



The Coming Upturn

STEPHEN SMITH, CFA

The economic recession we have experienced for the last 16 months has resulted in enormous hardship for millions of Americans. The stock market sell-off has depleted portfolios whose value was the source of many plans for the future. In many ways, this is the worst economic environment since the Depression in the 1930's. The Federal government is attacking the problem aggressively, with the outcome of their efforts still in doubt.

Smith Group is in the business of managing portfolios with investments in the stock market. The value of these portfolios is closely linked to the corporate profit picture that is set by the overall economy, so we are keen observers of all the interrelationships that affect market valuations. Very recently, we have begun to see

early signs of a possible upturn in the economy and the stock market. While it is too early to definitively state the end of the recession is in sight, the recent increase in consumer spending for small-ticket items, along with other signals, is encouraging.

In my thirty-plus years of professionally managing client portfolios using an earnings-based approach, I have noticed that both the absolute and relative performance produced by the process has an earnings cycle basis. Essentially, the clearer the earnings picture, the better the performance and the murkier the visibility of corporate profitability, the more the investment process struggles to achieve its performance goals. In the most recent period, the economic downturn has clouded the earnings picture,

and when the upturn arrives, earnings visibility will increase.

Recessions normally end because of increased consumer-related spending and because businesses have over-reacted to the poor business environment and have stocked their inventories too low and start restocking. In this recession, both consumers and businesses have followed this normal pattern. The financial system is also under extreme duress, causing credit to be relatively unavailable, another symptom of almost all recessions.

Prices have fallen for a wide variety of assets, including real estate and company shares. Typically

(Continued on page 3)

INVESTMENT TEAM

Stephen S. Smith, CFA
John D. Brim, CFA
Bradley J. Baker, CFA
Bill Ketterer, CFA
Royce W. Medlin, CFA
Eivind Olsen, CFA
A. Michelle Pryor, CFA
Kathryn M. Terry
Richard C. Villars, CFA
Christopher M. Zogg, CFA



The Inversion of Growth

ROYCE MEDLIN, CFA

Smith Group employs proprietary ranking models to identify companies with attractive fundamental characteristics. One of them, Growth Outlook, identifies companies that are in the early stages of an improving earnings growth cycle. Over long periods, this model has helped identify companies with realized earnings growth in excess of expectations, resulting in market-beating performance. Unfortunately, the market's preference for companies with improving earnings is not a constant and there

are periods when inversions occur.

The accompanying charts on page 5 depict performance of companies ranked by Growth Outlook in the Russell 1000 back to 1995. Companies are grouped into quintiles (200 companies in each bar) and performance measured. Over time, better ranked companies demonstrate strong performance and worst ranked companies extremely

(Continued on page 5)



Smith Scorecard

JOHN BRIM, CFA

The 1st quarter saw a furthering of the U.S. equity market sell-off that began in October 2007. At its trough on March 9th the S&P 500 Index had fallen 56% from its peak on October 9, 2007. A strong rally at quarter end was led by financial companies with the S&P 500 Index bouncing 18% off its low, while finishing the quarter down 10.9%. The small cap Russell 2000 Index dropped 15.0% on the quarter. Shares of growth-oriented companies led value stocks across all market capitalizations.

After trailing the broad market from the market peak, Information Technology stocks outpaced all other economic sectors in the first quarter and finished as the only sector with positive returns. Despite the rebound which began in March, Financials had another terrible quarter, slumping -28% in the S&P 500 and -25% in the Russell 2000. Consumer Discretionary stocks

were more resilient, only deflating -8% in the S&P 500, and outpacing their less economically sensitive peers in staple consumer businesses which sunk 11%. This reversal did little to offset the dramatic plunge of Consumer Discretionary stocks relative to Consumer Staples during the market sell-off. From the peak through 2008 large cap Consumer Discretionary shares fell 42% dwarfing the 12% dip in Consumer Staples.

Smith Group utilizes both quantitative and qualitative analysis to invest in high quality companies poised to accelerate earnings growth and exceed investor expectations. Risk control features of our investment process include attractive valuation, high earnings quality, and strong corporate governance. Over long periods each of these portfolio characteristics have proven to be powerful performance drivers. Over the past year our focus on a high likelihood of reported

earnings exceeding investor expectations proved a headwind. Periods when this portion of our process does not add value can coincide with low investor confidence in forward earnings growth and often monetary policy intervention. The current economic environment certainly faces both of these challenges. However, alignment with better than average earnings quality contained the downside associated with the negative performance from the growth components of our investment process.

During the quarter our Disciplined Alpha – Russell 1000 Growth strategy reached its one year performance mark. Since its inception the strategy has topped its benchmark by 2.4% per year net of fees with a 2.5% tracking error¹ (equaling an information ratio² of 0.96). Smith Group's Large Cap Core/Value
(Continued on page 4)

“... alignment with better than average earnings quality contained the downside...”

PRODUCT	1Q 2009		1 YEAR		3 YEARS		5 YEARS		ANNUALIZED SINCE		INCEPTION DATE
	GROSS	NET	GROSS	NET	GROSS	NET	GROSS	NET	GROSS	NET	
Large Cap Core/Growth	-9.3%	-9.5%	-38.0%	-38.7%	-13.2%	-14.1%	-3.2%	-4.2%	7.0%	5.9%	1/1/1996
<i>S&P 500</i>	-10.9%		-38.1%		-13.1%		-4.8%		3.8%		
<i>Russell 1000 Growth</i>	-4.1%		-34.3%		-11.3%		-4.4%		2.5%		
Large Cap Core/Growth 130/30	-10.6%	-10.8%	-38.0%	38.6%					-26.6%	-27.3%	5/17/2007
<i>S&P 500</i>	-10.9%		-38.1%						-27.3%		
Large Cap Core/Value	-12.4%	-12.6%	-33.7%	-34.4%	-9.7%	-10.6%	-0.9%	-1.9%	2.7%	1.7%	4/1/1999
<i>S&P 500</i>	-10.9%		-38.1%		-13.1%		-4.8%		-3.0%		
<i>Russell 1000 Value</i>	-16.8%		-42.4%		-15.4%		-4.9%		-0.6%		
Disciplined Alpha R1000GR	-3.9%	-4.0%	-32.3%	-32.6%					-31.7%	-32.1%	2/26/2008
<i>Russell 1000 Growth</i>	-4.1%		-34.3%						-34.4%		
Multi Cap Core/Growth	-7.3%	-7.5%	-36.4%	-37.1%					-24.5%	-25.3%	4/20/2007
<i>Russell 3000</i>	-10.8%		-38.2%						-26.0%		
<i>Russell 3000 Growth</i>	-4.5%		-34.4%						-22.0%		
Small Cap Equity	-15.8%	-16.0%	-42.0%	-42.6%	-21.9%	-22.6%	-7.6%	-8.5%	0.5%	-0.5%	7/1/2001
<i>Russell 2000</i>	-15.0%		-37.5%		-16.8%		-5.2%		-1.2%		
<i>Russell 2000 Growth</i>	-9.7%		-36.4%		-16.2%		-5.4%		-3.6%		

Please see Performance and Firm Disclosures on Page 6



Fog To Fair Skies

RICK VILLARS, CFA

'Uncertainty' was the catch word for the last quarter. Investors were unsure how far house prices would fall, how many jobs would be lost, whether credit markets would open, how much more capital banks need, and questioned that politicians will be able to pinpoint an effective path to recovery. In turn, that left comparable levels of ambiguity around earnings prospects for stocks. Given investors hate vagueness it is logical in hindsight that markets would establish new cyclical lows as buyers stepped to the sidelines to await more clarity. The road ahead will hinge on the emergence of greater foresight or further ambiguity.

Earnings expectations have suffered the most draconian cuts on record over the recent past. Given the economic backdrop and inflated analysts' previous notion of sustained peak margins it was probably justified. But is pessimism pervasive enough to open the door for positive surprises? Given the pace of downward guidance in the lead up to quarterly earnings reports the current quarter is not prone to prop

that door open. Yet, in subsequent months investors should be vigilant in watching for constructive signs. Complacency in a downward profit trend is apt to be the turning point for the better.

At the end of the day, consumers and businesses need to return to some level of borrowing and spending in order for corporate revenues to expand. Once that happens there should be slack capacity to deliver expanding earnings.

At a sector level there are challenges and opportunities. Financials could prove to be either. Given the steep yield curve, once write-offs abate the basic business of lending money to qualified borrowers happens to be quite profitable right now. Consumer Discretionary companies in the mean time have learned to live on battle rations so any loosening of household purse strings will feel like a feast. On the flipside, comparisons in the energy complex will be tough this year with a peak-to-trough swing in energy

"The road ahead will hinge on the emergence of greater foresight or further ambiguity."

prices of two-thirds. This is more significant than most think because 32% of 2008 earnings came from this sector. Finally, U.S. companies last year increased dependence on foreign earnings. This year our trading partners are mostly worse off than locals and a firmer dollar has clipped our competitiveness.

It will be a challenging year but may prove pivotal. Like most, we are looking for signs the fog is lifting and do find some comfort that the pace of deterioration is moderating.

The Coming Upturn

(Continued from page 1)

the lower prices attract potential buyers, who remember when the same assets were selling at a higher price. Eventually transactions happen, indicating to other potential buyers on the sidelines that prices may be headed higher. This prompts more transactions, which pull prices up, and the economy

"Since 1930, the average 18-month stock market return coming off a recession-related market bottom is +42%"

enters a multi-year upward pattern. All of this happens naturally in our economic system, even without the government intervening. When the government prints more money than the economy needs (monetary stimulus) and spends more money than it receives from taxes (fiscal stimulus), both of which are happening now, normal economic recovery forces get a boost.

The developing economic recovery, which is widely forecasted for the second half of this year, is already being reflected in the stock market. It appears that the market bottom established on March 9 will hold, establishing a base for a potential new bull market. Typically, as the economy recovers, corporate profitability has its best percentage gains of the upturn, and stock market benchmarks enjoy their best gains of the bull market. Since 1930, the average 18-month

stock market return coming off a recession-related market bottom is +42%.

Smith Group's investment process focuses our portfolios on companies with a high level of undiscovered profit growth. Historically, as profits surge, so does the level of excess return in the portfolios that we (and others with a profit focus) manage. Of course, every recovery is different, and predicting future returns from any investment process is difficult. However, if past patterns apply to the current market environment, we may be near the beginning of a very nice period for both the stock market and for the portfolios that we manage.

Scorecard

(Continued from page 2)

strategy also stands out as a top performer. The strategy reached its 10-year anniversary. For the life of the strategy it has bested the S&P 500 and Russell 1000 Value Index by more than 4.7% and 2.3% per year net of fees, respectively. A detailed performance look is shown in the table on page 2.

Definitions:

¹Tracking error: The standard deviation of the difference between returns of a portfolio and the returns of the benchmark.

²Information Ratio: A ratio of portfolio returns relative to the returns of a benchmark adjusted for the volatility of those returns. Information ratio (IR) measures a portfolio managers ability to generate excess returns, but also attempts to identify the consistency of the

investor..

R_p = Return of the portfolio; R_i = Return of the index or benchmark; S_{p-i} = Tracking error (standard deviation of the difference between returns of a portfolio and the returns of the benchmark).

$$\text{Information Ratio} = \frac{(R_p - R_i)}{S_{p-i}}$$

The Second Derivative

BILL KETTERER, CFA



The second derivative is getting more than its share of media coverage these days. The bad news is getting less bad. Housing sales are not as slim, the manufacturing contraction not as steep, negative earnings revisions compared to positive not quite as overwhelming. In a world where the gloom is so pervasive little rays of sunshine are welcome and bulls argue they are indicators of better times to come. On the other side of the debate are those that view the concept as grasping at straws, while others contend that things are just too bad for the second derivative to work. But the turning point in some lead indicators has proven statistically relevant if not perfectly so.

The purchasing managers survey measuring manufacturing new orders is one illustration of this point (see graph). While orders are still contracting at index readings below 50, historically when the index troughs below 40 then recovers it has been a good time to own stocks. In all but one instance since this survey began in 1955 that was the case. Note that prior to the last recession the market climb was fairly steady and ultimately ended in a double digit gain.

While the indicator is statistical, the effect is behavioral. Selling pressure from investors fleeing the market reaches a crescendo when the assessment of the outlook is at its worst. As long as economic momentum is deteriorating buyers find few reasons to resist the trend and sellers find plenty of fuel to be

aggressive. A simple supply and demand mismatch occurs. So as information flow begins to abate selling pressure lessens and a better mix of buyers and sellers eventuates. This is how market bottoms are formed.

The one exception to our example was in January 2001 where a collapse in orders actually preceded the recession yet to come and recovering order trends suffered a relapse as the business contraction took hold. This illustrates the caveat in the second derivative. In order for it to work marginal progress has to continue. We agree that recent improvement in marginal data flow is encouraging but recognize there are still overhanging economic issues. Continued vigilance is needed in watching for signs of confirmation or reversal.

This indicator actually bottomed in December of last year so this time it looks like it was about 3 months too early. But the March rally may continue if the indicator maintains its incremental improvement. Yet, clearly in order for this lead indicator to provide positive guidance for the present market the economy will need to continue on the road to recovery.

Using second derivatives as market indicators takes attentive monitoring and they can be subject to reversal. They are not indicators that call a definitive market bottom. Instead they should be thought of as positive indications of trends that can

(Continued on page 5)



Second Derivative

(Continued from page 4)

continue provided future events support an upward slope. Today, investors can begin to take some

comfort in things getting 'less bad' but they need to be careful in their application of the second derivative concept.

Growth Inversion

(Continued from page 1)

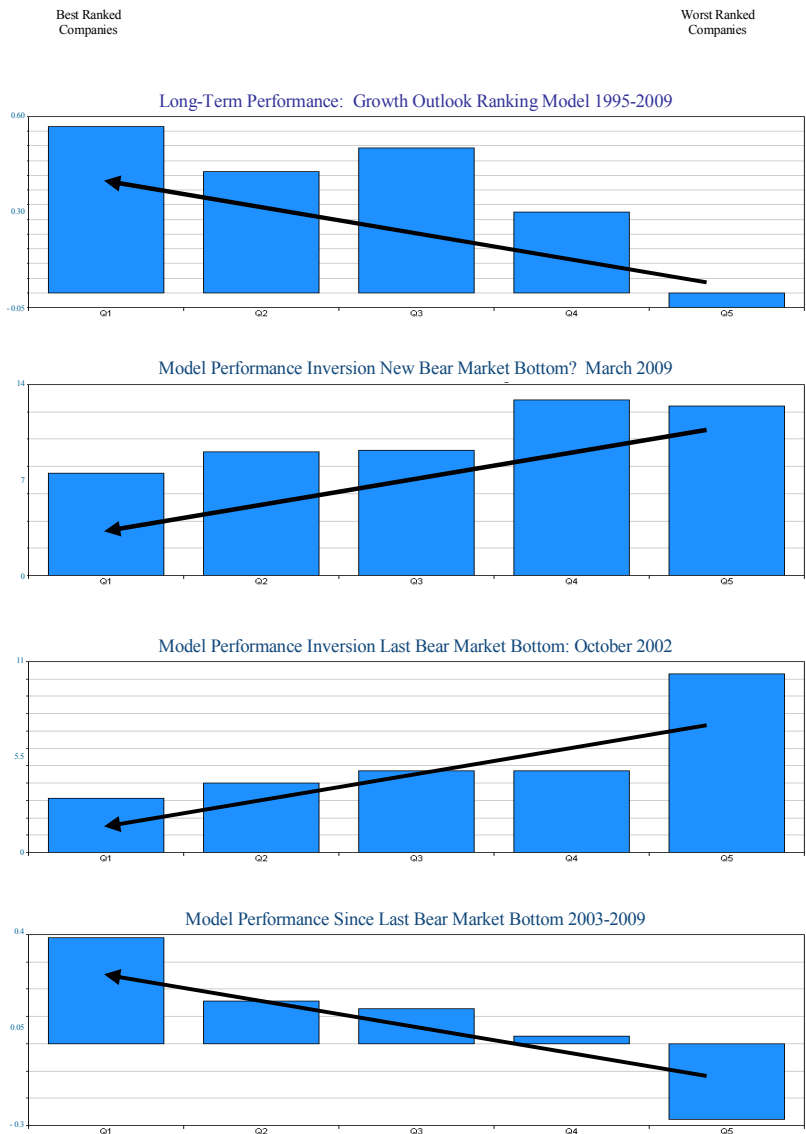
poor returns. In fact, the top fifth have outperformed the S&P 500 on average +6.9% per year. Bottom fifth companies underperformed by a dramatic -8.8%. This performance is not transaction costs burdened nor turnover constrained so is not fully capturable, but the magnitude and direction of performance serves as a strong lodestar for stock selection and portfolio construction.

March proved a difficult one for our process. The middle two charts show performance inversion in both Mar-2009 and Oct-2002. These months have in common poor relative performance for our strategies relative to their benchmarks but appear to coincide with a bear market bottom.

The idea that bear market bottoms begin with a "junk" or "relief" rally holds up under scrutiny. The rational explanation is companies teetering on bankruptcy finally hit bottom and are the first to improve. This is consistent with improving market sentiment and a belief that the monetary and fiscal response to the weak economy is taking hold. A look at the best performing stocks since the March low confirms this notion, with AIG and Citigroup the best performing stocks, each up over 150% over a 3-week period.

To end on a positive note (and as depicted in the bottom chart), our process began to produce excellent results after the bear market bottom inversion of 2002. In fact, relative performance of all our strategies was strong in the following year and led to a multi-year streak of outperformance. We believe the same patterns will hold true through this cycle and investors will once again value earnings growth as a primary driver of stock prices.

Growth Outlook in Russell 1000: All Average Quintile Returns



Disclosures

Founded in 1995, Smith Asset Management Group, L.P. ("Smith Group") is a registered investment advisor that specializes in equity investment management services. The firm manages assets for a diverse list of clients, which includes foundations, endowments, corporate pensions, public funds, multi-employer plans and high-net worth individuals. Effective Jan. 1, 2006, the firm was redefined to exclude wrap SMA business. Smith Group claims compliance with the Global Investment Performance Standards (GIPS®). Smith Group has received a firm-wide verification for the period Jan. 1, 1996 - Dec. 31, 2008. To receive a complete list and description of Smith Group's composites and/or a presentation that adheres to the GIPS® standards, contact John Brim, CFA at (214) 880-4608, or write to Smith Group, 100 Crescent Court, Suite 1150, Dallas, TX 75201, or john@smithasset.com. The Large Cap Core/Growth, Large Cap Core/Growth 130/30, Small Cap Equity, Large Cap Core/Value, Multi Cap Core Growth and Disciplined Alpha—R1000Gr composites are comprised of accounts whose primary objective is growth of principal by investing primarily in stock of U.S. companies. Smith Group performance is the total return including cash and cash equivalents, gross of fees, of an asset-weighted composite of all discretionary portfolios. Performance is expressed in U.S. dollars. Net of fee performance shown reflects the deduction of the maximum applicable fixed rate fee level, 1.0% of managed assets per year for the Large Cap Core/Growth, Large Cap Core/Growth 130/30, Small Cap Equity, Large Cap Core/Value, Multi Cap Core Growth composites and 0.50% of managed assets per year for the Disciplined Alpha—R1000Gr composite. All performance returns include the impact of cash, cash equivalents, dividends and interest. The S&P 500, Russell 1000 Growth, Russell 1000 Value, Russell 3000, Russell 3000 Growth, Russell 2000, and Russell 2000 Growth indices, are unmanaged indices of the shares of large, mid and small U.S. corporations. All index performance includes capital appreciation and reinvested dividends and is presented gross of fees.

Earnings Surprise: According to many academic studies, earnings surprise has had a positive relationship to relative performance in most time periods and for most companies. However, this does not mean that this relationship exists for all time periods and for all companies. In the recent past, periods coinciding with an inverse relationship between earnings surprise and relative performance have typically been periods in which corporate earnings are not the focus of investors' attention. Additionally, companies, which have had a chronic negative relationship between earnings surprise and relative performance, are typically those companies whose earnings are not product-driven, such as commodity companies. There is no assurance that the historic positive relationship between earnings surprise and relative performance will exist in the future. Nor is there any assurance that the historic ability of Smith Group to forecast a high rate of positive earnings surprise companies will exist in the future.

Past performance is not indicative of future results. As with any investment vehicle, there is always a potential for profit as well as the possibility of loss. Actual results may differ from composite returns, depending on account size, investment guidelines and/or restrictions, inception date and other factors. Nothing contained in this presentation should be construed as a recommendation to buy or sell a security or economic sector.

This material is for your own personal information, and we are not soliciting any action based upon it. The material is based upon information we consider reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Opinions included in this material are as of March 31, 2009 and are subject to change without prior notice.

If you no longer wish to receive letters from Smith Asset Management Group, LP, please fax your letter with the words "Opt Out" at the top to 214-880-4641. Once we receive your request, within ten business days you will no longer receive any non-client-specific communications from Smith Asset Management Group, LP.

Should you require any further information, please contact: John D. Brim, CFA | john@smithasset.com