Smith Group
ASSET MANAGEMENT

Exceeding Expectations

EIVIND OLSEN, CFA

APRIL 2012

Market Perspectives Excerpt

The Smith Group portfolio management team has considerable experience at identifying companies growing earnings faster than expectations. The team utilizes a quantitative screening and ranking process combined with fundamental analysis confirming the companies' classification. Because of the focus on exceeding expectations, the final activity in the process is a relative assessment. What are expectations and why? What is the probability the company is going to exceed those expectations?

The first fundamental step is a validation of the trends we see in the screening and ranking process. Are growth and quality trends actually improving or does the data reflect a temporary phenomenon? As with all screening and ranking systems, ours is dependent on data that occasionally does not tell the full story. A change in accounting inputs, like tax rates or a reversal of special charges, shows up as an increase in expectations but does not represent an improvement in the prospects for the business. On the other hand, accelerating acceptance of a new product or structural demand driven changes in the character of customers served represent sustainable change in a company's outlook.

Understanding the source of business improvement is critical. Earnings growth driven by sales growth is generally more sustainable than expanding margins, but that is not universally true. Capital intensive or R&D driven businesses with a long payback period, or those taking advantage of technology to fundamentally change cost structure, can also create new profit trends. Of course, no sales trend analysis is complete without a look at the competitive landscape. Does the company have a cost or quality advantage? Are there barriers to entry? Fundamental analysis is important in distinguishing which companies have the capital structure or supply chain to take advantage of new opportunities and which do not. The other component of this analysis is, "is there a group of analysts that do not recognize these improved business prospects and why"? Analysts are very bright but tend to be somewhat risk averse. They often look for confirmation of emerging trends before fully integrating them into earnings models used to publish their official estimate. This gives first movers an opportunity to recognize a change before it is fully reflected in consensus earnings expectations and generally in stock prices.

In summary, our singular focus is finding profit trends not fully reflected in consensus estimates, but that are likely to be recognized as analysts gain confidence in their sustainability. Our success in this regard is an accomplishment we take great pride in.