SCHAFER CULLEN

CAPITAL MANAGEMENT

July 28, 2017

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Mid-Year Update

Forget Trump and Forget the Economy
But... Don't Forget the Safety Net

The two most common questions we get are how will President Trump affect the market and when will we see the next recession? Our Long Term Value Study, just below, answers both questions. The study shows that from 1968 to the present, every single five-year period featured some unnerving political events, a bear market, or both. Among the traumas, there was the Nixon resignation, 9/11, and the sub-prime financial crisis. **But the study also shows that a market participant who focused on a price discipline and invested for the long term did far better than one who reacted to the political and macro-economic headlines of the day.**

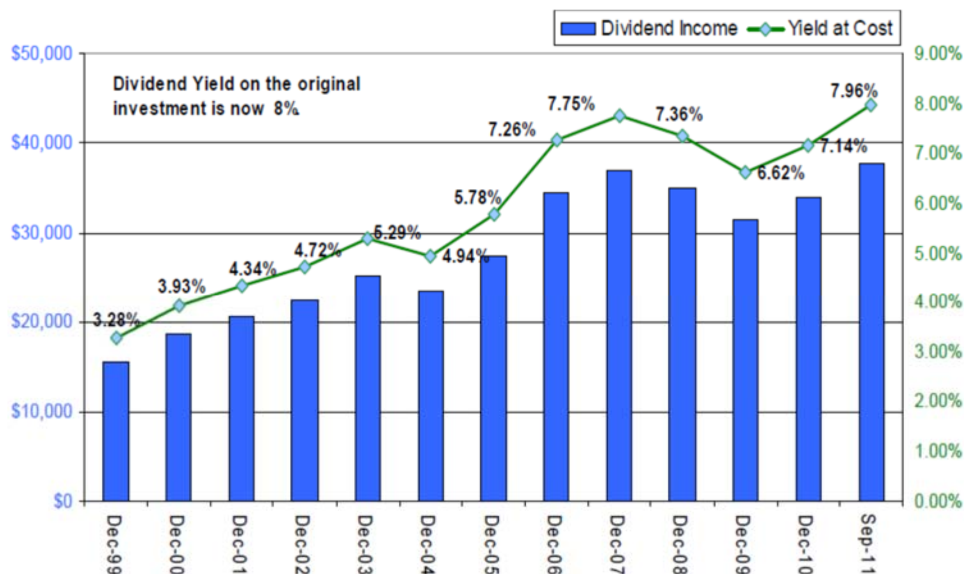
Long-Term Investing
Active vs. Passive
Consecutive 5-Year Periods 1968 – 2015

	Bottom 20% Stocks by P/E	S&P 500 (Passive)	Recessions	Bear Markets	
1968 – 1972	8.0%	7.5%	1969 – 1970	2/1968 - 5/1970	-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 1/2000 - 9/2001 3/2002 - 10/2002	-19% -34% -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%
2013 – 2016	17.5%	14.3%			
Annualized Average:	**15.1%**	**9.5%**			
1968 – 2012 ($1 million)	**$570 million**	**$59 million**			

*Annualized Returns. The three-year period (2013-2015) is shown for informational purposes only and is not included in the annualized averages or cumulative returns
Source: SCCM Research, 2016

The Safety Net

Because the ***present expansion is one of the four longest recoveries in recent history*****,** it would seem a good time to remember the need for a safety net. What we mean by a safety net is an investment strategy that combines P/E discipline, high dividend yield, and dividend growth. **History shows that while this strategy does well on a risk-adjusted basis in a straight up market, it underperforms on an absolute basis. However, when the market turns down, the strategy dramatically outperforms.** The study below is our performance during one of the worst periods in market history, the Dead Decade between 2000 and 2011.



Cumulative Total Return	
High Dividend Value Equity	**+94.01**
S&P 500	**-4.48**

Source: SCCM Representative Account, September 2011

During the period, we experienced two extreme and devastating markets, the tech collapse and the financial crisis. But the chart above shows why our portfolio outperformed – the dividend growth of stocks held. **The portfolio dividend yield at cost grew from 3.3% at the beginning of the period to 7.9% at the end.** The result: investors in the fund almost doubled their money during the Dead Decade, while the S&P 500 was actually down.

When the Party Ends

As just noted, we are presently experiencing one of the four strongest expansions in the last century. **In the table below, you can see that when the market finally corrected in previous expansions, the most popular stocks of the period had a severe and prolonged decline**. Ironically, earnings for those same stocks continued to go up even though their stock prices were going down. **So what happened was not about earnings, but about price.**

Major Expansion	Top Stock	P/E Multiple at Peak	Return 5 Years Later	Return 10 Years Later
Roaring 20's				
	Radio Corp of America	73.0	-99%	-99%
Nifty Fifty				
	International Business Machines	42.5	-28%	10%
	Xerox	254.1	-70%	-83%
	Polaroid	26.9	-79%	-87%
Tech Bubble				
	Cisco	230.4	-78%	-67%
	Intel	50.8	-66%	-76%
	Microsoft	79.9	-55%	-48%
FANG				
	Facebook	43.3	?	?
	Amazon	193.2	?	?
	Netflix	224.2	?	?
	Google	33.9	?	?

Source: SCCM, 2017

Vanguard 500 Index Fund – Remember the 1990's

The Vanguard 500 Index Fund first became very popular during the build-up of the Tech Bubble in the late 1990's. **Buying the fund gave investors exposure to equities, and they benefitted as the market went up and as high-priced tech stocks were rapidly added to the composition of the index.** The strategy worked in the up market, and the Index became the nation's largest mutual fund, replacing active investor Peter Lynch's Magellan Fund, which had been on top for some time.

However, when the bull market ended, the Index Fund declined steadily for years because of poor performance and redemptions. The Fund's biggest inflows were registered at the market's highs in 1998 – 1999, but by 2009, half of all the investors had bailed out. The reason becomes obvious looking at the table below, which shows the performance of the Vanguard fund relative to value stocks.

Date	Vanguard 500 Index Fund	Value- Bottom 20% of S&P by P/E
2000	-9.2%	18.3%
2001	-11.9%	15.4%
2002	-22.10%	-8.6%
2003	28.59%	37.5%
2004	10.82%	22.5%
2005	4.87%	15.1%
Cumulative Return	**-6.87%**	**141.91%**
Annualized Return	**-1.18%**	**15.86%**

Source: SCCM., 2017

Memories, of course, are always short, and so today the Vanguard 500 Index Fund is even more popular than it was in the 1990's. A new marketing feature of the fund is a cheap fee, something popular in the current environment. **What might explain the renewed success is that 20 years after the debacle, a whole new bunch of millennial investors have arrived, unaware of the Index's relatively recent past.** Things may be different for the Index this time, but there are many similarities between the TECH stocks of the 1990's and the FANG stocks of today. **Tech high fliers fueled the growth of the Index then and now.**

Fees

Promoting a cheap fee may work in an up market, but when the market retreats the fee charged is probably not a factor. **The Long Term Value Study shown earlier would seem to make clear that more important than the fee is having a price discipline. That discipline helps to prevent what Ben Graham said is the almost irresistible investor temptation to buy high and sell low – precisely what occurred with Vanguard investors in the 1990's.** Accordingly, it would seem that paying a reasonable fee for good advice is money well spent.

While reasonable fees are an important consideration, they hurt the investor when fee-cutting becomes a priority and the importance of having help during times of market volatility is ignored. We make sure to point out in our initial meetings with clients and advisors that while performance is obviously important, equally important is making them comfortable with their portfolios in all kinds of markets. **We also stress that we can pretty much guarantee that during the next five years there will be a time when they will question why they are in the market, or why they are in value stocks, or maybe both. Our job is to get them through these periods.** If we can do that, then most investors become believers.

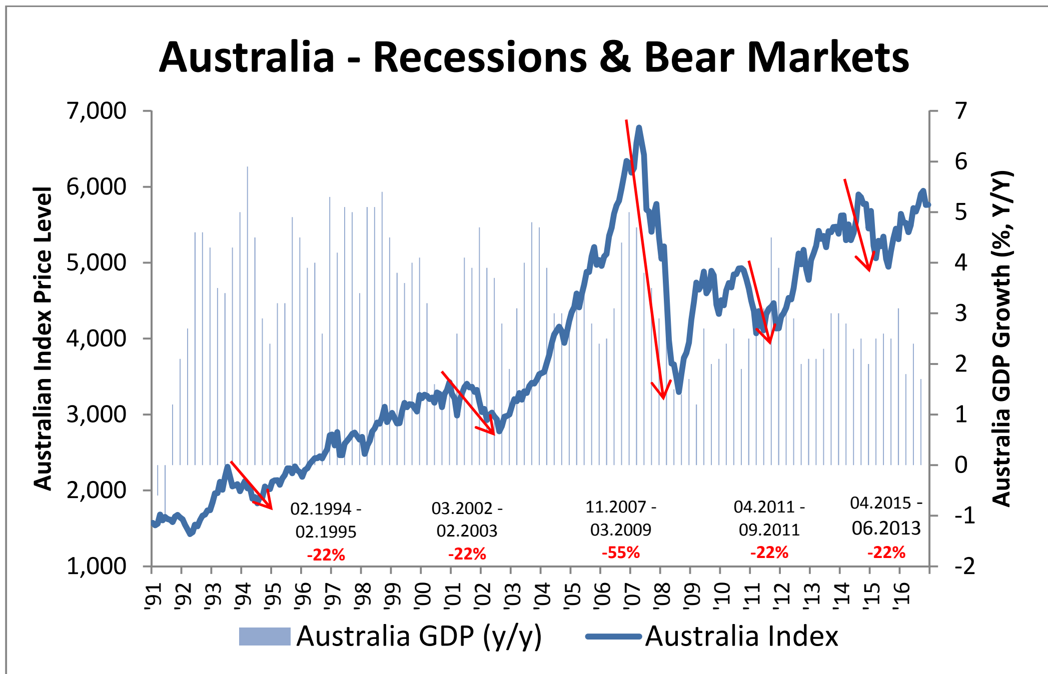
No More Recessions?

A big question among investors is how much longer can we go without a recession? When governments in the U.S. and the rest world are doing everything in their power to keep their economies going, some investors have come to feel that a recession can perhaps be pushed off indefinitely. Over the last seventy-five years, there have been twelve recessions, and the longest period without a recession has been eight or nine years. Since we are now pushing the limits of that time span, it seems prudent to be on the alert.

It recently came to our attention that Australia has gone twenty-five years without a recession. This is hard to believe, but I think this can be largely explained by the phenomenal growth in China and its demand for industrial commodities from Australia.

So what happens to the market in that kind of environment? On the chart below that shows Australian GDP going up for twenty-five years, we superimpose the performance of the country's stock market.

What we see is that despite the long-lived good macro-economic news, Australia had multiple market corrections, some of which were worse than those in the United States. The message here is that markets eventually make adjustments to valuations regardless of the absence of recessions.



Source: Bloomberg, June 30, 2016

Conclusion

History shows it is important not to try to time the market and not to overreact to political and macro-economic news. It is better to be disciplined and to invest for the long term. Also a dividend discipline can help cushion the market's volatility and provide a safety net when markets become challenging.

Jim Cullen
Chairman & CEO

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