

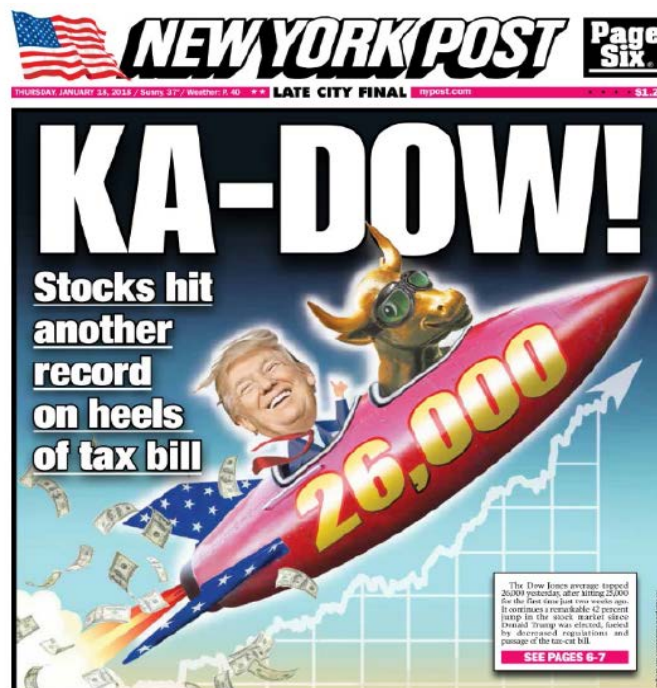
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Chairman & CEO

2018 Outlook Flying High

A look inside the strong market of 2017 reveals something unique -- the longest period ever without a 3% correction. We believe the reason for the one-way market was that skittish investors, not knowing what to do as the 2016 election approached, sold out when Trump won. Now those once nervous investors have been steadily coming back into the market.

Meanwhile, the huge move in equities over a period of nine years received little attention from the non-invested public and almost none from the millennials. **However, in January 2018 all that changed, the doors were blown off, and the market exploded to new highs on record volume.** The result was that the stock market finally made newspaper headlines, one of them appearing on the January 18th 2018 cover of the New York Post.



What was behind the sudden explosion? The answer appeared in another headline, this time in the January 27, 2018 edition of the Wall Street Journal: **RETAIL INVESTORS JUMP INTO THE MARKET.** The article pointed out what has created all the attention and excitement, especially with the millennials, is the publicity about the wild swings of Bitcoin and other cryptocurrencies.

The article went on to report that after sitting out nearly all of the nine-year bull market, individuals, led by the millennials, were pouring into stocks. The discount brokerage firms Ameritrade, E*trade, and Charles Schwab, reported huge surges in client activity at the end of 2017, that accelerated in January. The firms attributed much of the activity to retail investors who were opening brokerage accounts for the first time lured by the excitement over Bitcoin and cannabis investments.

The article said that Ameritrade saw a 72% rise in new business among millennials, **while Schwab told the WSJ reporter that retail business was up 49% from a year earlier and that more than half of their new clients were forty or younger. Schwab also said that because the market was hitting new highs on a daily basis, the younger investors were afraid of missing out.**

Problems in ETF Land

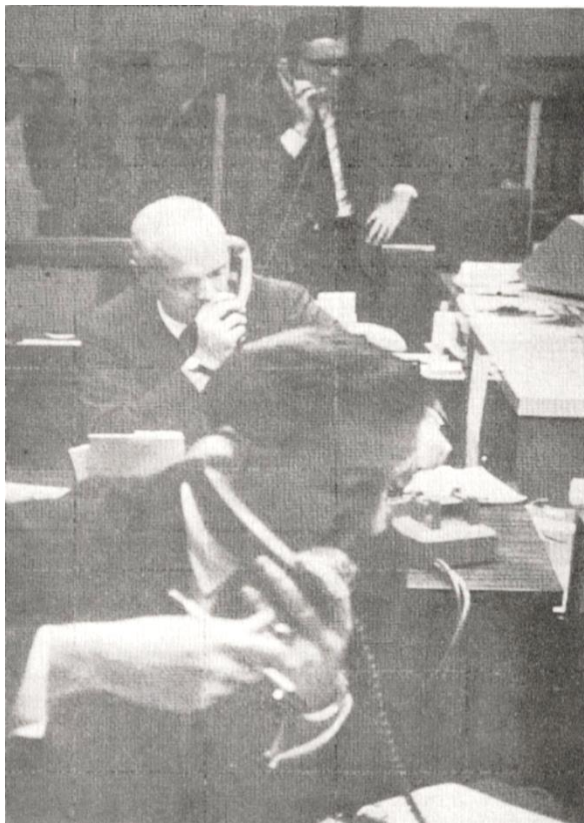
One reason for the popularity of ETFs among millennials is they can buy them on their smart phones. But there has been such a flood of new ETFs that it has been hard for the issuers to get the attention of the under 40 investors. Of course, the best way to attract attention is hot performance. And the easiest way to achieve that in a strong up market is to use leverage. **The result is that many of the new popular ETFs have loaded up with two or three times leverage.** An example of aggressive speculation is a new fund called FNGU, which has 3x leverage and only invests in the FANG stocks plus Tesla, Alibaba and a few other equally high P/E multiple stocks.

The Dangers of Debt

Throughout stock market history the combination of volatility and leverage has wiped out the market's most aggressively leveraged players. When I started on Wall Street in the mid-1960's, the hottest stock group was composed of companies called conglomerates. These were huge holding companies that had made a slew of hostile acquisitions by taking on massive amounts of debt. The conglomerate stocks were the darlings of the market and every day they were the most actively traded. A few of the names were Leasco Data Processing, Gulf & Western, Solatron Devices, LTV, Litton Industries, University Computing, and National Student Marketing. Each had its own wild story.

The press loved the conglomerates, but even the media was shocked when 29-year-old Saul Steinberg of Leasco Data marched into Chemical Bank, the sixth largest bank in the US, with an offer to take them over. That was the top. Shortly after Steinberg made his offer, we

had a recession and a market correction. Leasco Data and nearly all the conglomerates were wiped out.



Source: *The New York Times*, October 20, 1968
"Dow 1,000 by Year-End Seen Possible"

Retail Investors

Even after the really bad experience investors had with the conglomerates, speculation was still in the air after the 1969 recession. Our Merrill Lynch office on Wall Street (pictured on the left with me in the back) was mobbed every day with traders. To separate them from the brokers, a plexiglass wall was put up. In the public section we had chairs, a couch, the Dow Jones ticker and research reference books. **Our office, like most of the brokerage offices at that time, looked like a British betting parlor.**

Margin accounts became the new hot way to play the market for retail investors. These allowed them to borrow money against their portfolio in order to buy more stock. As long as the market was moving up, adding leverage to your account dramatically increased performance. And so margin accounts became almost irresistible to the average investor.

Institutional Investors

As the stock market was heating up for the public, the major institutions also began to show interest in common stocks. **Up until then, banks and major financial institutions avoided the market because of the disastrous experience they had after the crash of 1929 and the Depression of the 1930s.** During the 1960s, the leading stocks on the NYSE were high quality companies with strong financials and exceptional growth prospects like **IBM, McDonalds, Xerox, Polaroid, Eastman Kodak, among others.**

JP Morgan was the first major institution to start investing in these high quality companies. **All the others then started piling into the same stocks, which came to be known as the "Nifty Fifty".** The shared assumption was that these great companies could be purchased at any price because their future earnings power were so strong that paying any price for them would eventually be justified. **That assumption proved to be wrong.** During the next recession,

which began in 1974, the high valuations for the Nifty Fifty were tested and failed to justify the favored group's sky-high valuations.

When the market broke, the combination of retail margin calls and institutional liquidation combined to wipe out most of the margin accounts and many of the brokerage firms that had provided the leverage. Also, institutional firms specializing in research on the Nifty Fifty stocks eventually disappeared. To show you just how devastating the unwinding was to Wall Street, we reproduce below an underwriting announcement from the time. Remarkably, every single brokerage firm on the list either went bankrupt or was merged out of existence.

The New York Times

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New York Securities Co.	F.S. Smithers & Co.	C.E. Unterberg, Towbin Co.
Van Alstyne, Noel & Co.		

June 16, 1969

Source: New York Times, June 16, 1969

The Present Outlook

Even after a nine year bull market, stocks continue to roll along, with the tax bill adding fuel to the fire. President Trump, while extremely unpopular in the polls, has at least helped the market in one significant way: **large US corporations have been intimidated by his unpredictability.** A couple years ago, they would proudly announce opening a new plant in Bangladesh. Today the same corporations are emphasizing building plants somewhere in the US.

In general the market news is positive. Large and small business confidence is strong, consumer confidence is improving, earnings estimates are being raised, and global markets are doing better. Rising earnings have been especially good news for investors. **But we need to remember that valuations, for one reason or another, eventually tend to sneak into play.**

The Cycle: Where Are We?

Because valuations are at risky levels, we undertook a new research project that compared earnings with price, dividends, P/E multiples, and dividend yield for all the consecutive five and ten-year periods going back to 1920 (more detail on this in a later letter). After studying the resulting data, our conclusion: **Ben Graham was right when he said after spending sixty years in investment business that markets are completely unpredictable on a one, two, three or even four year basis.** We also concluded that when the market P/E multiple is low and earnings are increasing, a good period for stock prices eventually, but not always immediately, follows. Conversely, when P/E multiples are high and earnings are flat or going up or down, market performance is even less predictable. In short, determining the direction of stock prices at any given time is hard to do.

Long Term Strategy

Our familiar advice after reviewing the data from our new research project: don't try to time the market, invest for the long term and be very disciplined about price.

We felt it was timely to again present our historic study on long term investing. The study tracks all of the consecutive five-year periods going back to 1968, comparing the performance of the bottom 20% of stocks of the S&P 500 by P/E (Value) compared to the index itself, adjusting for P/E annually.

What the study shows is that volatility of performance is smoothed out by using the five-year periods. This is because five years gives the portfolio enough time to be driven more by earnings rather than short-term factors like fear, greed and momentum.

When we did the study we knew how challenging some of the five-year periods were, and so were surprised at the consistency of performance given such things as 9/11, the Tech Bubble, the Nifty Fifty, the Financial Crisis, etc.. The right hand column of the chart shows all recessions and bear markets during each of the five year periods. **Hard to believe, but for the long term investor, no matter how bad the news, it didn't pay to react to recessions and bear markets.**

Long-Term Investing Active vs. Passive Consecutive 5-Year Periods 1968 – 2016

	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			

Source: SCCM Research, 2017

Conclusion

The two biggest obstacles to long term investment success are taking on too much leverage and trying to time the market.

Invest for the long term and be disciplined about price. The rest is noise.

Jim Cullen
Chairman & CEO

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