Capital Management, LLC

www.smscap.com

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

November 2003

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).

Going With the Flow, the Funds Flow

Generally speaking, individuals are as disciplined about their investments as Ben Affleck and Derek Jeter are about holding back on a night out on the town. Known for their tendency to chase recent performance, individual investors often get stung by bad timing, putting money to work in areas where the upward trend has just about run its course. This year is no exception as the stock market's impressive gains have once again attracted the attention and money of individual investors.

According to the Investment Company Institute (ICI), an industry organization that tracks mutual funds assets, roughly $80 billion of new cash has moved into stock funds so far this year (through August). The $80 billion increase, while not insignificant, is still relatively modest compared to the $310 billion that mutual fund investors plowed into stock-related funds in 2000, right as the last bull market peaked.

Are the investors that are moving into stocks now too late or is the party just getting started? Time will tell, but observing the past behavior of mutual fund investors can shed some light on market trends and where we might be headed.

Mutual Funds – Individuals Preferred Investment Vehicle

Just like Affleck and Jeter who find the action they're looking for at their "favorite establishments", individual investors have their own preferences when it comes to vehicles for making investments. In research conducted by the ICI, nearly 50% of all U.S. households and 89% of all U.S. investors own mutual funds. Further, roughly $7 trillion of U.S. wealth is invested in mutual funds, accounting for approximately 20% of U.S. corporate equity ownership. In comparison, Exchange Traded Funds (ETFs), a relatively new investing vehicle, only have $117 billion in assets.

Together with other investors, including pension funds, insurance companies, and foreign investors, mutual fund investors clearly have a significant impact on the global funds flow given the changing supply and demand dynamics for different asset classes. Further, mutual fund investors primarily stick to three core asset class categories when allocating the bulk of their portfolios: equities (domestic and foreign stocks), bonds, and money markets (cash).

Unlike some individual investors and specific funds that maintain strict portfolio allocations (i.e. 60/40 stocks/bonds), the total of all mutual fund assets tends

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

to be more fluid. New purchases, redemptions and exchanges amongst fund classes all impact total mutual funds holdings.

As the table below illustrates, asset class holdings as a percentage of total mutual fund assets shifts over time, tilting the scale from one asset class to another. Shifts from year to year can be quite pronounced or more gradual.

Total Mutual Fund Market Allocations

Year	Equity Funds	Hybrid Funds	Bond Funds	Money Market	Total	S&P 500
1990	**22.5%**	**3.4%**	27.3%	**46.8%**	100.0%	-3.1%
1991	29.1%	3.7%	28.3%	38.9%	100.0%	30.5%
1992	31.3%	4.8%	**30.7%**	33.3%	100.0%	7.6%
1993	35.8%	7.0%	29.9%	27.3%	100.0%	10.1%
1994	39.6%	**7.6%**	24.5%	28.4%	100.0%	1.3%
1995	44.4%	7.5%	21.3%	26.8%	100.0%	37.6%
1996	49.0%	7.2%	18.3%	25.6%	100.0%	23.0%
1997	53.0%	7.1%	16.2%	23.7%	100.0%	33.4%
1998	53.9%	6.6%	15.0%	24.5%	100.0%	28.6%
1999	**59.0%**	5.5%	11.9%	**23.6%**	100.0%	21.0%
2000	56.9%	5.0%	**11.6%**	26.5%	100.0%	-9.1%
2001	49.0%	5.0%	13.3%	32.8%	100.0%	-11.9%
2002	41.7%	5.1%	17.6%	35.5%	100.0%	-22.1%
Aug-03	46.4%	5.5%	17.3%	30.7%	100.0%	
Avg.	**43.7%**	**5.8%**	**20.2%**	**30.3%**		

Source: Constructed by SMS Capital Management, LLC with data from the Investment Company Institute

This chart seems to support the theory that investors shift their money among competing core asset classes and favor the one with the best near term performance. For example, in 1999, towards the height of the bull market, equity funds comprised 59% of all mutual funds. At the same time, money market balances were at their lowest point for the 1990-2002 time frame, shown at 23.6%.

Then, at the onset of the bear market in 2001, investors sought out “safer” investments and switched courses from stocks to bonds. During the next two years, over $210 billion of net cash would flow into bond mutual funds, moving the percentage in bonds from a low of 11.6% to 17.3%. Not surprisingly, the aggregate bond index returned 10.2% versus a negative 22% for the S&P 500 in 2002 as investors’ higher demand for fixed income securities helped drive up prices for the asset class.

www.smscap.com

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

Still chasing returns, individual investors were selling stock funds in favor of bond funds as recently as February of this year, withdrawing over $11 billion in stock funds in the first two months of 2003.

Then, as the market started moving higher in March following the Iraq War, money started flowing back into stocks. With the upward momentum proving to be more than a short rally, the buying accelerated. The increased demand for stocks has driven the S&P 500 and Nasdaq up over 25% and 40% since March, respectively. Investors have been taking money from their money market accounts to support their stock fund purchases and are just now starting to sell their bond funds, raising equity mutual fund holdings to roughly 44% of total holdings.

Where Are We Now?

Interestingly enough, as of August, asset class allocations are close to their averages for the period covered in the chart, with stocks slightly exceeding their average.

In order for equities to continue to their move upward, there needs to be continued demand for stocks and an ample supply of funds to purchase them. Improving economic data, and higher corporate earnings should be enough to keep investor demand up, but what about supply?

At the beginning of the year, there was clearly enough supply of cash on the sidelines to fuel a market run (35%, the highest percentage in a decade). But is the Margarita machine quickly running out of ice? Like a Liza Minelli hangover, investors still feel lingering pain from the money they lost when the stock market bubble burst in 2000. Despite the allure of higher stock market returns, investors might not let their money market account balances dwindle too low this time around. With bond funds already below their average allocation, investors might keep their remaining cash on the sidelines.

On the flip side, with rates on money market funds at or below 1%, with no signs of budging any time soon, there is a stronger case to be made that more yield-starved, investors will return to their undisciplined ways and sooner or later move out of bonds and money market funds and into stocks. All it takes is a few percentage point shift to have an impact.

Capital Management, LLC

www.smscap.com

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

This time around, it might make sense to go with the flow, at least for a little while longer. Although there will be some dips along the way, look for investors to keep this party going into 2004.

*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.