

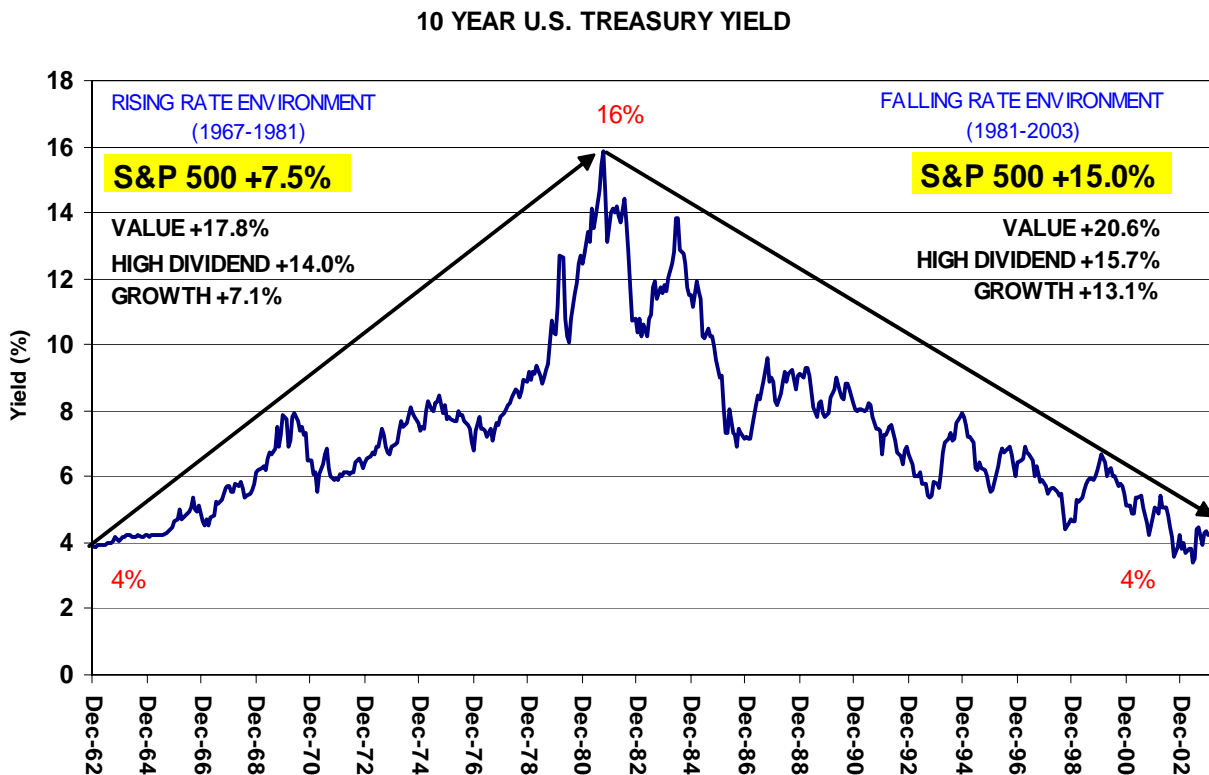
**MID-YEAR 2004
MARKET COMMENTS**

July 15, 2004

WHAT IF... HIGHER INTEREST RATES

In the last few years, investors have had a lot of worries with which to grapple, not least among them a vicious three-year bear market and the 9/11 terrorist attacks. The new worry is a fear of rising interest rates and higher inflation. With inflation and interest rates near 50-year lows and with the economy turning up, these fears seem justified.

To address these concerns, we undertook a study of the relationship between interest rates and the stock market over the last 40 years. The results were eye opening. In the chart below, we show the performance of the S&P 500 and the major investment styles in both rising and falling interest rate environments.



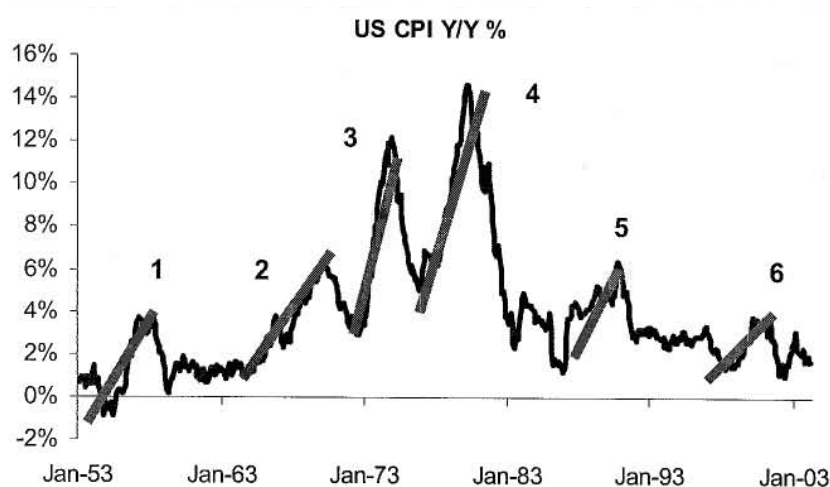
Value = bottom 20% of S&P500 by P/E,
 High Dividend = top 20% of S&P500 by yield,
 Growth = highest 20% of S&P 500 by P/E

SURPRISING RESULTS

What jumped out in the study was that, in a rising rate environment, the value stocks (+17.8%) and more interestingly the high dividend stocks (+14.0%) dramatically outperformed the S&P500 (+7.5%). Also, despite the stronger economy fueling stronger earnings in the rising rate environment, the growth (high P/E) stocks only performed in line with the market. One thing we haven't discussed here is how bonds underperformed in a rising interest rate environment.

INFLATION - SAME PATTERN AS INTEREST RATES

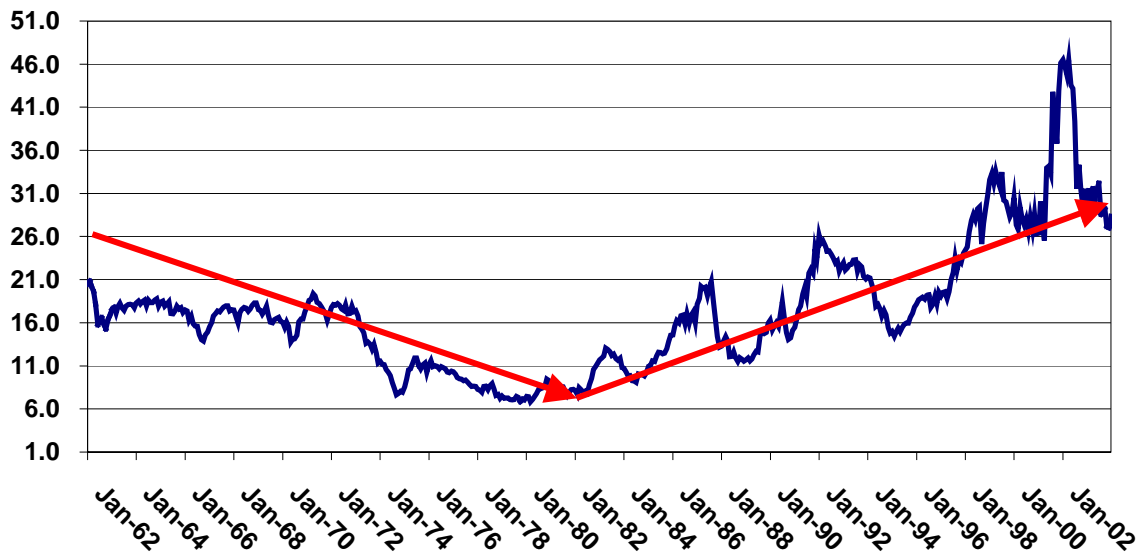
The chart below shows how the inflation rate tracks almost exactly the same pattern as the interest rates chart on page 1. This makes obvious sense because they both tend to rise during periods of economic growth.



WHY VALUE AND HIGH-DIVIDEND STOCKS OUTPERFORMED

P/E multiples decline: The chart on the next page shows the price-earnings multiple of the S&P500 over the same 1961-2004 period. We can see that P/E's decline as inflation and interest rates rise, and conversely, P/E's rise as both rates decline. If we were to invert this chart, the data points would track precisely the shape seen in the interest rate and the inflation charts. In other words, price performance does not deteriorate because of earnings – which are actually growing – but rather due to the contraction of P/E multiples. In a high interest rate and inflation environment, a higher premium is usually placed on price **relative** to earnings and not just earnings alone.

S&P 500 Index P/E



More down periods: Another reason why the value stocks and the high dividend value stocks outperformed in the rising interest rate environment is because, during that time, there were more down periods for the market. It is during down periods that value stocks, particularly the high-dividend value stocks, dramatically outperform.

MANY INVESTORS MAY BE OVER-WEIGHTED IN BONDS

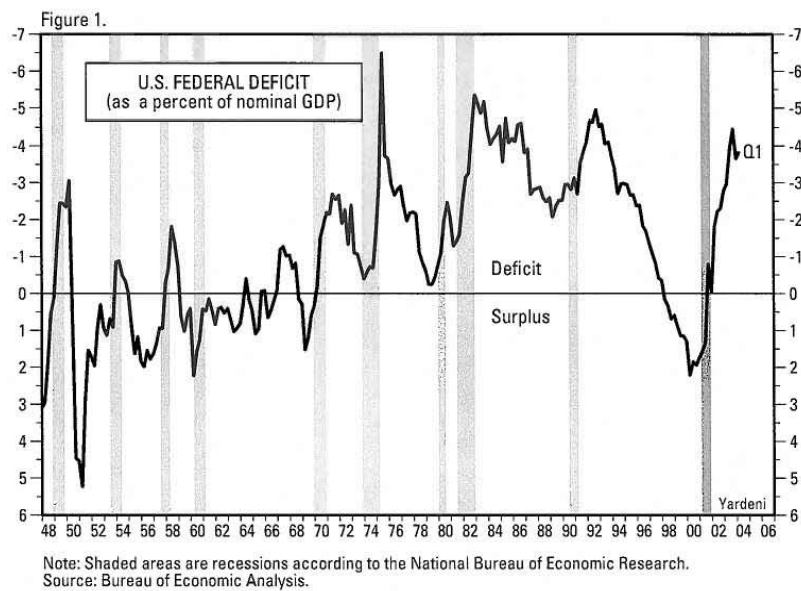
Because of the three-year bear market and ongoing geopolitical concerns, half of all the money invested in mutual funds is still sitting in money market and bond funds even though yields are at historic lows - money market funds are yielding less than 1%.

There is certainly a place for bonds in most portfolios. But, if history is any guide and interest rates gradually move higher over the next decade or so, it is clear that being over-weighted in bonds is not a good idea. **Complacency** is behind the overweighting in bonds in many portfolios, as they have performed reasonably well over the last twenty years. **Fear** is also a factor. And because “fear and greed” move markets, there is always someone who will panic investors by predicting the imminent collapse of the stock market (remember Joe Granville and Robert Prector).

Scaring investors is not lost on bond guru Bill Gross, who made headlines two years ago when the Dow was at 7,000 by saying the market was going to drop to

5,000 – instead it went to 10,000. Gross recently made headlines again by claiming that U.S. equities are at their highest risk level in thirty years, citing, among other things, excessive government debt. Then, as now, Gross is right to say there are risks in the market. There are always risks. But, because we have just emerged from a three-year bear market, historical experience would lead us to believe that chances favor a recovery, not another full-blown crisis.

Moreover, Gross’ alarm about government debt is misleading. While government debt is high and certainly needs to be addressed, the chart below puts that debt into perspective. As you can see, government debt today, as a percentage of GDP, is actually slightly lower than it has been historically following the major recessions of the last 30 years.



Source: Prudential Financial /Prudential Equity Group, LLC

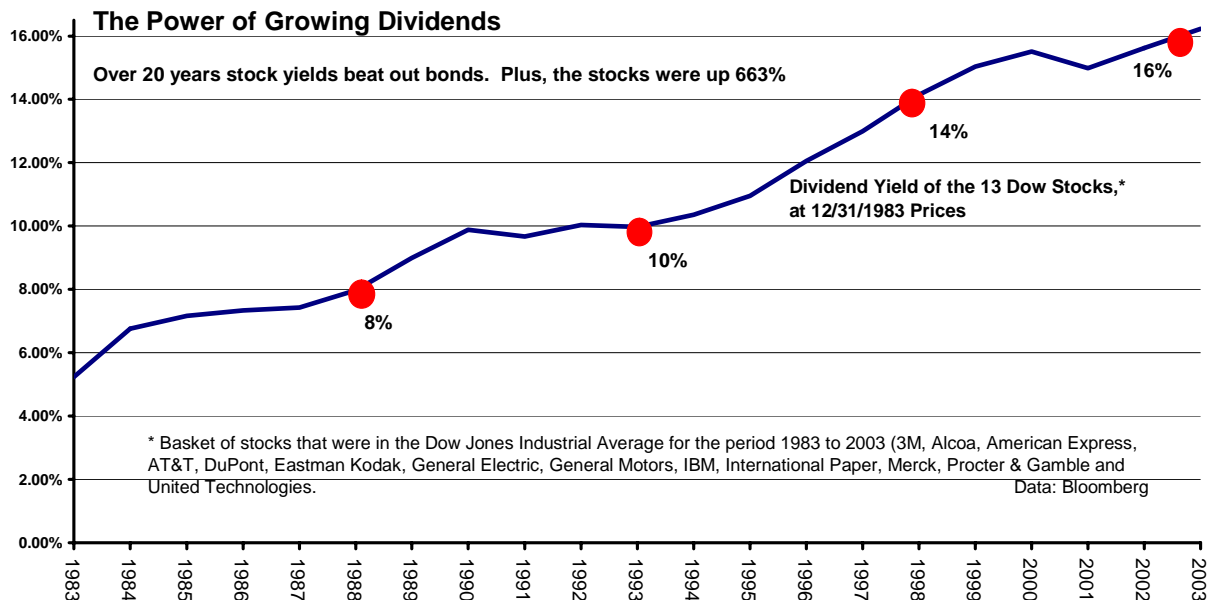
NOW - A TIME FOR DIVIDENDS

In the higher inflation and interest rate environment that we foresee, the value of dividends and steady dividend growth may become even more appreciated. The chart on the next page demonstrates the power of dividend growth over time. The upward rising line tracks what happened to the highest yielding stocks in the Dow Jones Average over the last 20 years – a period of time, incidentally, when dividends were out of fashion on Wall Street.

We can see in the chart that the steady growth of dividends alone resulted in an 8% yield on the original portfolio after 5 years, 10% after 10 years, 14% after 15 years

and 16% after 20 years. Furthermore, the market value of the portfolio itself went up 663% over this time period.

The future for dividend growth may be even brighter. The percentage of earnings being paid out in dividends is at one of the lowest levels in thirty years. Meanwhile, corporate earnings in the last two quarters have been the strongest in twenty years. These two factors combined with the new favorable tax treatment for dividends should make prospects for dividend growth better than they have been for a long time.

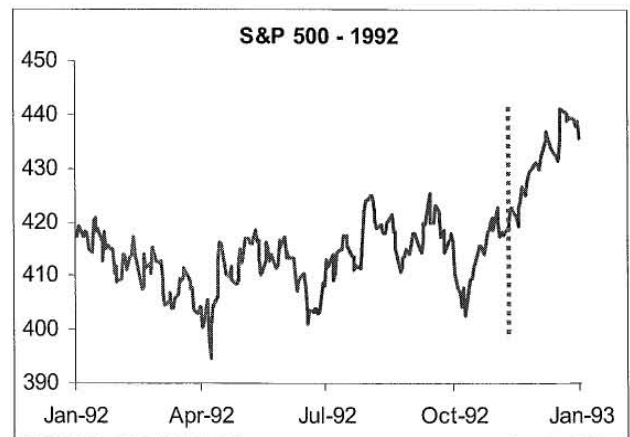
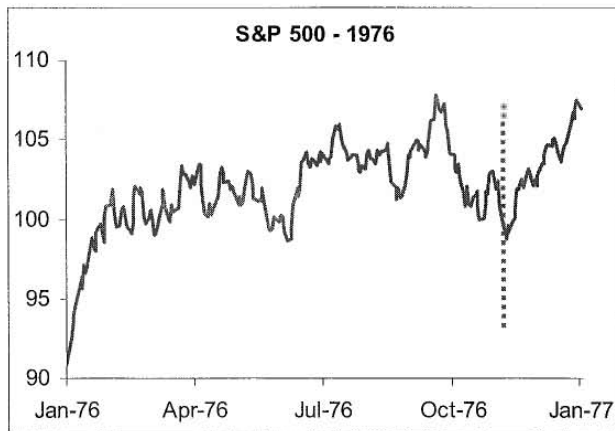


Incidentally, accountants we've talked to over the last several months indicate that the favorable dividend tax treatment is having a dramatic impact on tax returns. If John Kerry were to be elected president, there may be some modification of the tax cuts. However, it should be noted that high dividend stocks performed very well long before the recent tax bill.

THE ELECTION

For the short term, there are many questions on Wall Street regarding the importance of the election in November. Historically, a presidential election year has been a good one for the market, though more often than not, most of the gains have come in the last few months of the year. Some of this pattern can be attributed to seasonality. We hear the expression "Sell in May and go away" because over the last 50 years, the market has averaged only a 1% return from May to November, while from November to April, the average gain has been 7%.

A mid-June survey of Wall Street hedge fund managers showed that an astonishing 100% believed that President Bush would be reelected. This means that a Kerry victory has not yet been priced in the market. But history shows that the anticipation of a change in administration is often far worse than the change itself. Market strategists ISI Group did a study – shown in the two charts below – that points out what happened in 1976 and 1992 when Democratic challengers beat Republican incumbents. As you can see, much like the present period, the market did not do much until the election was over.



Source: ISI Group

CONCLUSION

A period of rising interest rates and rising inflation is not necessarily bad for the market, but it is usually a more difficult period for overpriced and speculative stocks. We believe we're entering a more challenging and discriminating market, which has historically been a good relative time for value and high-dividend stocks.

James P. Cullen
President

Disclosure:

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