Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Stock Pickers Rejoice

BRAD BAKER, CFA

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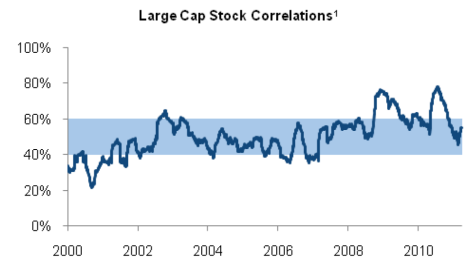
In the middle of last year we joined the chorus lamenting how macro driven markets had become. Some pundits even suggested that so much money was flowing to Exchange Traded Funds (ETFs) that the age of bottom-up stock-picking was drawing to a close. When stocks are indiscriminately bought and sold due to money flow rather than whether or not they possess attractive characteristics, it is tough for earnings driven investors, such as Smith Group, to differentiate themselves. Thankfully, those market conditions have largely reversed and investors are once again rewarding companies with better fundamental traits.

The return to normalcy is best observed in correlations between individual stocks and the market. The graph below shows how closely correlated stock returns had become in the Russell 1000 in mid 2009 and how those relationships have returned to levels similar to what they were prior to the financial crisis. Apparently, reports of the death of stock specific price drivers were premature. At the time stocks were moving in lockstep, there was a flood of money into ETFs and daily market fluctuations were driven by macroeconomic news. Similar macro forces are still present today but correlations have not had the commensurate spike. While it was very easy to conclude there was a new normal in play, where the main driver of returns was something other than identifying good companies, the data does not support that conclusion. Looking back over history, stock prices move most broadly in the same direction when the market is experiencing a precipitous drop. In fact, the most prominent jump in stock correlation occurred during October 1987 in the midst of Black Monday. From this data it appears stock correlations are the result of a much more basic human characteristic; fear. When the fire alarm goes off and everybody rushes for the door there is very little thought given to which stock to sell.

Digging more deeply, there are some interesting differences between sectors. For instance, the highest correlations tend to be in Energy, which is a fairly recent phenomenon. There was a significant increase in correlations in the sector in the late 1990's, which appears to have established a new range (graph below). Several mega-mergers occurred between integrated oil companies around the same time, which might explain less return dispersion.



At the other extreme are consumer companies, with lower average correlations (chart below). Both Consumer Discretionary and Staples sectors encompass a broader subset of industries, with more disparate profit drivers than other sectors. Because of this it should not be too surprising the opportunity for stock selection is greater within these two stock groupings.

In our portfolios we are once again experiencing rewards for picking the right stocks as correlations have moved toward normal. Stock price relationships with the market have dropped in all sectors but are still marginally above the median, so we expect to see even more opportunity as correlations drop further.

[1] *Average correlation of 60-day returns of Russell 1000 companies with the Equal Weighted Index (sector correlations are with sector index returns)*