



CAPITAL MANAGEMENT, LLC

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By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

2008 - Second Half Commentary

From an investment perspective, the best thing that can be said about the first half of 2008 is that it is finally over!!

As of mid-year, energy was the only sector of the market that managed to register positive returns. While the S&P 500 was down -12.83% in the first half, the energy sector was up 8.12%. However, that relatively strong performance is not so impressive if you take into account the tailwind of record high oil prices. Furthermore, since the end of June, even energy has succumbed to this declining market and is now down 4.4% for the year (as of the writing of this article on 7/22).

Financial services, namely banks, have taken the biggest hit in this year's market pullback, falling 31%. Write downs for bad loans continue to take a toll on banks' earnings, balance sheets, and stock prices. This year's dreadful performance for bank and other financial services firms is particularly tough since it is on top of the 21% drubbing the sector took last year. Clearly, the bottom in financials has proved harder to come by than photos of Brangelina's baby twins. Given the extent of damage to this vital sector, it is a wonder that the stock market is not down further. In very simple terms, it is difficult to have an expanding, market-driven economy without a sound and properly functioning lending system.

Strangely, all this gloom and doom is not typical of an election year. Generally, elected and appointed government officials do everything possible to keep the economy's wheels firmly on the tracks leading up to an election. This year, the White House, Congress, and the Fed seemingly run into more problems at every turn and can't act or pass legislation fast enough to thwart more economic fallout.

Year-to-Date –as of June 30,2008 (Total Returns - Including Dividends)

Index	Total Return (%)*
S&P 500	-11.91%
Russell 2000 (Small Cap)	-9.30%
MSCI EAFE (International)	-11.08%
Emerging Markets	-9.25%
U.S. Bond Aggregate	1.26%

In my outlook for 2008, I optimistically forecasted that mid single-digit earnings growth for large cap multinationals would carry the overall market modestly higher, leading to another year of positive gains. Outside of financials, earnings for the S&P 500 have been growing at or better than that pace, but if the economy continues to slow, continued earnings growth will be in jeopardy.



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For the remainder of the year, I expect the market to continue to struggle with downward revisions to earnings, inflationary fears, and the lingering effects of the housing and credit crisis. However, the upcoming presidential election and potentially lower oil prices could go a long way to alleviating these significant overhangs on this troubled market. In the meantime, investors should continue to tilt portfolios towards a reasonably conservative stance as events unfold.

It's all about Oil

The U.S. consumer is dealing with the perfect storm of record gas prices, plummeting home values, and tighter credit. Since our economy is 2/3 consumer spending, a stretched consumer will undoubtedly result in slower economic activity and reduced corporate profits.

While stricter lending standards, heightened inflationary pressures, and falling home values are of serious concern, it is soaring oil prices that perhaps have the biggest impact on investor psychology. **In other words, a big move up in oil prices would likely take the market lower, but on the flip side, a big move down would almost certainly lead to a significant relief rally.**

Oil, which has doubled in the last year alone, has been enjoying a longer and more powerful bull market than many thought possible. The oil bulls attribute the black gold's rapid rise to several factors including increased demand from developing countries like China and India, under investment in exploration and production which has kept crude supplies in check, and investors desire to invest in a commodity which will hold value against a declining U.S. dollar.

While the absolute cause of oil ascent is not certain, there is no debate that the high price of oil is wreaking havoc on the U.S. as well as other economies around the world. Companies caught off guard are scrambling to cut costs and pass through higher energy prices to preserve profitability. Stretched consumers are also cutting back on discretionary spending with more of their income being devoted to filling up the tank.

However, something else is also going on as a result of higher energy prices. Consumers of energy are cutting back on their consumption. Evidence of this demand destruction is everywhere!! Major auto manufacturers sales have plummeted (particularly sales of trucks and SUVs), surging sales of motor scooters, record use of public transportation, and actual data pointing to year over year declining demand for U.S. gasoline. In fact, worldwide oil demand is only expected to rise 1% this year, and there is a good chance that given the weakening global economy that this forecast is too optimistic.

In the near term, concerns of supply disruptions, demand for a U.S. dollar hedge, and geopolitical events may influence the price of oil, **but global economic prosperity should be a requirement for prices to rise from these already elevated levels.** Prosperity is not the word I would use to describe the state of the U.S. economy or most economies around the world at this moment. "Struggling" and "sluggish" are more like it! Struggling and sluggish should result in falling energy demand and therefore lower prices, at least over the next several months.



Summing it up and Portfolio Positioning

In the second half of the year, the economy will continue to have its challenges. The credit crunch and weak housing market will continue to have lingering negative effects on growth. These negatives will be somewhat offset by a strong export market benefiting from the weak dollar, fiscal stimulus, and favorable monetary policy (low short term interest rates).

We have now had three straight quarters of negative returns for the S&P 500. While the losing streak may continue, falling oil prices may prove to be the key catalyst to end the trend in the back half of the year. Again, oil is the wild card.

Investors should continue to keep their stock allocation at or below target rates and not get too excited by sudden bursts in the stock market. Chances are that the start of the next multiyear bull market is still a ways off. However, making some adjustments to capitalize on market volatility is prudent.

Over the past couple of years, I have suggested taking profits from small and mid cap funds and move to large cap (particularly large cap growth). Now, I see this as a good time for investors to take some profits from their international exposure and redeploy funds in the battered large cap value sector. Given the terrible performance of the financial sector, now is a decent time to slowly start picking up exposure to that area. I do not expect a strong recovery just yet, but it is hard to predict the bottom and stock prices tend to move before improvement in the fundamentals are evident. Furthermore, many companies in this sector are now selling at or below already lowered book values. International stocks (particularly the European market) have outperformed their U.S. counterparts for the last several years. However, higher interest rates, slowing exports, and inflationary pressures may hurt those markets over the next year or so.

On the fixed income/bond side, high quality short term bonds still offer the best risk/return profile. Junk bonds do not yet offer a high enough yield to compensate investors for the risk of defaults which are sure to increase. I do expect that as the Fed looks to raise interest rates either later this year or most likely next year, there will be a good opportunity to move into longer term investment and non investment grade bonds to pick up better yields. Until then, holding some cash in money market funds is still a good way to go despite the low yields.

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