



## Relative Performance Rotation

STEPHEN SMITH, CFA

A couple of years ago, I celebrated my 30<sup>th</sup> year in the investment management industry. The industry has changed a lot during that time and yet many things remain the same. Most of the change is related to proliferation of data and technology available to customize investment solutions. The speed at which investment decisions are made and implemented also is a transformation.

Among the many timeless aspects of our industry is the cyclicity of the excess return periods of all investment processes. There are ebbs and flows to every investment process, usually related to

biases investment managers instill in their process. Most investment managers have a bias toward either growth or value, large or small companies, and these days, either U.S. domestic or international. Then there is the “secret sauce” each manager has, distinguishing their process and performance pattern from the competition.

At Smith Group, we have a growth bias and the proprietary parts of our process are focused on our unique way of finding high quality companies, growing faster than the market expects, whose shares are reasonably priced. As proof of the effectiveness of our process, the

performance that we have produced for our long-term clients is pretty amazing, ranking near the top of most performance databases.

Lately, however, the forces that favor us in the long-run have turned against us. For reasons related to the long and severe economic downturn, investors have been attracted to companies benefitting from the federal government’s life-support system. These companies are not high quality, have no realistic growth plan, and typically have no earnings or book value on which to establish a valuation framework. Since the  
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## Spring Rally: Under the Hood

TRAVIS BRIGGS

The market rally began on March 10, 2009 and was a major relief to us all. The preceding bear market was notable as ending with one of the worst capitulation phases on record. There are consistent themes to market recoveries and the purpose of this article is to highlight one; the significant role the highest beta, or most risky securities, played in the recent rally.

Beta is a common measure used to calculate the riskiness of a stock relative to the overall market. High beta is associated with volatile stocks, stocks that have a history of amplifying market variability. Following a bear market bottom, it is not unusual for stocks with the largest price declines to rebound the  
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**Smith  
Scorecard**  
JOHN BRIM, CFA

The 2nd quarter saw a continuation of the equity market rally that began in mid-March. For the quarter the S&P 500 Index rose 15.9%, its best 3 month stretch since fourth quarter 1996. The S&P 500 has risen 38% since March 9, yet still stands 41% below its peak of October 2007 and 20% below its level of ten years ago. Small cap stocks fared even better than large cap stocks during the period, as the Russell 2000 Index gained 20.7%. Among large cap stocks financial companies led the charge higher advancing 35.8% followed by information technology stocks which rose 19.8%. Information technology is easily the best performing sector year to date having advanced 25.0% v. 3.2% for the S&P 500 Index. Health care and consumer staples

companies lagged the indices in both large and small cap stocks. Smith Group portfolios were generally underweight financials and overweight health care and consumer staples companies for the period.

Low-quality, beaten-down stocks played a significant role in driving performance during the quarter. While growth oriented benchmarks fared well during the period, it was not the inherent “earnings growth” characteristics of the companies in the benchmarks that led the charge. In fact, most investment factors associated with growth-oriented investing performed quite poorly during the market rally. Stocks with high forecasted growth underperformed those with lower predicted growth rates,

stocks with rising earnings expectations underperformed companies with declining expectations, and stocks reporting significant positive earnings surprises trailed those featuring sizeable negative earnings surprises. The best performing investment factor for the quarter was “risk” as measured by almost any metric. Within the S&P 500 stocks with the lowest 5 year Beta<sup>1</sup> underperformed stocks with the highest 5 year Beta by a stunning 70% from the March bottom. The risk control features of Smith Group’s investment process generally favor lower volatility/beta stocks. For more on this topic please see the article entitled [Spring Rally: Under the Hood](#) on page 1.

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*“... risk control features of Smith Group’s investment process generally favor lower volatility/beta stocks...”*

PRODUCT	2Q 2009		YTD		1 YEAR		3 YEARS		5 YEARS		ANNUALIZED SINCE INCEPT.		INCEPTION DATE
	GROSS	NET	GROSS	NET	GROSS	NET	GROSS	NET	GROSS	NET	GROSS	NET	
Large Cap Core/Growth	5.5%	5.3%	-4.2%	-4.7%	-34.9%	-35.5%	-11.0%	-11.9%	-2.0%	-3.0%	7.3%	6.2%	1/1/1996
<i>S&amp;P 500</i>	15.9%		3.2%		-26.2%		-8.2%		-2.2%		4.8%		
<i>Russell 1000 Growth</i>	16.3%		11.5%		-24.5%		-5.5%		-1.8%		3.6%		
Large Cap Core/Value	9.0%	8.7%	-4.6%	-5.0%	-26.8%	-27.5%	-7.4%	-8.4%	0.8%	-0.2%	3.5%	2.5%	4/1/1999
<i>S&amp;P 500</i>	15.9%		3.2%		-26.2%		-8.2%		-2.2%		-1.5%		
<i>Russell 1000 Value</i>	16.7%		-2.9%		-29.0%		-11.1%		-2.1%		0.9%		
Disciplined Alpha R1000GR	14.8%	14.7%	9.8%	9.6%	-24.1%	-24.5%					-19.0%	-19.4%	2/26/2008
<i>Russell 1000 Growth</i>	16.3%		11.5%		-24.5%						-20.6%		
Disciplined Alpha S&P500GR	13.0%	12.7%	5.3%	4.8%	-23.9%	-24.7%					-18.0%	-18.8%	9/24/2007
<i>S&amp;P 500 Growth</i>	14.6%		7.5%		-23.9%						-18.5%		
Multi Cap Core/Growth	7.4%	7.1%	-0.4%	-0.9%	-32.8%	-33.5%					-19.5%	-20.3%	4/20/2007
<i>Russell 3000</i>	16.8%		4.2%		-26.6%						-17.8%		
<i>Russell 3000 Growth</i>	16.8%		11.5%		-24.5%						-13.8%		
Small Cap Equity	15.6%	15.4%	-2.6%	-3.1%	-35.9%	-36.5%	-15.6%	-16.4%	-5.4%	-6.4%	2.3%	1.3%	7/1/2001
<i>Russell 2000</i>	20.7%		2.6%		-25.0%		-9.9%		-1.7%		1.2%		
<i>Russell 2000 Growth</i>	23.4%		11.4%		-24.9%		-7.8%		-1.3%		-0.9%		

Please see Performance and Firm Disclosures on Page 7



## Green Shoots to Roses

RICK VILLARS, CFA

At this point, the concept of 'Green Shoots' has been around the block a few times and is worn around the edges. While we are encouraged by data turning less bad, most economic indicators have yet to turn positive. Recoveries normally trough with less bad data that eventually turns to healthy positive data. But a thriving economic garden with flourishing activity needs jobs, credit, and propensity to spend.

By all indications, the wintery chill of a possible financial and economic Armageddon passed in March. But to depict the scenario as, "in like a lion and out like a lamb" is premature. Most perma-bears are now conceding the likelihood of total meltdown is abating and the debate has moved on to the shape and strength of

recovery when it finally does get started. The consensus on the economy is moving toward a view that an anemic recovery starts in the next couple of quarters. Given the inputs the most likely path looks to be an 'L' shaped result with the key being how much the U.S. consumer decides to save versus spend. If savings rates return to the long-term average of 8% then consumption will be a modest positive rather than a robust driver.

Interestingly, the March to May market rally had little to do with whether or not sprouts would turn to roses. Instead the stocks that surged were those most at risk of meltdown if the economy collapsed. The most beaten down in the selloff were the winners in the early stages of the rally. Evidence suggests

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*"...rally had little to do with whether or not sprouts would turn to roses."*

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the 'Beta Rally' is transitioning to a more normal state, where earnings once again drive the market. The ratio of positive to negative revisions has now equalized so a more normal earnings environment should unfold. If the recovery is tepid, as we expect, companies will have to settle for weak top line growth. Budget retail stores are showing signs of nascent recovery but companies dependent on a return of higher end spending are still in a cost-cutting  
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## Relative Performance Rotation

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market bottom in early March of this year, those companies have tended to be the best stock market performers. Companies we favor have not kept pace with those investments.

Temporary, aberrational periods such as we just experienced in the second quarter have happened before and they will happen

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*"...enduring, highly-disciplined qualities of our investment process are what attract most of our clients..."*

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again. They are usually associated with a large dose of government intervention in the capital markets. The last such period was the fourth quarter of 2002, near the end of the last recession when the Federal Reserve was flooding financial markets with cash. Our portfolios performed very poorly then as well.

The enduring, highly-disciplined qualities of our investment process are what attract most of our clients to us. We have the greatest appeal to investors with a long investment horizon, who realize that unusual performance cycles, such as we have recently experienced, usually set the stage for an aftermath that is sometimes remarkably positive. In fact, the two best five year performance periods in our long record immediately followed underperforming periods similar to what we

have just seen.

Because our investment process is so earnings-focused, the turn in our relative performance is likely to occur when the economic cycle provides Wall Street enough evidence for conviction to raise their near future earnings forecasts. We have just recently begun to see signs of that behavior. After a period of near unanimous declines in earnings forecasts, lately there have been about as many upward revisions as cuts. If history is a guide, that would be a good sign for our investment process. Our relative performance has historically excelled when the economy is growing at a steady pace, and investors are most attracted to the high quality, fast growing companies that we favor. That time appears to be unfolding.

# Scorecard

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Smith Group's investment process is designed around our belief that corporate earnings determine stock prices and excess returns can be achieved through investing in the shares of high quality companies poised to accelerate earnings growth, thus exceeding investor expectations. Smith Group's focus on populating our client portfolios with companies that have a high likelihood of reporting earnings growth rates above investor expectations has historically produced an attractive and consistent pattern of positive excess returns relative to the market benchmarks. Periods in which our investment process is most

challenged to achieve positive excess returns tend to be characterized by low investor confidence in the outlook for corporate earnings. Said another way Smith Group's investment process focuses on corporate earnings and when investors lose confidence in the accuracy of expected earnings they become fearful of the uncertainty in profits and stop caring about earnings expectations and shift their focus to other drivers. Therefore, Smith Group's investment process is more effective in a stable or expanding corporate earnings environment in which investors have greater confidence in the sustainability of future earnings growth trends. Smith Group recognizes that maintaining confidence and belief in an investment manager during periods of underperformance is difficult.

We strive to provide as much straightforward information as possible so that clients can draw informed conclusions about the long-term efficacy of our investment process and not be forced to make decisions solely based on short-term results.

<sup>1</sup> Beta is a measure of the systematic risk of a security. Beta measures the historical sensitivity of a security to movements of the market index. The value for Beta is expressed as a percentage of the market where the market Beta is 1.00. A security or portfolio with a Beta above the market has volatility greater than the market. If the Beta of a security was 1.3, a 1 percent increase in the market return resulted, on average, in a 1.3 percent increase in the security's return. A security or portfolio with Beta below the market has lower volatility than the market and the return on the security will move less than the market return.



## Sticking To Fundamentals

ROYCE MEDLIN, CFA

The 2nd quarter witnessed a dramatic unwinding of the depression scare that gripped investors beginning late last summer. The rally off the bottom favored the highest beta, highest risk stocks that were hardest hit going into the bear market. Virtually every company characteristic that our portfolios have

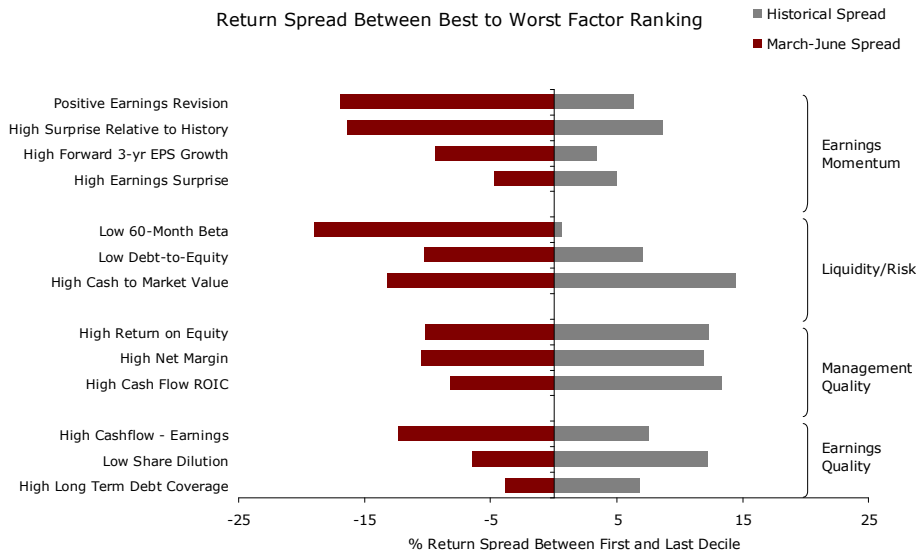
exposure to experienced negative returns during the quarter. Needless to say, in a market where companies with the worst earnings momentum, worst management quality, and worst earnings quality go up the most, we underperform. Fortunately, this "factor inversion" has normalized since peaking in April and a return to

fundamentals appears to be at hand.

The chart shown reveals just how out of line with history the recent period has been as it relates to stock price performance and attractive company fundamentals. The red bars represent the performance of the best ranked 100 companies out of the largest 1000 in the recent period (March to June) and historically going back 10 years. As you can see, characteristics such as attractive earnings momentum which typically has positive performance of around 5% (gray bars) underperformed the worst 100 by around 10% on average (red bars). This was also true for high profitability, or management quality, measures as well as earnings quality characteristics focusing on operating cash flow generation and low use of leverage. Perhaps the overwhelming trend during the quarter was the excessive gains awarded to the highest beta/highest

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Return Spread Between Best to Worst Factor Ranking



## Fundamentals

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volatility stocks. Of all the company characteristics shown on the graph, beta is the least associated with positive or negative performance historically and is

typically an undesirable portfolio exposure that we carefully control.

Looking ahead, we believe investors will once again reward companies with positive alignment to the characteristics shown on the previous page. Implicit in this belief is that the economy, markets,

earnings will stabilize and that process is underway now. As this stabilization occurs, our portfolios are well-positioned to take advantage of the return to fundamentals that will inevitably follow.

## Spring Rally

(Continued from page 1)

most. In fact, it is typical. What is unusual this time is the extent to which those stocks bounced and the length of the beta rally. As you can see in the chart below, this recent rally from the bear market bottom lasted twice as long and was three times as strong.

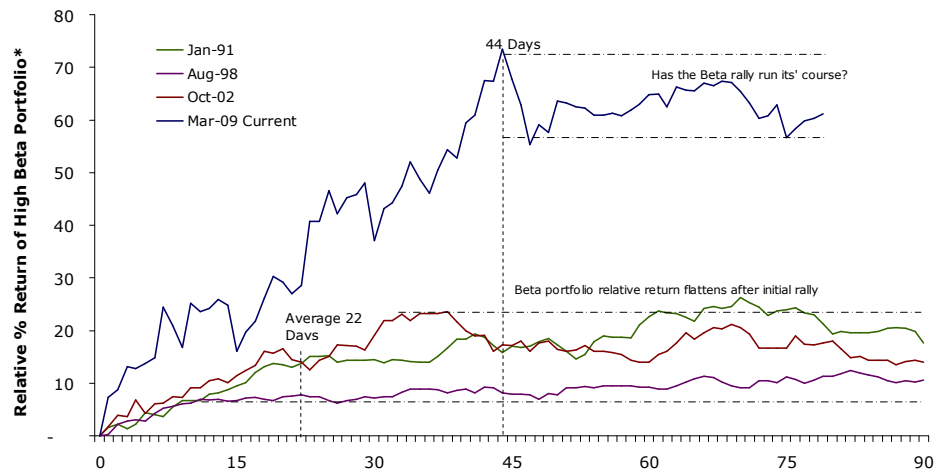
The return of high beta over lower beta stocks was calculated by comparing the relative cumulative price change of the 100 highest beta securities in the S&P 500 to the full index. Looking back over the last four market rallies following a bear market, you can see that high beta stocks have performed meaningfully better than their lower beta counterparts in the initial stages. The typical outperformance of high over low beta is around 18% and generally lasts around 22 days. In contrast, the most recent rally was marked by high beta outperforming low by over 70% and lasting 44 days. The magnitude of this rebound most likely reflects the severe economic, financial and political uncertainty associated with the recent bear market. It was unquestionably different this time around. With the fall of former financial icons like Bear Stearns,

Lehman Brothers and AIG, it was unclear when or how all of this was going to end. But, as the stimulus package was unveiled and the probability of a complete financial meltdown abated, the most “at risk” stocks soared as they stepped back from the edge of the cliff. Companies whose fundamentals had held up better also traded higher, but failed to keep pace with the most risky and economically sensitive.

What does all this mean? We believe the dramatic returns associated with high beta over the past three months are transitory and not sustainable. Beta is clearly a powerful influence over performance for short periods of time. Yet, it is an ephemeral force subject to perfect market timing. History has proven the most reliable source of excess returns over the market is

a consistent application of an investment process based on earnings fundamentals. The chart supports our belief that this beta rally has ended. We are optimistic and feel the stage is set for a “return to fundamentals”. We see a recovery on the horizon as it relates to overall earnings growth expectations and that should lead us back into a more normal period where stock prices reconnect to fundamental measures. Our exposures to earnings growth, earnings quality, and valuation remain consistent, which will greatly benefit your portfolio as the market returns to rewarding companies growing earnings ahead of expectations.

**Relative Return of High Beta Stocks\* From Bear Market Bottoms**



\* Equal weighted portfolio of 100 highest beta stocks relative price move to S&P 500

\*\* Beta rally after the market bottom or first retest of bottom



## Earnings Stress

RICK VILLARS, CFA

The majority of the time there is a distinct linkage between expected company earnings and stock prices. Yes, valuation ebbs and flows but it is almost always stated in terms of the future earning power of the underlying company, with professional analysts providing investors with a sense of those profits. As a result, investors depend heavily on this group and place a high degree of trust in their expertise and foresight. Unfortunately, confidence in the veracity of the actual numbers tends to be cyclical in nature.

At the Smith Group we invest considerable effort in analyzing analysts, investors and their behaviors to movements in changing growth outlook. Over the past year we have observed a breakdown in the trust investors place in analysts' profit projections. Last summer it was not uncommon to hear strategists using the phrase, "no one really believes consensus estimates are achievable". This was proven true and amplified as earnings melted down in following quarters and negative revisions accelerated at a record pace. The resulting lack of trust in analyst estimates

characterized the period. Earnings were judged inaccurate because each downward revision was soon followed by another and the snowball picked up steam as it progressed down the hill. Finally, investors just gave up on using earnings as the denominator in valuation calculations and the normal link disconnected. Markets reverted to trading on emotion and the main trade was risk avoidance driving the market to a deeply oversold condition. In the March reversal much of that risk avoidance was unwound and earnings still did not matter.

Because of the reliance our process places on analyzing changes in the earnings growth outlook we have been studying periods when downward revisions overwhelm positive estimate changes, which intuitively has a significant effect on investor trust in estimates. Our indicator calculates periods of extreme stress in revision activity. What we have found is that our Growth Outlook indicator can lose effectiveness during those periods. The chart below depicts that relationship. We found negative quarterly excess returns are

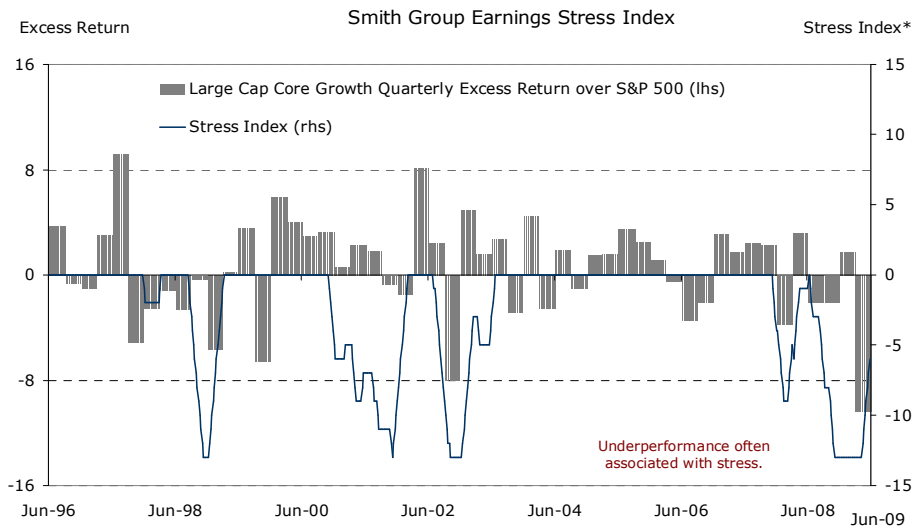
often associated with some of the highest revision stress. The most notable example is the 4<sup>th</sup> quarter of 2002, associated with a period when the ratio of negative to positive revisions exceeded our stress threshold for a full 24 consecutive weeks. While dramatic, that period pales compared to the present episode, when the stress threshold was breached 35 consecutive weeks and the ratio of negative to positive revisions reached 9-to-1.

However, the silver lining is that once the ratio normalizes investor confidence returns and they once again begin to care about earnings. During those periods the predictive power of our Growth Outlook indicator improves dramatically and we enjoy a period of extended excess return. ***The positive/negative revision ratio moved back above the stress threshold on May 15<sup>th</sup> and has continued to improve back into positive territory.*** Our stress indicator is quickly returning to normal and while a repeat of history is not assured we believe our traditionally strongest factor, Growth Outlook, will once again prove itself.

## Shoots to Roses

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mode due to absent revenues. With record idle plant capacity, investment in the private sector is unlikely any time soon and most industrial companies are apt to be laggards. While they have not been the winners in the recent rally, defensive companies with steady profit growth still have the strongest fundamentals. We believe the worst is behind us but rationality needs to return to how investors view earnings.



\* Stress Index = # of weeks in the last 13 that rolling normalized FY2 diffusion index is below -1 Standard Deviation

## 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 - Mar. 31, 2009. 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](mailto:john@smithasset.com). The Large Cap Core/Growth, Small Cap Equity, Large Cap Core/Value, Multi Cap Core Growth, Disciplined Alpha-R1000Gr and Disciplined Alpha-S&P500Gr composites are comprised of accounts whose primary objective is growth of principal by investing primarily in stocks 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, 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 and Disciplined Alpha-S&P500Gr composites. All performance returns include the impact of cash, cash equivalents, dividends and interest. The S&P 500, Russell 1000 Growth, S&P 500 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.

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