Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

1Q 2009

REVIEW & OUTLOOK

"A thing long expected takes the form of the unexpected when at last it comes."

– Mark Twain

Despite a late rally that lifted stock prices—and spirits—from the abysmal levels of early March, the first quarter of 2009 was another bad one for stock markets around the world. The S&P 500 Index of large U.S. companies declined 11% in the quarter, while small cap stocks suffered a drop of more than 14%. Bonds generally held their value over the last three months, once again outperforming stocks even in the face of heavy issuance from governments and corporations alike.

More than enough punditry about the causes and the required remedies for the malfunctioning financial markets and the comatose global economy is available over the airwaves, on the internet and even in old-fashioned print media. Much of this bumper crop of "expert" commentary examines the events of the past 18 months and draws grim comparisons with the 1930s, leaving investors feeling uncertain, fearful and even angry. These days it seems that many of us expect the worst.

Numerous indicators underscore the discouraged state of investor expectations. In the six months ended February 28, net outflows from equity mutual funds totaled more than $200 billion, while money market mutual fund balances increased by $285 billion. The yield on 90-day U.S. Treasury bills was below zero in late March, an unusual condition that illustrates just how eager nervous professional and individual investors are to avoid risk. According to Ned Davis Research, measures of investor sentiment derived from polls reached "extreme pessimism" levels in early March, as the S&P 500 sank below levels last encountered in 1996. The soaring price of gold—considered by some to be the ultimate store of value in times of hardship—can also be viewed as an indicator that investors' expectations are quite pessimistic.

The seeds of financial market recovery are germinating in these very gloomy expectations. Almost everything that happens in the financial markets can be explained by the difference between reality and generally held expectations of what ought to be. For example, the epic collapse in technology stocks that triggered the crushing bear market of 2000 – 2002 can be attributed, in large part, to the unrealistic expectations about future growth rates in those days. When technology companies encountered a routine cyclical downturn beginning in early 2000, the mismatch between lofty expectations and pedestrian reality led to a market rout. On the other end of the spectrum, when expectations become so low that small incremental positives, or even a lack of bad news, constitute a pleasant surprise, stock prices are poised to stabilize or even recover lost ground. The current state of expectations suggests we are at or very near one of these points today.

The Critical Role of Earnings Expectations

Corporate earnings are a very important factor in Thompson, Siegel & Walmsley LLC's ("TS&W") investment process. Earnings underpin corporate cash flow, which is the primary focus of our fundamental analysis and valuation calculations. In addition, we pay attention to how expectations

about earnings are changing over time and how reported earnings compare with widely held expectations. We favor companies for which earnings expectations are improving relative to their peers and those that show a consistent ability to exceed earnings expectations. Very few firms can produce steadily rising earnings in the present environment. Therefore, we are paying special attention to companies whose results exceed expectations, even if those results are below the prior year's level.

> *"...profit expectations may finally be reaching the point where fewer companies will post results that are significantly worse than what investors expect."*

With the economy now well into the second year of a severe economic recession, analysts' estimates of corporate profits have been declining for several quarters. In the early stage of this process, analysts, investors and corporate managers failed to reduce their profit forecasts quickly enough—a habitual problem. Reality, of course, has turned out to be much harsher than expected, causing companies to issue warnings about their profit outlook or to report nasty "earnings surprises." Nearly half of all large companies reported earnings that fell short of expectations in the 4th quarter of 2008. As expectations played catch-up, stock prices rapidly adjusted to the downside, explaining the stock market's poor performance in the final quarter of last year and into 2009.

Expectations about corporate profits will play a critical role in determining the performance of the stock market over the balance of this year. According to Starmine, a service that compiles and analyzes analysts' corporate earnings predictions, first quarter 2009 profits for the Russell 1000® Index of large U.S. companies are expected to decline by about 38% compared with the same period of 2008. Among small cap stocks, the anticipated earnings downturn is even more profound. Analysts currently expect a 62% year-over-year decline in small cap profits in the first quarter.

Although it is impossible to know precisely, profit expectations may finally be reaching the point where fewer companies will post results that are significantly worse than what investors expect. The growth rate of corporate profits has now fallen well below the long-term trend, as has the level of corporate profit margins. Company managements have also wised up about setting unrealistic expectations. Many companies have withdrawn any earnings guidance for the year ahead, and those that are willing to offer a forecast are taking an extremely cautious stance, something that was rare even a year ago. As we move through 2009 and comparisons to the prior year become progressively easier to match or beat, more companies will be in a position to meet or exceed lowered expectations. For the full year, analysts expect large cap profits to be down 30-40%, but the consensus expectation is that 4th quarter 2009 profits will show an increase over 2008's bombed-out level.

We are not arguing that corporate earnings news over the next few quarters will be sunny. To the contrary, with U.S. GDP certain to be down for the fifth consecutive quarter in the period just ended March 31, there is little chance that aggregate earnings will be anything but terrible. We do think, however, that at some point quite soon collective

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expectations will be just as bad, and perhaps even worse than reality, and the capacity of bad news to shock market participants will be exhausted. Just as analysts and investors habitually overestimate earnings as the cycle peaks, they become too pessimistic near the bottom, setting up markets for surprises of a happier sort.

What Did You Expect?

The linkage between expectations and stock prices is valuation, which is another important factor in TS&W's investment process. Low valuation indicates that expectations are also low, while high valuation

points in the opposite direction. Back in 1999, large cap stocks sold at nearly 30 times earnings and offered historically low dividend yields. This sky-high valuation was an indication that expectations were very lofty—far too lofty, as it turned out. Today, large cap stocks trade at 13-16 times very depressed 2009 earnings forecasts and offer dividend yields that exceed medium term U.S. Treasury note yields. This is a sure sign that expectations are modest. This does not tell us when stock performance will improve, or which stocks will do best, but it does indicate that the overall level of downside risk has been substantially reduced. In short, this time of gloomy expectations is a good time to search out investments with an attractive risk-reward ratio.

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TS&W's expectations are born from a combination of experience, careful fundamental analysis and a measure of skepticism about the outlooks offered by corporate chieftains and Wall Street analysts. One part of our investment process is a quantitative screen that identifies stocks that are inexpensive, suggesting that they are the subject of low expectations, yet have some positive change taking place. We use fundamental analysis to set our own expectations, independent from the market consensus, about return potential and downside risk. We invest in those companies that offer a favorable ratio of potential return to risk. Determining that tradeoff usually comes down to getting the expectations right.

At our weekly research meetings and less formal gatherings over the last few months, our portfolio managers and analysts have been brimming with ideas that fit this tested formula. We have also noted a few fragments of economic news, such as better housing market statistics and firmer retail sales trends that suggest the cyclical economic downturn may no longer be getting worse. For these reasons, we feel a measure of confidence despite the pervasively gloomy expectations that beset most investors.

As we ponder the eighth major bear market and seventh recession of TS&W's 40-year history, one aspect of the current environment causes us to modify our expectations. The U.S. government's aggressive and unprecedented response to the severe economic downturn should help to jar the economy and the financial markets back to a healthier trajectory. While we welcome this response, we are concerned that the scope and scale of government intervention in business and the economy will fundamentally change the landscape in which investors operate. One TS&W portfolio manager equates the government's activism to a "giant economic science project," the outcome of which we will not know for some time. As we formulate our expectations, we will be careful to examine how new government policies, priorities, programs, taxes and regulations alter competitive dynamics and change the probable outcomes for the companies in which we invest. We expect to find both new challenges and promising opportunities.

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