Smith Group
ASSET MANAGEMENT

Global Opportunity

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Market Perspectives Excerpt

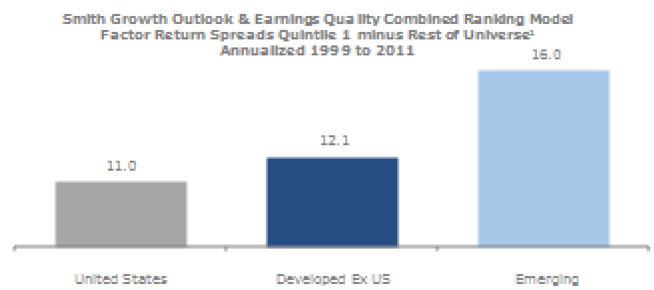
As markets have become more globalized stock analysis techniques have become more homogeneous than ever before whether a company is traded in New York, London, Tokyo, Sydney, or Hong Kong. The CFA Institute now has more members outside the U.S. than inside. Money managers have offices around the world and investment bankers view the securities industry through a multi-geography looking glass. The result is that the flow of global financial information is quite similar to what we use to select stocks and construct portfolios domestically. It is also more readily available, complete and timely than ever before.

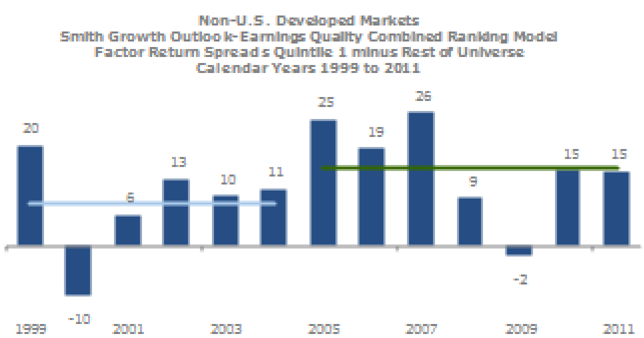
Our process for finding U.S. companies growing faster than expectations begins with a ranking process using criteria we have identified to predict that specific outcome. The Smith Growth Outlook and Earnings Quality factors embody those selection criteria and are our primary ranking mechanism. An obvious question for us in looking beyond our borders is, “Can the criteria we use to select stocks domestically work on a more global basis?”

We have spent the last few years deepening our understanding of global markets and how our methods apply. This work has demonstrated three main conclusions: First, not only do our factors work outside of the U.S., they work better. Second, the efficacy of our factors outside of the U.S. seems to be improving over the last decade. Third, emerging markets in particular are an excellent opportunity for our methods.

The first chart compares the broad effectiveness over the last thirteen years of a 50/50 combination of our Growth Outlook and Earnings Quality inputs by measuring the return spread between top ranked quintile (top 20%) and the rest of the universe. By this measure, our highest ranked U.S. stocks beat their lower ranked peers by +11.0% on an annualized basis, which has been a strong performance driver for our returns. But the same methodology applied to non-U.S. developed markets yielded a +12.1% advantage and in emerging markets the gap was positive by +16.0%.

The next chart shows a time series of annual relative returns in non-U.S. developed markets using the same Q1 to rest methodology. Note the consistency of added value and rising return advantage. In eleven of thirteen years, contribution from this factor input measure was positive, or almost 85% of the time. In the first half of the analysis period, the average return was around +8.5% and increased to nearly +16% during the second half.





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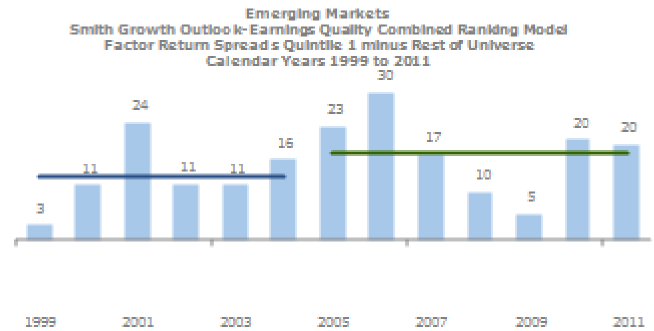
The final chart is a representation of the same comparison of the value from our factors available in emerging equity markets. Not only is the return gap higher than developed markets, but it is substantially more consistent. The returns to our process were positive in every calendar year and the return potential increased in the second half of the time period. This probably reflects a relationship between the lower efficiency of information available in many emerging markets versus developed and the rising number of companies that have listed for trading in the last decade. Just enough information for us to analyze but not so much as to dilute the signal seems to be our sweet spot.

"... consistency of added value and rising return advantage ..."

In conclusion, we have built our investment platform and portfolio construction processes to reflect the way we look at the world, and expansion into global investing requires the two to be compatible. Our factor efficacy in a global context is a first, important step along the road to our success in those strategies. We will expand into more detail regarding the performance within each region in future articles.



[1] Calculation: Average monthly return annualized of the best 20% of companies in universe minus that of the rest of the universe.

Universe: United States = Russell 3000

Developed and Emerging Markets = All ordinaries traded on exchanges with liquidity greater than US$750,000/day where a Growth Outlook and Earnings Quality score can be calculated