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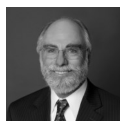

Finding Unexpected Growth

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From the beginning of my career in the investment management business over 35 years ago, I have found that the key to producing positive excess returns is to identify companies that will grow their earnings faster than what is expected by Wall Street. Originally that meant focusing on next quarter's earnings report and finding companies that would report a "positive earnings surprise". As the years passed, this became such a popular approach to growth-oriented investing, and companies' management became so adept at manufacturing these positive surprises, that the performance power associated with finding quarterly positive surprises diminished.

At Smith Group, we have adapted to this new paradigm by lengthening our forecast horizon from quarterly surprises to 12-month surprises. One of our primary gauges for whether our investment team is successfully performing its stock-picking role is whether our portfolio companies deliver a higher level of earnings growth a year from now than was expected at the beginning of the period. We have indeed been successful at finding companies that produce a 12-month earnings surprise. The typical large cap company, as represented by the Russell 1000 constituents, has fallen short of forward 12-months earnings expectations by a margin of –1.5% over the last ten years and the typical small cap company, as represented by the Russell 2000 constituents, by a gap of –9.0%. This shortfall is in contrast to our experience where our large and small cap portfolios have held companies that on average delivered earnings better than expectations over the same period.

To find this unexpected positive growth, we have developed a number of tools beginning with how we construct our Buy List of eligible companies for our client portfolios. The models that we have developed over the years point us toward companies that have improving Wall Street earnings expectations, excellent earnings quality, and reasonable valuations.

Once the Buy List is formed, our eight member investment team conducts fundamental research in a way that is somewhat different from what I have seen at many of our peers. All of us have either a CFA charter or a CPA, and have years of fundamental research experience, which is important in the final analysis of portfolio holdings. But we go beyond traditional fundamental research. We set out to better understand the relationship between analyst expectations and reality. In many ways, our technique relies on the behavioral qualities of both Wall Street analysts and company managements.

Here is a sample of some of the relationships we consider when searching for unexpected 12-month forward earnings growth:

- Individual analyst revisions – Rather than relying solely on an aggregate earnings revision model, we dig deeper to the level of the individual analysts to determine the timing and magnitude of estimate changes. Sometimes we even look to the apparent motivation of the analyst's decision to change his/her earnings estimate. Greater understanding of the underlying data adds value.
- Pattern of quarterly earnings reports – We track both the trend of a company's earnings surprise reports and the behavior of the consensus earnings estimate leading into the report date. Our preference is a company that has steadily rising earnings estimates going into their quarterly report and then beats the ever-increasing consensus estimate. This indicates management is not artificially manufacturing a positive surprise.
- Sales revisions – To avoid the recent tendency of companies to primarily grow their earnings through an expansion of their profit margins, which is a technique that has limits, our preference is for a company to beat the consensus for both earnings and sales. This is a more sustainable trend for companies in the acceleration phase of their growth cycle.
- Low growth preference – Our studies show that companies with a low expected growth rate tend to have a higher likelihood of beating expectations. So, unlike most growth-oriented investors, we prefer a lower expected earnings growth rate that a company beats, rather than a higher expected growth rate that the company only matches. Our process benefits as expectations rise, while other growth managers often

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Unexpected Growth

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suffer from owning companies with unsustainably high expectations.

Going all the way back to the 1970's, my experience tells me the stock market, with the vast number of trades that are done, is an efficient pricing mechanism for known information regarding earnings growth rates. The key to adding positive excess return to what is provided by the stock market is to invest in companies with surprisingly positive earnings growth rates. At Smith Group, our investment process is to find that type company and own them in our client portfolios. Our performance record shows that to be a sound approach to investing.