REPRINTED FROM JULY 29, 2019

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Looking for Unexpected Earnings Growth and Obsessively Managing Risk

STEPHEN S. SMITH founded Smith Group Asset Management, a Dallas-based investment management organization, in 1995, and serves as the company's CEO and Chairman of the investment committee. He began his career in the late 1960s as an engineer with NASA in the lunar landing program. Mr. Smith joined Wachovia Bank as a computer systems analyst in the mid-1970s and transitioned to the bank's investment management division in order to help design and implement a portfolio management system. He left Wachovia and joined what is now known as Bank of America in 1983. Mr. Smith held a number of senior investment positions at Bank of America until he departed in 1995 to found Smith Group. Mr. Smith has an engineering degree and an MBA, both from the University of Alabama, and he was awarded the Chartered Financial Analyst — CFA — designation in 1981. He is a member of the CFA Institute and the CFA Society of Dallas-Ft. Worth. Mr. Smith is an active volunteer in his community and serves on the board of directors for a number of charitable organizations.

SECTOR — GENERAL INVESTING

TWST: Let's start with an introduction of sorts to your company — a little bit about the firm's history and a snapshot of what the business looks like today.

Mr. Smith: I'd be glad to do that, and if you don't mind, I will start with a little bit of my personal history because that forms the foundation of what we do here at Smith Group. I have an engineering degree, and early in my career, I worked for NASA in the Neil Armstrong Lunar Landing Program. I was a rocket scientist early in my career, got an MBA and then went into the financial services industry after that.

There are several things that I learned back in my NASA days that really formed the foundation of who we are at Smith Group. One of those things I learned is that you've got to have a common mission that you are all striving to achieve. In NASA, of course, it was putting men on the moon and bringing them back safely. At Smith Group, our mission is to be an industry leader in terms of producing returns per unit of risk, and all our investment team members here fully buy into that mission. That's what gets us motivated every day.

The second thing I learned is that you must have the right mix of technology and human judgment. It's great to use computers to help you out, but computers should not be making decisions for you. So at Smith Group, we make extensive use of computing power and technology, but in the end, our portfolio managers make the decisions on our portfolios. We use computers so extensively that some people think of us as being quant managers, and we are not that. We are bottom-up fundamental stock-pickers who use a lot of technology.

The other thing that I learned is that you must have everybody pulling in the same direction. You've got to know what you are doing, and people need to have their specific role on the team. We are organized in a way so that all our portfolio managers are skilled at what they do, and each has industry assignments for identifying good companies that are going into a portfolio, and they also have assignments for the various investment strategies we have.

All that forms the foundation of our company. Smith Group was founded in 1995, so we are almost 25 years old now. When I founded the company, I determined that as we grew, we would not only manage our growth appropriately, but we also would make sure that we were bringing the right kind of people onto our investment team.

Right now, we have seven portfolio managers; I've personally been involved in hiring all of them, and the qualities that I look for in identifying portfolio managers are, number one, they have to think like an engineer. They have to be problem-solvers. It doesn't mean they have to have an engineering degree, but they must think like an engineer, know how to use a scientific method to identify and solve problems.

The second thing I require is that the members of our portfolio management team have to have the proper training in order to be able to analyze the companies that will go into the portfolio and the right kind of training to manage the risk of our portfolios. The Chartered Financial Analyst, or CFA, program is very good at training us to do that; I got my CFA charter back in 1981, and I require every member of the portfolio management team to either have the CFA charter or have a CPA, and that's a requirement of all seven of us.

And the last thing that I require is that the members of the team must be team players. We don't allow a star system, star stock-pickers. We don't allow that at all, and as we've interviewed people over the years, it's amazing how many individuals think they know better than anybody else what it is that causes a winning stock. If people check that box, we don't even really give them much of an interview because we don't want people that are coming in with their own way of doing things.

We have been in business now for almost 25 years, seven portfolio managers, and our business is managing a bit over $3 billion. We are an institutional money manager. We are not a financial adviser. The majority of our clients are institutions. We're intentionally set up that way.

We are 100% employee-owned. I'm the largest shareholder but own considerably less than 50% of the shares of the company. I have been granting ownership stakes to various key individuals, and all of the members of our portfolio management team have shares of the company. We use that as a way of motivating portfolio managers to stay here and stay motivated to satisfy the needs of our clients. The average portfolio manager has been here for just over 15 years and, on average, had about 10 years of experience before they came here, so they have, on average, about 25 years' experience.

In a nutshell, that's who we are. We get up every morning trying to be the best in the business at producing returns per unit of risk. If you'd like, we can go into how we do that as we get deeper into the interview.

Highlights

Stephen S. Smith discusses Smith Group Asset Management. The firm's goal is to be the best at producing returns per unit of risk. One of the ways Mr. Smith attempts to do this is by using the right mix of technology and human judgment and finding undiscovered earnings growth. Mr. Smith is a growth manager who is obsessive about managing risk. He says this causes a more stable performance pattern. Mr. Smith also notes that his definition of growth is different from other managers. He looks for high relative growth as opposed to high absolute growth. Companies discussed: Bank of America Corp. (NYSE:BAC); Procter & Gamble Co. (NYSE:PG); Exxon Mobil Corporation (NYSE:XOM); Microsoft Corporation (NASDAQ:MSFT); McDonald's Corp. (NYSE:MCD); Amazon.com (NASDAQ:AMZN); IBM (NYSE:IBM); Eastman Kodak Company (NYSE:KODK); Facebook (NASDAQ:FB) and Alphabet (NASDAQ:GOOG).

TWST: Yes. One thing I noted while looking at your website was your focus on capturing "unexpected earnings growth." What led you to focus on this, and how do you accomplish this?

Mr. Smith: It began way back in the 1970s when I first began my career, having moved over from being a computer system engineer to starting to manage portfolios within a bank trust department. What I found was, in that era, and to a large extent it still exists, is that if you go back to the theory of pricing stocks, what is it that causes people to pay a certain level when they are trading a stock? What we learned in the CFA program is that, at least in theory, the value that a company is worth any day is equal to the discounted present value of the future earnings stream. So if you can forecast what the future earnings stream is and discount it back, that's what you should be paying for a stock.

What I found is that if a company grows at the amount that was expected at the beginning of the period, then you likely are going to get a market performer. It is unexpected growth that then becomes realized as time moves along that causes the price of the stock to move up as the unexpected earnings are realized by more and more investors.

I was involved in a study back in the late 1970s at the University of North Carolina where we determined that companies that reported what we call "positive earnings surprises" would typically outperform. In that era, we were just looking at quarterly earnings surprises because nobody else was looking at that. These days — as time has moved along and you've got Bloomberg and CNBC and all of these other media outlets that are pronouncing earnings surprises, positive or negative, and earnings guidance — it means that quarterly earnings surprises don't really work very well anymore to produce positive excess returns. We have found that if you can look farther out, if you can look 12 months, 24 months out and get it right about when a company is going to grow faster than expected, then you typically will outperform.

TWST: What else would you add about your overall investment philosophy, your research capabilities and anything else that differentiates Smith Group from your peers?

Mr. Smith: There are several differentiators and two of them that I would highlight. First, we are categorized as a growth manager. We find companies that grow faster than expected, and so we are in that growth bucket. One thing that I've found is different between the way we do things and many of our growth peers is that we are really obsessive about managing risk. Many of our growth manager peers, what they are trying to do is find companies that will grow really rapidly, and they figure if they can get that right and the companies grow very rapidly, they don't have to worry too much about the risk of the portfolio because people will be astounded at how well they are performing.

"What I found is that if a company grows at the amount that was expected at the beginning of the period, then you likely are going to get a market performer. It is unexpected growth that then becomes realized as time moves along that causes the price of the stock to move up as the unexpected earnings are realized by more and more investors."

We don't do it that way. We manage risk at every level in the portfolio, and one thing that tends to do is cause our performance pattern to be much more stable than many other growth managers, which means that when the market goes down, we tend not to go down as much, and if the market is raging forward as it's doing this year, then we tend to not do quite as well as the other growth peers. So we manage risk obsessively.

The other thing that separates us from many of our growth peers is the definition of growth. Most growth managers are just looking for companies that have high absolute growth rates. They would rather have a company that's expected to grow 30% that then grows 30%. We are looking for high relative growth, so we would rather have a company that's expected to grow 10% and grows 15%

than one that's expected to grow 30% and then grows 30%. So that's another thing that separates us from many of our growth peers. It's just a definition of what is growth; ours is relative growth, while with most other growth managers, it's absolute growth.

TWST: I know you have a variety of strategies as well as a large-cap growth mutual fund. Could you give us an overview of the various strategies you manage for your clients?

Mr. Smith: I will start by saying that the vast majority of the assets we manage for clients is in large-cap U.S. growth equities. That's well over 80% of what we do, and we do that in a couple of ways. One is within a tightly focused portfolio of only about 40 stocks, and the other is in a large portfolio that has 70 or more stocks.

We do it that way because we have some clients that are not as sensitive to the benchmark relative risk. For the other ones that are more sensitive to benchmark relative risks, we have more stocks in the portfolio and manage the portfolio to have similar risk characteristics to the benchmark. So that's the vast majority of what we do. Most of our clients are in those strategies, and that's really what our company is based around.

the risk of the portfolio and especially the risk of the stock market that is so late in this cycle. We are over 10 years into this bull market, and although market cycles don't die of old age, this is getting pretty late. This has caused many people to be a little bit concerned. They don't want to pull completely out of stocks, but they don't want to take the full risk of the stock market.

Our dividend growth strategy is a very low-risk, very low-beta strategy. And in fact, since we've been managing it, there have been 11 times that the stock market — defined to be the S&P 500 — has gone down at least 5%. In all 11 times, we went down less than the market did, and people like that.

That dividend growth strategy is one that we have not really been offering to the marketplace until just recently, but we are getting a lot of interest because of the two categories of investors I mentioned: one that wants high level of income that will grow and the other that is concerned about where the stock market is going and is looking for a lower-risk approach. So the dividend growth strategy is one that I think people are beginning to find more and more interesting.

"It's become more challenging to add value in large-cap U.S. growth. We do that, but not to the extent that we can overseas and not to the extent that we did earlier in the life of our company when the U.S. markets were not as efficient. So we found that our process works especially well overseas, much as it did in the U.S. in the 1980s and 1990s."

Over the years, though, we have identified other ways that we can satisfy client needs. We have a couple of small-cap U.S. strategies, one focused, and another that is more diversified. Also, about eight years ago, we began investing overseas, meaning in international stocks. What we found is that the markets are much less efficient overseas than they are in the United States.

It's become more challenging to add value in large-cap U.S. growth. We do that, but not to the extent that we can overseas and not to the extent that we did earlier in the life of our company when the U.S. markets were not as efficient. So we found that our process works especially well overseas, much as it did in the U.S. in the 1980s and 1990s.

The strategy that we are featuring right now because of where we are in the stage of the stock market cycle is what we call our dividend growth strategy. The way that came about is, beginning back in the early part of this decade, coming out of the financial crisis, many of our clients were saying that they weren't getting the returns from their bond portfolio that they used to. They noticed that bonds and stocks were actually yielding just about the same amount. So they asked us to come up with a way that we could use our process of finding undiscovered earnings growth and apply that to undiscovered dividend growth.

We have been doing that now for over seven years, and what we've found is that dividend growth strategy really meets the needs of several different kinds of investors. One is the investors that really live off their income, and they can't live off the 3% static growth that Treasuries provide. Given the choice, what they'd rather get is maybe a 3% starting yield and then have that income grow every year.

Within our dividend growth strategy, the dividends have grown at more than 10% a year over the seven years we've been managing this strategy. At the same time, the principal of that portfolio has grown at almost 10% a year. That makes our dividend growth strategy especially suitable for clients that are looking for a higher level of income than they get from Treasuries and a principal level that will grow over time much greater than the inflation rate.

The other type of client that we found where our dividend growth strategy is most suitable is people that are really concerned about

1-Year Daily Chart of Bank of America Corp.

Chart provided by www.BigCharts.com

TWST: With the dividend growth strategy, what's your typical number of holdings? Is that a more concentrated or more diversified portfolio?

Mr. Smith: We hold about 20 stocks in the portfolio, and they tend to be very comfortable names like **Bank of America** (NYSE:BAC), **Procter & Gamble** (NYSE:PG), **Exxon** (NYSE:XOM), **Microsoft** (NASDAQ:MSFT), **McDonald's** (NYSE:MCD), companies that people would recognize. This strategy has very low turnover, 10% to 15% a year, which equates to two or three trades a year. And one of the benefits of that low turnover is that we are not taking a lot of gains.

That means the tax efficiency of the dividend growth strategy is really good. In fact, we've calculated it over the life of the strategy, and we are almost as tax efficient as an S&P 500 ETF or index fund, which are known for tax efficiency. We also offer this strategy at a lower fee, only charging about 50 basis points for the dividend growth strategy, which people find attractive.

TWST: You mentioned some well-known names there. Would you talk a bit about some favorite investment ideas right now and what you like about them?

Mr. Smith: Getting away from that dividend growth strategy and looking at our more broad-based portfolios, what we are seeing is that earnings expectations are moving upward. Even as late as we are in this economic cycle, consumer discretionary companies are still doing very well, even in light of what's going on within the **Amazon** (NASDAQ:AMZN) framework of retail, based on earnings expectations. We are also seeing good earnings expectation growth in the health care area. The areas that are suffering the most are those that are most affected by the tariff war that is going on these days.

1-Year Daily Chart of Procter & Gamble Co.

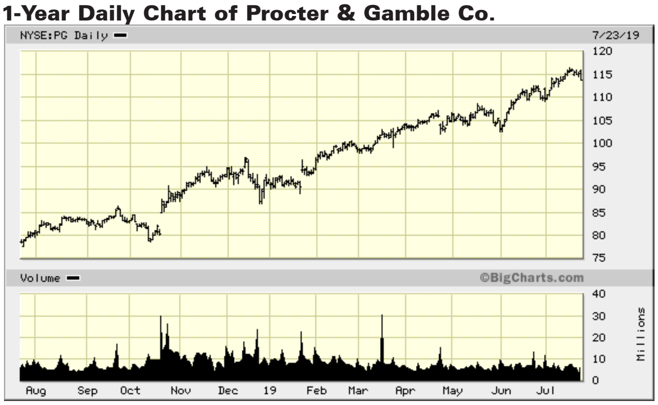

Chart provided by www.BigCharts.com

Technology stocks are looking better and better. They continue to do well. The areas that we are most concerned about are the megacap technology stocks, the so-called FAANG stocks that dominate the benchmarks because they are so huge. It's looking very much like what we saw back in the 1998, 1999 time period when these companies were thought of as never going down because they had a so-called moat around them. I've had a long enough career that I saw a moat around **Polaroid** and **IBM** (NYSE:IBM) and **Eastman Kodak** (NYSE:KODK); they had dominant positions in their industry until they didn't, and then when they didn't, they had a long downward slide.

So although we do own **Facebook** (NASDAQ:FB), and we own **Google** (NASDAQ:GOOG), we don't own them at the level that the benchmarks do. And it does appear that some of the FAANGs, especially **Amazon** with valuation levels that are off the charts, seem to be pricing in expectations that are way better than they could ever achieve. So we like bread-and-butter technology, consumer discretionary and are especially concerned by the megacap technology companies that dominate the growth benchmarks.

TWST: Outside of those megacap tech companies, are there any other areas you are particularly cautious about right now?

Mr. Smith: The industrial sector is not doing very well because a lot of that sector is affected by the tariff wars that are going on. The energy area is one that causes some concern. Energy prices have come down recently, and stock prices usually react to that. But overall, we're seeing an economy with an economic expansion that is 10 years old but is not acting that way.

From the middle part of this cycle, let's say the five-year mark, I went on record numerous times as saying it looked like we had the possibility of this being the longest economic expansion we'd ever had, and now we're right up on the anniversary of doing that. The numbers I saw the other day show that GDP grew about 3% in the first quarter, and it looks like maybe it's going to be around 2% this quarter. Then, it seems likely it will continue to go up from there.

1-Year Daily Chart of McDonald's Corp.

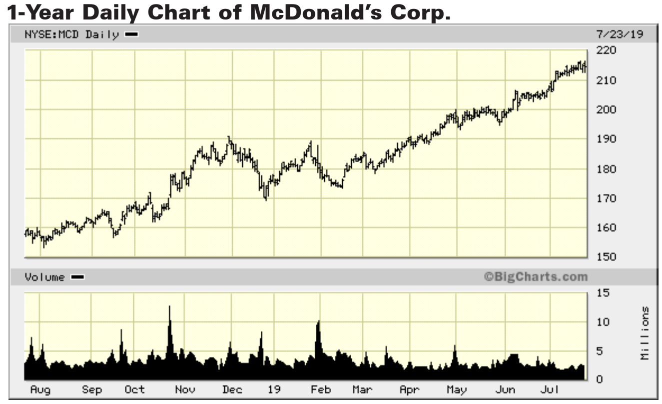

Chart provided by www.BigCharts.com

TWST: What other market indicators, macroeconomic factors, are you most focused on right now? What do you think other investors should be paying attention to?

Mr. Smith: It seems that the media has captured investors' attention to a greater extent than ever before and especially with all of the things going on with the G-20 summit now and what's coming out of that. More and more professional investors, and especially amateur investors, are spending so much time watching the news and getting fearful because it looks like bad things are about to happen. My suggestion is, turn the news off and just look at what companies are doing, how much money they are making, which ones have the greatest sales growth expectations, and focus on basic business fundamentals. If you do that, then the world doesn't look quite as bad as otherwise.

And the valuation of the market right now, I think, is very reasonable. Profit growth is as good as you would expect, especially this late in the business cycle, and despite what most people would guess, the analysts are on average raising their earnings expectations, not only for earnings this year but even for earnings next year and the year after, especially for companies we own. It doesn't mean they're going to be right, but if you just look at business fundamentals, then we've got a really good environment right now. That's being reflected in the U.S. stock market, which is up 15% or so already in half a year.

"Our dividend growth strategy is a very low-risk, very low-beta strategy. And in fact, since we've been managing it, there have been 11 times that the stock market — defined to be the S&P 500 — has gone down at least 5%. In all 11 times, we went down less than the market did, and people like that."

So if you just turn off the TV, you would say, "Good days are here again." That is being supported by what investors are doing in bidding up stock prices and based on what the business fundamentals are doing. With our large-cap portfolios' companies, the earnings over the last year were up about 25%. That's pretty remarkable this late in the cycle.

TWST: Is there anything else I didn't ask about that you would like to discuss?

Mr. Smith: I would like to highlight, again, our dividend growth strategy because what we are hearing in the marketplace is that more and more people are becoming risk-averse, and that's both because of the lateness of the cycle, and it's also because the Baby Boom generation — and I'm at the leading edge of that — many of us need to start living off the income their portfolio is producing. So what I would like to emphasize, whether you use our dividend growth strategy or use somebody else's, you'll see companies that are growing their dividends at 6%, 8%, 10% a year. Plus, they are doing that steadily and are doing that because their earnings are growing at that same rate. That means, if done right, there's plenty of room in the stock market to live off your income, get essentially pay raises that are two or three times what the inflation rate is and then have principal that goes up in line with what corporate profits are doing, which is usually 6%, 8%, 10% a year.

I really think that if investors are worried about where the stock market is and are tempted to pull out of it completely, now is not the time to do that. It's OK to go down the risk spectrum, down the risk ladder, and I think our dividend growth strategy is particularly well-suited for that type of investor.

TWST: Thank you. (MN)

STEPHEN S. SMITH
CEO & Chairman
Smith Group Asset Management
100 Crescent Court
Suite 1150
Dallas, TX 75201
(214) 880-4600
(800) 582-3435 — TOLL FREE
(214) 880-4640 — FAX
www.smithasset.com
email: info@smithasset.com

Disclosures

Firm: Smith Asset Management Group, LP ("Smith Group") is a registered investment adviser. Since it began operations in 1995, Smith Group has provided equity investment portfolio management services to U.S. institutional and high net worth clients. The data shown in this presentation represents the investment results of a group of taxable and tax-exempt accounts managed by Smith Group with similar investment philosophies, objectives and servicing requirements. Effective Jan. 1, 2006, the firm was redefined to exclude wrap SMA business.

Holdings, Economic Sectors and Characteristics: It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities and economic sectors shown. A list of recommendations made within the last twelve months is available upon request. The information shown is not intended nor should it be construed to be a recommendation to buy or sell an individual security or economic sector. Any portfolio characteristics or holdings that are shown are intended to present the portfolio as it existed on the date of the report. You should not assume that these same characteristics or holdings will exist in the future.

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.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Past performance is not indicative of future results. As with any investment vehicle, there is always a potential for profit as well as the possibility of loss. Actual results may differ from composite returns, depending on account size, investment guidelines and/or restrictions, inception date and other factors. Nothing contained in this presentation should be construed as a recommendation to buy or sell a security or economic sector. This material is for your own personal information, and we are not soliciting any action based upon it. The material is based upon information we consider reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such.

© 2019 The Wall Street Transcript, 622 3rd Avenue, New York, NY 10017
Tel: (212) 952-7400 • www.twst.com