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Fast Growth may be Hazardous to your Wealth

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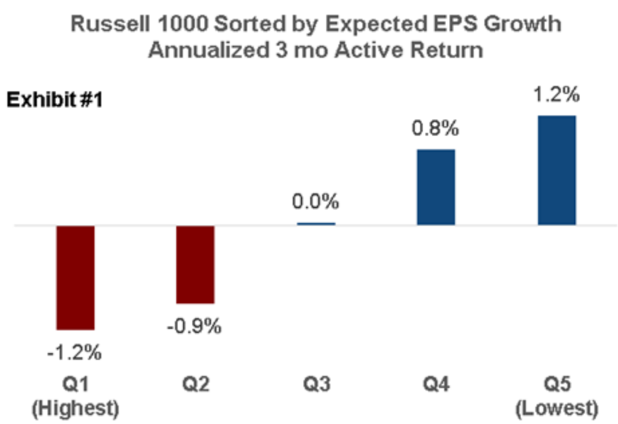
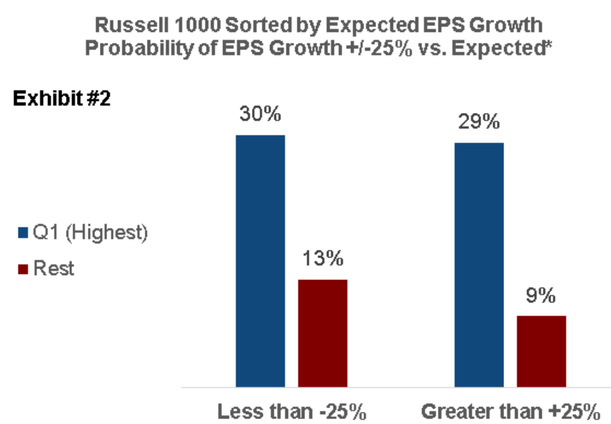
The investment management industry expends a considerable amount of time and energy to find companies that are growing faster than their peers. While it may make intuitive sense that growth companies will outperform their slower growing peers, is growth really the panacea we have built it up to be? The data actually says just the opposite as illustrated in Exhibit #1. This chart shows the annualized three month relative return of Russell 1000 constituents sorted into quintiles by how fast they are expected to increase earnings in the next twelve month period. On average, owning companies with the highest expected earnings growth has resulted in the worst relative returns. The average active return for a top 20% grower is –1.2% versus a positive 1.2% on average for a bottom 20% grower.



But below the long-term average numbers we see a great deal of variability. In fact, a little more than half the time the top 20% expected earnings growth stocks delivered better returns than the other 80%, so how can the long-term average be so bad?. The reason is that during the quarters when these high growers were laggards they underperformed by a much wider margin (average -3.6%) than during the quarters where they outperformed (average +2.0%). Perhaps that relationship is due to the fact that when high expectations are met the reward is much smaller than the penalty for when results are disappointing.

Further exploration supports that conclusion. Looking at earnings surprise data[1] for the same period shows the reward for a large positive surprise in quarterly announced earnings was a +2.1% average stock jump during the following 10 days, while those companies reporting a large negative surprise slumped a more significant -3.0% on average over the same period. Looking at an alternative measure like earnings revisions shows a similar relationship[1]. In this case, the companies suffering the worst downgrades were also the worst performers, where the worst 20% on average underperformed the remaining 80% by -1.9%.

Companies with high growth expectations are also apt to deliver much higher or lower earnings than expected over the subsequent twelve month period. Exhibit #2 shows the likelihood of a company delivering earnings that are either much better (at least 25% above) or much worse (at least



25% below) expectations. Historically, high expected growth companies have reported a large beat or miss 59% of the time, with a slightly higher probability of a miss, while the rest of the universe has only done it 22% of the time. This propensity to surprise by a large margin has the

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[1] Measurement period Jan-96 to May-15
* Measurement period Jan-95 to May-15. Measures the % of companies where the difference between the realized earnings growth rate and the First Call/ Thomson Reuters consensus forecasted growth rate at the beginning of each rolling twelve month period is greater than +/- 25%.

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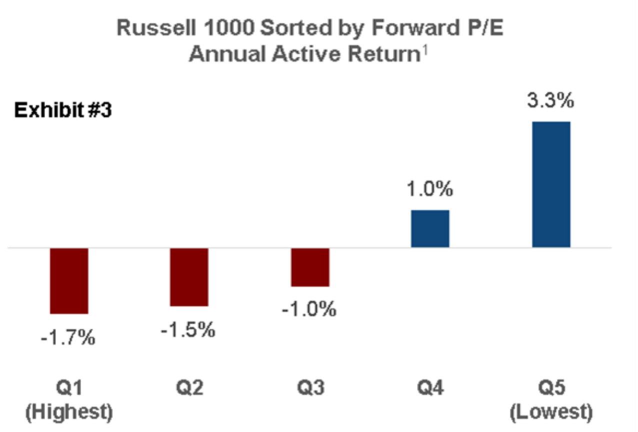
effect of amplifying the penalties for failure and the rewards for success. Since the penalty for failure is larger than the reward for success this amplification works against this investment strategy.

The other factor at play is that investors normally reward higher expected EPS growth with higher valuations. Unfortunately for high growth investors, on average high valuation is a headwind. This is illustrated in Exhibit #3, which shows that the most expensive stocks on a price/earnings basis have been the worst performers over time[1]. The top 20% valued stocks lagged the remaining 80% on average by an annual -2.2%. High valuations justified by high expected growth leave more room for the impact of revaluation when expectations are adjusted lower. Similar to our observation about high growth, there are periods of time when high value does outperform. There are almost as many years when high P/E meaningfully outperforms as when it underperforms. But the magnitude of underperformance (-11%) is larger during years when value lags by a meaningful margin than the outperformance (+9%) during years when it is a positive factor. Once again, high valuation is not always bad, but over time it represents a headwind to relative performance.



[1] Measurement period Jan-96 to May-15

Attempting to find the fastest growing companies as a way of bettering the benchmark makes intuitive sense and there are some investors that have been successful doing just that. But in aggregate, high growth expectations often lead to disappointing results. Since investors place a higher valuation on companies they expect to have faster growth they are more susceptible to significant downward revaluations when disappointments occur. While there is reward for being right, the penalty for being wrong is greater and the probability of either scenario occurring is increased when expectations are high. The combination of 1) high expectations, 2) high valuation, 3) more risk than reward, and 4) a propensity to deliver large positive and negative surprises creates a headwind. Yes, there are periods when high growth companies outperform, but reliable forward looking indicators of when they might occur are in short supply. So over the long term chasing companies with the fastest growth expectations is a higher risk endeavor.

Unlike our peers obsessed with finding the fastest growing companies, at the Smith Group our focus is on finding companies with *unexpected* growth which aren't necessarily those with high expectations. This allows us to consider the full spectrum of growth opportunities in our strategy universes without the high growth limitation.

For additional information on Smith Group and our investment strategies and capabilities, please visit www.smithasset.com or contact us at 800.582.3435 or info@smithasset.com. The website contains information you may find useful regarding Smith Group including research articles, our economic and financial market outlook and detailed information on our team and investment capabilities.