

MARKET COMMENTS

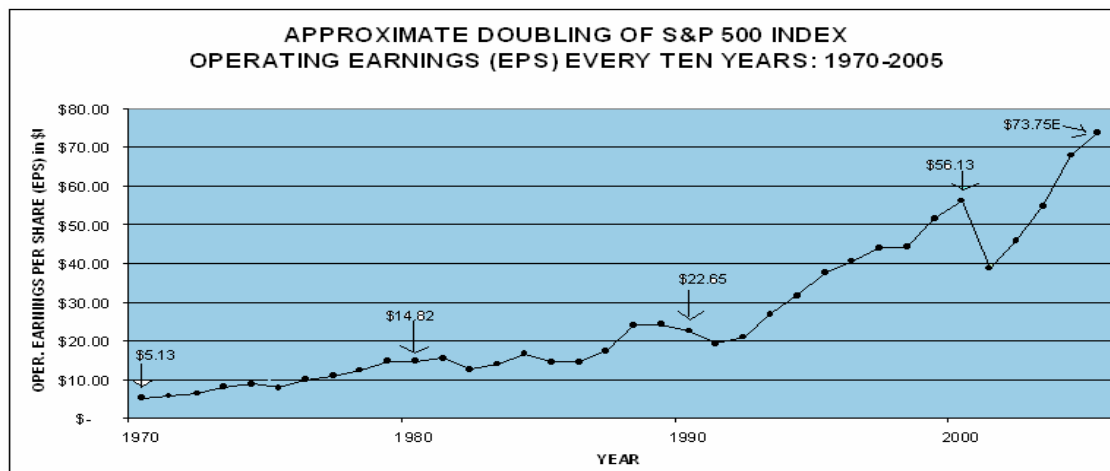
August 30, 2005

“Forget everything else and focus on two simple principles. Buy stocks for the long term (5-year periods) and avoid over paying by applying the disciplines of P/E, Price/Book and Dividend Yield.”

In our January 2005 Market Comments, we used the quote above from Benjamin Graham that summarized his 50 years in the investment business. Except that we chose to omit the first three words in bold face, thinking that they would distract the reader from Graham’s advice. But after watching hours of CNBC in the months since, we have regretted the omission.

It is hard to believe that the seemingly important information reported every day by the business media isn’t more useful for investors. One would think that it is crucial to know whether interest rates are moving higher or lower, whether inflation is heating up or cooling off, whether the dollar is strengthening or weakening, and so on. But we think it is safe for investors to ignore all the information on CNBC. Why? **Because the companies whose stock we own are conscientiously making the adjustments to the changing business environment so that they can continue to grow their earnings.**

The table below shows just how successful S&P 500 companies have been, as earnings have roughly doubled every 10 years, regardless of economic and market conditions.



CORPORATIONS ADJUST

Throughout stock market history, almost every 30 to 50-year period produces any number of crises, including wars, recessions and speculative manias. During the last 35 years, investors and corporations have had to deal with **five economic recessions, two of the three worst stock market bubbles and crashes of the last century, eight down years, the market crash of 1987 (featuring a 28% drop in one day), the terrorist attacks of 9/11 and two Iraq wars.**

Even when corporations do their job and produce relatively consistent long-term earnings growth, the investor still has to deal with a stock market that tends to be much more volatile than earnings. What should he do? The answer is to follow Graham's advice of combining a price discipline (P/E) with a long-term approach (5 years).

Below we reproduce the chart used in our earlier 2005 Market Comments, showing how applying Graham's advice has produced powerful and consistent returns.

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	9.66%	1985-1989	16.29%
1969-1973	0.00%	1986-1990	6.14%
1970-1974	1.11%	1987-1991	10.53%
1971-1975	12.44%	1988-1992	15.37%
1972-1976	17.81%	1989-1993	14.54%
1973-1977	17.02%	1990-1994	10.10%
1974-1978	24.71%	1991-1995	23.17%
1975-1979	34.30%	1992-1996	17.92%
1976-1980	24.67%	1993-1997	22.01%
1977-1981	18.20%	1994-1998	17.79%
1978-1982	22.18%	1995-1999	18.22%
1979-1983	24.53%	1996-2000	13.90%
1980-1984	26.07%	1997-2001	13.26%
1981-1985	26.46%	1998-2002	4.74%
1982-1986	27.63%	1999-2003	12.14%
1983-1987	18.92%	2000-2004	16.01%
1984-1988	18.22%		

THE HIGH DIVIDEND DISCIPLINE ALSO WORKS

In our 2005 Market Outlook and the study above, we used price discipline (P/E). If we use the dividend discipline instead (the highest 20% of stocks by yield in the S&P 500), the results, shown below, are equally impressive.

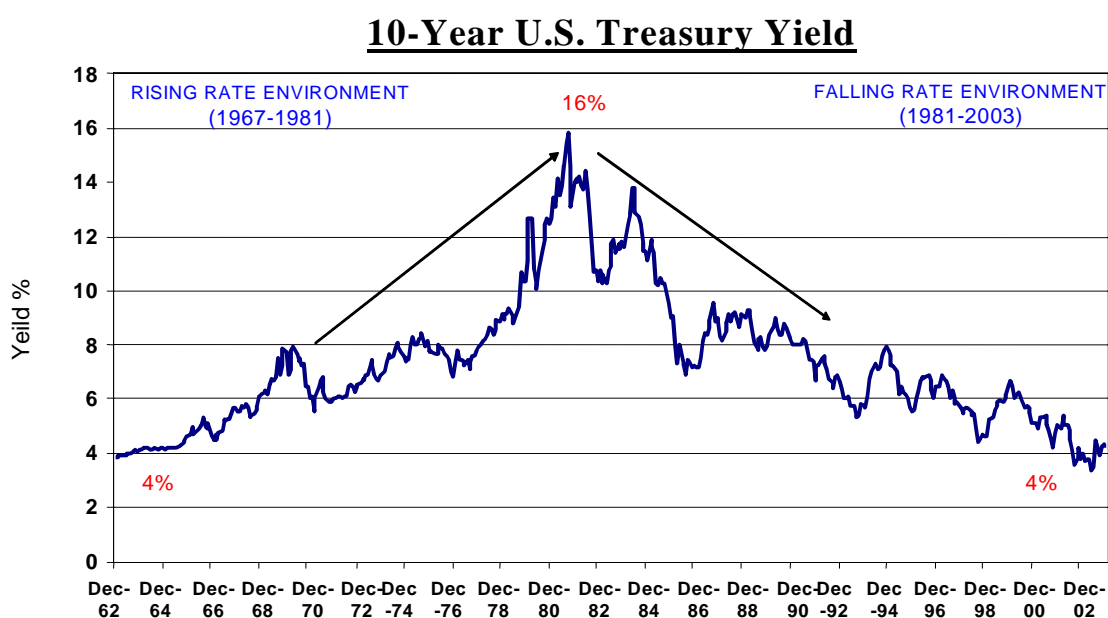
Rolling 5-Year Performance: Top 20% of S&P 500 By Dividend Yield

(Annualized Rates of Return)

Period	S&P 500 Top 20% By Yield	Period	S&P 500 Top 20% By Yield
1968-1972	8.68%	1985-1989	18.35%
1969-1973	1.32%	1986-1990	8.17%
1970-1974	2.45%	1987-1991	12.48%
1971-1975	10.82%	1988-1992	16.18%
1972-1976	16.52%	1989-1993	15.46%
1973-1977	14.63%	1990-1994	10.48%
1974-1978	17.67%	1991-1995	21.01%
1975-1979	24.76%	1992-1996	15.39%
1976-1980	16.54%	1993-1997	17.88%
1977-1981	11.72%	1994-1998	15.84%
1978-1982	16.69%	1995-1999	13.50%
1979-1983	22.24%	1996-2000	10.72%
1980-1984	20.28%	1997-2001	10.36%
1981-1985	22.62%	1998-2002	3.20%
1982-1986	23.12%	1999-2003	7.50%
1983-1987	16.58%	2000-2004	12.68%
1984-1988	15.15%		

CAN YOU REALLY FORGET EVERYTHING ELSE?

If interest rates go from 4% to 16% and back again to 4%, shouldn't that be a major investment consideration? Surprisingly, the answer is no when investors stick with Graham's advice. In the table below, we plot the rolling 5-year performance periods for the 10 years when interest rates were rising the fastest and comparable periods when rates were falling the fastest. Surprisingly again, performance for the long term investor was unaffected by the interest rate environment – in fact, returns were better during periods of rising rates.



Performance During The Spike in Rates 1971-81

5-Year Periods	Bottom 20% by P/E Annualized Returns
1971-1975	12.44%
1972-1976	17.81%
1973-1977	17.02%
1974-1978	24.71%
1975-1979	34.30%
1976-1980	24.67%
1977-1981	18.20%
Average Return	21.31%

Performance During Rapid Decline in Rates 1981-91

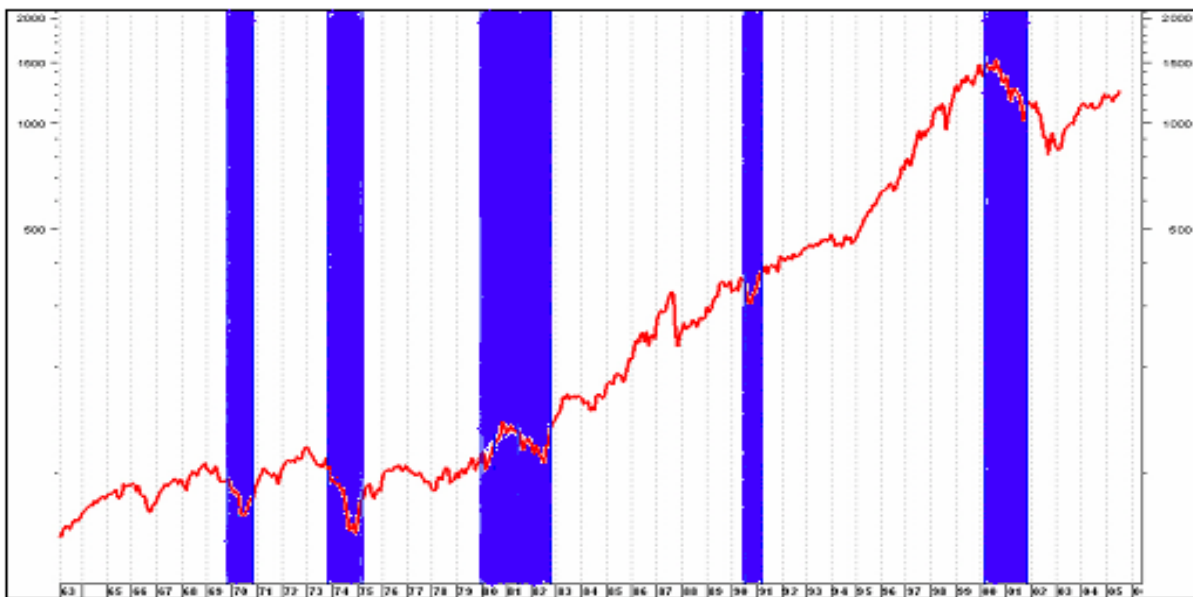
5-Year Periods	Bottom 20% by P/E Annualized Returns
1981-1985	26.46%
1982-1986	27.63%
1983-1987	18.92%
1984-1988	18.22%
1985-1989	16.29%
1986-1990	6.14%
1987-1991	10.53%
Average Return	17.74%

IGNORE RECESSIONS?

Interest rates are one thing, but how can investors ignore recessions? You can if you again stick with Graham's advice.

In the study below, we took what would be the worst possible scenario for an investor: that is, to start buying stocks the year before a recession began. Even so, the performance for all of the 5-year periods is very strong.

S&P Stock Prices and Recessions



* Blue lines denote recessionary periods.

5-Year Annualized Returns Starting One Year Before The Recession Began (5-Year Periods / Low P/E Discipline)

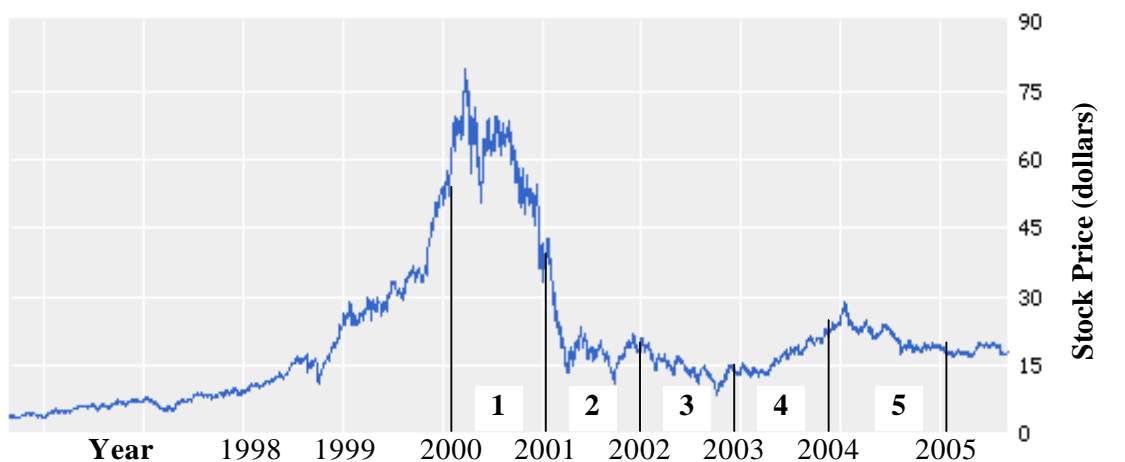
Recession Period	5 Year Return (Year before recession started)	Annualized Return (For 5-year periods)
1969-1970	1968-1972	9.66 %
1973-1974	1972-1976	17.81 %
1981-1983	1980-1984	26.46 %
1991	1990-1994	10.10 %
2001	2000-2004	16.01 %

USE BOTH OF GRAHAM'S PRINCIPLES

There have been times in stock market history when experts felt that as long as you were a long-term investor, you could ignore price discipline, especially for the fastest growing companies. When I started in the business, the “Nifty-Fifty” bubble stocks of the 60’s were called “deserted island stocks” – the idea was that you could spend 5 years on a deserted island and come back to find those stocks always higher. Not so! For example, the three favorites of the era, IBM, Xerox and Polaroid were still down 50% on average, 5 years after their highs.

Before and after the bubble of the 1920s, the same was true. The most popular stock of the time was RCA. In 1929, it was selling at \$150 a share, but 5 years later the price was \$10 a share. The most recent cautionary tale of ignoring price discipline is the performance of technology stocks after the recent bubble. As a proxy for tech stocks, we show the performance of Cisco. Five years after the bubble, investors are still down almost 80%.

Cisco Systems Inc. (1998-2005)



SUMMARY

Take Graham’s advice and invest long term and with price discipline. While the approach is simple in theory and our experience shows it works in practice, investors still have to contend with the emotions and volatility of the stock market.

Jim Cullen

Disclosure:

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