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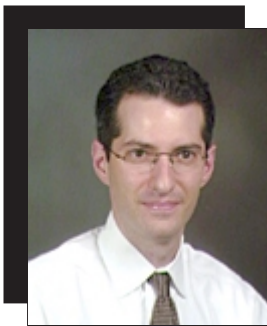
Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

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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 Founder

Steven Sheldon has more than ten 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 where he managed a \$100 million portfolio. 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 Association for Investment Management and Research (AIMR) and the Houston Society of Financial Analysts (HSFA).

And in this Corner...Deflation.

Whatever happened to the days when inflation was the most feared economic force in the world, stealing the good people's precious purchasing power? If the CPI (Consumer Price Index) over the past several months is any indication, it appears as though inflation has retired and left deflation to take over as the next great economic threat.

Unlike inflation, which is marked by rising prices of good and services, deflation is sneaky and subtle in that it first charms a country's citizens with appealing lower prices before unleashing serious blows to an economy.

The Great Depression of the 1930s is an example of what happens in a deflationary cycle. Reduced prices eventually lead to a contraction in spending as buyers anticipate falling prices. As prices continue to fall, the decline in economic activity feeds on itself. People and businesses earn less income to pay their debts and force prices still lower in a process that economists call a deflation-debt spiral.

The FED Fights Back

Afraid of such a situation, the Federal Reserve is aggressively stoking the U.S. economy with historically low interest rates to ward off the potentially devastating effects of falling prices.

In his testimony to Congress on July 14, 2003, Fed Chairman Alan Greenspan acknowledged that the chances of a Great Depression-like scenario playing out are about as likely as him facing off against Tonya Harding in a "Celebrity Boxing" match. Okay, so maybe he didn't say that but he did acknowledge that the prospects for deflation were quite remote. Even so, the damage to the economy would be so painful that he isn't taking any chances. Thus, the Federal Reserve will likely hold short-term interest rates around 1% "for as long as it takes" the economy to show clear signs of picking up.

What's Does This Mean For Investors?

If deflation does materialize, the best place for investors to put their money would be in longer-term U.S. Treasury bonds rather than corporate bonds and stocks. In a declining price environment, corporations struggle to earn a profit, thereby challenging their ability to repay corporate debt. In contrast, investors holding U.S. bonds (yielding up to 5% as of 7/22/03) will earn a real return up to 5% on their money (depending on the level of deflation and barring a default by the U.S. Treasury) since there would be no inflation eroding the value of their principal and interest. Of course, over time more investors will be attracted to these high real returns and push bond prices up and yields down.

The more likely scenario, however, is that inflation's retirement would be as brief as Evander Holyfield's first, second, and perhaps even third retirements. Between Bush's substantial tax cuts and the Federal Reserve's aggressive expansionary policy, the



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economy is getting a full dose of needed liquidity. Over time this stimulus should work its way through the system and bring about more consumption, more profits, more jobs and inflation.

In an environment of mild inflation, investors holding stocks would do well since many companies can pass through higher prices on to their customers, preserving the companies' profitability. In higher inflation environments, precious metals such as gold do well.

If inflation is higher than anticipated, current bondholders will lose value since the interest rate on the bonds they hold is fixed at levels where the bondholder would not earn a positive real return. Investors who desire the safety of U.S. Government bonds but are nervous about higher future inflation should consider buying TIPS. TIPS are a type of U.S. Treasury bond that provides holders with protection against inflation.

How Can SMS Help?

As an active portfolio manager, SMS Capital Management, LLC (SMS) monitors changing market conditions and global economic indicators (such as prospects for deflation or inflation) that impact the risk/return profile of core asset classes (stocks, bonds and cash). SMS makes strategic asset allocation decisions for its clients' portfolios based on its fundamental view of the economic landscape and the personal financial situation and objectives of its clients.

For a complimentary consultation, please call 713-402-6116 or email us at info@smscap.com.

Here Are Some Tips on TIPS

In 1997, the U.S. Government introduced a product that offers bondholders protection against inflation. U.S. Treasury Inflation-Indexed Securities commonly referred to as TIPS, have the same liquidity and safety as U.S. Treasury securities but have an added feature that adjusts the bond principal to keep pace with inflation.

Key characteristics of TIPS include:

- Issued in maturities of 5 and 10 years and are sold in denominations of \$1,000
- Principal of the bond is adjusted every six months by a version of the CPI (Consumer Price Index)
- Redeemed at maturity at the greater of the inflation-adjusted principal amount or its original par (an additional safeguard offering holders protection against deflation as well)
- Interest rate is a fixed percentage but is applied not to the par amount of the security but to the higher inflation-adjusted principal over life of the bond. If inflation occurs throughout the life of the security, every interest payment will be greater than the previous one.



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So What's the Catch?

At first glance it appears that TIPS are a no risk investment for conservative investors. While TIPS are an attractive product, they are not without their share of pitfalls.

First, TIPS carry a lower interest rate than conventional Treasury bonds. Consequently, if inflation turns out to be lower than expected, bondholders would have done better with a conventional bond carrying a higher interest rate. If, however, inflation is higher than expected, bondholders would do better with TIPS due to the inflation-adjustment feature.

Second, the inflation adjustments to principal are treated as ordinary income for tax purposes. Even though the principal adjustment is not received until the bond's maturity, bondholders must pay taxes on the gain in the year reported. Therefore, TIPS are best suited for tax-deferred and pension accounts.

Third, a rise in interest rates is not necessarily always accompanied by a corresponding rise in inflation. Since TIPS are intermediate term bonds, significant short-term rises in interest rates would reduce the value of the bonds.

For investors wanting diversification, TIPS can also be purchased through mutual funds, as opposed to individual securities. Fidelity and Vanguard both have funds that strictly buy TIPS.