



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

July 2009

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).

2009 – Second Half Outlook

After six consecutive down quarters for the market, investors found themselves in a seemingly unfamiliar, yet welcome situation in the second quarter of 2009 – they made money! This reversal of fortune which started in early March continued largely unabated in the second quarter as investors stepped back into riskier assets.

The impressive rally, sparked by surprisingly positive news in the banking sector, quickly spread to almost all market sectors and asset classes. After hitting an intraday low of 666 on March 6th, the S&P 500 surged to an intraday high of 956 on June 11th, representing a 43% gain. The market's strong move up can be attributed to both a relief that a total collapse of the world's financial system is "off the table" as well as optimism that an end to this brutal recession is near.

Indeed, recent signs suggest that the rate of contraction has slowed and the economy is stabilizing to some degree. However, for the market to hold its gains and go even higher in the second half of the year, the economy will have to do more than just stagnate. **Given the severity and nature of the current recession, skepticism about a "V-shaped" recovery is warranted.** Optimism might prove temporary, relegating this advance to nothing more than an impressive "bear market rally".

The market will likely be range-bound until next year. At which time, investors will have a better sense as to the outlook for sustainable economic growth and corporate profits. Investors should continue with a more conservative stance, but slowly adding to equities on market pullbacks. Maintaining an overweight position in investment grade corporate bonds as well as a small allocation to higher quality high yield bonds makes sense as those asset classes still offer an attractive risk/return profile even though yields have come down from their record levels.

First Half Review

Despite the strong second quarter, the S&P 500 finished the first half with only a 3% gain due to the horrific beginning to the year.



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

For the First Half of Through June, 30, 2009 (Total Returns - Including Dividends)

Index	Total Return (%)*
S&P 500	3.16%
DJIA	-2.02%
Russell 2000 (Small Cap)	2.66%
International	7.95%
U.S. Bond Aggregate	1.34%

International stocks outperformed U.S. stocks in the second quarter following their poor relative performance last year. Also, “growth” stocks continued to outperform “value” over the first half of the year but the performance gap narrowed in the second quarter as financials (a big component of value indexes) led the market rally.

U.S. Treasury bonds, which were the only asset class to have made big gains in 2008, suffered in the first half of 2009. Interest rates plunged at the end of last year as investors sought the safety of U.S. government obligations. As rates fell, the value of U.S. Treasury bonds shot up, particularly for longer term bonds. Now, with concerns over the massive supply of U.S. dollar denominated debt that will have to be issued to fund growing deficits and investors shifting back to riskier assets, interest rates have risen. The yield on the 10-year Treasury bond has gone from 2% at the start of the year to over 3.5% in the second quarter, hurting the performance of Treasury bonds.

In contrast, investment grade and high yield bonds had strong performances as investors looked to take advantage of attractive yields. In fact, most investment grade bond funds beat the S&P 500 in the first half of the year with considerably less volatility.

Out of Crisis Mode, but...

The big question on investors’ minds is whether or not the stock market will go back down to (or even below) its March lows. While there are no certainties, there are some favorable developments that should soothe those concerns.

First, the financial crisis that brought the market down to decade low levels has ended. The fear surrounding the potential “nationalization” of the U.S. banking system no longer exists. The rally in bank stocks enabled weakened financial institutions to raise billions of new capital. Those funds, along with current earnings, should be sufficient for the megabanks (those deemed “too big to



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

fail”) to cover future losses rather than have to go back to the government for help. That does not necessarily mean that banks are a great investment or that they won’t continue to suffer losses from bad loans (particularly residential and commercial real estate), it just means we are not likely to have another crisis and panic of that magnitude. In fact, several banks have already started paying back the government funds they received.

Second, some confidence in the credit and capital markets has returned. At the height of the crisis, not even high quality companies were able to raise funds in the public markets. Thus, the government had to step in to provide credit to many corporations. Now, companies can not only issue debt and equity in the capital markets, but they can also do it at much better terms than just a few months ago.

Third, given how quickly the market took off from its lows, investors that missed the rally will look to put money to work in the stock market on pullbacks. There is still a massive \$3.7 trillion of cash in money market funds. This should help create a floor above the March low as buyers step in on dips.

Finally, the economy will show further signs of improvement towards the later part of the year. Aggressive government policies and the natural course of the business cycle will take effect and investors will bid up stocks as positive data comes in.

Despite these positives, the economy continues to face many challenges in the short run. Higher consumer savings (savings rate surged to 15-year high of 6.9% in May), less credit availability, more regulation, and high unemployment will all drag on economic growth and corporate earnings for the next several quarters. **As investors come to the conclusion that corporate earnings will be under pressure for quite some time, stocks will be susceptible to pullbacks.**

The net effect over the remainder of the year will likely be that the market trades in a narrow range. From current levels, the range might be up or down 10% as the market vacillates between optimism and pessimism.

Portfolio Positioning and Strategy

For the next couple of years, investors should position their portfolios to be more “total return” oriented rather than just dependent on capital appreciation for returns. **This means favoring investments that generate dividends, interest income, as well as strategies that are not strictly dependent on a steadily rising stock market.**



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

In my January 2009 forecast, I suggested, **“With all the uncertainty still surrounding the state of the global economy, investors should maintain a more conservative stance with regard to equities, as better risk-adjusted opportunities are presently in the bond market.”** In fact, through mid year, investment grade and high yield bonds funds have outperformed the S&P 500 by a wide margin (with significantly less volatility). Investors should stick with the strategy of overweighting corporate bonds for a while longer as the market continues to digest the new reality of a slower growing world. In addition, the summer and fall months typically pose some difficult seasonal headwinds for the market. Long term investors should look to incrementally add to equity and bond holdings on pullbacks. Emerging markets, U.S. mid cap stocks as well as high yield bonds represent good areas to add.

*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.