SCHAFER CULLEN

CAPITAL MANAGEMENT

Value Equity

Q4 2018 Commentary

Market Review:

Through the first three quarters of 2018, it appeared as though the US equity market was headed for another big year, as the S&P 500 was up over 10% to that point. However, the fourth quarter quickly erased those gains, with the S&P 500 finishing down 13.5% for the quarter and the Russell 1000 Value down 11.7%. It was the worst quarterly performance in ten years, since the depths of the financial crisis in the fourth quarter of 2008. The month of October turned out to be the worst-performing month since September 2011, and after a modestly positive November, the market finished the year with its worst December since 1931. The full-year 2018 turned out to be the worst year for US equities since 2008, with the S&P 500 down 4.4% for the year, despite the index EPS on track to increase approximately 20% from 2017. 2018 also ended the streak of nine consecutive years of positive returns for the S&P 500, which tied the longest streak in history since 1936.

On a sector basis, Energy was the worst performer, down 23.8%. The WTI oil benchmark, which began the quarter at a nearly four-year high of $75 per barrel, declined 38% to $45 on concerns of excess inventories in the midst of slowing global growth. Information Technology (-17.3%) was the next worst performer. After being up 38% in 2017, then another 25% through the first three quarters of 2018, Technology pulled back sharply as each component of the so-called FAANG index fell into bear market territory. Industrials (-17.3%) and Consumer Discretionary (-16.4%) were the next worst performers. Utilities (+1.4%) was the only sector to finish the quarter in positive territory, as it and other defensive sectors, including Real Estate (-3.8%) and Consumer Staples (-5.2%) outperformed. Health Care was the best performing sector for the year (+6.5%), benefitting from its defensive attributes and the perceived alleviation of regulatory scrutiny over high drug prices.

The fourth quarter was a reminder of how abruptly sentiment can shift, not only on stocks, but on the US economy. In early October Fed Chairman Jerome Powell telegraphed interest rates were “a long way from neutral”, noting that extremely accommodative monetary policy was no longer necessary. This statement alone appeared to spark investor anxiety. By November, Powell shifted course, stating rates were “just below” neutral, and by the December rate hike of 0.25% the Fed dot plot implied there would only be two raises in 2019. While few indicators point to an imminent recession in the US, tempered outlooks from prominent technology and industrial firms indicate increasing pockets of weakness. The market sell-off was also driven by fears of a potential trade war with China. With $250B of Chinese goods already subject to tariffs, the Trump administration said it was prepared to impose tariffs on all remaining Chinese imports, before both sides agreed to delay any further tariff actions for 90 days.

Heading into 2019, we believe political unrest will likely continue to weigh on global markets. In the US, this includes a partial Federal government shutdown over funding for a border wall, President Trump’s surprise announcement on a US troop withdrawal from Syria, and a newly Democratic-led House of Representatives sure to apply pressure on Trump. Internationally, we believe markets will continue to contend with significant uncertainty surrounding Brexit, conflict between President Emmanuel Macron and protesters in France, and a new President in Brazil, among a host of other issues.

Performance Analysis:

The Value Equity strategy composite declined 9.3% (net) in the fourth quarter of 2018. The Russell 1000 Value declined 11.7% and the S&P 500 declined 13.5% for the quarter.

Figure 1: Value Equity Returns vs. Benchmark

	Q4	YTD	1 Yr	3 Yr	5 Yr	10 Yr
Value Equity (gross)	-9.3	-2.8	-2.8	9.9	7.7	11.8
Value Equity (net)	-9.3	-3.2	-3.2	9.4	7.2	11.1
Russell 1000 Value Index	-11.7	-8.3	-8.3	7.0	6.0	11.2
S&P 500 Index	-13.5	-4.4	-4.4	9.3	8.5	13.1

**December 31, 1993. Performance for periods greater than 1 year is annualized.*

The fourth quarter's heightened volatility and dramatic sell-off were led by deep Cyclicals and Technology stocks, in particular the FAANG index. While macroeconomic factors, namely slowing global growth, escalating China trade tariffs and normalizing monetary policy negatively impacted equity markets, the unwinding of algorithmic/high frequency trading positions also contributed to the steep slide. While Growth outperformed Value in 2018 by 680 basis points (Russell 1000 Growth – Russell 1000 Value returns), Value outperformed Growth by 420 basis points in Q4.

Portfolio Changes:

Aetna (AET), a long-term holding in the strategy, was acquired by **CVS** on November 29th for cash and CVS stock. CVS shares that were received in the transaction were maintained in the strategy.

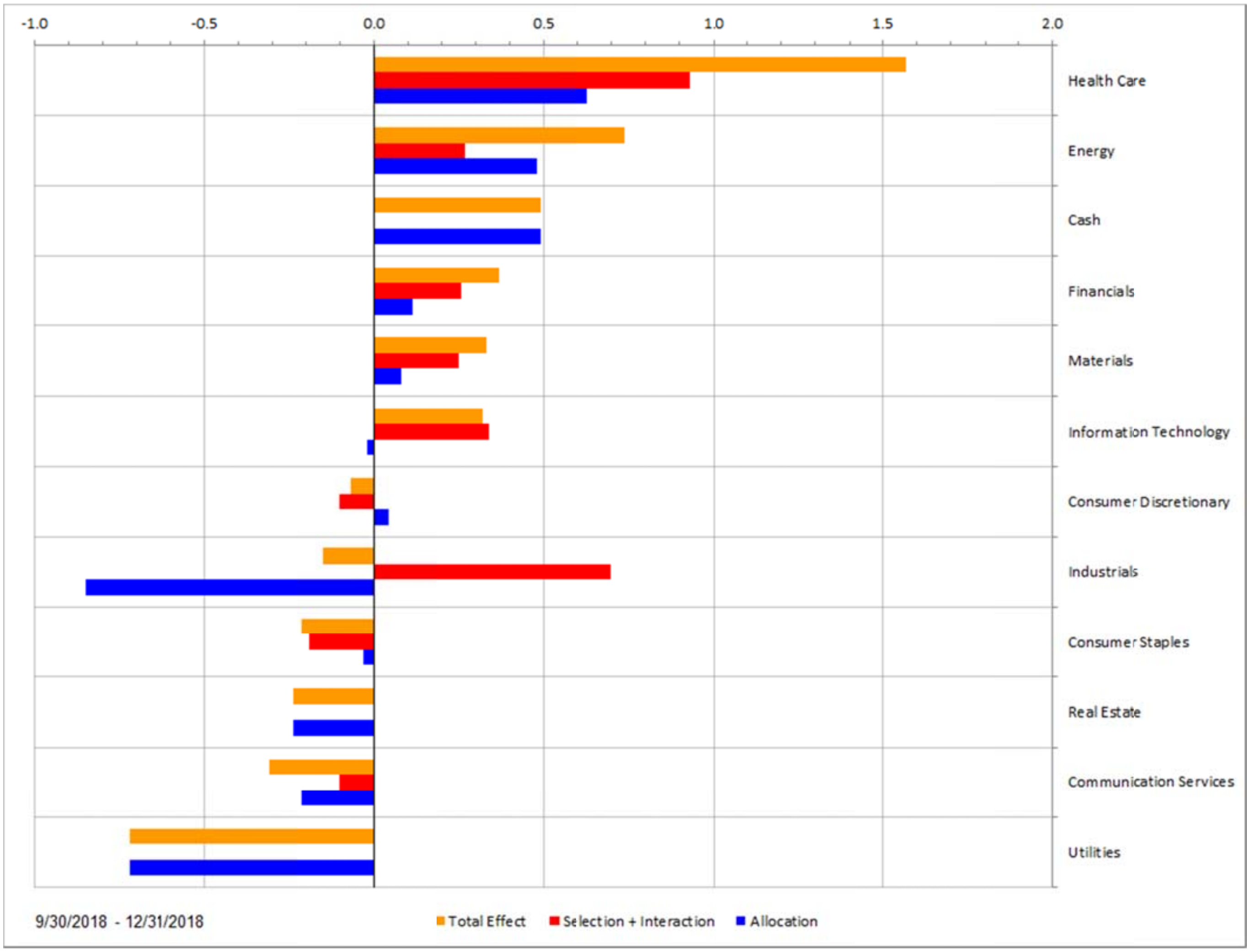
Sales / Reductions

Garrett Motion (GTX), the small-capitalization automotive supplier spun out from Honeywell, was sold from the strategy. GTX lacks significant product differentiation and scale in the highly commoditized auto supply business.

Resideo Technologies (REZI), the small-capitalization security solutions provider spun out from Honeywell, was sold from the strategy. The strategy currently holds a number of high quality industrial companies we feel are more attractive investments over REZI.

Portfolio Attribution:

Attribution Effects –Value vs. Russell 1000 Value 9/30/2018 – 12/31/2018



Source: SCCM/Bloomberg, 12/31/2018.

The following attribution analysis of the Value Equity portfolio utilizes the Russell 1000 Value as the benchmark of comparison for the fourth quarter of 2018.

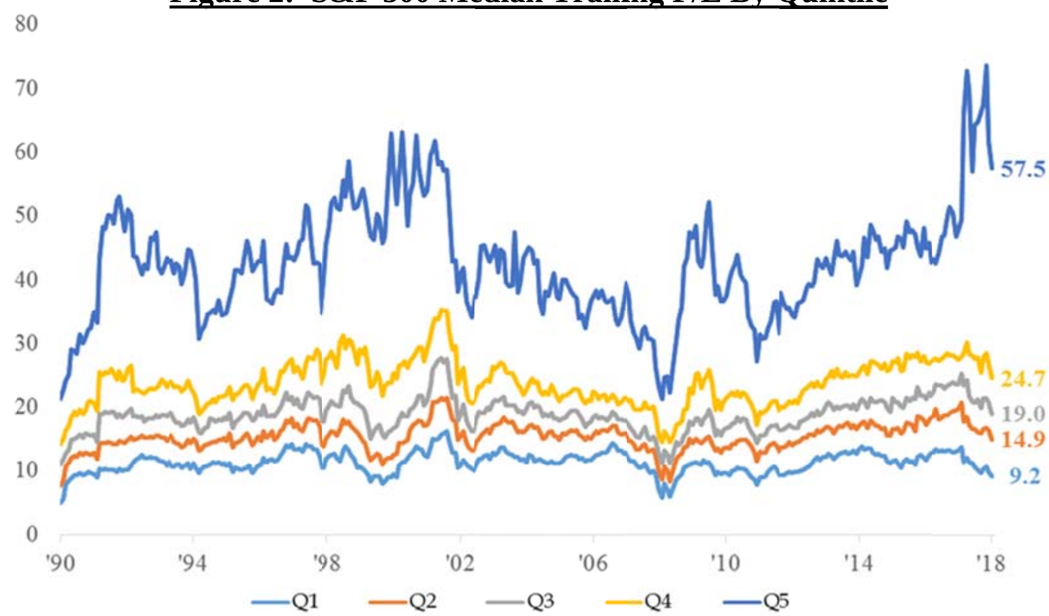
Our overweight allocation and strong stock selection made ***Health Care*** the largest contributor to relative performance for the quarter. The Health Care sector declined less than the overall market in the quarter, completing a year in which it was the best-performing sector overall. Merck (+8.5%) reported strong quarterly results with sales of its leading immuno-oncology drug, Keytruda, up 82% year-over-year. Aetna (+5.1%) was acquired by CVS Health in the quarter; this $70B transaction was announced in late 2017 and closed in November, creating a healthcare services firm including CVS's pharmacies and Aetna's health insurance business. Our underweight allocation and strong stock selection in the ***Materials*** sector aided relative performance. Commodities-sensitive Materials companies declined sharply in the quarter on US-China trade fears and concerns of slowing global growth. However, Newmont Mining outperformed (+15.2%), partially aided by a rise in gold prices in the quarter. Our underweight allocation combined with strong stock selection in the ***Energy*** sector aided relative performance. Energy was the worst-performing sector in the quarter as the WTI oil benchmark, which began the quarter at a nearly four-year high of $75 per barrel, declined 38% to $45. Chevron (-10.2%), although down significantly, declined far less than the overall sector, helped in part by its integrated business model that makes it less exposed to sharp swings in oil prices. Finally, the portfolio benefitted from our strong stock selection in ***Information Technology***. Arrow Electronics (-6.5%) declined far less than the broad sector as it reported record sales, reflecting strong electronic component demand.

Our underweight allocation to ***Utilities*** detracted from relative performance, as it was the only sector to finish the quarter in positive territory. Our underweight allocation and stock selection in the ***Consumer Staples*** sector detracted from relative performance. Archer Daniels Midland (-17.9%) declined partly on ongoing trade concerns, as China instituted a 25% tariff on US soybeans earlier this year. Lastly, our underweight allocation and stock selection in the newly-formed ***Communication Services*** sector detracted from relative performance. The defensive sector declined less than the overall market, and our position in AT&T (-13.7%) declined partially on concerns regarding ongoing subscriber losses in its DirecTV satellite unit.

Market Outlook:

Strong US economic data and robust corporate earnings growth in Q4 took a backseat to the market's increasing concerns on slowing global growth, the China trade war and normalizing monetary policy. The risk-off environment in 2018 resulted in 90% of major asset classes posting a negative return, versus the historical average of 29%, a pattern not experienced since 1921. While S&P 500 index earnings are expected to be up over 20% for 2018, with the index price decline, the Price/Earnings multiple fell 22%. Valuation multiples compressed the greatest for deep cyclicals (Energy, Financials, Industrials) and the least for stable sectors (Health Care, Utilities). The rapid market sell-off and elevated volatility have presented an increasing number of attractive investment opportunities not seen for quite some time. However, the dispersion in valuation multiples remains high – a number of industries are trading at recession-like multiples while Growth stock valuations remain high. In past cycles, heightened volatility has historically led to multiple compression driven by the highest multiple stocks[1]. Even with the recent underperformance of Growth relative to Value stocks, the valuation of Growth stocks are at extreme levels relative to historical averages.

Figure 2: S&P 500 Median Trailing P/E By Quintile



Source: Strategas Research, 12/31/2018.

[1] Bernstein Research, "US Portfolio Strategy", December 2018.

A headwind to global equities has been the tightening of monetary policy by world central banks. At year-end 2018, 56% of developed and emerging market central banks were tightening policy (30+ countries), the largest proportion in seven years. Historically, equities tend to deliver lower returns when more than half of the world's central banks are tightening policy[2]. In addition, the Federal Reserve's balance sheet run-off (quantitative tightening) continues to drain excess liquidity with the real global monetary base currently contracting 1% and projected to further contract by 4%+ by December 2019 if the Fed's current target of nearly $500B in assets roll off and the ECB and BOJ maintain assets at current levels. However, with global growth decelerating, central banks are already looking to adjust monetary policy, helping to stabilize global equities.

Fundamentally, in our view the prospect for US equities in 2019 appears positive, supported by a mid- to high-single digit year-over-year growth in S&P 500 earnings, relatively attractive valuation multiples and market sentiment coming off extreme levels. However, the current economic recovery's record length and the stark divergence between the economic recovery and financial recovery since 2009 should be considered. Nominal GDP growth in this cycle has been one of the weakest since the 1930's while equity market returns have been one of the strongest driven in part by unprecedented stimulus and aggressive monetary easing and a record level of share repurchases estimated at $4.5T in the US corporate sector. With less stimulative monetary policy and rising sovereign and corporate debt levels, the wide dispersion between asset price inflation and real economy inflation are at risk of convergence. In this environment, risk-adjusted returns are likely to adjust to more normalized levels and strategies that have delivered superior risk-adjusted returns through market cycles become even more critical.

In the current market environment, we believe investors should be more mindful of risk, not less. The most effective way to manage risk is to adhere to an investment discipline focused on valuation and quality, which is the core tenet of our investment approach. Relative to fixed income and equity benchmarks, the valuation of our portfolio remain attractive. The strategy trades at 13.9x forward earnings versus 16.5x for the S&P 500 and 15.2x for the Russell 1000 Value.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Best Regards,
Schafer Cullen Capital Management, Inc.

[2] Ned Davis Research, "Global Monetary Tightening Hurting Equities", December 2018.

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The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy. The index is unmanaged and has no fees.
The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe.
It includes those Russell 1000 companies with lower price-to-book ratios and lower expected and historical growth rates. One cannot invest directly in an index.

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