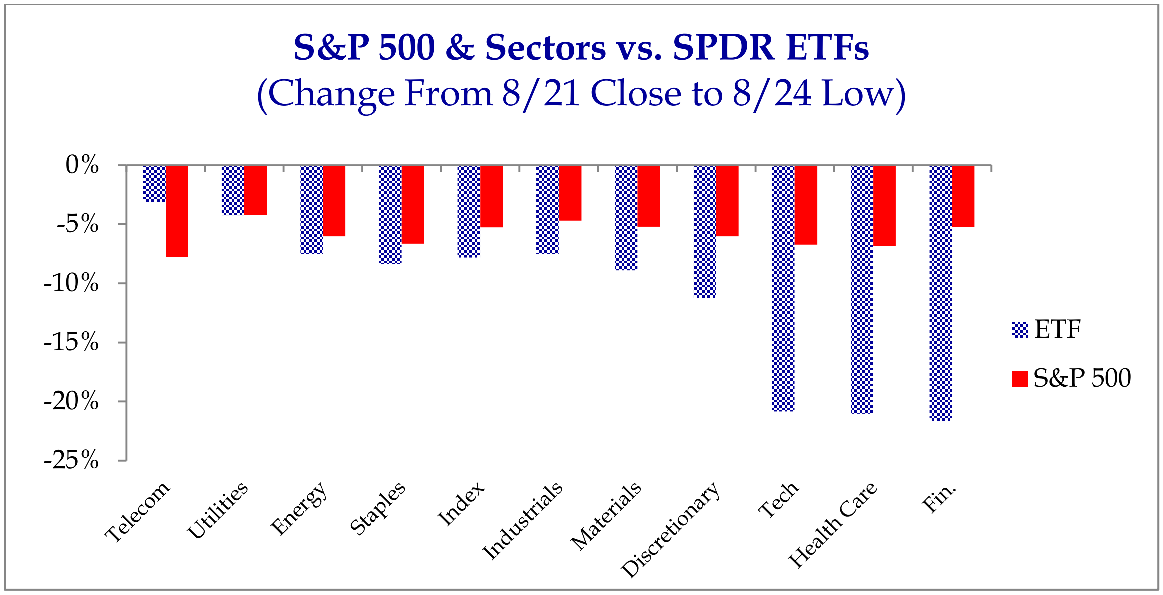

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Bear Markets

Monetary easing and the spread of QE's have seemed to provide a way for the U.S. and other countries to avoid economic slowdowns. And the policies of the central banks have contributed in a big way to our recent melt-up market. As a result, there is a growing belief that we can now indefinitely keep at bay any kind of economic slowdown. **Maybe, but for the long-term investor, economic contractions and bear markets should be considered part of the reality of investing rather than something that can be permanently put off.**

Earlier studies we did on active versus passive management illustrate how disciplined value investing works in bear markets. You will find in the chart below all of the consecutive 5-year periods since 1968, then all the down periods in each of the 5-year periods, and finally, in the last column, annual performance for the bottom 20% of stocks by P/E. **Note that every annualized 5-year period was actually positive despite recessions and shocks of various sorts.**

In every single period, investors had to cope with down markets – except during the Tech Bubble build-up of 1993-1997. However, the 5-year period that followed produced the worst results of the study. **In any case, it is hard to believe that $1 million invested in 1968 in the low P/E strategy would have grown to $578 million by the end of 2012 – astonishing growth during a 44-year period in which the stock market encountered all kinds of obstacles and challenges.**

5-Year Performance: 1968 – 2013
Annualized Returns

	Bear Markets	Bottom 20% Stocks by P/E
1968 – 1972	- 36% 12/1968 – 05/1970	+9.7%
1973 – 1977	- 46% 1/1973 – 2/1974	+17.0%
1978 – 1982	- 24% 4/1981 – 8/1982	+22.2%
1983 – 1987	- 33% 8/1987 – 10/1987	+18.9%
1988 – 1992	- 20% 7/1990 – 10/1990	+15.4%
1993 – 1997		+22.0%
1998 – 2002	- 19% 7/1998 – 8/1998 - 34% 1/2000 – 9/2001 - 34% 3/2002 – 10/2002	+4.7%
2003 – 2007	- 56% 10/2007 – 3/2009	+17.3%
2008 – 2012	- 19% 4/2011 – 10/2011	+2.0%

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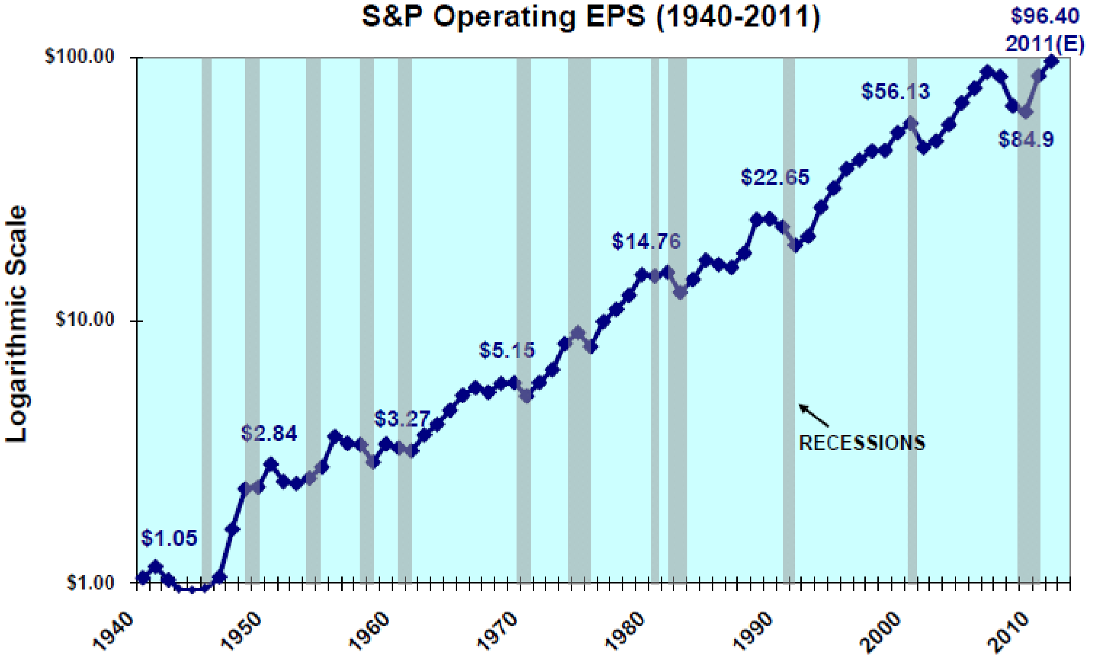
Why Stocks Go Up

Looking at the prior table on bear markets, investors might wonder how the stock market can do so well. The answer is corporate earnings. In the chart below, we have superimposed the recessions for the last 50 years on top of the earnings of the S&P 500. **What we see is that earnings keep working irregularly higher, despite all of the recessions and other setbacks, because corporations will do just about anything to grow their earnings.** In fact, corporations tend to double their earnings every ten years.

S&P Operating EPS (1940-2011)



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

Conclusion

Stocks go up over time because earnings go up over time. And as long as one doesn't overpay for stocks, the market has proven to be a good place for long term investors. **Moreover, after the correction in the melt-up market, investing in value stocks should be timely.**

Jim Cullen

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