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Smith Group Sweet Spot

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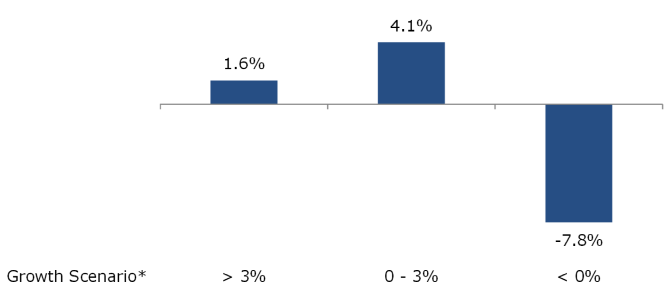
As I travel meeting with clients and prospective clients, I am often asked whether the current economic environment is conducive for positive excess returns from the Smith Group investment process. That is such an important question that we conduct ongoing research into the fundamental factors most closely linked to our relative performance cycle.

Back in 2010, we did some work on our historic performance in various growth environments. This revealed 'positive but slow economic growth' as the environment where our process had delivered the best excess return.

Updating this data for the period 1995 – 2013, shows that about 49% of quarters have had Real GDP growth between 0% and 3%. In those quarters, our flagship product, Large Cap Focused Growth had excess return to the S&P 500 57% of the time, with an average annualized excess return of 4.1%. Exhibit #1 shows the results of this long term study.

But how has this relationship held up since we did the initial

Exhibit #1: Smith Large Cap Focused Growth Quarterly Annualized Excess Return v. S&P 500 sorted by U.S. Real GDP growth

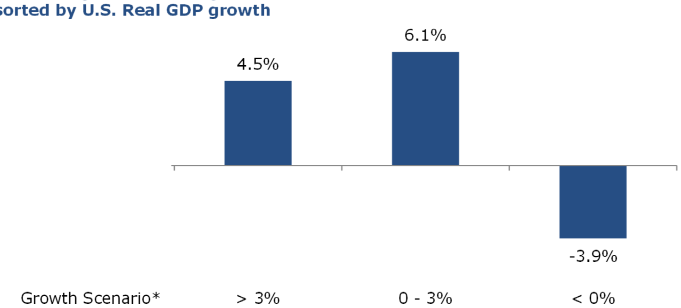


study? Looking at 2010 – 2013, it is consistent with the original findings. During this latest period there have been 12 quarters of below 3% growth and the Smith Large Cap Focused Growth portfolio had positive excess return in 6 of them, or 50% of the time. The annualized average excess return for the slow growth quarters was 2.7%, which is higher than the strategy annualized excess return for the full period. This would imply that the positive relationship with slow economic growth is holding up.

Depending on which consensus one looks at, GDP growth expectations for 2014 and 2015 are at or slightly below 3%. Will this modest growth environment continue to help us deliver value for our clients?

We felt that question deserved more exploration and have done a similar study on the Smith Group Composite model used for compiling the buy list. Linking excess returns to the stock selection model strengthens our statistical case. Looking at the period we have data for (1996 – 2013) we found results that are consistent with the excess return study which is displayed in Exhibit #2. In this case, we measured the annualized quarterly spread between the

Exhibit #2: Smith Composite Model Annualized Quarterly Return Spread between Quintile 1 and Quintile 5 sorted by U.S. Real GDP growth



average return of the top quintile (top 20% ranked) stocks in the Russell 1000 ranked using our composite model over the bottom quintile (worst 20% ranked), then sorted the quarters into the same GDP growth buckets used in the excess return study. As shown, the most profitable economic environment was once again 'slow growth'. Although, the relative composite model signal for 'high growth' quarters compared to 'slow growth' is a bit better than in the excess return study. The consistency is also quite good. In 71% of the 'slow growth' quarters the Q1 to

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** Growth Scenario = Real quarterly GDP growth annualized*

Exhibit #1 Calculation: Average annualized quarterly excess return of each quarter where the Real U.S. GDP annualized growth fell within each scenario for the time period: Jan. 1, 1995 through Dec. 31, 2013

Exhibit #2 Calculation: Average quarterly return spread between the best 20% and worst 20% for companies ranked using the Smith Composite model for each quarter where the Real U.S. GDP annualized growth fell within each scenario for the time period: Jan. 1, 1996 through Dec. 31, 2013

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Q5 spread for the composite model was positive, compared to 68% for 'high growth' periods and 57% for 'negative growth' periods.

Overall, the comparison between Large Cap Focus Growth excess return experience and the Composite model supports our conclusion that the Smith Group economic sweet spot is slow growth. Although, fast economic growth is also quite profitable as well. The environment where our process has struggled a bit in the past has been in recessions. However, it is worth noting that if the second quarter of 2009 were removed from the composite model study dataset, this category would also be positive. Unless one is expecting a recession in the coming quarters this data would suggest that the Smith Group is likely to deliver positive excess return in the slow, steady expansion the economy is currently experiencing.