

JULY 31, 2009

Reporting Season Themes

The reporting season has been notable for how positive earnings reports have been, both in percentage of positive reports and in the size of the positive surprise. The impact on investor mood is very evident in the surge in stock prices during the early stages of reporting season. Yet, companies are delivering earnings via cost savings and sales have failed to surprise on the upside. Logically, the top line needs to begin to grow eventually to produce sustained earnings growth but at what point is that? We explore that question further below.

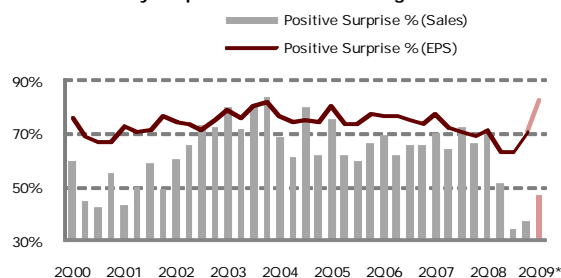
Q2 Reporting Season	% Reported	% Beat (EPS / Sales)	Median Reported % Surprise (EPS / Sales)	Median Q2'08 - Q2'09 % Earnings Growth	Median Q3'08 - Q3'09 Expected Earnings Growth	Median 2009 Expected Earnings Growth
S&P 500	50%	83% / 47%	6.7% / -0.2%	-16.8%	-11.2%	-9.8%
Ex Financials	48%	86% / 42%	6.8% / -0.7%	-15.2%	-11.1%	-9.4%
Smith Group Large Cap Core/ Growth	35%	100% / 64%	14.6% / 0.9%	13.4%	8.6%	9.7%

S&P 500 Sectors						
Consumer	40%	86% / 30%	10.2% / -1.0%	-22.6%	-13.0%	-15.6%
Consumer Staples	34%	100% / 36%	6.5% / -0.9%	-1.3%	1.5%	2.5%
Energy	45%	83% / 38%	7.9% / -1.5%	-64.4%	-66.2%	-59.5%
Financials	59%	68% / 68%	8.7% / 4.1%	-32.8%	-15.6%	-14.2%
Health Care	68%	88% / 71%	4.9% / 0.8%	6.9%	4.2%	6.4%
Industrials	66%	88% / 18%	6.2% / -1.9%	-21.4%	-25.5%	-20.1%
Info Tech	49%	84% / 63%	10.0% / 1.0%	-27.8%	-17.2%	14.4%
Materials	71%	84% / 26%	12.4% / -2.6%	-41.3%	-12.7%	-40.3%
Telecom	40%	67% / 50%	3.0% / 0.1%	-8.4%	-3.9%	-3.6%
Utilities	17%	80% / 33%	2.7% / -2.2%	-7.5%	-0.1%	-4%

Do Earnings Lead or Lag?

The chart at right shows that it is normal for surprises to increase as earnings recessions bottom. It is an early sign that things might be getting better. In fact, while it is still early if the trend continues for the remainder of this reporting season the portion of positive surprises could be at a record level. But is it a problem that sales are not surprising? Here again the pattern looks fairly normal. History shows that sales

Quarterly Surprise % of Total Beating Consensus



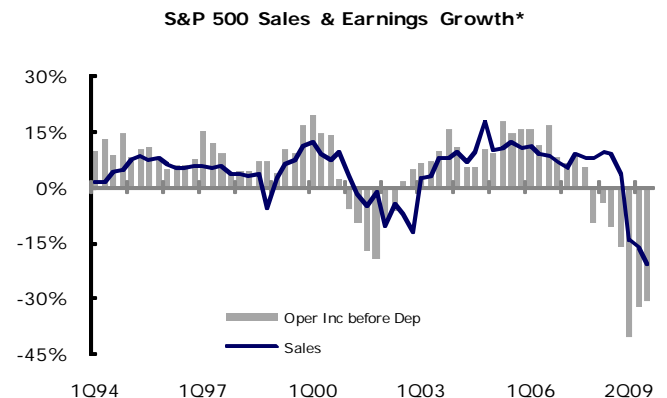
Source: Reuters data, Smith Group Asset Management calculations
* as reported through July 24th

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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. Nothing contained in this presentation should be construed as a recommendation to buy or sell a security or economic sector.

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surprises shrink during earnings recessions and are slow to reaccelerate when earnings begin to firm. There could be many reasons for this. Maybe analysts were more aggressive about cutting earnings than sales in the first place or it could be that since there are more inputs to the earnings per share formula that it is just harder to get right with the same degree of accuracy. In the present quarter earnings downgrades in the lead up to the season was more aggressive (revised down -5.7% equal weighted average) when compared to revenue downgrades (revised down -1.7%). That could very well be a contributor. However, the chart at right shows that it is normal for the turn in sales growth/contraction to lag the peaks and valleys of earnings and we believe this to be a bigger driver. Once sales growth turns positive sales surprises are apt to emerge.



Source: Compustat

* year-over-year quarterly aggregate sales and income growth

The reason for the lag has to do with operating leverage. Companies cut costs in a recession, creating operating leverage, and sometimes they overshoot. These excess cuts can allow for an earnings uptick before sales actually pick-up but you will notice that even in the 2003 rebound sales growth was positive before earnings accelerated. Positive earnings surprises are the early building blocks of a new bull market. Sales growth and the positive revisions that come with it are the next steps to sustainable earnings growth. While we are still somewhat skeptical about where sales growth will come from, we recognize current trends are the norm in an earnings trough, which would lead the market higher if the rest of the script is completed.

In the table on page one you will notice that while positive earnings surprises were fairly uniform across sectors, sales surprises were not. Financials and Info Tech were relatively high, they also had the best sales growth. Energy and Industrials have the lowest sales surprise, they are both late cyclical businesses. To date, our companies are reporting quite well with 100% surprising on the earnings line and 64% on the sales line. Our process is designed to identify companies with accelerating growth trends and our objective is to have a higher portion of our companies deliver positive surprises. So far, this quarter our companies are delivering against that goal. Our company analysis does not specifically target on sales growth but Earnings Quality and Growth Outlook are the cornerstone of our process, which are both impacted by the relationship between top- and bottom-line growth. The result is a portfolio of companies less dependent on cost cutting for earnings growth.

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