Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

OCTOBER 2009 | Volume 15, Issue 3

IN THIS ISSUE: Sticking to Process 1 | New Normal 1 | Smith Scorecard 2 | Transition Zone 3 | Smith Normal 4

Sticking To Our Process

STEPHEN SMITH, CFA

The economic turmoil that began almost two years ago has taken its toll on the lives of millions of Americans and on the stock market portfolios of countless investors. Because the stock market is a leading indicator, it began moving upward well before the official end of the economic downturn, and is now up over 50%, by most measures, since the bottom was established back in March. Other leading indicators are also moving higher.

As the recession negatively impacted the stock market, its effect was not evenly felt across the spectrum of economic sectors and investment styles. The heavy hand of the federal government played a hefty role in shaping the recession we experienced and the economic recovery now at hand. It is even threatening to reshape the framework of American capitalism for the near future. To a degree not seen since the 1930's, the federal government supported a large number of companies headed to failure, and this shifted investors' preference toward that type company.

Throughout the economic turbulence, including the just-completed third quarter, the Smith Group style of owning high quality, growth companies struggled to keep up with the benchmark portfolios. We have analyzed this situation from a number of perspectives, and have concluded that when the best stock market performers are companies that are losing money and are flirting with bankruptcy, we will struggle to keep up. Those two qualities are prevalent in the best-performers' list since the stock market upturn started last spring.

One of the hallmarks of our portfolio management processes is that a very large percentage of our portfolio companies grow faster than is expected, resulting in a succession of quarterly earnings reports that exceed expectations. In all three quarters of this year, the percentage of companies in our largest investment

(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

Life in the New Normal

BRAD BAKER, CFA

There has been considerable ink spent on predictions of a 'new normal' and what that means. Many fear the idea, but at Smith Group we welcome it. But before we tell you why let's clarify what the phrase refers to. Since Bill Gross coined it let's take his definition, "which is a period of time in which economies grow very slowly as opposed to growing like weeds; in which profits are relatively static; in which government plays a significant role; in which the consumer stops shopping until he drops and starts saving." While we are not in complete agreement with this assessment, there are elements that are likely to have a significant impact on the ensuing recovery.

The main reason we are encouraged is that

(Continued on page 5)

Smith Scorecard

JOHN BRIM, CFA

Since the bear market nadir on March 9th U.S. equity markets have risen at a meteoric pace. For the third quarter the S&P 500 Index gained 15.6% and the small cap Russell 2000 Index advanced an even more impressive 19.3%. The S&P 500 has risen 55% since March 9th and stands 30% below its peak of October 2007 and 2% below its level of ten years ago (including reinvestment of dividends). Among large cap stocks financial companies once again led the stampede higher advancing 24.7% followed by industrial stocks which rose 22.4%. After trailing the broad market from the market peak through the end of 2008, Information Technology is the best performing sector year to date having advanced 46.1% v. 19.3% for the S&P 500 Index. Health care and consumer staples companies lagged the indices in both large and small cap stocks. Strong performance of financials and industrials and underperformance of health care and consumer staples is indicative of investor's preference for higher risk assets over the past seven months. The market rally has been led by the highest risk, highest beta[1] stocks that had been beaten up the most and had the highest potential for bankruptcy. Other examples of this "risk preference" are the strong performance of industrial commodities, precious metals, and junk bonds.

The investment process that we follow at Smith Group has been consistently applied throughout the history of the firm and is a continuation of the process that our founder, Stephen Smith, CFA, developed over 30 years ago. The Smith Group process applies an engineering approach to investment management. Using both quantitative and qualitative analysis, we invest in high quality companies poised to accelerate earnings growth and exceed investor expectations. Each quarter we measure our ability to find companies that report earnings growth rates that exceed expectations. To do this we compare the percentage of companies in the portfolio reporting positive earnings surprises to the companies in the stock market indices. Since 1996, 89% of Smith Group portfolio

(Continued on page 4)

"For companies reporting during the third quarter 89% of holdings in Smith Group portfolios reported positive earnings surprises compared to 68% of Russell 3000 Index holdings."

PRODUCT	3Q 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	11.1	10.9	6.4	5.6	-19.1	-19.9	-8.5	-9.4	0.1	-1.0	8.0	6.9	1/1/1996
S&P 500	*15.6*		*19.3*		*-6.9*		*-5.4*		*1.0*		*5.9*		
Russell 1000 Growth	*14.0*		*27.1*		*-1.9*		*-2.5*		*1.9*		*4.5*		
Large Cap Core/Value	10.0	9.7	4.9	4.2	-16.4	-17.2	-5.5	-6.4	2.6	1.6	4.3	3.3	4/1/1999
S&P 500	*15.6*		*19.3*		*-6.9*		*-5.4*		*1.0*		*-0.1*		
Russell 1000 Value	*18.2*		*14.9*		*-10.6*		*-7.9*		*0.9*		*2.5*		
Disciplined Alpha R1000GR	13.4	13.3	24.6	24.1	-2.1	-2.6					-9.4	-9.8	2/26/2008
Russell 1000 Growth	*14.0*		*27.1*		*-1.9*						*-10.6*		
Disciplined Alpha S&P500GR	13.7	13.6	19.8	19.4	-4.1	-4.6					-10.4	-10.8	9/24/2007
S&P 500 Growth	*13.6*		*22.1*		*-2.6*						*-11.0*		
Multi Cap Core/Growth	12.4	12.1	11.9	11.1	-16.1	-16.9					-13.7	-14.6	4/20/2007
Russell 3000	*16.3*		*21.2*		*-6.4*						*-10.8*		
Russell 3000 Growth	*14.1*		*27.3*		*-2.2*						*-7.6*		
Small Cap Equity	17.2	16.9	14.2	13.4	-19.3	-20.1	-9.7	-10.6	-2.1	-3.1	4.2	3.2	7/1/2001
Russell 2000	*19.3*		*22.4*		*-9.6*		*-4.6*		*2.4*		*3.4*		
Russell 2000 Growth	*16.0*		*29.1*		*-6.3*		*-2.6*		*2.9*		*0.9*		

Please see Performance and Firm Disclosures on Page 6

The Transition Zone

RICK VILLARS, CFA

While not yet reported it looks like economic growth turned from green shoots to roses in the third quarter and the question has evolved to, “will there be a spring freeze before the rose bush erupts with new sprouts?” Yes, there are still a multitude of economic issues. There always are as recession transitions to expansion. Each time the issues differ in composition and magnitude but common first steps are often rebuilding of inventories and government stimulus leading sustainable final demand. The U.S. economy is not out of the woods yet but is glimpsing rays of sunlight through the trees.

The stock market is acting on cue. In the early stages of a new bull market the risk trade is in full play. During this stage market drivers tend to be macro in nature rather than micro. Yet, as this bull market matures investors will once again start asking the tough company specific questions and earnings growth will once again differentiate the winners from the losers.

“...with profitability way below trend the reversion to the mean argument favors an earnings recovery...”

Much has been written comparing the ten years preceding the March bottom to the

(Continued on page 5)

Sticking To Process

(Continued from page 1)

strategy, large cap core/growth, whose earnings reports exceeded expectations was at least 90%. In fact for the quarter that just ended, 97% of large cap core/growth holdings beat earnings expectations. While that feature is normally associated with positive relative performance, it was not last quarter, as investors searched for winners in the government bailout program.

Now the earnings recovery is at hand and government intervention is waning, investors seem to be shifting their preference toward companies apt to benefit most from the economic recovery. We saw early signs of that during September, when most of our portfolios outperformed their benchmarks.

The last performance cycle with similarities to the present one was associated with the boom-bust of the dotcom craze and the recession that accompanied it. During that era, a two-year period of underperformance by large cap core/growth, was followed by an eight year period of stellar returns relative to all its benchmarks. Those periods are illustrated below.

As we weather the economic storm that is subsiding, our portfolio management team is consistently applying the same process, with essentially the same individuals who have been managing Smith Group portfolios for years. I continue to be personally, fully involved in the portfolio management, as always.

We continue to exercise tight quality controls over the key metrics that have led to our successful long-term performance. (Even with the recent poor relative performance our largest strategy, large cap core/growth, still ranks near the top of most performance databases since inception). Companies with strong financial quality that are growing faster than expected dominate our portfolio holdings. Over time, those companies have outperformed, as have the portfolios we manage that contain those companies. Our portfolio management methods have worked in the past and will in the future. The impending turn to a more stable and positive economic environment should provide the catalyst for that performance outcome.

“...impending turn to a more stable and positive economic environment should provide the catalyst... ”

Large Cap Core Growth Annualized Excess Return vs.	*S&P 500 Index*	*Russell 1000 Growth*	*Period Length*
Jan-96 to Dec-97	+3.0%	+5.0%	2.0 yrs
Jan-98 to Dec-99	-9.6%	-20.7%	2.0 yrs
Jan-00 to Dec-07	+5.0%	+9.5%	8.0 yrs
Jan-08 to Sep-09	-8.8%	-10.8%	1.8 yrs
Jan-96 to Sep-09	**+1.0%**	**+2.4%**	**13.8 yrs**

Scorecard

(Continued from page 2)

companies report quarterly positive earnings surprises versus 66% for the Russell 3000 Index. For companies reporting during the third quarter 89% of holdings in Smith Group portfolios reported positive earnings surprises compared to 68% of Russell 3000 Index holdings.

The success of Smith Group's investment process is highly dependent on whether investors are focused on corporate earnings when making stock price decisions. When the linkage between stock prices and corporate earnings breaks down our process underperforms. Over the past year companies reporting earnings that fell below investor expectations have significantly outperformed companies reporting earnings that exceeded investor expectations. February is the only month which saw meaningful positive performance to companies beating earnings expectations. Over long time periods, positive earnings surprise has been a very powerful performance driver. Periods when stock prices do not react positively to improving earnings generally coincide with low investor confidence and economic weakness.

While investors are still exhibiting a preference for higher risk trades, we see indications that companies with strong fundamentals are being rewarded in the stock market. The generally strong performance of Smith Group's investment strategies during September may be a leading indicator of a return by investors to preference for higher quality and improving earnings outlooks when making stock price decisions.

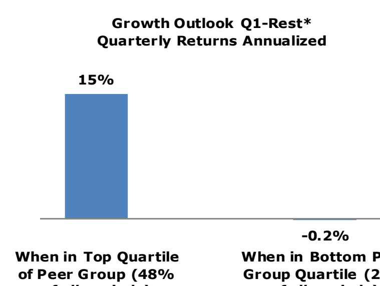
[1]: Beta is a measure of the systematic risk of a security. Beta measures the historical sensitivity of a security to movements of the market index. The value for Beta is expressed as a percentage of the market where the market Beta is 1.00. A security or portfolio with a Beta above the market has volatility 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.

The Smith Normal

MICHELLE PRYOR, CFA

Smith's long-term top tier performance has arguably had its' ups and downs. However, to be at the top of the league charts there have logically been more positive periods than negative. In fact, we were in the top quartile echelon half of all quarters in the history of Large Cap Core Growth. During those positive quarters our earnings growth outlook model was almost always being rewarded. The comparison is at right. What the calculation shows is that when the Smith Group is performing in the top 25% of managers, which is almost half of the time, the highest ranked companies in terms of our earnings growth projections are also being rewarded by an average annualized quarterly spread of 15%. On the other hand, when we are in the bottom quartile of managers highly ranked companies were lagging by an average annualized quarterly spread of –0.2%.

Dissecting those positive periods the main commonality of them is that they are periods where earnings matter the most. Clearly, being an earnings centric manager, when stock prices and profit decouple we find ourselves sailing into a headwind. The two worst periods in our investment history were 1) during the internet bubble when investors were focused on web companies capturing clicks and eyeballs and 2) during the gut wrenching great recession when investors were focused on bankruptcy and bailouts. But today is a new day and investors have returned to scrutinizing revenues, expenses, and profits. After months of not being valued by investors in September large cap companies top ranked for earnings outlook are once again being rewarded by the market. We are proud of our record of finding high quality companies growing faster than expectations and fully expect that success to be rewarded in the majority of periods.



* Quarterly returns of R1000 companies ranking in top Quartile relative to all other R1000 companies

The Zone

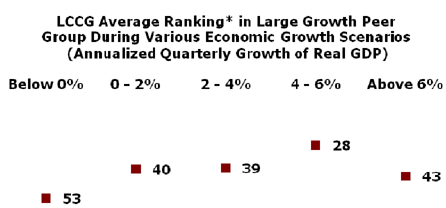
(Continued from page 3)

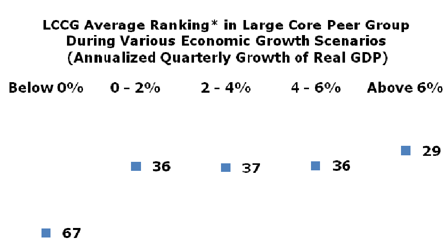
ten years prior to the 1982 bottom because they share the rare experience of a full decade where stock returns were negative. Bulls use it to promote the idea of the genesis of a multi-decade sustained hard charging, snorting bull move. But this is not 1982, when the trailing P/E was 8.8x, price/book 1.0x, the Fed Funds rate 10.25%, and 10-year treasury yield 13.6%. Clearly, that 25-year bull market had a significant valuation tailwind its contemporary cousin does not. For today's stock prices to sustainably move higher earnings growth has to be the driver. The good news is with profitability way below trend the reversion to the mean argument favors an earnings recovery in the short-term poised to transition to a self reinforcing positive feedback loop. Companies cut costs and employment to the bone. The third quarter story is apt to reflect revenue quickly flowing to the bottom line. Yet, cuts were of a magnitude anticipating the second coming of the great depression and companies might find themselves capacity constrained needing to hire back furloughed workers quicker than normal. Thus, the positive loop gets started. We are like many strategists worried about unresolved issues threatening to derail this rally. However, we acknowledge the economy might be able to earn its way out of the near term crisis and some of those issues will rollover to the next recession. In the mean time, it is probably more likely that consensus is too bearish rather than too bullish.

New Normal

(Continued from page 1)

in a slow growth environment companies growing faster than expectations are apt to look more attractive to investors than in 'Old Normal' times when earnings growth was easy to find. We excel at this and have a consistent record of finding a higher portion of companies exceeding expectations. Some of you have asked for proof that we can perform well in a slow growth environment and to that end we offer the following.



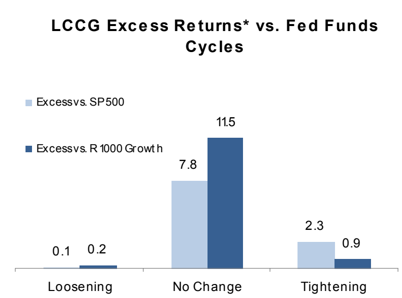


* Average quarterly ranking within peer group for each quarter where annualized Real GDP growth was within the stated range

Over the long-term the Smith Group Large Cap Core Growth style has earned a 14th percentile rank against all U.S. large cap equity managers in the Callan Associates, Inc. Performance Universe®. We have done so by consistency across all economic growth environments rather than being especially good in fast or slow periods. The only time we on average underperform our peer group is during negative economic growth as the charts bottom left illustrate. During all times of economic expansion we handily beat the median manager on average in both peer groups. Because of that consistency we have a high degree of confidence in performing well in a slow growth world. The only real outlier during expansions is during times of hyper growth when more aggressive managers are apt to benefit. In those periods we still beat the median growth manager on average but not as consistently. When the economy is growing at a somewhat controlled pace investors are paying attention to earnings and that is our preferred stock picking environment. That actually makes sense because at growth extremes macro trends tend to float or sink all boats together, while more measured growth allows better run companies to differentiate themselves.

Another characteristic to consider is how we perform during various phases of the Fed Funds cycle. As the chart below shows, a neutral Fed is best for the Smith Group methods of selecting stocks. Once again it may very well be a function of top-down versus bottom-up drivers. When the Fed funds rate is in motion it is a primary driver of macroeconomic factors evolving and impacting the earning power of large groups of companies. As noted above, that environment is more difficult for company differentiation and a tougher landscape for earnings driven investment styles. Slow growth, as depicted in the 'new normal', would argue for a less active Fed and less of the extremes of economic growth.

If the 'new normal' comes to pass we are far from fearful. Instead, it is an environment that could offer us an opportunity to shine.



* Annualized return relative to the benchmark

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 - June 30, 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. 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.

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.

Investment manager peer rankings are based on the Callan Associates, Inc. Performance Evaluation Universes. Callan Associates, Inc. All Rights Reserved.

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 September 30, 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