Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

A Different Kind of Quality

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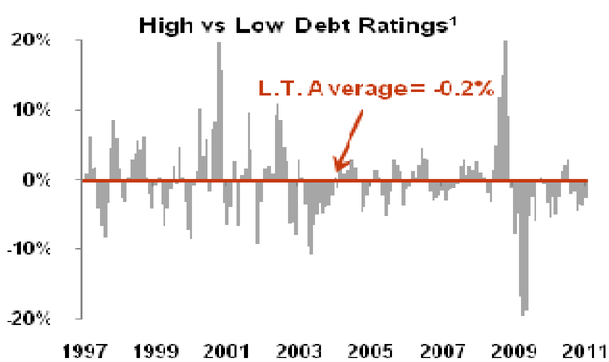
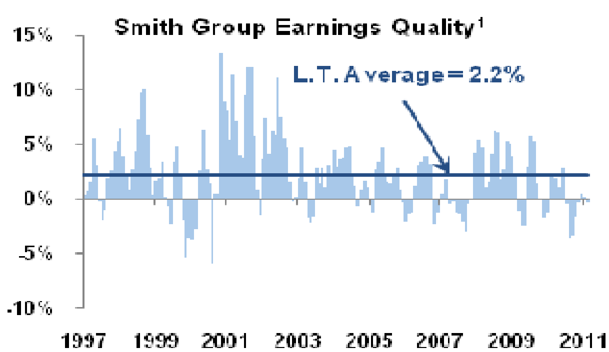
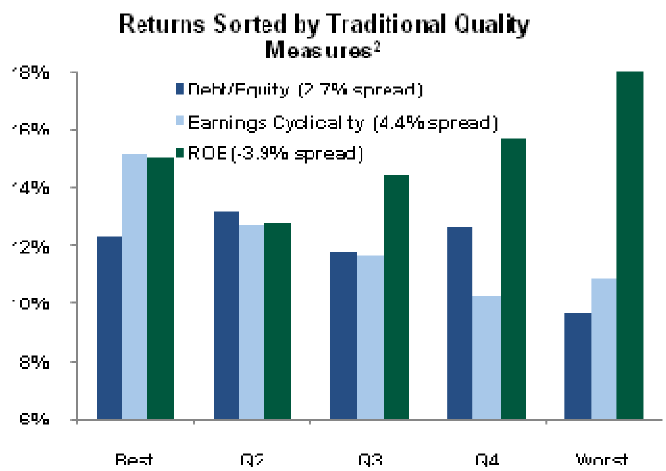
APRIL 2011

There is no lack of Wall Street strategists calling for the quality rally that has so far eluded supporters of high quality. The Smith Group falls into that camp but we have a slightly different definition of quality. Most would define quality in terms of earnings stability, balance sheet strength, or high debt ratings. While all are great measures of intuitively desirable companies, they have proven to be unstable contributors to a stock selection process. Instead our research has led us to concentrate on a set of Earnings Quality measures proven over time to be positive contributors to excess returns. A comparison of the two graphs at right shows buying companies with highly rated debt would produce an erratic return stream with slightly negative long-term value, while using our Earnings Quality measure delivered positive returns much more consistently.





The chart in the next column illustrates returns associated with traditional quality measures. Investors reward companies for earnings stability, low debt ratings are neutral in their eyes, and high return on equity appears to be a losing strategy. Earnings cyclicality is the most consistent factor. The most stable earners had an average annualized return 4.4% greater than the least stable earners. The most attractive debt ratios were not consistently rewarded, but there is benefit in avoiding the most leveraged of the Russell 1000. Finally, relative returns to underlying profitability, as defined by return-on-equity (ROE), are very unstable and the least profitable were the best investments in this analysis. While we do not subscribe to the notion that low profitability is an attractive investment strategy, we do recognize the inputs to ROE can be manipulated in a way that makes it an unreliable measure of comparison between stocks. While traditional quality is intuitively desirable, it is statistically less effective.

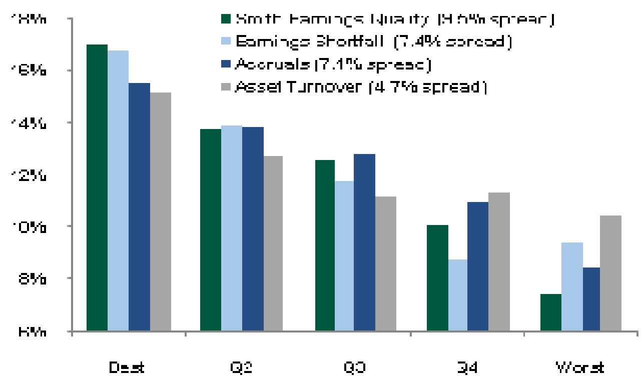


In contrast, Earnings Quality indicators are dramatically more consistent and demonstrate information value in producing stock returns. The chart at top right illustrates a few of the inputs we use and shows the combination of components is stronger than any of the individual elements. Investing in progressively better ranked stocks in each of the individual indicators produces a consistent benefit. Earnings shortfall, a measure of non-cash earnings, is the most powerful. Balance sheet accruals and asset turnover are also effective, but the most compelling case is how they work together to produce a composite Earnings Quality indicator that is more stable and adds more value than even the best individual components. Over the long-term, companies in the top quintile beat those in the bottom by 9.5% annually.

Smith Quality

The Smith Group is a high quality investor and we tend to avoid companies that rank poorly using traditional measures.

Returns Sorted by Earnings Quality Inputs[2]



We believe it helps us avoid some of the worst negative surprises. Yet our excess return is primarily driven by utilizing the predictive value of earnings quality trends to identify companies with earnings growth prospects that are accelerating or deteriorating faster than is widely expected by the consensus.

[1] Difference between the average rolling 3-month returns of Russell 1000 companies sorted by high (A- or better) and low (BBB+ or worse) S&P senior debt rating or between the best and worst 20% of companies ranked by the Smith Earnings Quality factor

[2] Average monthly return of Russell 1000 companies annualized for companies sorted into quintiles by the stated quality factor. Period Jan-96 to Feb-11 except from ROE, which is Jan-03 to Feb-11 due to data availability