



Capital Management, LLC

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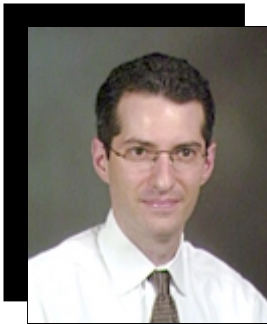
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By Steven M. Sheldon, CFA

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).

Second Half 2003 Market Commentary

The Lunch Special

Investors tend to react much the same way as a frugal patron at an expensive restaurant, always searching for the best deal relative to what else is currently on the menu. Not everyone in the restaurant (market), however, appears to be hungry or has yet noticed the “Lunch Specials.” If so, equity prices would be higher than where they are today.

Despite strong first half 2003 gains, equities remain an attractively priced asset class on a risk/return and relative value basis. Too many concerns, however, are keeping investors from buying. The still fresh, painful memories of a brutal three-year bear market, the fear of more terrorism, concerns regarding a sustained economic recovery, and most recently, the prospects for deflation are all weighing on investors’ minds. While these concerns are not without merit, portfolios heavily allocated towards U.S. government bonds (particularly medium and long-term) are not being sufficiently compensated for the risks they are taking. Equities, higher quality junk bonds, short-term investment grade corporate bonds, foreign bonds (that hedge currency risk), TIPS (inflation-adjusted bonds), and money markets funds are more appealing asset classes.

First Half 2003 Review

It’s amazing how quickly market sentiment can turn. In February, rising global geopolitical tensions in advance of the imminent war in Iraq sent already nervous investors scurrying from the stock market into the safe haven of U.S. government bonds and precious metal funds. In our February 2003 newsletter entitled “Style and Class Matters” (available at www.smscap.com), we cautioned investors: “Don’t bet on the end of the world”. We suggested that the market’s angst at that time provided an excellent opportunity for investors to start reallocating portfolios heavy in cash and bond funds over to equity funds, and in particular growth-oriented funds. SMS believed that growth funds, which had been soundly out performed by both U.S. Treasury Bonds and value oriented stocks over the prior three and five-year periods, would begin to outshine other asset classes as the U.S. economy and investor sentiment improved.

Sure enough, the hysteria surrounding the Iraqi conflict and potential terrorist activities subsided and since mid March the market has had a strong showing.



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The chart below shows the relative returns of the major U.S. market indexes and core asset classes for the first half of the 2003.

Market Index	Year-To-Date (6/25/2003)
S&P 500	10.85%
Russell 1000 Growth	12.71%
Russell 1000 Value.....	10.47%
Nasdaq	20.00%
Russell 2000.....	15.69%
MSCI EAFE (Int'l)	9.21%
Bonds	4.42%
Money Market	0.5%

In the first half, “growth” performed well relative to “value” mainly due to the strength of technology, biotech and other mid and small cap emerging growth sectors.

Surprisingly, bonds continued to rally to record heights following the war in Iraq. Most investors expected treasury yields to reverse direction and start trending upward (pushing bond prices down) following the end of the war and easing of tensions. Greenspan’s public comments regarding the Fed’s vigilant fight against potential deflation, however, pushed historically low bonds yields even lower defying predictions from many economists and market experts. The 30-year Treasury Bond fell from 4.96% at the start of the year to 4.44% on 6/25/03 while getting as low as 4.1% on 6/13/03.

Junk bonds with hearty coupons continued to lure yield hungry investors. Savvy investors that moved into that asset class in late 2002 and early 2003 when yield spreads (the difference between U.S. treasuries and bonds of lesser quality securities of equal maturity) were the widest did well. They got equity-like returns (greater than 15% total return; yield plus appreciation in bond value) for holding debt instruments. Since spreads have compressed significantly across the board, holders of lower quality high yield bonds have benefited the most. Investors that bought higher-yielding global bonds, particularly those that did not hedge currency, also did well by profiting from a depreciating U.S. dollar.

Going Forward – Stocks vs. Bonds

Despite the recent run-up in stock prices, SMS continues to view equities as an attractively priced core asset class and sees good potential for further gains over the remainder of 2003.



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Relative Value and Risk

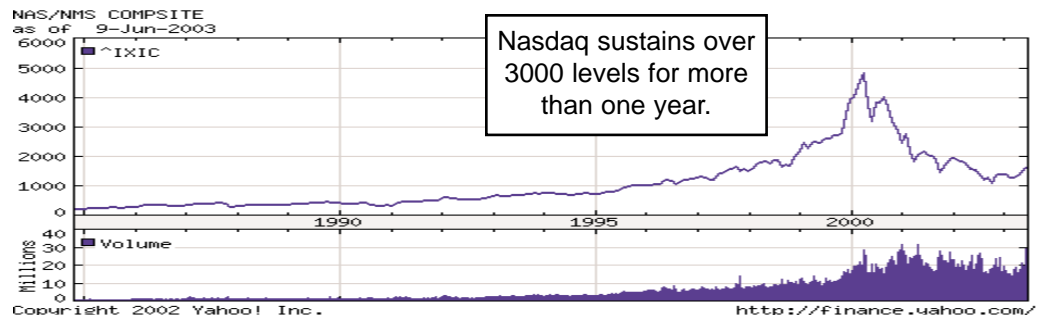
The current Forward Earnings Yield for the S&P 500 is 5.4% (as of 6/25/03) versus the yield on the 10-year U.S. Treasury Bond and yield on cash of 3.4% and .6% respectively. The Earnings Yield is the inverse of the P/E ratio and translates the commonly used valuation metric into a ratio that enables a better relative value comparison to other securities. Rational investors vying for the best deal currently available should move towards equities to take advantage of their better relative return profile.

Further, not only are 10-year and 30-year U.S. Treasury Bonds yielding 3.4% and 4.4% respectively, but also bondholders are getting historically low yields and exposing their principal to both long-term inflation and interest rate risk. For example, if interest rates rise by 1%, the value of a typical intermediate term bond fund will fall by approximately 6%. The only scenario that makes bonds attractive at these levels is if an environment of persistent deflation develops, as is the case in Japan, a highly unlikely case.

Although slight deflation may arise in the near term, a sustained deflationary environment is unlikely. Over time, aggressive fiscal and monetary policy initiatives currently being implemented by Congress and the Federal Reserve will eventually take hold and lead to an expanding economy with mild inflationary pressure. Investors buying long-term bonds at today's historically low yield levels are exposing themselves to significant principal risk. Should interest rates move back up to more normal levels, the value of bonds will decline. Chances are inflation isn't dead but just in a coma for a while!

New Paradigms Rationalize the Abnormal

Talk of new economic paradigms always seems to surface in market bubbles, as is the case in the bond market. When the Nasdaq was streaking to crazy levels in 1999 and 2000, people rationalized that the "New Economy" with incredible demand for emerging technology justified high valuations. If you look at the chart below, you will see that the Nasdaq stayed above 3,000 for an extended period of time before melting away.





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Extreme periods seem to persist just long enough to make reasonable people feel that, indeed, the new paradigm may be plausible. That would explain the large number of investors currently buying 10-year and 30-year bonds at historically low yield levels, something that would have seemed implausible to them just a year earlier.

Don't get lulled into believing that thirty-year returns of 4.5% are normal and here to stay. They probably aren't!

Some Bonds Make Sense

While much of the value has been squeezed out of the lower quality junk bonds since the fourth quarter of 2002, higher quality junk bonds with a reasonable spread over treasuries (5%), shorter duration foreign bonds, and short-term investment grade corporates offer a fair return for the risk being taken.

Investors buying already bid up lower quality high yield bonds are taking on equity-like risk and getting debt-like returns (the reverse of the 4th quarter 2002). These investors will eventually recognize this risk/return mismatch and move over to equities where returns are commensurate with the risk being taken.

Foreign bonds offer a better relative value than U.S. government bonds given the wider yield spreads (2% European Central Bank Rate vs. 1.0% U.S. Fed Funds Rate). Funds that hedge out currency risk (where a rising or falling dollar will not have an impact on returns) are a safer bet.

TIPS (inflation adjusted bonds) are also attractive since the market is likely over discounting the potential for future inflation.

Tax Relief

George Bush's recently passed tax legislation that reduces income tax rates on dividends and long-term capital gains to 15% further tilts the scales towards equities over bonds. Since interest income on bonds is taxed as ordinary income (up to 35% rate for high income earners) investors would earn a better return from the S&P's dividend yield of 1.5% on an after-tax basis than with a 2-year U.S. Treasury bonds yielding 1.35%, not including the prospects for capital gains or losses.

And the Money Flows

Historically, money flows from retail investors tend to be a contra-indicator to future performance as the masses tend to chase asset classes that posted the best performance in the most recent past. Despite recent warnings from industry gurus like Bill Gross, renowned manager of the PIMCO bond fund, and conservative mutual funds companies like Vanguard, investors continue to pour more money into bond funds.



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A record \$140 billion and \$53 billion has poured into bond mutual funds in 2002 and YTD 2003, respectively, while equity funds saw net outflows in 2002 and have attracted only modest sums through April 2003. If this contra-indicator holds true, it suggests that bondholders are seeing the final stages of a bull run.

There is also plenty of money still sitting on the sidelines. Over \$3.3 trillion of the \$6.4 trillion in mutual funds is in bond and money market funds. Once these investors realize that they are not getting adequately compensated on a risk/return basis in bonds and cash, many will seek better returns in equity funds. Just a few percentage shifts in allocation translates into billion of dollars of demand for stock with limited supply. Ultimately this leads to higher stock prices.

In Closing

Fundamentally, SMS believes that the worst for corporate America has passed and U.S. businesses will begin to reap the benefits of restructured operations, improved balance sheets, lower borrowing costs, a cheaper dollar, and improved corporate governance. As a result, bottom line earnings should continue to grow, providing support for higher equity prices.

SMS Capital Management, LLC develops strategies that are tailored to each client's specific needs and objectives. Through its "Index Plus" approach and strategic asset allocation model, SMS builds and manages diversified portfolios that put a premium on superior performance and effective risk management.

We hope to be of service to you in the future. Please contact us for a complimentary consultation and assessment of your portfolio.

**Please note that some SMS client portfolios may not contain all elements of the strategy discussed here. Individual client customizations may preclude certain elements of this strategy from being implemented.*