Capital Management, LLC

www.smscap.com

6575 West Loop South, Suite 603 • Bellaire, Texas 77401
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

June 2010

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 15 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). He is also a Past-President of the MBA Council of Houston.

2008…Déjà vu?

With the S&P 500 hitting an intraday low of 1040 on May 25th, the market logged a fast 15% correction from its 2010 high set in April. This was the second and far more severe pullback of the year (the first was in Jan/Feb and was an 8% decline). After the brutal drop in 2008, the dizzying rally of 2009, two corrections in 2010, including a few minute, 9% "flash crash" on May 6, investors are understandably nervous and confused.

Will the stock market have another meltdown like in 2008? Or, is this just another correction in a longer term bull market?

My sense is that current volatility in the market will not disappear in the second half of the year. However, at the end of the year, the market probably won't be that far from where it started. We are neither likely to repeat the steep declines of 2008, nor likely to see the stellar returns of 2009.

Another Crash or Something Different?

In 2008, the economy reached a near standstill as the global banking and financial crisis stifled funding for both consumers and businesses. Leveraged hedge funds, inundated with redemption requests, were forced to liquidate holdings regardless of the price. The lack of liquidity for borrowers combined with panic-driven selling from retail investors drove asset prices down sharply across the board. The stock market crashed along with corporate profits. The Dow finally bottomed around 6,500.

Will this happen again? A panic-driven sell-off back to 2008's levels, while possible, is unlikely. Banks and corporations have strengthened and restructured their balance sheets, the global economy is still growing, albeit at a slower pace, and corporate profits are improving from last year's levels. Furthermore, crashes of 2008's magnitude don't happen very often and usually do not occur when so many investors are fearful of it as is the case today.

A more likely scenario is that the market's mood will continue to swing from enthusiasm over growing profits to despair that the global growth outlook will not be as robust as investors had hoped for a few months ago. The result will be a range-bound and volatile market.

Currently, the price-to-earnings (P/E) ratio for the market (S&P 500) is roughly 13x 2010's estimated earnings and 15x trailing earnings. If earnings continue to come in in-line or ahead of forecasts, the S&P could very well move back up to the upper end of the trading range of 1200-1,230 level over the next several months (2010 EPS estimate of $82 with 15x multiple), representing a gain of about 10-12% from current levels.

Some pundits argue that since we are coming off such a low recessionary earnings base that over the next year the market should trade off of 2011's earnings which would represent a more normalized level. Applying a 15x multiple to that earnings estimate puts the S&P at 1,425 (representing a 30% increase from current levels). I would argue that the macro headwinds of less leverage, higher future taxes, higher

www.smscap.com

6575 West Loop South, Suite 603 • Bellaire, Texas 77401
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

unemployment levels, less government spending, and more regulation support a lower market multiple than the boom decades of the 1980's and 1990's. Lower multiples (high single digits to lower teens) applied to slower growing earnings over the next few years might be the situation we are facing. This environment will not likely produce a sustained, smooth bull market ride for stocks.

Positioning

Heading into 2010 I was concerned that the stock market was getting too far ahead of the underlying fundamentals. In my 2010 outlook I warned "…most stock and bond markets are currently in the "fair to over-valued" range, investors should be cautious about adding at these levels. "

Given my outlook for a range-bound market, investors should continue to emphasize more total and absolute return strategies for their portfolios as well as some active management. A higher allocation to high quality income producing investments that generate dividends and interest is appropriate. In addition, alternative and "value" strategies that have lower correlations to the overall stock market will help minimize portfolio volatility while generating positive returns.

*None of the information or data presented herein constitutes a recommendation by SMS Capital Management, LLC or a solicitation of any offer to buy or sell any securities. Information presented is general information that does not take into account your individual circumstances, financial situation or needs, nor does it present a personalized recommendation to you.

Although information has been obtained from and is based upon sources SMS Capital believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Past performance is no indication of future results.