

THOMAS SMITH
AND ASSOCIATES

**INVESTMENT
PHILOSOPHY
AND
PROCESS**

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INTRODUCTION

A 2003 DALBAR* study revealed that over the past 19 years the S&P 500 Index** had earned an average of 12.22% annually. Yet, over that same period the average equity mutual fund investor earned a paltry 2.57% annually! The difference in wealth accumulation between these two return numbers is staggering. Over 19 years, a \$1 million dollar investment would grow by \$7.9 million to a total of over \$8.9 million if compounded at 12.22%, while a \$1 million dollar investment would grow by a mere \$600,000 to just over \$1.6 million if compounded at 2.57%. This \$7.3 million difference in wealth accumulation represents a cumulative return of 730% of the original investment!

During this time, inflation, as measured by the Consumer Price Index averaged just over 3%, which means that the typical equity fund investor actually *lost* money in terms of purchasing power. The reason for this dismal investor performance had little to do with the now well-recognized fact that the overall markets, as defined by the various indexes, outperform most investment managers over time. It's primary cause was investors letting their emotions whipsaw them into and out of the markets, typically at the worst possible times. As equities rose to new heights overly optimistic investors jumped into the market just before a correction began. As the correction turned into a bear market fear drove investors to the sidelines. As a recovery in prices emerged fear kept them on the sidelines. As the recovery continued, optimism drew them back into the market just in time for the cycle to repeated itself all over again. Investors lacked a disciplined strategy, tailored to meet their own personalities- a strategy they could stay committed to over the long-term.

But, the story gets even worse. After-tax returns were even lower still. The vast majority of equity fund managers pay little attention to the negative tax impact of their typically high-turnover strategies. This was exacerbated by the additional taxes subtracted as clients repeatedly purchased and sold their fund shares.

This is no way to build wealth! That the average equity fund investor would actually lose money during one of the greatest long-term market cycles ever experienced is a travesty - a travesty Thomas Smith and Associates seeks to rectify through a disciplined combination of common sense strategies that clients can stay committed to and effective, tax-efficient portfolio management that helps them capture the tremendous wealth building power that our markets hold.

Within this brochure we will introduce you to our way of helping clients build wealth. From our investment philosophy to our model portfolios - from tax considerations to the value components which drive our fees - we will address the totality of our approach.

Thomas Smith and Associates is a unique wealth management firm - one with which we hope you will partner for many, many years as together we maximize the growth of your hard-earned money, building wealth that you can draw upon to attain all of your goals and realize all of your dreams.

*DALBAR is the nation's leading financial services marketing research firm.

**The S&P 500 is an unmanaged index of large company stocks created and maintained by Standard and Poor's.

INVESTMENT PHILOSOPHY

The Importance of Asset Allocation

Rigorous academic studies performed over the last half-century have clearly identified the overwhelming importance of the asset allocation decision in diversified portfolio management. Over time, 90%-95% of the performance of any given diversified investment portfolio is determined by its particular exposure to various asset classes. Investors have many asset classes in which they can invest including, but not limited to, stocks, bonds, cash, precious metals, and real estate. History has demonstrated that each asset class has particular long-term return and short-term volatility characteristics. The unique characteristics of each asset class and the interplay that occurs when they are combined must be the primary considerations when designing a proper investment strategy. Individual security selection, trading costs and the timing of various buy and sell decisions will also impact performance over time, but their impact is merely incremental relative to the critical asset allocation decision.

At Thomas Smith & Associates we focus first and foremost on determining the most appropriate strategic asset allocation strategy for each client. While the asset class choices are virtually endless, we have found that most all of our clients can successfully meet their investment objectives utilizing the three asset classes with which they are most familiar and comfortable – stocks, bonds, and cash. Therefore, these are the asset classes we utilize in constructing diversified investment portfolios.

Equities for Growth

Equity securities (common stocks) are the growth engine of our portfolios. Historically, over the long-term stocks have provided real returns even after adjusting for the two major value-robbing factors - inflation and taxes. Bonds, by contrast have provided little real return. Because it is our goal and the goal of our clients to build *real* wealth over time, we rely upon stocks to provide us with the opportunity for growth.

Fixed-Income and Cash Investments for Stability

Fixed-income securities (bonds) and cash investments (money market funds) have historically been less volatile than stocks. The insertion of these assets into an equity mix will smooth the volatility of the overall portfolio. In the long run this exposure will diminish total return prospects, since these asset classes have historically returned less than stocks. However, experience has taught us that clients will actually build more wealth if they have an investment strategy that matches their psychological ability to endure short-term volatility and thus remain fully invested. It is impossible to build wealth while letting emotion drive you to frequent changes in your investment mix.

EQUITY INVESTMENT PROCESS

Dependable Earnings Growth

If asset allocation is the key and equities are the growth asset of choice, we must capture the growth potential of stocks for our clients in concise, efficient portfolios. The key driver of equity appreciation is the growth of company earnings, as earnings are the return that equity shareholders receive from their investment. The higher the prospects for future earnings growth, the greater the potential return to the shareholder and thus the greater the present value of the stock. A stock's price rises as expectations of future earnings prospects rise. A stock's price falls as expectations of future earnings prospects fall. All things being equal, a company with greater anticipated earnings growth will see its stock price rise above that of a company with lesser earnings growth prospects.

Some companies, however, tend to be very dependable in their generation of earnings, while others tend to be more erratic. The more erratic the earnings generation, the more volatile the stock. At Thomas Smith & Associates, we focus on stocks of companies who have demonstrated a past history of very dependable earnings generation. As we look to expectations of earnings growth over the next five years, we want to have a high degree of certainty that the earnings growth will indeed materialize. The more erratic a company has been in generating dependable earnings in the past, the greater the anticipated future earnings growth we will demand before we consider investing.

Since earnings growth drives stock appreciation, we make certain that our equity portfolios have five-year projected earnings growth rates that are above the average for the indexes with which they are compared. The desired result of this process is to deliver for our clients growth that is above that of the comparable equity index with less volatility along the way.

Proprietary Screening Process

Our firm utilizes a proprietary quantitative process developed by Thomas Smith to identify stocks for investment consideration. We screen from virtually the entire universe of domestic stocks (over 8,000) to find our candidates. Typically, only around 150 meet our stringent criteria. At any given time we are invested in around 65 - 70 of these candidate names. This process allows us to deliver excellent risk-adjusted returns for our clients relative to the overall equity market.

EQUITY INVESTMENT PROCESS

The Purchase Decision

When choosing stocks from our candidate list in which to invest we seek to identify those that have the best total return prospects over the next five years. We take this longer term perspective in order to reduce portfolio turnover, as excessive turnover produces higher trading costs and short-term capital gains taxes, both of which reduce overall returns. While expected earnings growth rates, past earnings predictability and future total return prospects are the key determinants of selection, over 30 different criteria are actually taken into consideration during our purchase selection process. We take great care before we buy because we plan to hold our choices for an extended period of time.

The Sell Decision

The decision to sell can often be more difficult than the decision to buy. There tends to be more emotion involved in selling an investment and successful investors have learned to take much of the emotion out of their decision making process. To help us negate as much emotion as possible Thomas Smith developed a proprietary quantitative sell discipline that aids us in differentiating between a stock's normal fluctuation and that of a downward movement that indicates larger fundamental problems. The process also helps identify when a winning stock has become overextended, leaving little opportunity for further appreciation.

Portfolio Construction

Though a great deal of time and effort is expended in the selection, purchase and sale of individual stocks, all of it pales in importance to the portfolio construction. This, we have found, is the most misunderstood aspect of investing, as most investors focus on the individual securities rather than the overall characteristics of the portfolio.

As stated earlier, we construct concise equity portfolios that attempt to capture the performance characteristics of the overall equity markets as reflected by certain benchmark indexes. Therefore, we are sensitive to portfolio characteristics such as average weighted market cap, sector weightings, market exposure, and style exposure and how they relate to the appropriate comparison indexes. Individual security selection and retention is not treated in isolation, but rather viewed in the context of how it impacts the overall portfolio.

In the end, two proprietary model portfolios guide the construction of the equity exposure in all accounts. They are utilized to effectively and efficiently meet the growth needs of all Thomas Smith and Associates clients.

EQUITY MODEL PORTFOLIOS

Cornerstone Equity

There are over 8,000 publicly traded domestic stocks. However, the stocks from 500 of the largest companies, which constitute the S&P 500 Index, account for almost 80% of the capitalization of the entire domestic equity market. If asset class is the key determinant and you decide to include domestic equities as an asset in your portfolio, you must have significant exposure to the large company stocks which comprise this index. They are the cornerstone of your equity asset exposure.

Thomas Smith created the Cornerstone Equity model portfolio in June of 1999 to deliver to clients the performance characteristics of large company stocks as defined by the S&P 500 Index. Since that time, Cornerstone Equity has delivered better returns *and* less volatility than the index, all while holding an average of only 33 stocks. Because overall portfolio construction factors are aligned with the index, Cornerstone has tracked the S&P 500 closely. However, because of our focus on companies with past earnings predictability and superior future earnings growth prospects, Cornerstone has been able to deliver better actual returns and lower volatility than the index.

Completion Equity

In September of 2000, Thomas Smith created the Completion Equity model portfolio to capture the performance characteristics of the remaining 20% (by capitalization) of the domestic equity market, which is comprised of stocks from the thousands and thousands of mid-size and small companies not included in the S&P 500 Index. The name Completion Equity is an obvious reference to completing one's exposure to the domestic equity asset class.

Completion Equity has typically included only around 33 stocks and is constructed to track the S&P 1000 Index. The S&P 1000 Index is a combination of the S&P 400 Mid-Cap Index and the S&P 600 Small-Cap Index - its goal being to accurately reflect the domestic equity market outside the large-cap S&P 500.

Because there are many more stocks in this universe, capturing their performance characteristics in a concise portfolio is more problematic than it is for large-cap stocks. Despite these challenges, Completion Equity has also been able to deliver better returns than the S&P 1000 Index with less volatility.

OTHER CONSIDERATIONS

Taxes

Taxes can be an enormous impediment to effective wealth accumulation over time. Nearly all of our clients have an acute awareness of this phenomenon. At Thomas Smith and Associates, we manage each of our portfolios in a highly tax-efficient manner. Pre-tax returns closely match after-tax returns. We accomplish this by keeping turnover low. When stocks are sold they have usually been held for a long enough period so that lower capital gains tax rates apply to the profits realized from the sale. In addition, realized losses can often be taken in a timely manner to help reduce a client's overall tax amount for a particular year.

Turnover

As mentioned above, we work to keep turnover low in our portfolios. There are costs associated with trading, both in terms of commissions and bid-ask spreads. Low turnover keeps costs at a minimum and boosts long-term performance potential.

Tactical Allocation

Fundamentals drive valuations over the long-term, but market sentiment can materially impact prices over the short-term and intermediate-term. Thomas Smith and Associates utilizes a proprietary process to determine when equity pricing may be overvalued or undervalued in the aggregate. As such, we will engage in tactical allocation strategies to reduce risk and increase return to a client's overall portfolio. We do not attempt to time the markets, so this is a practice in which we rarely engage. Still, we consider it imprudent to leave strategic allocation strategies unaltered when fundamentals clearly indicate that doing so would not be in the best interest of the client.

FEES

Thomas Smith and Associates is a fee-only investment advisor, which is to say, we derive no income from commissions. We are not salesmen - we are a financial advisory and professional portfolio management services firm. We assess no up-front charges and no exit fees. The fees we charge are completely transparent and clearly defined before you engage our services. These fees are billed in arrears and drawn directly from accounts on a monthly basis. Our clients may immediately cancel their agreement with us at any time, at which point our fees will instantly cease. There are no hidden or unexpected costs. This approach provides our clients with the utmost comfort and flexibility. They are able to easily assess the value received at any given point in time. As a result, we must earn our keep each and every day. If clients choose to leave, the income we derive from servicing their account instantly ends. But, if they prosper and choose to stay, we prosper as well.

The Value Components

From our perspective, there are three main value components which drive the charges associated with any investment service or product. These components are **advice**, **portfolio management** and **administration**.

We define **advice** as the process of helping clients define their financial objectives and strategically guiding them towards successful realization of those objectives. Some “do-it-yourself” investors feel they have no need for such assistance and therefore avoid paying the cost by utilizing discount brokerages or no-load mutual funds. Our clients see value in our professional advice for which they are willing to pay a fee.

Portfolio management, we define as the process of building and maintaining an investment portfolio or portfolios to successfully implement the strategy that the advisory component has defined. Though no-load mutual fund investors have eschewed advice, they are willing to pay the fund an internal portfolio management fee. An investor purchasing and selling individual securities through a discount brokerage firm has decided to personally handle both the advice component and the portfolio management component, paying a fee for neither. Our clients see value in our professional portfolio management for which they are willing to pay a fee.

The final value component, which we call **administration**, encompasses all of the multitude of activities associated with the daily requirements of account administration including trade execution and clearing, bookkeeping, statements, etc. This is the only component for which our discount stock trader above is willing to pay. These costs are assessed by the firm that holds your account and not Thomas Smith and Associates. The vast majority of our clients hold their accounts at LPL Financial Institution Services located in Charlotte, NC. We have arranged for our clients to pay minimal fees for their services and we derive no income from these fees. The administrative functions that we perform, separate from LPL FIS, we provide at no additional charge as long as the account is held at LPL FIS.

FEE SCHEDULE AND ACCOUNT MINIMUMS

Listed below are the annual fees for our services as they relate to the three value components identified. These are annual fees which are drawn directly from accounts in monthly increments at the end of each month.

Fee Schedule

Asset Level	Advisory Services	Portfolio Management	Administration*	Total Fee*
Up to \$250,000	0.70%	0.70%	No fee*	1.40%*
\$250,001 - \$500,000	0.60%	0.60%	No fee*	1.20%*
\$500,001 - \$1,000,000	0.50%	0.50%	No fee	1.00%
Over \$1,000,000	0.40%	0.40%	No fee	0.80%

*Thomas Smith and Associates assesses a 0.25% annual Administration Fee on first \$500,000 for accounts not held at LPL FIS.

This is a tiered fee schedule. The fee for the first \$250,000 in assets is 1.40%. The fee on the next \$250,000 is 1.20%. On the next \$500,000 the fee is 1.00%. On all assets above \$1,000,000 the fee is 0.80%. Therefore, as an example, the average annual fee on a \$500,000 account is 1.30%. The average annual fee on a \$1,000,000 is 1.15%. This schedule applies to equity accounts. Fees for asset allocation blend accounts will be less depending upon the level of fixed-income asset exposure.

Account Minimums

The minimum account size at Thomas Smith and Associates is \$250,000. Some account minimums may be higher depending on the amount of fixed-income exposure required to produce a client's appropriate strategic asset allocation strategy.

THE FIRM'S PRINCIPAL

Thomas G. Smith, Jr., CFP, CFA

Thomas Smith began his financial services career 18 years ago, learning the investments industry from the ground floor up. Over the years he has gained experience as a trading desk broker, operations and trading supervisor, Compliance Director for a major regional investment firm, Director of Research and Financial Planning Services for the same firm, and a Senior Portfolio Manager for a registered investment advisory firm. This well-rounded background has enabled him to build a working knowledge of most every aspect of the financial services industry. Along the way, he obtained the two most prestigious professional designations in the industry - Certified Financial Planner (CFP) and Chartered Financial Analyst (CFA).

The CFP designation was introduced in 1972 and has become the most widely recognized financial planning credential among consumers. The Certified Financial Planner Board of Standards in Denver, Colorado, oversees the use and qualification of CFP Candidates. CFP licensees are individuals who must meet the initial certification and re-licensing requirements of the CFP Board. The CFP certification process involves completing an extensive two-year course of study in financial planning, passing a comprehensive examination, showing experience in financial planning and agreeing to adhere to a code of ethical conduct. The licensee must also complete 30 hours of continuing education every two years with a mandatory two hour Ethics Course. The purpose of this credentialing process is to assure the public that financial planners who are authorized to use the marks CFP and Certified Financial Planner meet rigorous professional standards.

The Chartered Financial Analyst (CFA) Program is a globally recognized standard for measuring the competence and integrity of financial analysts. The CFA program is sponsored by the CFA Institute. First awarded in 1963, the CFA charter has become the designation of professional excellence within the global investment community. Around the world investors recognize the CFA designation as the definitive standard for measuring competence and integrity within the profession of investment management. Those who earn the right to use the CFA designation demonstrate a commitment to lifelong learning that is essential to providing the high-quality service that today's investment industry demands. Its curriculum develops and reinforces a fundamental knowledge of investment principles. Three levels of examination measure a candidate's ability to apply these principles at a professional level. The program is a minimum of three years in duration with over 2,000 hours of study. The CFA exam is administered annually in more than 70 nations worldwide.

This rare combination of experience, education and professional development has put Thomas Smith in a position to provide a unique service for clients of Thomas Smith and Associates.

CONCLUSION

Never in history have investors had so many options from which to choose. Never in history have investors had so much real-time information freely and readily available with which to make their decisions. Yet despite it all (or maybe even because of it all) the DALBAR survey clearly reveals that their efforts to maximize the growth potential of their investment capital has been thwarted. Much of the blame for this can be laid at the feet of the very industry that is supposedly committed to seeing that they succeed in their investment endeavors.

The “do-it-yourself” segment of the financial services industry would have you believe that anyone - even those who must meet the time requirements of their full-time careers - can succeed on a part-time basis just as well as trained and experienced professionals who work at investing full-time. While there are doubtless some rare individuals who are up to the task, the results of the vast majority are not encouraging.

The advisor segment of the financial services industry is dominated by commission-based approaches that give rise to natural conflicts of interest between advisors and the clients they are supposed to serve. In an attempt to generate sales, more and more products are created, but in the end these products are simply new ways of packaging the various asset classes that are the real drivers of performance.

We are biased of course, but we feel we have developed a unique advisory approach that eliminates the conflicts of interest - a strategic approach that helps clients avoid emotional mistakes and a portfolio management approach that succeeds materially in the long run by not trying to succeed dramatically in the short run. Our service is not for everyone. It is for those who are seeking a trusted and competent advisor and manager to whom they can delegate the monumentally important task of protecting and growing their wealth with a level of care and expertise that is better than that which they could do, or choose to do, themselves.

In the end it boils down to two beliefs. First, we feel that even after paying our fees you will end up with more wealth in the long run by employing our services than you will if you attempt to do it yourself. If this were not so it would make no sense for you to hire us. Second, if you recognize a need to pay for advice and portfolio management services, we feel we can help you build more wealth than you would realize with any other financial services firm. We base this belief on the nature of our processes and the reasonableness of our fees. If you agree, then we need to take the next step by having you read our publication entitled *Designing Your Investment Strategy*, which helps us identify the appropriate strategic investment strategy for you.

Thank you for taking the time to read this brochure and thank you for considering Thomas Smith and Associates.