Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Stressing Balanced Portfolio Management

CHRIS ZOGG, CFA
OCTOBER 2011

The Smith Group process is grounded by the premise that earnings drive stock prices and companies growing faster than expectations will be rewarded most of the time. This proves to be true in most market environments but there are times when economic/market headwinds can reduce the importance placed on company fundamentals. When this condition arises the impact of common market risk factors, like Beta, is amplified. The key to an active manager successfully navigating these periods is to increase focus on risk management in portfolio construction to avoid being on the wrong side of those market driven risks without abandoning their alpha disciplines.

We monitor a basket of market stress measures to gauge the extent of macro drivers in the market to tell us when to increase the weight of risk management compared to alpha exposure in portfolio construction decisions. These include things like stock correlations, return attributable to common market risk factors, dispersion of returns to our buy criteria, and estimate diffusion. This awareness allows us to react and reduce market risk exposures as stress builds.

We all know that success in investments is dependent on effective analysis of the probability of a set of outcomes. Black-and-white signals with 100% certainty are not achievable. The headwinds for our process results in 'reduced efficacy' of our inputs but does not mean 'no efficacy'. For instance, using our primary selection criteria, encompassed in our Growth Outlook factor, the probability of top ranked stocks producing positive returns moderates when market stress rises, but is still almost 60%. While this is not as high as it is in normal market environments, it is still a respectable batting average. Because of this risk management should complement alpha exposure, rather than replace it.

The 2008-09 risk trade, first off, then back on, coupled with a sophisticated risk-managed product we introduced in 2008 has led to a deep team understanding of how individual stock prices react to drivers that impact a broad group of stocks at the same time. As a result, we are better equipped to both understand and manage those risks.

The current environment is showing some signs of stress, which have not been confirmed by all of our indicators. However, we have been able to largely prepare for a more stressful environment over the course of the summer by reducing market risk exposures, while continuing to find companies that fit our criteria indicating growth in excess of expectations. For instance, in our current portfolio, Beta is 1.02 to the benchmark, compared to 1.12 as of 3/31/11. At the same time, our companies continue to experience upward revisions and positive surprises at a higher rate than the market. We are diligently working to continue to both deliver alpha and manage risk exposure.