



A New Decade: Renewed Focus

STEPHEN SMITH, CFA

The investment process we use at Smith Group to produce investment returns for our clients has delivered a very strong long-term record. For example, our flagship Large Cap Core/Growth strategy ranks in the top tier among our peers in virtually all of the performance databases since inception of the firm almost fourteen years ago. One reason for this good performance is that we are intensely focused on a single investment approach. We only own high quality companies that grow faster than expected. Any company that fails our standards for quality or growth immediately leaves our portfolios.

I began my investment career using the Smith Group approach to high quality growth investing over thirty years ago. Over the years, the market environment and computer technology have caused and allowed a number of fine-tunings to the process. For example, we now have our own business quality and corporate governance

measurement system, rather than simply using off-the-shelf quality ratings, as I did in earlier periods. We also have many more dimensions to our measurement of a company's growth potential than I used in the 1970's and 1980's.

In 2008-09, our client portfolios experienced dramatic underperformance that is the worst we have produced since the 1998-99 period. The primary culprit for these negative relative returns is that high-quality/high-growth companies have been dramatically out of favor during the rebound from the Great Recession period. Investors flocked to companies that were failing and those benefiting from government bail-outs.

In addition to strong headwinds for our style of investing, I also believe our stock selection was not as effective as it could have been. I accept personal responsibility for that and have decided to
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INVESTMENT TEAM

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Raising The Bar On Earnings Surprise

CHRIS ZOGG, CFA

The Smith Group was founded on the belief that if we find high quality companies growing faster than expectations, we will be rewarded. After all, a portfolio of companies with underappreciated earnings growth is bound to rise as higher potential profits are realized. Historically, the event where that price appreciation is most evident is around the time of an earnings

announcement and the response to a positive earnings surprise.

We have been very successful at selecting a high portion of companies that deliver positive earnings surprises, so the question becomes, "is the objective of finding companies with positive earnings surprises and avoiding those that disappoint still a

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Disciplined Alpha

KENT SMITH

Our investment process was designed to meet client's needs by producing a performance pattern that is less volatile than peers, but one that outperforms its targeted benchmark. These goals form the foundation of our firm's investment philosophy and have guided new strategy development over the years.

In 2007, the market volatility that emerged as a precursor to the recession drove some clients to reduce their overall risk budgets. Consequently, we were approached by multiple clients with the request to add additional risk-control features to their portfolios. These clients believed in our philosophy of earnings growth that beats expectations and buttressed by high earnings quality, but also wanted to minimize risks external to these beliefs such as beta, momentum, and volatility. Based on this need we created our Disciplined Alpha strategy.

What is Disciplined Alpha? It is a process designed to provide exposure to our

fundamentally-driven stock selection models within a risk-controlled framework.

Our fundamental stock selection models identify company characteristics that generate superior performance over a variety of market environments. We use technology to help maximize exposure to these "alpha" characteristics, yet, identify and control portfolio risk exposures difficult to assess by traditional portfolio management techniques. Experienced portfolio managers then validate company fundamentals, assess portfolio characteristics, trading impact, and risk/return estimates. The Disciplined Alpha process produces portfolios that fit a client's needs without unintended risks or surprises.

One way to think about relative risk is through the "active share" measure. Active share determines the extent of active exposure being employed by an investment manager relative to a benchmark (see scale below). Most enhanced index strategies have active share of approximately 10%;

"...maximize exposure to alpha characteristics yet control risk exposures..."

more concentrated portfolio such as our Large Cap Core/Growth strategy has active share around 80%; and Disciplined Alpha has active share of roughly 50%.

Why Disciplined Alpha? The last couple of years have been a reminder that the great volatility moderation is over and risk budgets have come under pressure. The Disciplined Alpha strategy is designed to generate excess returns within a predetermined risk range. The potential reward of a stock selection process is often undone by unintended risks and exposures taken during the portfolio construction process. This strategy limits those unintended risks. If a manager can isolate key alpha drivers used in stock selection, the portfolio construction mistakes that are often made are less likely to penalize

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Index 0% Active Share	Enhanced Index 5-15% Active	Disciplined Alpha 50-60% Active	Lrg Cap Core Growth 80-90% Active	Concentrated 100% Active
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Renewed Focus

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shift my role here at Smith Group to allow me to become more personally involved in every phase of managing our portfolios. As a result of this decision, many of my business-management duties are being re-assigned to other members of our management team.

I am confident that as 2010 begins, the re-doubling of my efforts to producing the best performance for our clients will achieve the results that we all need. I also plan to spend more personal time with our clients this year, beginning in the first quarter.

As the New Year unfolds, we are leaving behind the worst decade for stock market investing in recorded history, by most measures. The recession has almost surely ended, a new bull market has likely begun,

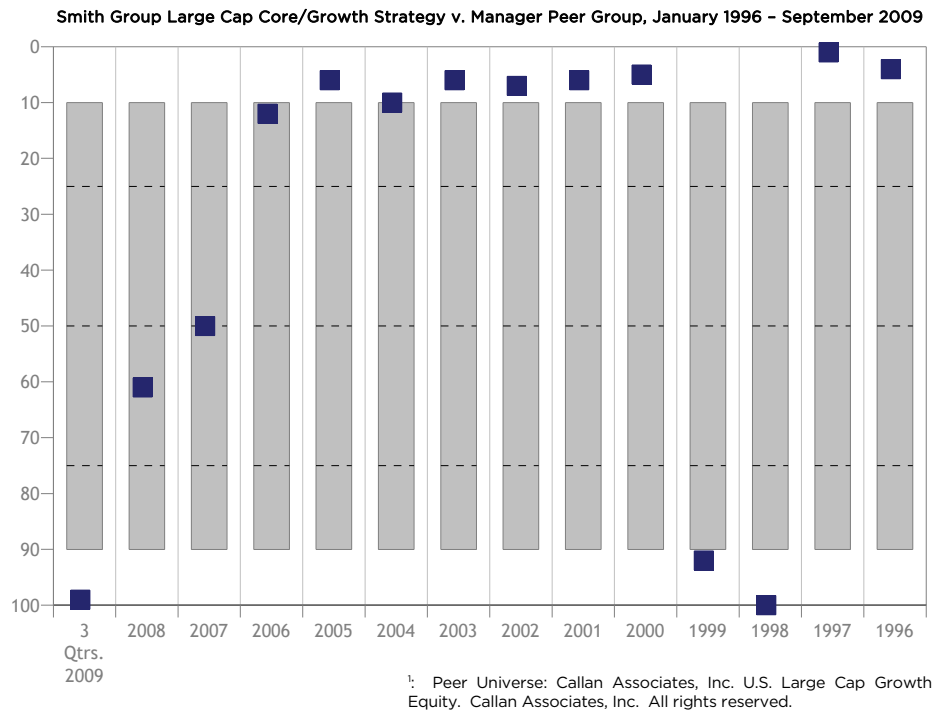
and the key drivers of good stock market performance are in place for the portfolios that we manage for our clients. I look forward to my renewed focus on every phase of the portfolio management process, and the results that I believe we will deliver for our clients beginning in early 2010.



Lessons Learned

JOHN BRIM, CFA

The past two years have proven one of the most challenging periods in U.S. equity market history and one of the most challenging relative performance periods for Smith Group's investment process. Smith Group's Large Cap Core/Growth strategy boasts one of the best long-term track records in the investment management industry, ranking in the top tier of our peer group since the firm's inception¹. Yet our top tier track record has not been achieved without periods of underperformance. As the table at right shows Smith Group's Large Cap Core/Growth strategy has ranked in the 10% of its peer group in 8 of the last 14 calendar years, but the strategy has also ranked in the bottom 10% in 3 calendar years. The period Jan. 1998 – Dec. 1999, was a period of underperformance very similar in length



and magnitude to the current environment. For the seven years following the 1998 – 1999 period Smith Group's Large Cap Core/Growth strategy provided an annualized

net of fee return of +6.6% v. +1.7% for the S&P 500 Index and -2.9% for the Russell 1000 Growth Index.

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Is It Different This Time?

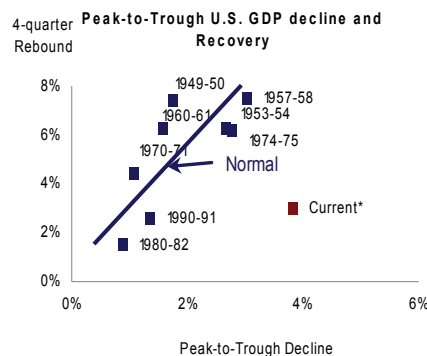
RICK VILLARS, CFA

The case for a "New Normal" of below trend economic growth for the foreseeable future is logical. After all, consumers should rebuild savings after a decade long spending binge and companies should be loath to hire and invest given the uncertain environment. Yet, many an investor has gone broke based on what the economy or market *should* do. The chart at right shows there is a direct relationship between the depth of the decline and the trajectory of recovery. Yet, current recovery estimates do not reflect that link. When the phrase "New Normal" was coined they were careful to avoid the synonym "It's different this time", which every experienced investor recognizes as the kiss of death. If it is not different this time a repeat of

history suggests a 'V' shaped recovery is a good probability.

So far, the economic and earnings recovery has played out in textbook fashion. Incremental improvement is common as rebounds unfold and this one has been no

different. Less bad data has begun to turn positive and earnings estimate downgrades have yielded to a strong upgrade cycle. With each increment the market edged higher. As long as the upside improvements persist the market bias is apt to remain in the same direction.



Cost containment is assumed in 2010 earnings estimates and naysayers have been vocal. On closer examination, operating leverage assumptions are quite normal, if not on the conservative side. This would support further upgrades, especially, if economic growth exceeds the current sub-3% consensus expectation. Our 2010 market expectation is close to the

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Raising The Bar

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profitable strategy?" Updating the Smith Group earnings surprise study, we found that the concept of stock price reaction to a positive or negative earnings surprise is alive and well. But there has been an evolution in the price pattern around the earnings announcement event itself.

Steve Smith's early studies showed prices moved in a more gradual sloping trajectory as seen in the 1980's graph at right. Information leakage ahead of the report date led to stock prices trending up or down in the days leading up to the actual report and there was minimal movement on the day of the actual report. Then in the following days as content was digested the trend continued, albeit at a slower pace. There was a clear gap between large positive and negative surprises, with a more modest performance pick-up between marginal positive and negative results. This research was the basis for predicting positive earnings surprises.

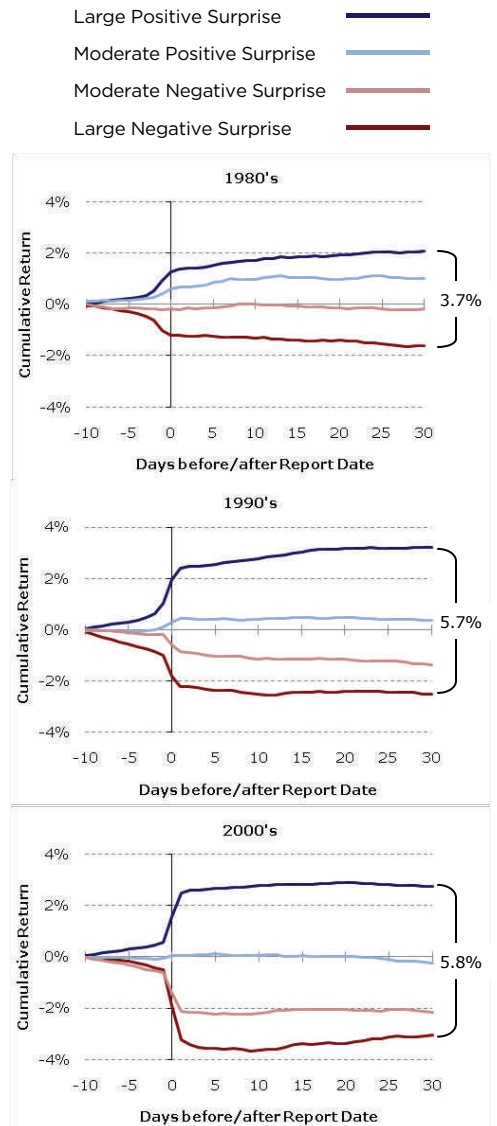
In the 1990's the pattern was similar but more exaggerated around report date. The potential value of differentiation between large positive and negative surprises grew from 3.7% to 5.7%. The difference between marginal positive and negatives improved from 1.2% to 1.7%. Clearly, the reward for being right grew.

In the latest decade, price patterns have mutated some and have become more erratic, especially during periods of economic turmoil. Yet, the average return differential between large positive and negative surprises remains virtually the

same at around 5.8%. The gap for marginal positive and negative surprises is slightly wider at 1.9%. The reward for holding companies with large positive surprises is similar to the 1990's but the move is concentrated around report date (the dark blue line at bottom right). On the other hand, marginal positive surprises have added no value (light blue line at bottom right). **The main shift is in the magnitude of value in avoiding both marginal and large negative surprises** (the red lines). While the drop on the day of the report has amplified significantly, the value associated with selling after the fact has become inconsistent. In fact, during strong market rallies it was not unusual for a negative surprise to rebound strongly and end positive 30 days later.

Regulation FD, enacted in October, 2000, is one factor impacting information flow that may help explain changes. It mandated dissemination of relevant information to all investors simultaneously. Concurrent investor action means price movement has become concentrated and more pronounced. It would also logically result in the lack of follow through after the event as the information vacuum resumes. The only pattern it really does not seem to explain is the price rebound for companies reporting a negative surprise. The dramatically negative price reaction to large negative surprises supports the behaviorist theory that human avoidance emotions are stronger than attraction, and recovery is a rational upshot of an overreaction. Yet, the recovery pattern is actually quite erratic and very different from quarter-to-quarter. An alternative theory relates to the information vacuum following a report that allows stocks to begin trading on market factors instead of stock specific news.

Universe: Russell 1000



In summary, the value of predicting large earnings surprises has grown and the payoff for avoiding negative surprises has become even more important. Recognizing these changes has focused our research efforts to determine how to more accurately predict these events in the future.

See *'The Inversion Bar Raised'* for more significant observations.

"...value of predicting large earnings surprises has grown..."

Disciplined Alpha

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performance. Lastly, the key benefit to this strategy is the stability it provides.

With the 2-year anniversary of the strategy occurring in this quarter, we have decided

to roll the strategy out to additional clients. Over this period, the strategy has passed the most turbulent stress test of our time with returns that are above the benchmark since inception and has validated our simulation results which went back 10 years prior. We currently manage over \$1 billion in Disciplined Alpha assets benchmarked against large cap growth indices. In 2009, this strategy was up 33.44%. We also have

the capability to customize the benchmark to core if a client needs different benchmark exposure.

We are excited to offer these new solutions to our clients and the marketplace and will continue to maintain our focus on our proven investment process.

If you have any questions regarding this new strategy, please feel free to contact us.



The Inversion Bar Raised ROYCE MEDLIN, CFA

As mentioned in the 'Raising The Bar' article, the return spread between large positive and negative earnings surprises is greater today than when the Smith Group process was conceived. Below is another look at the same results but with a focus on inversion periods. Inversion periods would be defined as those where negative earnings surprises outperform positive earnings surprises. While these are rare, they do occur.

The blue line and gray bars measure the spread between large and moderate positive surprises versus large negative surprises. When the spread is positive, our process of finding stocks likely to report a positive surprise is rewarded.

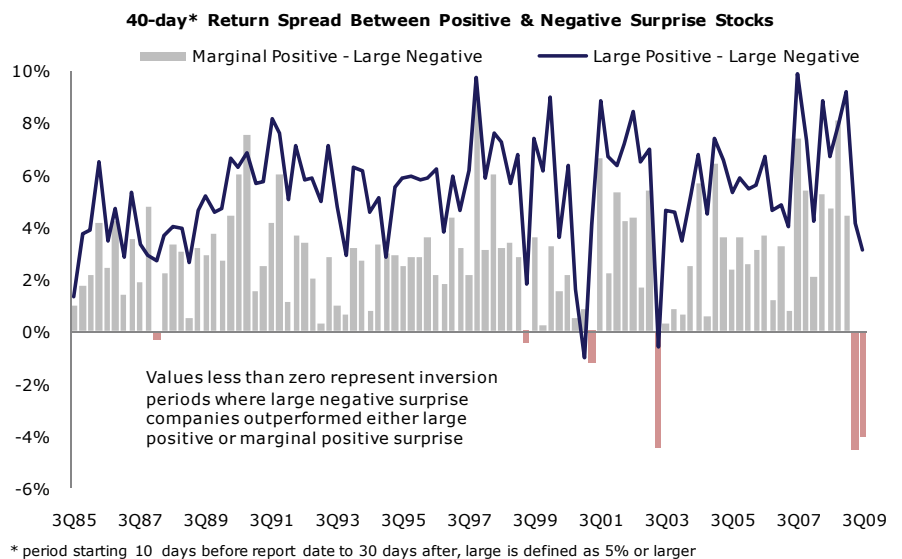
Unfortunately, there is a periodic inversion when large negative surprise companies (which we avoid) actually outperform companies reporting marginal positive surprises (those that we own), and in some cases even beat those with large positive surprises (those we find most desirable). Chart values below zero indicate quarterly returns of large negative surprises that exceed either large or marginal positive surprise stocks. When this anomaly occurs our process suffers headwinds that are difficult to overcome.

Thankfully, these episodes are rare and tend to be very short in duration. In addition, the positive relative performance of positive earnings surprise companies quickly.

Of note, these inversion periods have been more common and more dramatic in the 2000's than in previous periods, but also of note, positive spreads in this period have increased during times when earnings surprise is working well. These results are consistent with our performance pattern of the past decade. We are currently suffering from two dramatically negative quarters that coincide with a bear market recovery,

similar to the last time this occurred in 2003.

While it feels "different this time" and clients are leery, we believe the highest probability outcome is for a return to normal. Remember, our process has not changed and the success rate of companies that beat growth expectations hasn't skipped a beat through this difficult period. Betting against positive earnings surprise, which represents a bet against 86% of all quarters in a the past decade, is a bet I wouldn't take. If history is a guide, our clients will again experience the benefits of our proven investment process.



Lessons Learned

(Continued from page 3)

Smith Group recognizes that just because a period of underperformance has precedence does not make the period any less challenging for our clients. However, we do believe there is insight to be gained from viewing the current performance period relative to prior challenging periods.

Smith Group applies an engineering approach to investment management. By leveraging technology and fundamental research, we identify high-quality companies with undiscovered growth potential, creating risk-controlled portfolios designed to produce attractive return patterns.

At Smith Group we continue to be very successful at finding high-quality companies that are growing faster than expected. We believe an improving economic and corporate earnings outlook will lead to continued improvement in the efficacy of earnings growth and earnings quality performance drivers within U.S. equity markets and consequently significant improvement in the relative performance of Smith Group's portfolios.

Our earnings-oriented **process has been consistently applied** since inception. This is evident through our ability to reliably

identify and invest in companies that exceed earnings growth expectations. Over Smith Group's almost 14 year history 90% of holdings in the Large Cap Core/Growth strategy report earnings growth rates that exceed expectations v. a 73% average for the S&P 500 Index. **Over the past year 89% of Large Cap Core/Growth holdings have reported earnings above expectations**, including a 97% positive surprise rate in the 3rd quarter v. a 71% rate for the S&P 500.

The past year has seen unprecedented levels of market volatility which has exposed all types of investment vehicles to risks that were previously under appreciated by investors. Portfolio risk controls that served their roles well in the past have, in many cases, proved inadequate. Several aspects of our investment process can and must be improved in order to more effectively manage through periods as we have just experienced. A few areas where we believe immediate attention is required are:

Tighter controls on portfolio risk levels – Recent stock market volatility has highlighted that the boundaries we had placed on the acceptable levels of risk (namely individual stock volatility) were too wide. Accordingly we are reviewing all measures of risk in the portfolio and making adjustments to the risk tolerances in the portfolio's where appropriate.

More effective use of portfolio turnover –

The swiftness and severity of the economic downturn caused more companies to be sold due to deteriorating fundamentals. However, a more measured approach to trading in the portfolio would have guarded against the short term extremes in market sentiment over the past year, forcing us to more keenly focus on the longer-term earnings prospects of companies we owned.

We believe the “home run” returns in the snapback of stocks “priced for failure” have been achieved and investors are returning to earnings and other fundamental factors to discriminate between the winners and losers in the corporate landscape. Our investment process is especially well positioned to benefit from a period of modestly below trend growth as investors focus on quality and are willing to pay a higher premium for undiscovered growth during periods in which “growth” is dear. While there is value in looking at the past and applying its lessons, an improving economic and corporate earnings outlook lead us to believe the best days for the performance of our investment process lie ahead.

Different This Time

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consensus of 1225 for the S&P 500. However, we would assign a higher possibility of an upside surprise than most.

Earnings upgrades in Consumer

Discretionary and Information Technology are common. As a result many of those companies are showing up on our buy list. Assumed 2010 operating leverage in Consumer Discretionary is pretty full but that would be expected after such a long period of consumer contraction, so many of these companies have the ability to deliver under-appreciated growth. In contrast, Information Technology earnings estimates

assume moderate operating leverage. This could represent an opportunity for a surprise in the coming year.

Overall, 2010 should be less volatile than its' predecessor. There is still plenty that can go wrong so the market is climbing a wall of worry, which means many investors are not in the game yet and will provide support if the market has a correction.

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 - Sep. 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, 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, and Large Cap Core/Value 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.

Active Share is a measure of the percentage of stock holdings in a portfolio that differ from the benchmark index. Active Share is calculated by taking the sum of the absolute value of the differences of the weight of each holding in the portfolio versus the weight of each holding in the benchmark index and dividing by two. Source: Cremers, M. and Petajisto, A. 2006 "How Active Is Your Fund Manager? A New Measure That Predicts Performance", Yale ICF Working Paper No. 06-14. This material is for your own personal information, and we are not soliciting any action based upon it.

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