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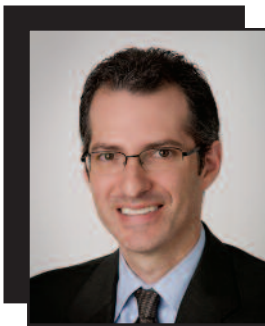
6575 West Loop South, Suite 603 • Bellaire, Texas 77401  
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

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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 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.

## 2010 - Market Outlook

As we head into 2010, investors should be in a much better mood than they were this time last year. Indeed, those that persevered the market drubbing of 2008 and early 2009 saw the value of their portfolios climb back to levels thought unimaginable just a few months ago.

Signs of recovery in the economy coupled with close to 0% rates on bank deposits and money market funds have driven investors back into “risky assets”, lifting valuations in the process. In fact, after bottoming in March, the S&P 500 has rallied roughly 65%. At this level, the S&P 500 is approximately halfway between its 2007 high and its 2009 low. So, where do we go from here?

On a multiple of operating earnings (p/e) basis, the S&P 500 is now trading on the high side of “fair value” at 27x trailing earnings and 19x 2009’s full year expected earnings. For 2010, analysts project earnings for the S&P 500 index to jump 35% from 2009. If the economic recovery proves to be stronger than currently expected, earnings and expectations for future growth will rise. That scenario could lead to further upside in the market, possibly another 10%-20% over the next 12-18 months.

Of course, the opposite may also materialize where the economic recovery may prove to be more subdued and less sustainable than expected, maybe even a dreaded “double-dip” recession. That scenario could lead to a meaningful correction.

**Given the current valuation of the market, already high expectations for earnings growth, and the still significant headwinds facing the economy, adding to or overweighting stock market exposure at these levels may not be warranted. The same can also be said for the bond market.**

At the end of last year, corporate and high yield bonds offered investors a tremendous opportunity with both attractive absolute yields and premiums over Treasury bonds not seen since the days of the Great Depression. Now, yields have now come down and spreads have narrowed significantly, putting the price of most corporate and high yield bonds in the “fair value” range.

As we head into 2010, investors should be cautious and wait for better opportunities to add to broad market stock and bond holdings. **A continued focus on generating absolute returns from a combination of appreciation, dividends, income and alternative strategies remains appropriate in this environment.**



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## 2009 Review

Once again, the events of 2009 proved that market sentiment and momentum can shift suddenly and unexpectedly. After the awful start to the year, the global stock and bond markets bottomed in March and have had a largely uninterrupted advance the rest of the year.

International developed outperformed the U.S. market, but the performance differential can be attributed to currency moves. Small caps outperformed large caps for much of the rebound, but large caps have led since October, possibly suggesting the maturing of the bull advance.

High yield and investment grade corporate bonds had a stellar year, easily outpacing U.S. Treasuries and the U.S. bond aggregate.

### Year to date 2009\* (Total Returns - Including Dividends)

Index	Total Return (%)*
S&P 500	25.4%
DJIA	22.7%
Russell 2000 (Small Cap)	23.2%
International (Developed)	30.0%
U.S. Bond Aggregate	5.8%

\*Total returns through 12/15/09

## Fool Me Three Times?

Over the past decade, investors have suffered through two severe bear markets, making them as enthusiastic about having all their money in stocks as Tiger Woods is about having the inevitable “I made a mistake and I’m seeking counseling” interview with Oprah.

In fact, despite this year’s gains, retail investors have actually taken a net \$2 billion dollars out of stock mutual funds this year. Instead, bonds have been the investment of choice this year as retail investors have flocked to the safety and attractive yields of the asset class. In particular, investment grade and high yield bonds have had big inflows. For the first 10 months of 2009, investors seeking higher returns poured over \$300 billion into bond funds while withdrawing close to \$500 billion from money market funds.

The rise in the stock market can largely be attributed to buying from foreigners, institutions, pension, and hedge funds. However, for the rally to be sustainable



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and have another significant leg up, it will likely require a change in the attitude and willingness of retail investors to commit new capital. There is still over \$3 trillion dollars sitting in money market funds. It remains to be seen whether U.S. retail investors, particularly the Baby Boomers approaching retirement, will continue to adjust their investment strategies from a “growth” stock orientation to a more “capital preservation” fixed income strategy.

A popular contrarian argument is that retail investors are big buyers at market tops. If that is true, this bull market in stocks is not over yet, but the bond market’s advance is likely near its conclusion. Therefore, if the U.S. retail investor starts to purchase stocks it would be a positive short-term indicator for the market.

### **Portfolio Positioning and Strategy**

Even though the market likes to climb the proverbial “Wall of Worry”, there is no doubt that this wall is high and has some barbed wire on top of it. The desire and necessity for consumer’s to rebuild savings, higher future tax rates, more regulation, perpetually higher unemployment, lack of consumer credit, prospects for higher interest rates, and stimulus dependent growth are just a few of the headwinds that will drag on growth for the next few years.

Of course, it is difficult to know if the market will go higher or lower in the immediate future, but this backdrop continues to favor a more balanced approach to portfolio composition than one strictly focused on capital appreciation. U.S. fiscal and monetary policies have been much like those of Japan’s. Their stock market went through an extended 20-year bear market with big mini-bull markets followed by big bear markets. It is possible that we are at the start of a new multi-year bull market, but it is more likely we are still working our way through the bear market that started in 2000.

Given this backdrop and that most stock and bond markets are currently in the “fair to over-valued” range, investors should be cautious about adding at these levels. If we are still in the extended bear market, investors will have more chances to put cash to work on market weakness. New stock investments should be more “value” oriented. Stocks with safe dividends and reasonable valuations are also attractive in this environment.

International markets benefitted from a falling U.S. dollar in 2009, but that trend may reverse, perhaps temporarily, in 2010. Deterioration in the credits of countries like Dubai, Greece, and other European countries might make investors rethink their disdain for the U.S. dollar. Furthermore, signs that the



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U.S. economy is recovering will help the dollar as investors will anticipate higher interest rates making the U.S. dollar a more attractive currency to own. Any strengthening of the dollar would likely hurt most international investments, presenting a decent buying opportunity for those wanting to increase exposure to those areas.

Corporate bonds (both investment grade and high yield) offered a very compelling risk/return profile at the end of 2008, but now yields are very low and spreads are back within the normal range. **Investors should hold on to their core holdings, but some profit taking is advisable. Investors should not expect much more return from capital appreciation.** Look to add on weakness or reduce positions further if there is even more appreciation from here. Rather than move into U.S. Treasuries or automatically reinvest in bond funds, investors should let interest and profits roll into cash and wait for better entry points.

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