Capital Management, LLC

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

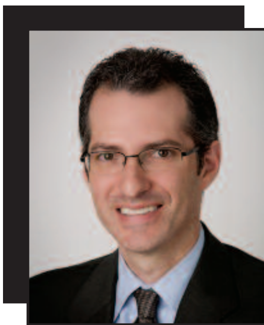
Good Riddance Summer, Welcome Fall?

September 2011

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.

The summer of 2011 will be remembered for a lot of things, unfortunately calm markets and pleasant weather (at least for those of us in Texas) will not be among them.

Hardcore political gridlock brought the U.S. government dangerously close to its first ever default on its debt. Thankfully, the unprecedented default scenario was averted, but not without some significant fallout. The political wrangling required to raise the debt ceiling failed to impress Standard and Poor's. Despite avoiding a default, the rating agency ultimately stripped the U.S. of its highly coveted AAA rating, claiming that the dysfunctional government offered too little, too late, in the way of a credible plan to reduce debt.

The negative headlines surrounding the ratings downgrade, resurfacing fears of sovereign defaults in Europe (in particular Greece), and weakening U.S. economic data were too much for investors to stomach. Stock volatility surged and the stock market correction that begun in April intensified. In the second week of August, the Dow Jones Industrial Average had four consecutive 400 point up or down days for the first time in history. Unfortunately, only two of those days were up. After the dust settled, the S&P 500 index was down 18% from the high's set in April, logging four consecutive down months.

In my *2011 Market Commentary* I suggested that investors prepare for what might be quite a volatile year and wait for a better buying opportunity**.** I wrote, **"I see the S&P 500 potentially trading as low as 1,100 and as high as 1,400, representing almost equal upside and downside cases." In fact, in April the S&P 500 got as high as 1,363 before sinking to a low of 1,119 on Aug 8th.** Given that highly volatile outlook, I encouraged investors to reallocate to long term target asset allocation levels and utilize some alternative equity strategies aimed at reducing portfolio volatility.

Now, with investor pessimism and widespread fear ruling the day (a notable change in sentiment from how we started the year), it remains to be seen if the pullback was just another deep correction (and a good buying opportunity) or the start of another bear market with further declines ahead.

At this point, I'm sticking with my prior forecast and suggest that we have seen both the highs and the lows of the year. Perhaps we finish the year close to where we started. Despite the stomach wrenching market swings, investors with a long term horizon should not bail out and deviate from their investment plan. Rather, investors should look to deploy some of their cash holdings into core large cap U.S. equity holdings as well as international and emerging markets which have corrected more significantly than the U.S. **In addition, high yield bonds now represent an interesting opportunity with increasingly favorable risk/return characteristics.**

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

More Dread Ahead?
If the economy is heading back into a recession then there is likely more damage to be done to the stock market. However, while recent economic data has been mixed to mostly negative, an imminent recession is not a foregone conclusion. If growth continues, albeit at a tepid pace, investor sentiment should improve enough to keep the stock market above the low point set on August 8th and potentially make a decent move higher. Increased mortgage refinancing activity, a drop in oil and gasoline prices, and the potential for some form of government stimulus aimed at creating jobs, all may help keep the U.S. economy from slipping back into a recession.

Based on current valuations and corporate earnings, a good case can be made that the market can rally in the last quarter back to a level around where it started the year. Keep in mind, even in bull markets corrections can be significant. Remember, last summer the stock market registered a 17% correction before resuming its upward climb.

The big wild card in the outlook continues to be the situation in Europe and Greece. Clearly there is risk that a Greek default will be the catalyst for a Lehman Brothers like domino effect across the globe. This situation continues to play out like a slow moving train wreck.

Portfolio Positioning
I continue to believe that over the next few years stock market returns will likely be more muted than in prior economic recoveries and that a more “total return” oriented strategy makes sense given this outlook. This strategy targets returns from not only capital appreciation, but also from dividends, income, and alternative equity strategies. Furthermore, large cap stocks still exhibit better risk-adjusted return characteristics and diversified portfolios should continue to be tilted in that direction.

On the fixed income front, very low interest rates make generating good returns challenging. However, high yield bonds, which sold off significantly in August, now represent a more compelling opportunity and investors should start moving into funds focusing on these lower quality bonds. Corporate balance sheets are stronger than they were in 2007 (prior to the last recession) and should help prevent significant defaults even if the economy remains weak.

*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.