SCHAFER CULLEN

CAPITAL MANAGEMENT

January 30, 2019

James P. Cullen
Chairman & CEO

2019 Market Outlook

Stay the Course

2018 was a down year for the S&P 500 and almost every other stock market around the world. **The result is that there is a lot of pressure on clients and advisors *to do something***. This has always been the case after a bad year even though history shows that for long term investors the best performance comes following down years.

The pressure to do something was dramatically highlighted by a BlackRock survey[1] of institutional investors. **The results showed that 68% of institutional clients were planning to cut their allocation to equities in 2019, using the rationale that they were reducing risk.** The clients said that they planned to move aggressively into what are called alternative investments. One has to question if these investments will represent less risk.

As we have noted before, history shows the best way to deal with the volatility of equities is to first, invest with a discipline and second, invest for the long term (i.e. five years). **What you can see in the study below is that the lowest P/E stocks of the S&P 500 (readjusted at the end of each year) tend to smooth out the results of all the negative years.** Also, what we see on the right side of the study is how challenging each five year period was because of recessions and/or bear markets that occurred in all of them.

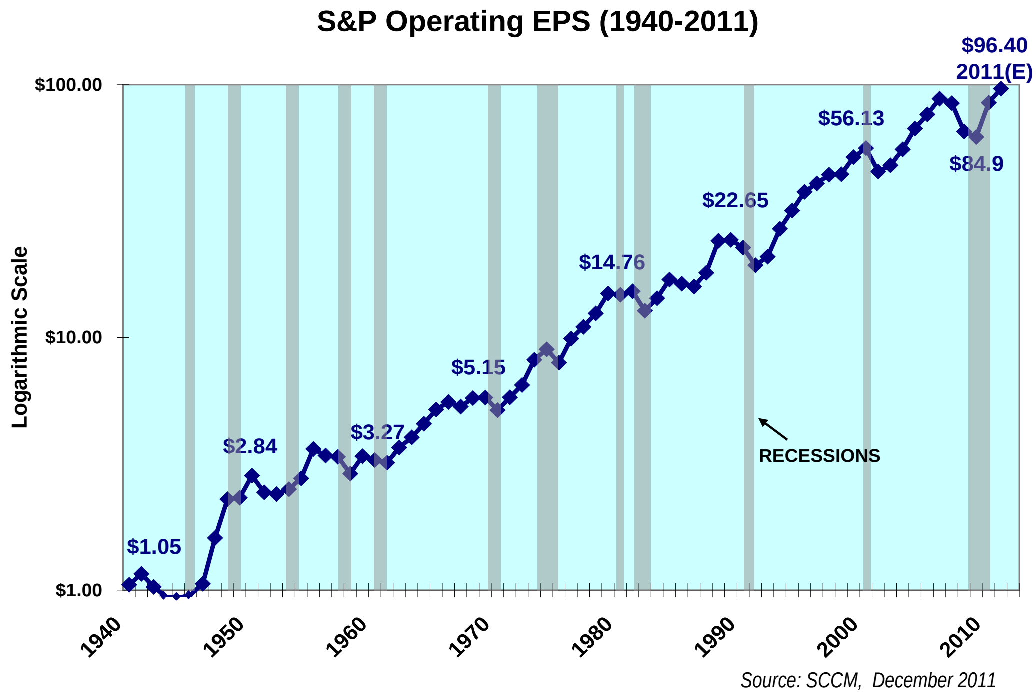
Long-Term Value Investing

Consecutive 5 Year Periods	Bottom 20% Stocks by P/E	Recessions	Bear Markets	Bear Market Return
1968 – 1972	8.0%	1969 – 1970	2/1968 - 5/1970	-36%
1973 – 1977	14.2%	1974 – 1975	1/1973 - 2/1974	-46%
1978 – 1982	24.4%	1979 1981 – 1982	4/1981 - 8/1982	-24%
1983 – 1987	20.1%		8/1987 - 10/1987	-33%
1988 – 1992	18.1%	1990 – 1991	7/1990 - 10/1990	-20%
1993 – 1997	22.5%			
1998 – 2002	7.0%	2000 – 2001	7/1998 - 8/1998 1/2000 - 9/2001 3/2002 - 10/2002	-19% -34% -34%
2003 – 2007	18.2%		10/2007 - 3/2009	-56%
2008 – 2012	5.6%	2008 – 2010	4/2011 - 10/2011	-19%
2013 – 2017	18.0%			
Annualized Average:	**15.4%**	**1968 – 2017 ($1 million)**	**$1,307 million**	

Source: SCCM Research, 2018

Long Term Value Investing

Why equities do well over time is explained in the below chart, which shows how earnings tend to go up over time regardless of bad news and recessions. Highlighted in the darker bands are the twelve recessions that occurred during the time period covered. Also, we see that earnings tend to double approximately every ten years.



Alternative Investments

The alternative investments referred to in the BlackRock study[1] are listed below. In the BlackRock study, clients say they want to put money into four investment alternatives:

1. 54% will be increasing holdings in <u>real assets</u>.
2. 47% will be increasing holdings in <u>private equity</u>.
3. 40% will be increasing allocations to <u>real estate</u>.
4. 20% will be increasing their <u>cash holdings</u>.

It would seem to be very debatable whether these alternative investments provide better risk/return prospects than equities. Below are brief comments on each category.

Real Assets

Real assets tend to be quite illiquid. We have seen a recent example in the experience of the Dallas Police and Fire Pension System[2]. They had invested $111 million in a land deal during the course the last three years and are now bailing out at $22 million. They say the decision frees up cash to be deployed in less risky plays.

Private Equity
Private equity seems to present an exciting way to invest money, but again liquidity can become a problem. There is a lot of real estate and a lot of leverage in private equity and very little regulation on how their investments are valued.

Real Estate
Here in New York, we continue to see apartment buildings going up and prices for luxury condos going down, making it hard to get excited over this sector. Also, one of real estate's savviest investors, Sam Zell of Chicago was interviewed by Bloomberg last week and showed little to no interest in real estate and much more interest in oil rigs.

Cash Holdings
Returns on cash are pretty low, unless one goes into the always uncertain market for junk bonds. If increasing cash is a tactical move as one waits to invest in stocks at a more opportune time that has always been tricky and mostly unsuccessful.

To show how tricky and unsuccessful, a study[3] done covering the period between 1994 and 2013 showed that the market returned 9% per year during the time span, but if the investor was out of the market just 35 of those 5040 days, the entire advantage of being in equities was wiped out. A look at those missed days shows that they appeared to occur at a good time to be out of the market.

Algorithms
A recent study[4] showed that mathematical algorithms are responsible for 80% of trading every day. This is one reason why the markets tend to be so volatile.

While algorithms may be a new term, they are certainly not new. Back in the mid 1980's, these mathematical approaches were driven by what was called a 'Black Box'. There was a period in the mid to late 1980's where this seemingly ideal mathematical strategy was developed by a few firms in San Francisco, and the strategy was called Tactical Asset Allocation. A few firms raised a phenomenal amount of money at the time with this seemingly irresistible strategy.

We had a personal experience with the Black Box strategy. After a long period of making a state pension fund comfortable with our value strategy, we received a large allocation from the group. Six months later, we were visited by the pension fund's consultant. He said the pension fund's board was very happy with our performance, but a San Francisco advisory firm specializing in the Tactical Allocation Strategy had just made a presentation to them. The firm highlighted their use of a Black Box, which produced signals that told them when to be in equities and when to be in bonds. While the board was happy with us, the consultant said that they could not turn down the phenomenal opportunity to employ "The Box" and were moving our funds to the new firm.

With the market going up, the advisor's Black Box signaled that the pension fund should get out of stocks and into bonds, and it did. The market continued to go up and the advisor was feeling the pressure to get back in. So he tweaked the math inside the Black Box, allowing him to shift back into equities. This turned out to be the top of the market. As stocks continued to drop, Tactical Asset Allocation was discredited and hasn't been heard from since. However variations of the Black Box keep popping up.

Today, algorithms are used in many different trading platforms and investment strategies, which can produce confusion. **But just remember what Warren Buffet has often said: "If you don't understand it, don't do it".**

Conclusion

Investors always have a lot of things to worry about, but are rewarded if they are disciplined enough to stay the course.

Jim Cullen

[1]Laverty, Kathleen. (2019, January 7) *Half of Institutional Clients to Cut Equities Exposure: BlackRock Survey.* Retrieved from www.FundFire.com

[2]Laverty, Kathleen. (2019, January 2) *Dallas Pension Invests $111M in Land Deal, Sells it for $22M*. Retrieved from www.FundFire.com

[3]Strategas Research, 2018

[4]Zuckerman, Gregory. (2018, December 25) *Behind the Market Swoon: The Herdlike Behavior of Computerized Trading.* Retrieved from www.wsj.com