



CAPITAL MANAGEMENT, LLC

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January 2004

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 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).

2004 First Half Market Commentary

Super Bowl Tickets Anyone?

The thought of putting new money into the stock market at the outset of 2004 feels a lot like buying tickets to the SuperBowl (if you can even find them) - the high prices make you queasy but the prospect of missing out on something spectacular inevitably makes you open up your wallet.

Investors, just like these sports fans, appear excited and anxious about the market's prospects in the New Year. Hoping for an instant replay of 2003, which saw the S&P 500 rise 26% and the Nasdaq surge an astonishing 50%, optimistic and aggressive investors are once again weighting their portfolios heavily towards stocks while the more cautious are holding steady or even paring back winning positions.

Despite the rapid and significant gains last year, current market conditions suggest that stocks will continue their winning streak, at least in the first half of 2004. With strong funds flow supported by low interest rates, little inflation and decent corporate profits; the market's upward momentum will likely remain intact as we head into this election year.

Keeping the Bench Warm

Over the next several months, those waiting for this new bull market to collapse will likely be disappointed. Armed with over \$2 trillion of investing power in the form of liquid money market funds, U.S. investors with cash parked on the sidelines have the ability to almost single-handedly keep this drive alive.

Playing it safe with money parked in money market funds earning 1% or less is getting old quickly. As the market continues to move up, more of these investors will grow impatient earning a measly return on their money.

Wanting to get in on the action, they will inevitably move their money into the market, forgetting all about the last time they played and left the game unconscious and on a stretcher.

This shift of funds between asset classes is already well underway. As the chart below illustrates, about 29% of total mutual fund holdings are invested in money market funds, compared to 35.5% at the beginning of 2003. Almost \$30 billion left money market funds in the two-week period ending December 23, 2003. During that time the S&P advanced 3.5% due to the heightened demand for stocks.



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Since 1990, the lowest percentage held in money market funds was in 23.6% in 1999 (the height of the last bull market). Even then, money market rates of 4-5% at that time were much more compelling than they are today. Getting down to the 1999 percentage probably will not happen, but the amount of cash in money markets can easily fall another few percent points before this bull market comes to an end. That translates into another couple hundred billion dollars of demand for stocks, meaning higher prices.

Breakdown of Mutual Fund Holdings

YEAR	EQUITY FUNDS	HYBRID FUNDS	BOND FUNDS	MONEY MARKET
1990	22.5%	3.4%	27.3%	46.8%
1991	29.1%	3.7%	28.3%	38.9%
1992	31.3%	4.8%	30.7%	33.3%
1993	35.8%	7.0%	29.9%	27.3%
1994	39.6%	7.6%	24.5%	28.4%
1995	44.4%	7.5%	21.3%	26.8%
1996	49.0%	7.2%	18.3%	25.6%
1997	53.0%	7.1%	16.2%	23.7%
1998	53.9%	6.6%	15.0%	24.5%
1999	59.0%	5.5%	11.9%	23.6%
2000	56.9%	5.0%	11.6%	26.5%
2001	49.0%	5.0%	13.3%	32.8%
2002	41.7%	5.1%	17.6%	35.5%
Nov-03	48.6%	5.8%	17.0%	28.7%
Avg.	43.8%	5.8%	20.2%	30.2%

Source: Investment Company Institute

In addition, if foreign investment in U.S. stocks, which has waned in late 2003, picks up, that will be an added boost. Foreign investors may find the U.S. equity markets more appealing if the U.S. economy continues to grow at a faster pace than other developed countries.

What If There's a Major Upset?

There's never a shortage of potential events or negative influences that can derail an advancing market. Just as this new bull market started at the end of 2002, it was the pending war in Iraq, the North Korean nuclear threat, and corporate corruption that were the threats of the day.

Now, those predicting near term gloom have added some additional "what ifs" and doomsday scenarios to the list including:



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After such a huge run-up, stocks must be overvalued...What if earnings do not continue to grow at a double-digit pace? What if interest rates rise dramatically from their historically low levels? What if there's another terrorist attack, even more devastating than before? What if the value of the dollar plummets? What if Mad Cow disease destroys our agricultural industry? What is the mutual fund scandal spreads?

While some of these threats may transpire, we believe that these events are already baked into the market (or in the case of football, the game day odds). It is the information we do not anticipate that are the true threats. Sure, the potential for terrorism, unforeseen geopolitical events and economic destruction are certainly real, but that's why having exposure to different asset classes is good idea. As we pointed out in our February 2003 newsletter and worth repeating again, "You don't want to bet on the end of the world because you won't be around to collect the payoff."

However, having some exposure to government bonds (both U.S. and other developed countries) as well as precious metals and commodities as part of a diversified portfolio will offer investors protection against geopolitical tensions like war and international terrorism.

What's the Over/Under?

Earnings of companies that make up the S&P 500 grew at approximately 18% over the last four quarters and are forecasted to grow at another 15% over the next four quarters. If these estimates materialize and the p/e ratio of the S&P 500 holds at its current level (at 21x times historical earnings and 18x forecasted operating earnings), the S&P 500 could rise as high as another 15-20% in 2004.

The 15% earnings growth estimate, while aggressive, does seem doable - especially given the Fed's expansionary monetary policy and the declining dollar. The cheaper dollar will not only help our exports but will also result in higher earnings for the U.S. multinationals that generate a significant portion of their revenues in foreign markets.

What Else Looks Good?

To conservative and more moderate investors, having their portfolios predominantly in the stock market will feel too much like throwing the risky long pass, given the ever-present possibility of a market correction. These investors can find some downside safety, piece of mind, and the potential to earn more stable returns in a well-diversified portfolio across multiple asset classes.



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However, with interest rates at historically low levels and alternative asset classes such as REITs, emerging market stocks and bonds, precious metals, and high yield bonds all at historically high prices, it's challenging to find other attractive asset classes.

Preferred stocks and funds investing in preferred stocks are somewhat attractive as compared to high yield funds (particularly in taxable accounts) given the new 15% tax on qualifying dividends. Some preferred securities have a similar risk profile but will result in higher after-tax returns. Also, floating rate funds, which invest in secured bank loans with floating interest rates, offer decent yields as compared to other short-term corporate and government bond funds while providing protection against rising interest rates.

Precious metals, natural resources and energy related funds should continue to do well in a cheap dollar and global economic recovery environment. When the dollar falls relative to other currencies, the price of dollar-denominated commodities, like gold, tend to rise as the commodities become cheaper. Also, robust demand for natural resources from China and the Far East should keep global commodity prices rising into 2004. REITs, emerging market and high yield bonds appear to have run their course but still might deliver decent income (as compared to other fixed income investments) for some time.

When investing in stocks becomes a "no-brainer", as it did in the late 1990's, that is the time to start unloading. As more money shifts into the market with rising returns, investors' perception of the risk they are taking will almost certainly change. How soon we forget.

How Can SMS Help?

SMS Capital Management manages portfolios that are customized to meet the needs and objectives of each client. SMS actively allocates the asset class mix of each portfolio with a view on prevailing market conditions, the risk/return profile of core and alternative asset classes, and the suitability of an investment for each client.

As we embark on 2004, we will continue our efforts to build and preserve our clients' wealth in the most prudent manner.