Capital Management, LLC

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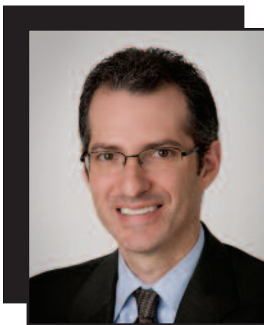
By Steven M. Sheldon, CFA

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 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.

I See Bulls, a Tiger but No Bears

The first quarter saw more favorable action for the U.S. stock market. In fact, this bull market has now gone on long enough to outlast Tiger Woods' "indefinite break from professional golf". The brief and relatively mild 8% correction in January proved to be nothing more than a decent short-term buying opportunity for those investors that want to bet on a sustained and robust economic recovery.

Prices Matter in the Long Run

From a valuation perspective, the broader market is expensive as measured by traditional valuation metrics. The p/e on the S&P 500's last twelve month's operating earnings stands at over 20x. Outside of the late 90's bubble years where the S&P was valued at close to 30x operating earnings, a ratio of 15-17x earnings would represent a more historical average for periods marked by growth, low inflation and low interest rates. Being generous and using the higher part of that range would put the "fair value" of the market somewhere around 1,000 for the S&P (about 16% below current levels). On a forward earnings basis, the market looks more reasonably priced at 15x this year's forecasted earnings, but that assumes that earnings will grow a very healthy 35% from 2009's levels. If the economy continues to build more momentum, earnings growth may prove achievable. Of course, forecasts are less than a sure thing and just expectations of strong earnings may drive the market higher in the short term.

Short-Term or Long-term Bull?

Despite the valuation issue, there is no denying the strength of this market. Its meteoric rise is just as spectacular as its plunge in 2008 (again reminiscent of a certain golfer's career). Now that this rally has progressed for over a year, the big question is how much longer it can last and how high it can go? Not surprisingly, bullish sentiment and complacency are setting in as investors get more comfortable with risk taking. Rising asset prices against the backdrop of an improving economy help build investor confidence. Last week's report showing jobs were actually created in the prior month was the latest catalyst to propel the market higher and within reach of the psychological Dow 11,000 level.

Should the recovery remain on track and earnings growth meet current expectations, there is a reasonable upside case putting the S&P500 in the 1250-1300 within the next 6-12 months. This would represent roughly 5%-10% appreciation from current levels.

However, medium and longer term threats to the stock market's performance remain. Lofty valuations, dependence on government stimulus, high unemployment, rising interest rates, more regulation, inflation, and higher tax rates will likely keep a lid on growth and the stock market in the next few years. It is more likely than not that we are still in a long term bear market and this is another cyclical bull market within that

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longer term bear market. However, even a humbled Tiger Woods must still be taken seriously on the golf course. Likewise, this bull market continues to shrug off lots of worry, keeping the upward trend intact.

Portfolio Positioning

Given the current valuation levels and high levels of optimism, putting new money to work in the broader stock market index is not that appealing. Investors should rely less on broad market exposure and stick with more "value" oriented and "balanced" funds. This strategy may lag in the final stages of the upward surge, but will pay off when we inevitably experience some downward volatility. Significantly reducing equity exposure may not be a wise move either. As long as the government is spending, the economy is expanding, and earnings are growing, the market may keep working. However, unless you have incredible timing and know precisely when to get out, paying attention to valuation is prudent.

With regard to fixed income, appreciation in bond funds has largely played out. Investors should look to take profits in short term bond funds and gradually redeploy in medium term high quality bond funds now that yields have risen to more attractive levels.

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