Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Sector Volatility

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The theory behind a strategy of sector rotation is that certain industry sectors perform better than others at certain stages of the economic cycle, and that investors can profit by shifting money from one sector to another. While over 150 years of data reveal a pattern of which sectors generally work best in each economic stage (e.g., materials outperform in the early recovery stage), the key to capturing excess return is to be able to *predict* when the market is about to transition into the next stage of the cycle (i.e., the duration of each stage).

Sector rotation theory assumes the economic cycle unfolds in a nice smooth curve, from 1) full recession to 2) early recovery to 3) full recovery to 4) early recession - while the market follows the same pattern and foreshadows the market cycle. However, the "recovery" we are currently in does not conform to a typical "U" or "V" shaped pattern seen in the past. In addition, significant government interventions have taken place (e.g., TARP, Affordable Care Act), which have a meaningful impact on multiple sectors, and have produced distortions in the normal pattern of sector dominance.

The table below shows the total return of the best and worst performing sectors (using the Global Industry Classification Standard) in the Russell 1000 versus the overall benchmark over the last four quarters. Absolute return varied widely as investors struggled with questions of the pace of the U.S. recovery, the severity of troubles in Europe, and the magnitude of the slowdown in key emerging market economies. In addition to the volatility in absolute returns, the difference between the performance of the top and bottom sectors was as high as 25 percent over this period, with an average spread of 20 percentage points. The penalty for an incorrect rotation was abnormally high.

The chart on page 2 shows the relative ranking of the ten GICS sectors in the Russell 1000 along with cash. The winning and losing sectors have fluctuated dramatically over the last twelve months as investors alternated between an appetite for risk and a more defensive posture. Some sectors, like Health Care, stayed near median relative performance in both up and down markets. But others, like Telecom and Utilities, experienced big changes in their rank ordering. For example, the Utilities sector went from being the best performer in the third quarter of 2011, to the worst in the first quarter of 2012, then back to a top ranked position in the most recent quarter. Financials were the opposite, ranking on the bottom in the third quarter of 2011, then rebounding through the first quarter of 2012, before falling back into the underperforming group in the quarter just ended.

At Smith Group, we do not attempt to time the market either at the broad level or by placing top-down sector bets. We believe that it is not effective or necessary to take on the extra risk and extra portfolio turnover associated with such an approach. Instead, our investment process uses a combination of quantitative screening and fundamental analysis to identify the best individual stocks for inclusion in the portfolio, and any buy/sell decisions are driven by this bottom up approach. We remain fully invested and focused on finding high quality, reasonably valued companies that grow earnings at a greater rate than expected.

Total Return Performance for Russell 1000 GICs Sectors

	Q3'11	Q4'11	Q1'12	Q2'12*
Best Performing Sector	0.3	18.5	21.3	11.4
Worst Performing Sector	(24.7)	7.6	(1.6)	(10.0)
Spread (Best to Worst)	25.0	10.9	22.8	21.4
Russell 1000	(14.7)	11.8	12.9	(5.4)

** Quarter-to-date through 6/27/12*

Sector Volatility

	Q3'11	Q4'11	Q1'12	Q2'12*
BEST	Utilities	Energy	Info Technology	Telecommunication
	Cash	Industrials	Financials	Utilities
	Consumer Staples	Materials	Consumer Discr	Consumer Staples
	Telecommunication	Consumer Discr	Materials	Health Care
	Info Technology	Financials	Industrials	Cash
	Health Care	Consumer Staples	Health Care	Consumer Discr
	Consumer Discr	Health Care	Consumer Staples	Industrials
	Energy	Utilities	Energy	Materials
	Industrials	Info Technology	Telecommunication	Financials
	Financials	Telecommunication	Cash	Info Technology
WORST	Materials	Cash	Utilities	Energy