SMS 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 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).

Yield With Caution

Like aggressive drivers that throw caution to the wind each time they pass a yield sign with their foot firmly pushing on the gas pedal, both aggressive and conservative investors are approaching “high yield” investments in much the same way these days. With interest rates still hovering at record low levels and a sense that the economy is finally getting better, investors looking for income-producing investments keep plowing more money into higher-yielding asset classes at a record pace.

Through September of 2003, $16.6 billion of money flowed into the high-yield bond sector which is currently on pace to exceed the yearly record of $16.9 billion of inflow in 1997. Similarly, emerging market bonds and REITs have also been the beneficiaries of accelerated money flows as income-starved investors continue to hunt for better returns.

So far, investors putting money to work in these areas have not only received higher yields than traditionally safer investments like government and investment grade corporate bonds, but have also been rewarded with appreciation in the value of their holdings. Over the last year, strong investor demand has pushed yields down across the board and prices have risen as a result.

As the chart below indicates, REITs, another popular higher-yielding asset class, have been big winners so far this year closely followed by emerging market bonds and high-yield bonds (including non-investment grade bonds and non-rated deep junk).

The chart also shows current interest rate spreads (i.e. the difference between the “risk free” rate on the 10-year U.S. Treasury and the yield of riskier asset classes). Historically, high-yield bond spreads have averaged 5% over Treasuries, but fluctuate depending on prevailing economic conditions. As part of normal business cycles, the spread between the rates on U.S. Treasury bonds and interest rates on securities of lesser quality narrow and widen. When economic conditions deteriorate, spreads widen, and when they improve, spreads narrow, reflecting the less risky environment.

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Asset Class	Yield*	Spread over 10-Year Treasury	YTD Total Return
Money Market	0.8%	-	-
10-Year U.S. Treasury	4.2%	-	-
Med Term Investment Bonds	4.6%	0.4%	5.7%
REITs	5.2%	1.0%	27.5%
High Yield – Higher Quality	6.6%	2.0%	14.4%
High Yield – Lower Quality	8.3%	4.1%	18.7%
Emerging Market Bonds	6.3%	2.1%	25.5%

*Compiled by SMS Capital Management as of Nov. 18, 2003 using proxies for asset classes.

Improving Fundamentals

Ostensibly, investors believe improving global economic conditions warrant lower yields and higher prices for these asset classes. Since last year, fundamentals in the high-yield sector have steadily improved compared to when the default rate on high-yield bonds was over 10%. Since then, the default rate has declined to roughly 5.5%. Yields on high yield bonds have followed suit falling from the 10-12% in 2002 to the current 6-8%, depending on credit quality, in addition to higher demand for the securities.

With regard to emerging markets, many of these developing economies are built on raw material exports and low cost labor, both of which are directly benefiting from restructuring and outsourcing going on in the U.S. and other developed nations. As a result of these trends, many of these emerging nations' economies are growing rapidly and are more financially sound than in the past.

Time to Reevaluate?

Despite some real improvements in the global economy, it's hard to envision that high- yield asset classes have much more room to appreciate.

At some point, one of two scenarios will likely occur. In the first scenario, investors will recognize that the high yields they were bargaining for are no longer high enough to compensate them for the perceived risk they are taking. These investors will swap into safer investment classes, accepting a slightly lower yield and less risk, or move into a riskier asset class anticipating a better risk/reward tradeoff.

In the second scenario, interest rates could reverse course and start rising, pushing up yields across the board and pushing the prices of all fixed income investments down.

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While the economic outlook does appear brighter than it did a year ago, investors would be wise to take their foot off the gas pedal and evaluate their holdings of higher-yielding securities.

Strategies worth considering include upgrading into higher quality junk bonds with shorter durations and out of the deep junk that has appreciated markedly. Or, move from high-yield bond funds to funds investing in preferred or common stock funds with a high dividend yield. Given the new tax laws (which have a favorable 15% tax treatment for qualifying dividends as opposed to income from REITs and bonds which are taxed at the investor's ordinary income tax rate), the after-tax income from stock funds may be competitive, particularly for funds in taxable accounts and investors in high tax brackets.

Also, consider selling out of emerging market bond funds altogether. With a 6% yield (a mere 2% premium over U.S. Treasuries), it's just a matter of time until the next international crisis in one or more of these volatile countries pushes these rates to more reasonable levels. Finally, investors desiring real estate exposure might substitute a REIT index in favor of a specific REIT that is subject to greater risks (geographic, sector, etc.).

How Does SMS View High Yielding Asset Classes?
SMS believes that having some exposure to certain high-yielding asset classes as part of a broadly diversified portfolio makes sense, but not necessarily for everyone or at all times. Since these asset classes' returns tend to be more volatile than other income- producing alternatives, they may expose an otherwise conservative investor to more risk than desired.

SMS actively evaluates these as well as core asset classes and determines appropriate allocations based on the relative risk/return expectations for the asset classes and the risk profile and investment objectives of each client.