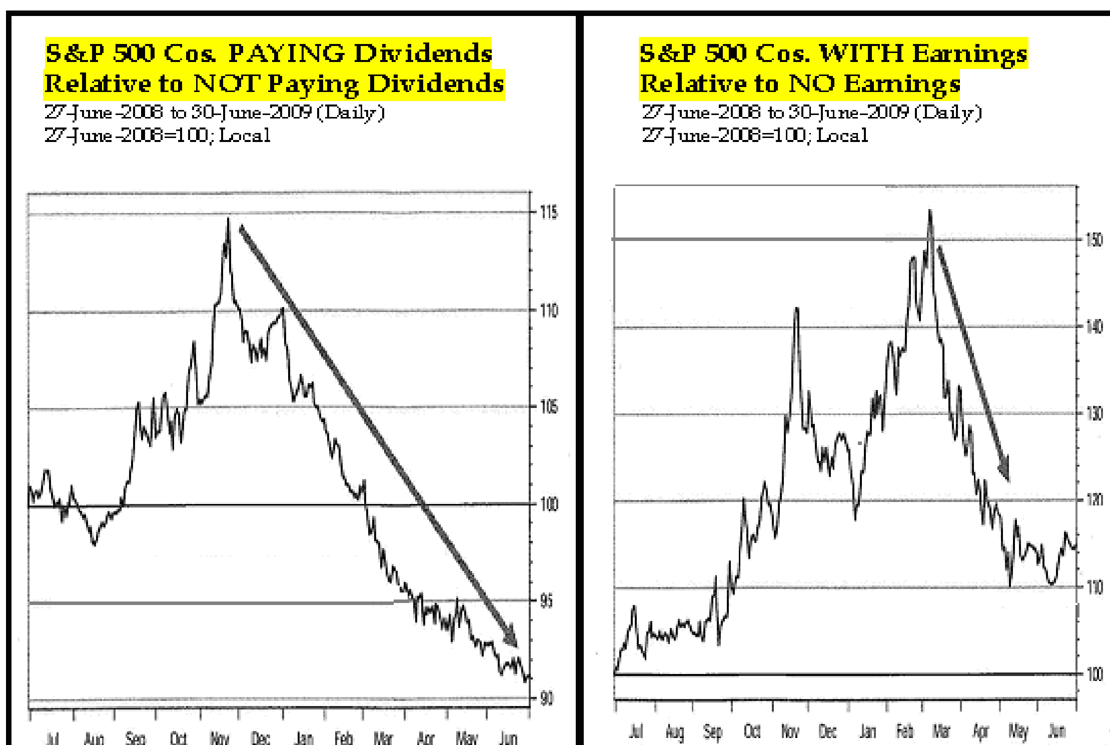
After the Turn

October 1, 2009

What history shows investors is that once the stock market is up over 40% after a major bear market, the back of the bear has been broken and a new recovery phase has begun. The tricky part is that history also shows investors that the period just after the turn is usually quite irrational, as panicky short covering and trading related to it become the main drivers of the market. The result is that the stocks with the worst fundamentals outperform those with the best fundamentals.

Just how upside down the market has become since the March bottom can be seen in the charts below. The first shows how companies paying dividends have dramatically underperformed those with no dividends. The second shows how companies with earnings have also dramatically underperformed those with no earnings. This is typical for the early stage of the recovery. **However, market history also shows us that eventually long term investors, focusing on fundamentals, come back in the market and buy companies with earnings and dividends.**

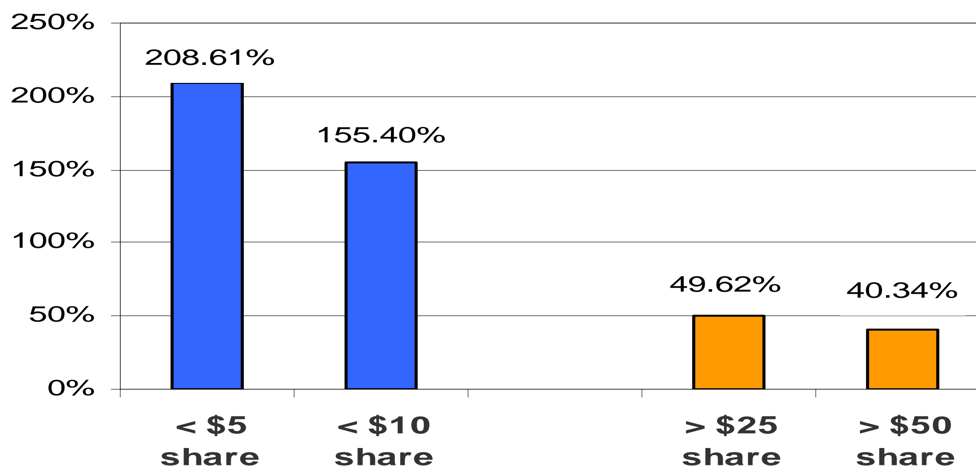


Source: FactSet Research Systems June 2009; StrategasRP

$5 “Junk Stocks”

Besides the rally in companies with no earnings or dividends, investors are looking at a third performance anomaly: a rally in the lowest priced stocks, those selling for under $5 a share, called “junk stocks” on Wall Street. Those companies are usually priced that way for a reason; they have lousy fundamentals and have typically been beaten down by short sellers. So when the market finally turns, there is a scramble by short sellers to cover. Short covering and speculative trading associated with the junk stocks has dramatically increased volatility, making up much of the market’s volume. A startling result of the phenomenon this year: stocks priced under $5 have outperformed stocks priced over $50 by 400%.

“Junk Rally” March 9th to August 31st



Volatile Environment

Even within the discipline of our value strategies, one can see wide divergences in performance coming from volatility, rather than fundamentals. Of our four major strategies, those that did the best last year have done the worst so far this year:

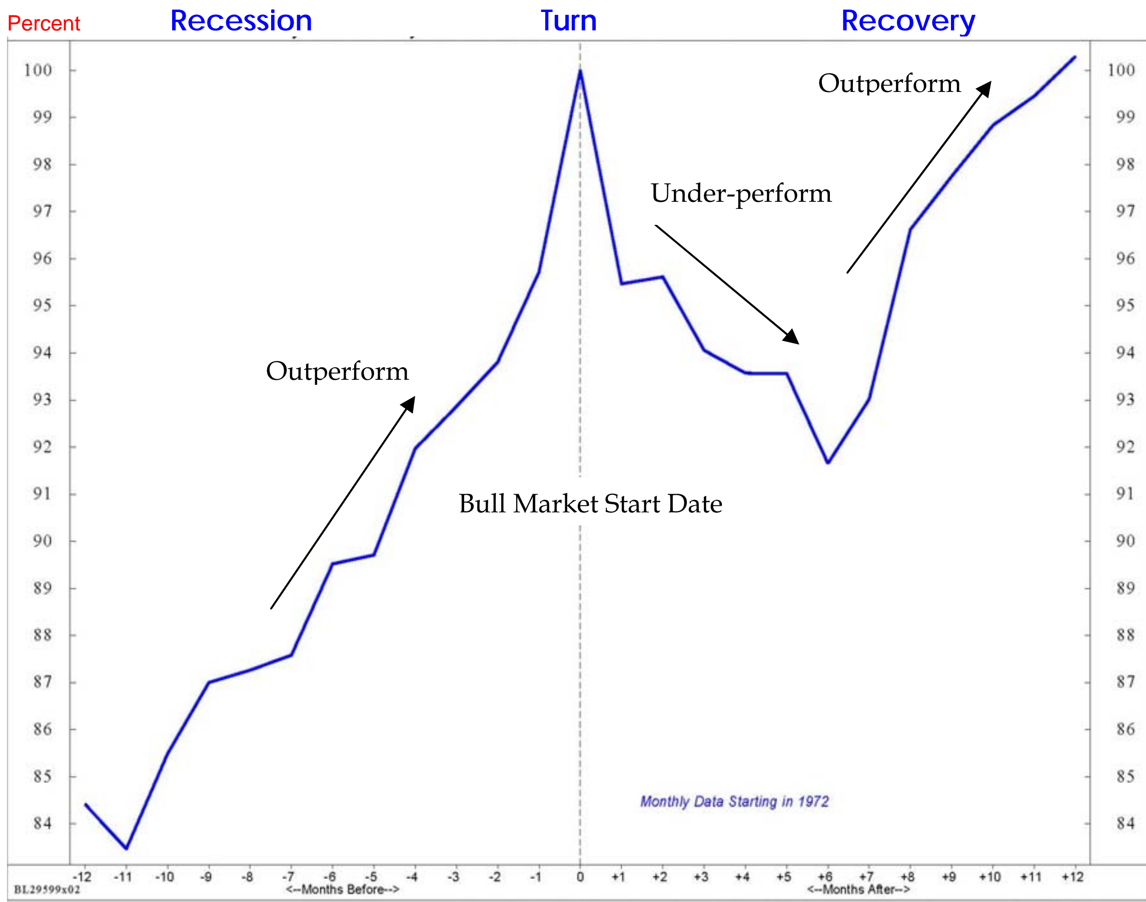
Strategy	Performance
Small Cap Global (Hedge Fund)	+ 31%
International High Dividend	+ 23%
Multicap Value	+ 14%
High Dividend	+ 4%

SCCM Composite Performance as of 09/30/09

Looking at the foregoing results, there is a temptation to give up on the most conservative and high dividend stocks, but history shows that is probably not a good idea, as can be seen in the chart below.

This chart (on the following page) looks at bear markets and subsequent rallies going back to the 1970’s. We can see that the highest dividend paying stocks outperformed in recessions and bear markets. Once the recovery started, these same stocks dramatically underperformed for an average of six months. However, after that time, the high dividend stocks resumed their outperformance. It may take longer for these stocks to resume their outperformance this time because the government has provided life support for many of the worst ”junk” companies.

S&P 500 Dividend Payers / Non-Payers Ratio Around Bull Market Start Dates

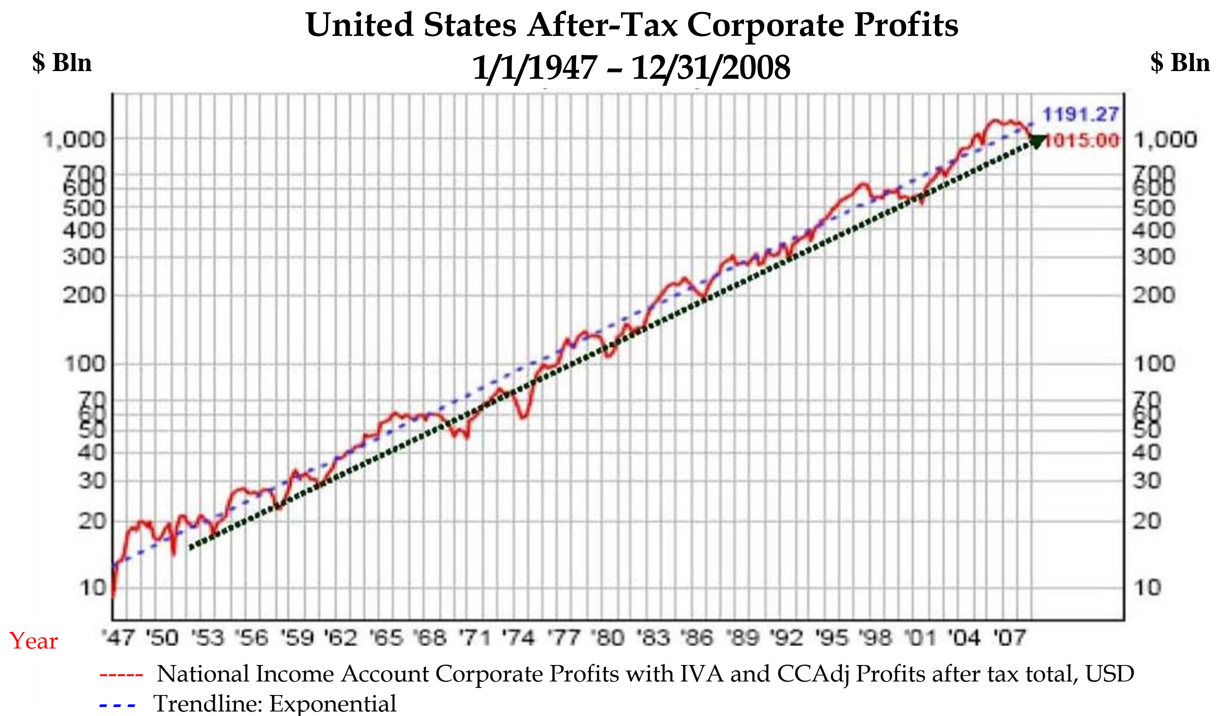


Complied using monthly data January 1972 – December 2003
Source: Ned Davis Research, Inc. 2009

Strategy

Ben Graham, the famous economist, emphasized how markets in the short term are completely unpredictable. The last few years show how right Graham was. But if investors are disciplined about price and put money in the market for the long term, which for us is five years, value stocks are given enough time for earnings and fundamentals to become the main drivers of portfolio value.

Looking at past history, Investors eventually come back into stocks that produce earnings and dividends. Why? Because, as the chart below shows, corporate earnings gradually work their way higher over time and these stocks track earnings.

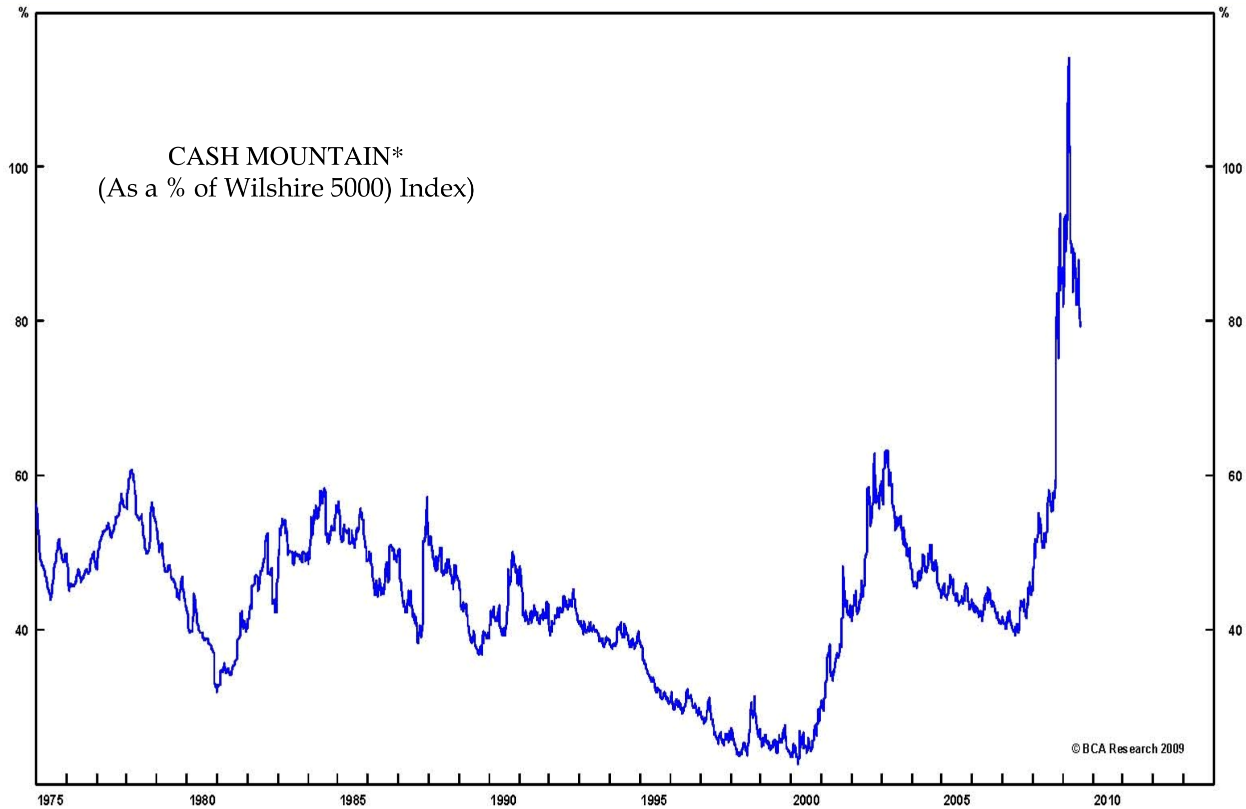


Source: Hays Advisory, June 29, 2009

Cash Still Plentiful

In our last letter, we had a chart showing extremely high levels of cash in savings accounts and money market funds – about $11 trillion at the market bottom, more than the value of the entire Wilshire 5000. Cash, of course, is the fuel for future stock purchases. We have updated the chart, shown below, to measure the effect the rally has had on cash levels. You can see that there is still a huge amount of money on the sidelines.

What usually happens is that once the low is made, and after the initial volatility, investors gradually start to realize that the ensuing recovery probably has staying power. Then investors supplant speculators and slowly come back into the market, focusing on fundamentals.



*Includes Money Market Funds & Savings Deposits
Source: BCA Research 9/30/09; Bloomberg LLP Dated Monthly

Conclusion

Once a bear market ends, there is a period of confusion, uncertainty and volatility as investors recover from the shock of the downturn. But as we pointed out in our last market letter, **the best returns for long term value investors generally come after a time like the one we've just had, when the stock market and corporate earnings both collapsed.** We showed how the five-year returns after major bear markets in the last fifty years produced the best annualized returns. This you can see again in the table below:

Recession	Next 5 years	Annualized Return **
1970-1971	1972-1976	+ 17.8 %
1973-1974	1975-1979	+ 34.3%
1980-1981	1982-1986	+ 27.6%
1990	1991-1995	+ 23.2%
2001	2002-2006	+ 16.0 %

Source: SCCM Research as of 12/31/08

*** Bottom 20% on a Price/Earnings Basis. On the last page, we have provided all the rolling 5-year returns for the P/E discipline going back to 1968.*

Jim Cullen
President

Disclosure:

Past performance is no guarantee of future results.

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* Small Cap Global (Hedge Fund) refers to the Schafer Cullen Global Small Cap Value L.P. / Ltd. Investments may only be made by accredited investors who have received the offering memorandum and have been approved for investment by the general partner. No offer to invest in the fund is intended by its inclusion in this report.

The Standard & Poor's 500 Stock Index (the **S&P 500**) is a commonly used measure of the broad U.S. stock market. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index. ***P/E** (Price-Earnings Ratio) is a* valuation ratio of a company's current share price compared to its per-share earnings.

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ROLLING 5-YEAR PERFORMANCE: BOTTOM 20% OF THE S&P 500 BY P/E

Annualized Rates of Return

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	**9.7%**	1987-1991	**10.5%**
1969-1973	**0.0%**	1988-1992	**15.4%**
1970-1974	**1.1%**	1989-1993	**14.5%**
1971-1975	**12.4%**	1990-1994	**10.1%**
1972-1976	**17.8%**	1991-1995	**23.2%**
1973-1977	**17.0%**	1992-1996	**17.9%**
1974-1978	**24.7%**	1993-1997	**22.0%**
1975-1979	**34.3%**	1994-1998	**17.8%**
1976-1980	**24.7%**	1995-1999	**18.2%**
1977-1981	**18.2%**	1996-2000	**13.9%**
1978-1982	**22.2%**	1997-2001	**13.3%**
1979-1983	**24.5%**	1998-2002	**4.7%**
1980-1984	**26.1%**	1999-2003	**12.1%**
1981-1985	**26.5%**	2000-2004	**16.0%**
1982-1986	**27.6%**	2001-2005	**15.4%**
1983-1987	**18.9%**	2002-2006	**16.0%**
1984-1988	**18.2%**	2003-2007	**17.3%**
1985-1989	**16.3%**	2004-2008	**-2.6%**
1986-1990	**6.1%**		

Source: SCCM Research - January 2009