Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

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INVESTMENT TEAM

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STEPHEN SMITH, CFA

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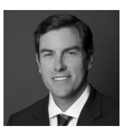


Hedge Fund Alpha's Vanishing Act

CHRIS ZOGG, CFA

It's certainly a popular exercise these days to bash the hedge fund industry as having evolved into a mediocre returning, high fee extraction business. The return evidence is fairly strong particularly in the past several years as the comparisons to equity markets have been tough given the strong overall returns in equities since 2009. But that's not a totally fair comparison given that most managers carry short capital to achieve less correlated returns to equity markets.

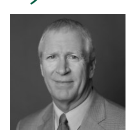
(click here to view full article)

Are Value and Growth still Converging?

EIVIND OLSEN, CFA

The outperformance over the last four quarters of both the Russell 1000 Growth index and the Russell 2000 Growth index over their Value peers has reignited the conversation about a resurgence of the Growth v. Value cycle. But since the financial crisis there really has not been a sustained return advantage for either index. In fact, 2014 had the lowest Growth v. Value return gap since 2005 for small cap and 2003 for large cap.

(click here to view full article)



Fast Growth may be Hazardous to your Wealth

RICK VILLARS, CFA

Intuitively, it is logical that the key to building wealth at a better than average rate would be to own the fastest growing stocks. The investment management industry expends a considerable amount of time and energy to find those companies that are growing faster than their peers. But are fast growing companies the panacea we have built them up to be? The data actually says just the opposite.

(click here to view full article)

For additional information on **Smith Group** and our investment strategies and capabilities, please visit www.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.

The Active Share Myth

STEPHEN SMITH, CFA

In recent years, one of the most widely promoted investment approaches has been for investors, especially institutional investors, to hire investment managers with highly-concentrated portfolios. The basis of this approach seems to have gotten a boost from the 2009 publication of a paper entitled, *How Active is Your Fund Manager? A New Measure That Predicts Performance* (Cremers et. al. 2009). In this paper, active share was designed to determine the degree your stock holdings *differ* from the benchmark portfolio. It is calculated by summing the differences in the weight of the holdings of a portfolio compared to the weight of the respective holding in the benchmark portfolio, and then dividing by two. The purpose of the active share measure is to determine how different a portfolio is relative to its benchmark portfolio.

The Cremers paper went beyond just laying out what active share is and concluded that "funds with the highest active share *significantly outperform* (italics mine) their benchmarks both before and after expenses, and they exhibit strong performance persistence". This paper and others that followed argued that a high active share is a good thing because it is associated with a manager's high-conviction in the holdings. Otherwise, the argument goes, why would the manager veer from the "diversification-is-a-good-thing" tenet that we all learned in Investments 101. High active share and highly concentrated portfolios became associated with high manager conviction, which was supposed to lead to superior excess returns relative to the benchmark. This led decision-makers who choose investment managers, especially for multi-manager institutional portfolios, to start a bandwagon movement into highly-concentrated portfolios and away from highly-diversified portfolios.

We now have five years of performance since the paper was published and we can test whether the theory was correct. To conduct this test, we focused on a manager group with many participants and with a range of diversification levels—U.S. large cap equity growth separate accounts, using the Callan Associates Inc.[1] manager database. Using the Callan[1] data, we divided the manager universe into quintiles based on the number of holdings in each portfolio. A total of 253 managers are included in the dataset, meaning approximately 50 managers were included in each quintile. We then compared various features of the most concentrated managers (quintile 1) to the most diversified (quintile 5). The time period for this comparison was the five years after the publication of the Cremers active share paper, 2010 - 2014.

The three comparisons we will look at are:

1) Average excess return relative to the benchmark.
2) Dispersion of universe returns.
3) Probability of picking a winning manager.

Despite the claim in Cremers' active share paper, our analysis demonstrated that the most diversified managers consistently outperformed the most concentrated managers, accomplishing that in four of the five years, and averaging +62 basis points per year. This is shown in exhibit #1 below.

As you would expect, the study revealed the most concentrated managers had the widest dispersion of returns among the manager groups. This results from the nature of active share because the concentrated managers are intentionally deviating their holdings away from the benchmark portfolio, and each manager is deviating in its own particular way with disparate market exposures.
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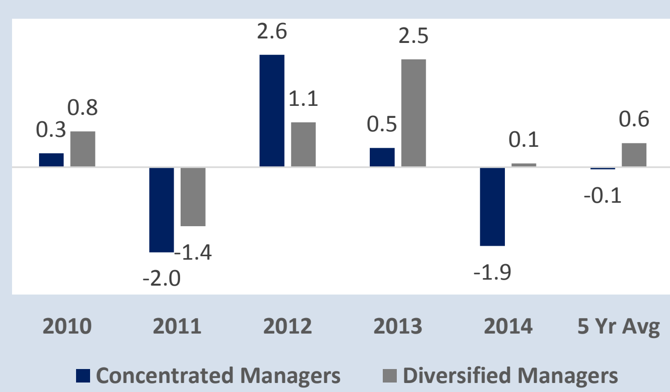
Exhibit #1: Average Excess Return



Returns presented are gross of management and administrative custody fees and net of trading costs.
Concentrated Managers = 20% most concentrated in the Large Cap Growth Universe
Diversified Managers = 20% most diversified in the Large Cap Growth Universe

You Spin Me Right Round …

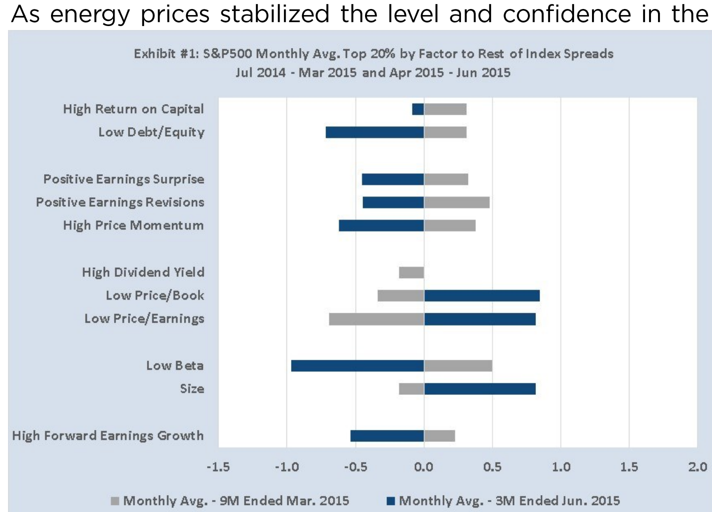
JOHN BRIM, CFA

Like the 1980's hit song bemoans, drivers in the market continue to spin leading to fits, starts, and reversals. U.S. equity markets, as measured by the S&P 500 Index, rose +0.3% in the second quarter. Small Cap stocks, as measured by the Russell 2000 Index, posted positive returns as well, returning +0.4% for the quarter. Non-U.S. equity markets posted similar results to the U.S. as the MSCI All-Country World Index ex-US rose 0.5% in U.S. Dollar terms. The meteoric rise of mainland China shares over the past year has reversed course as the Shanghai Composite is down 17% from the highs hit earlier in June. Further pain is likely as the rise was fueled in no small measure by bulging margin debt. Large cap growth stocks were inline with large cap value stocks during the period as both were up 0.1% for the quarter. Within small cap stocks, the strong outperformance of growth over value stocks continued as the Russell 2000 Growth index returned +2.0% vs. –1.2% for the Russell 2000 Value index. Over the past twelve months small growth stocks have outpaced small value stocks by 11.5%. The significant outperformance of small growth stocks was led by biotechnology companies. The biotechnology group alone accounts for 37% of the return spread between the small cap style indices. The group has returned +58% over the past year and represents 12% of the Russell 2000 Growth v. 1% of the Russell 2000 Value.

The sell-off in energy markets that began in mid-2014 abated in late March, as did the surge in the U.S. Dollar against other world currencies. Prices for West Texas Intermediate Crude peaked at $107 per barrel in June 2014 and bottomed at $43 in March 2015. Prices have since rebounded +40% to $60 per barrel. Shares of energy companies dropped more than -25% over that time period. The impact of the oil price collapse was felt across the entire economy as the outlook for hiring, capex and earnings moderated. Energy prices drove a more than $12 drop in 2015 earnings expectations for the S&P 500. Despite the fall in energy prices and earnings expectations from mid-2014 through March 2105, equity prices broadly continued to climb and investors focused their buying on high quality growth stocks with improving earnings outlooks.

As the macro market influences of falling energy prices and a rising U.S. Dollar stalled out, equity markets underwent a significant factor reversal, the breadth of which had not been experienced since April 2009. Within large cap stocks, exposures that had produced positive returns over the previous nine months reversed course. The trend was no longer the friend of investors as companies with favorable earnings and financial quality, rising earnings expectations and strong price performance all sold off. Over 80% of the equity market risk and performance factors Smith Group tracks reversed course following the bottoming of energy prices (see exhibit #1 below for a sample of market factor performance). Even the shares of recent stock market darlings with very stable earnings outlooks, such as Kroger Co., took a marked downturn as the stock fell -15% despite reporting a +15% earnings surprise on a +28% year over year earnings gain in early March.

As energy prices stabilized the level and confidence in the outlook for earnings has modestly improved. Interestingly, Europe has actually seen a stronger rebound in the outlook for earnings than the U.S. despite being a significant net importer of energy and the continued Greek debt crisis. The factor reversal of early second quarter has abated but the equity market leadership of 2014 and early 2015 has yet to return, other than the continued strong performance of biotech shares.



As we march ever closer to the first Fed interest rate increase since mid-2006, Smith Group believes a return to

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You Spin Me Right Round...

(Continued from page 3)

equity market leadership by high quality companies is likely along with a narrowing of the performance spread between growth and value companies. Investors should expect companies with strong cash flow and earnings growth along with stocks trading on lower relative valuation multiples to perform well headed into and following the beginning of the Fed tightening cycle. Traditionally an avoidance of higher risk stocks such as those with high beta and high price momentum is warranted. Technology would be expected to perform well while very interest rate - sensitive groups such as autos could be challenged. Biotech traditionally does relatively poorly early in a Fed rate increase cycle, due to its high risk profile, and given the historically high valuations and strong price momentum of the group, a significant reversal of fortunes would not be surprising.

Smith Group remains upbeat on the outlook for the U.S. economy and for the direction of equities. Despite the recent rise in energy prices, energy remains a significant tailwind for the global economy. The same is true for interest rates, despite a likely increase in short term rates through year end, global central banks remain in an extreme stimulative posture. A strong U.S. dollar will produce earnings headwinds for some multi-national companies, but it also helps tamp down inflation (because imports are cheaper) and the need for any aggressive action by the Fed. As we have stated before, equity market valuations are fair. With low inflation, low interest rates, and a strong currency, further multiple expansion is the path of least resistance. While market drivers will continue to spin in and out of favor, the conditions for a multi-year bull market are still in place.

The Active Share Myth

(Continued from page 2)

Exhibit #2 below shows the yearly comparison of return dispersion between managers within the two categories of managers.

The decision of which manager to choose to fill a slot within a multi-manager portfolio is often based on the past performance, among a basket of manager characteristics. Especially when the decision is made by a group, where consensus is important, the tendency is to be very heavily influenced by excellent recent past performance. It is difficult to argue against that characteristic. Yet, studies have shown that excellent recent past performance is rarely a predictor of success in the following year. Because of their concentrated holdings this cyclicality is amplified.

With that as background, it is not surprising that the probability of selecting a winning manager from a group of concentrated managers is much lower than when selecting from a group of diversified managers. (A winning manager is defined to be a manager that beats its benchmark for the subsequent 12-month period.) That is likely true because concentrated managers typically have much higher excess returns when their style drivers are in favor, and this makes them the hot manager about the time the market is rotating away from those same style factors. Diversified managers typically have much less amplitude in their return pattern, and usually a larger mixture of portfolio exposures that mitigate the risk of underperformance.

Exhibit #3 below shows the probability of picking a winning manager in either the concentrated or diversified manager categories.

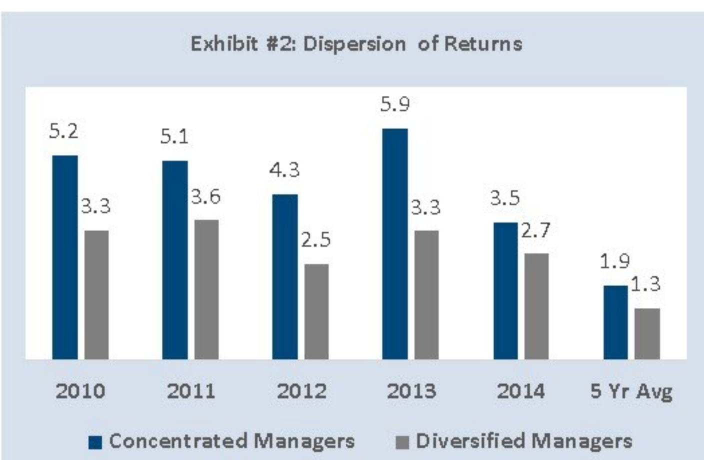
The Cremers active share paper in 2009 started a trend toward selecting managers with a high active share. High active share is usually associated with a highly-concentrated, and so-called "high conviction" portfolio management style. Concentrated managers have benefitted from this trend by capturing significant asset flows relative to the more diversified style of management.

When we reviewed what has happened in the past five years among the large cap equity growth manager separate account universe compiled by Callan, our study found that the most diversified managers relative to their most concentrated peers have:

1) Better average excess returns
2) Lower dispersion of returns between managers
3) A better chance of beating their benchmark

Based on these results, concluding that "funds with the highest Active Share have the highest likelihood of outperforming their benchmarks" is overly simplistic , if not erroneous. Just as the timing of markets is generally a fool's errand, so are strict conclusions about the absolute superiority of one investment approach over another. Both styles have unique advantages and disadvantages that will appeal to specific investor needs.

While highly concentrated portfolios can generate significant outperformance they can also lead investors into a performance hole where exposures and unintended bets destroy returns when the cycle turns against them. Often investors do not stick around for the time when the positive part of the performance cycle returns. A benefit of more diversified approaches to portfolio construction is that many of these unintended exposures can be mitigated. This reduces the likelihood of periods of significant underperformance, improves the realized risk-adjusted returns, and increases the likelihood that the client/manager relationship will have a long, fruitful life.



Smith Group Economic Scorecard

Economic Concept	Asset, Liability, or Neutral	Key Indicators	Comments
Consumer Spending		Consumer Confidence (YOY), Retail Sales, Consumer Confidence (10YrMA), Real PCE, Disposable Income, Confidence	Consumption inputs are assets almost across the board, except for retail sales. Consumer confidence is still elevated compared to the last 10 yrs rising on a YOY basis. YOY real personal consumption growth is a positive as is growth in disposable income. Retail sales growth is a neutral.
Credit Environment		Loan officer credit conditions survey, Small Business Credit Availability survey, Consumer Credit growth, C & I Credit growth	Loan officers are getting marginally tougher when extending consumer credit. But Small Businesses is finding credit increasingly easier to get. Growth in loan balances is expanding better than asset thresholds for both consumers and businesses. With three positive indicators this concept is an asset.
Employment		New Jobless Claims, Change in Private Employment, Job Openings, NFIB Hiring Plans	All employment indicators are exceptionally strong making the concept the most positive driver in the scorecard. New jobless claims have only been this low once since the 1970s. Job openings have accelerated to new all-time highs. Growth in private sector employment is well above the asset threshold at 2.3%. Small business hiring plans have completely normalized.
Energy		WTI - YOY, WTI vs 10yr MA, Pump Prices, Nat'l Gas, Energy Intensity, Energy Imports	Near term the price drop has a negative effect on CAPEX and employment. Long term the benefits are consumers with extra cash to spend and lower business input costs. The sharp YOY drop in energy prices across the board make this concept an asset. Energy intensity is improving and energy imports continue to fall.
Household Wealth		Net Worth (YOY%), Net Worth (% of Peak), Debt Service Ratio, House Prices, Stock Prices	Rising house and stock prices continue to push household wealth to new highs. Yet, the pace of growth has slowed. The HH debt service ratio continues to be near record lows, but has stopped improving.
Housing		Housing starts, Case-Shiller prices, NAHB Survey, Mortgage applications, Mortgage rates	Almost all of the housing indicators are better than asset thresholds. Housing starts are picking up. Price appreciation is not robust, but is still firm. There is even a brisk pace of mortgage applications for purchase. The uptick in mortgage rates is negative.
Interest Rate Environment		Fed Funds Rate, Yield Curve, Change in 10-year Treasury rate, Change in Fed balance sheet assets	Interest rates have been rising recently, but the YOY change in the 10-yr is still down. The Fed balance sheet is marginally shrinking, but by such a small amount that no one has really noticed. Yes, the Fed Target Rate is poised to begin rising. But rates are still so historically low that it would be difficult to call the interest rate environment anything but stimulative.
Business Spending		CAPEX Orders, CAPEX Shipments, CAPEX Surveys, NFIB Small Bus CAPEX Plans	Both large and small businesses are planning to invest at the margin in CAPEX, but not broadly enough to make sentiment a concept asset. In addition, while they say plans are to increase spending, actual YOY growth in new CAPEX orders has actually turn negative and shipments are growing at a slower pace.
International		JP Morgan Global PMI, CESI Europe, CESI EM, CESI Japan, Baltic Dry Index, Currency	The impact of international is a mixed bag. The Citi Econ Surprise indices around the world are mostly neutral with little upside or downside momentum. Japanese momentum is quite strong. PMI indices mostly show slower growth. USD strength has been a sales growth impediment. USD strength is ST negative, but sustained global economic growth is a positive. Significant headlines abound, but broader global growth impacts are muted.
U.S. Debt and Budget		Interest Payments on National Debt, Maturity Distribution, Deficit & Total Debt, Debt-to-GDP	With the average maturity of US debt below five years we worry about the long-term impact of rising interest rates on the US debt burden. However, short-term the deficit continues to improve incrementally, debt to GDP has stopped rising, and debt service relative to total outlays is actually falling a bit.

Smith Group Market Scorecard

Smith Group
ASSET MANAGEMENT

Market Concept	Asset, Liability, or Neutral	Key Indicators	Comments
Asset Flows		Mutual fund flows, Institutional Searches, foreign purchases of U.S. securities, ETF flows, ICI DomEq Flows,	While flows out of equity mutual funds have been dramatic, they have been more than offset by inflows to ETFs. Foreigners are still buyers of US equities as well.
Liquidity		Fed Balance Sheet (FRED-WALCL) (YOY%), BOJ Balance Sheet (FRED-JPNASSETS) (YOY%), ECB Balance Sheet (FRED-ECBASSETS) (YOY%), Cash in Money Mkt Funds v. 5yr ave	While the Fed balance sheet is modestly shrinking, it is still higher on a YOY basis, making it a neutral indicator. The BOJ balance sheet is increasing at a fast YOY pace and is an asset. ECB will be an asset soon if they maintain the current pace of purchases. Cash in money market funds is flat with the 5yr ave, but cash balances in managed mutual funds are at high levels. Overall the buying power of investors is still plentiful.
Earnings		F12M YOY EPS Growth, FY2 Diffusion, Guidance, FY2 Diffusion (4-wk change), S&P 500 F12M Expected Growth, % Pos Surp (Latest Report)	Earnings indicators have improved enough to make this concept a neutral from a negative. The diffusion ratio (#positive to #negative revisions) has recovered from low levels. Forward growth expectations are still modest, but have ticked up in recent weeks to above the neutral threshold. Recent earnings surprise experience is in line with the LT ave.
Macro		Citi Econ Surprise US, Citi Econ Surprise G10, Citi Econ Surprise China, ISM New Orders Manf, ISM New Orders Services	Economic Surprise index in the US is at low levels but has moved back up to neutral territory. All other CESI indices are in neutral territory as well with the exception of China. ISM New orders for both Manufacturing and Services are assets.
Sentiment		AAII Bull/Bear (contrarian), Inv Intel Bull/Bear (contrarian), Retail AA (ICI DomEq/Total), AAII Allocation Survey	AAII survey bull/bear ratio is close to flashing a contrarian buy signal. Inv Intelligence survey is less optimistic, which is a contrarian indicator, but is still a marginal liability. Institutional investors are underweight to long term averages, which is positive for the long-term outlook. AAII allocation survey shows retail allocations have risen to just below the liability threshold. Overall, sentiment has moved up to neutral from a liability
Geopolitical Risks		Disruptive global events	International headlines are full of risks that could have an impact on investor confidence, but so far seem to have had little impact on the trajectory of US stocks despite some day-to-day volatility. Oil prices seem to have stabilized. We still keep this concept as a liability because of the potential for disruptive events.
Revenues		FY2 Diffusion, FY2 Diffusion (4-wk change), S&P 500 F12M YOY%, % Pos Surp (Latest Report)	Sales growth expectations have worsened and reported sales for the first quarter were disappointing. Sales diffusion has improved from low levels, but with expectations so low this concept is considered a liability.
Valuation		S&P500 F12M PE v 10 yr ave, S&P500 F12M PE v 20 yr ave, S&P 500 PB v 10 yr ave, S&P 500 F12M EY v BAA, Graham & Dodd CAPE	Valuation, is not a good market timing indicator, but is mostly stretched making it a headwind. The PE v 10 yr ave is in liability territory. Against the 20 yr ave it is still neutral, but approaching the liability threshold. Graham & Dodd CAPE is a liability and EY relative to bond yields has moderated.

Disclosures

Founded in 1995, Smith Asset Management Group, L.P. (“Smith Group”) is a registered investment advisor that specializes in equity investment management services. The firm manages assets for a diverse list of clients, which includes foundations, endowments, corporate pensions, public funds, multi-employer plans and high-net worth individuals. Effective Jan. 1, 2006, the firm was redefined to exclude wrap SMA business. Smith Group claims compliance with the Global Investment Performance Standards (GIPS®). Smith Group has received a firm-wide verification for the period Jan. 1, 1996 - Mar. 31, 2015. To receive a complete list and description of Smith Group’s composites and/or a presentation that adheres to the GIPS® standards, contact John Brim, CFA at (214) 880-4608, or write to Smith Group, 100 Crescent Court, Suite 1150, Dallas, TX 75201, or john@smithasset.com. The S&P 500, Russell 1000 Growth, and Russell 1000 Value indices, are unmanaged indices of the shares of large U.S. corporations. The Russell 2000 and Russell 2000 Growth indices, are unmanaged indices of the shares of small U.S. corporations. The MSCI ACWI (All-Country World Index) and Russell Global Large Cap indices are free float-adjusted market capitalization weighted indices designed to measure the equity market performance of developed and emerging markets. All index performance includes capital appreciation and reinvested dividends and is presented gross of fees.

Earnings Surprise: According to many academic studies, earnings surprise has had a positive relationship to relative performance in most time periods and for most companies. However, this does not mean that this relationship exists for all time periods and for all companies. In the recent past, periods coinciding with an inverse relationship between earnings surprise and relative performance have typically been periods in which corporate earnings are not the focus of investors’ attention. Additionally, companies, which have had a chronic negative relationship between earnings surprise and relative performance, are typically those companies whose earnings are not product-driven, such as commodity companies. There is no assurance that the historic positive relationship between earnings surprise and relative performance will exist in the future. Nor is there any assurance that the historic ability of Smith Group to forecast a high rate of positive earnings surprise companies will exist in the future.

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