



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 thirteen 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).

Market Outlook - Where Do We Go From Here?

In the last month, we witnessed a serious meltdown of the global financial markets. While the exact causes can and will continue to be debated, there is no question that the severity of this crisis will have a lasting impact on our economic landscape.

As governments and central banks around the world scramble to contain the continuing fallout, investors wonder how long it will take to recoup the losses inflicted on their portfolios. The September and early October panic-driven crash was particularly cruel to prudent investors in that it hit all major categories of a so-called “diversified portfolio”, including domestic and international stocks, bonds, and commodities. Unfortunately, there were few places to hide.

Normally, the bond portion of a portfolio will offer some insulation from a reeling stock market. However, in this debacle, even historically safer investment grade bonds, municipal bonds as well as most other income-producing investments (other than Treasury bonds), took a licking as well. Fear swept through the entire system like a tsunami. Credit spreads (the yield difference between U.S. Treasury bonds and bonds of lesser credit quality issues) blew out way beyond historic proportions. In essence, yields soared as investors demanded more return for their higher perceived risk while the value of the underlying securities fell.

Is it Safe to Go out Yet?

It has taken unprecedented government intervention to try and bring this banking and credit crisis under control. Without government action, things would likely get much worse. These drastic government measures should start to have an impact in the weeks and months to come. The U.S. and the rest of the world are in the midst of an unavoidable economic slowdown, and it will take some time for the markets to heal from the damage that has been done. The important thing to realize is that just like all crises and economic fallouts before this one, this too shall pass!

Corporate earnings will no doubt be bad for the next couple of quarters. However, looking out into the next 6-12 months, there are some reasons to be optimistic that the seeds for an economic recovery have been planted. Interest rates that are once again at record low levels should spawn economic activity. The Federal Reserve has been steadily lowering interest rates to promote growth as well as enhance the profitability of banks. Central bankers around the world, particularly in Europe, had been reluctant to lower interest rates due to elevated levels of inflation. However, with commodity prices diving due to reduced demand, they now feel more comfortable taking a more aggressive stance towards focusing on growth. That should lead to further interest rate cuts around the globe where economic activity is also anemic.

Another positive is that the drop in oil prices has led to significant relief for consumers at the gas pump. Since every dollar matters in these painful times, consumers will have more funds to spend other than on fuel. Lastly, the sweeping measures taken by the Federal Reserve in concert with the U.S. and foreign governments aimed at getting credit flowing again will eventually have an impact. It is just a matter of when.



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Economic activity is cyclical. Unfortunately, this past cycle had a much harder landing than many had anticipated. Nonetheless, a recovery will emerge and a new upward cycle will begin once the excesses from the last cycle have worn off. Since markets are leading indicators of the economy, by the time the news is good and the mood is bright, the markets will have already improved. In past cycles, the stock market has started performing better anywhere from 6-9 months ahead of positive economic activity.

Portfolio Positioning

Shell shocked investors now have choices to make with regard to their portfolios and future allocations. With the world's markets having erased several years' worth of gains, chucking your equity holdings and piling into U.S. Treasury bonds at this point is not a wise move for long term investors. While you may avoid further losses if the markets continue to reel in the short run, you are likely selling at unattractive levels and harming your long term returns.

Rather, investors need to remind themselves as to why they chose to own stock. Over the long term they deliver better long term return than any other asset class and offer a hedge against inflation. Sitting in cash, while it feels comfortable in times of panic and hysteria, is not a good long term investment. Fortunately, the hysteria and panic will eventually pass. This decade has not been a good one for equity investors, but it can take a long time to bring investment expectations into balance. The great bull market of the 1990's brought return expectations beyond a reasonable level. Given this decade's subpar performance, there is a greater likelihood that the next decade will be much kinder and rewarding.

Therefore, investors should look at this as an opportunity to reevaluate their portfolios and look to make any changes in the next several months that could enhance long term returns. After such a significant correction in the markets, investors should take some cash designated for long term investment and gradually add to both stock and bond allocations. In particular, many investment grade bonds funds offer a superior risk/return profile given the extreme level of where yields have gone. It is very possible that those purchasing high quality bond funds may end up getting equity-like returns for taking bond-like risk.

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