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Back to Basics

An Interview with Mark S. Tyler, CFA

Basic materials stocks, a nearly forgotten investment backwater through most of the 1990s and the technology-crazed early days of the “new millennium,” made a significant contribution to Thompson, Siegel & Walmsley’s (TS&W) portfolio returns in 2005 and the first quarter of 2006. TS&W began expanding its exposure to the basic materials sector in early 2003, as the US economy emerged from an economic recession that depressed profits and stock prices for many companies in this sector. Since that time, we have maintained a significant representation in materials companies across all of our equity products. The Materials sector encompasses a wide range of commodity-related manufacturing industries, including companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products and metals, minerals and mining companies.

To better explain TS&W’s investment strategy and outlook for the materials stocks, we recently interviewed Mark S. Tyler, CFA, TS&W’s lead analyst for this suddenly glamorous group. Mark was an All-American football player at the College of William & Mary in Williamsburg, Virginia and has been an analyst and portfolio manager for both sell-side and buy-side investment firms for more than a decade. He joined TS&W in 2003.



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- Mark S. Tyler, CFA

Q: Mark, basic materials stocks account for about 4% of the market value of the broad large cap stock market, but they have a larger representation in TS&W portfolios. Why the interest in this relatively small group of stocks?

MT: The answer is actually pretty simple. The current low valuations on what we see as sustainable earnings power makes certain parts of the basic materials sector very attractive to us. Commodity producers significantly underperformed other market sectors during much of the 1980s and 1990s. In addition, certain segments of the basic materials sector experienced business liquidations, consolidation and very modest levels of capital spending. For this reason, when demand for commodities began to pick up earlier this decade, global production capacity in some segments was very tight, causing global inventories of those commodity products to steadily decline. The result is improved pricing and earnings power for certain commodity producers. Combine this with attractive valuations following an extended period of underperformance, and you have exactly the type of situation TS&W looks for: companies with strong and improving cash flow and earnings trends priced at a discount to long-term intrinsic value.

Q: It sounds like not all basic materials companies were created equally.

MT: It is important to distinguish between different subsectors of the materials space when analyzing demand and supply trends. For example, TS&W is less attracted to paper and packaging companies because this industry continues to be plagued by excess production capacity. While a strong global economy may boost demand, excess production capacity prevents paper companies from enjoying pricing power and peak margins. Some chemical companies face a similar situation. Chemical producers are processors of a commodity product, like crude oil or natural gas, which they buy from someone else. If they can’t control the end-market price of their product, they end up facing a profit squeeze from higher input costs. TS&W does not have much exposure to the chemical industry for this reason. One exception is the industrial gas companies, which enjoy higher and significantly more stable returns on invested capital than the average chemical company due to a better

Q: What other groups within the basic materials sector does TS&W favor?

business model. Because many industrial gas producers locate in close proximity to their largest customers, the business is characterized by regional oligopolies and long-term contracts with guaranteed profit margins. The gas companies are also benefiting from strong demand for hydrogen, a key input in oil refining.

MT: In addition to the industrial gases, we favor steel and mining companies right now. Steel stocks are attractive due to dramatically improved industry conditions resulting from the rapid consolidation that is taking place around the world. For example, the U.S. steel industry was in decline for several decades prior to the 2001-2002 recession. The speed with which the domestic industry was concentrated in the hands of relatively few larger companies was unprecedented. Steel-making capacity in the U.S. was reduced to a level in line with that of market demand. The result is an industry that is much more rational with regard to pricing and output and is enjoying significantly improved margins now that demand is increasing.

Q: Is the increased demand for steel due to rapid consumption growth in China?

MT: China is the force behind many global economic trends these days, but steel is a special case. Because of its bulk and the exacting requirements of end-users, steel tends to be a more regional commodity than others. China's demand for steel is growing rapidly, but it is also quickly becoming self-sufficient in steel. The real driver behind rising U.S. demand for steel right now is an increase in domestic public infrastructure and commercial construction spending.

However, China is an important part of the story for the base metals like copper, nickel and zinc, which are also interesting to us. And once again, this is a supply and demand story in its purest form. Demand is being driven by rising living standards in emerging economies around the world, especially China. It turns out that per capita consumption of base metals, like the copper used in plumbing and electrical wiring, is directly related to the advancement of people into the middle class. China's per capita consumption of base metals is at about the same level as the U.S., Japan and Western Europe at the beginning of industrialization, or about one-quarter of today's consumption in those developed economies. China has abundant labor, which allows it to be a low-cost producer of manufactured goods, but the country suffers severe shortages of natural resources. Despite its size, China lacks proven reserves of base metal ores. So China's growing industrial output and rising living standards make it the most significant variable in the demand for base metals.

On the supply side of the equation, there is essentially no additional supply that can be tapped to make up for demand spikes or mine production shortfalls caused by weather, equipment shortages or labor problems. Interestingly, the long downturn in the metals industry spans the entire careers of most managers of global mining companies, as well as the analysts who follow them. Consequently, over the last half of the down-cycle, spending on exploration and development of new reserves was anemic. Many of the new reserves that have been located are in politically sensitive or geographically remote areas, so it is extremely difficult to bring known reserves into production quickly. In addition, development of a new mine is typically a five-year or more process. When we add this up, we see a very favorable supply and demand situation for mining companies with strong reserve positions.

Q: It all sounds great Mark, but these stocks have had a good run over the last year or so. Do you think steel and mining stocks are still a good value?

MT: Yes. The stock price is the most important investment consideration, but the earnings power of the materials stocks we own for clients has grown even faster than the share prices. It is also important to remember that these industries were in a protracted downturn during most of the past quarter-century, so valuation comparisons with the recent past are of little value. The price of most metals in 2001 was in line with the prices last seen during the Great Depression, after adjusting for inflation. Metals prices generally rose for more than four decades after the Depression, so I could make the argument that we are still in the early days of the current upturn. These stocks can be quite volatile in the short-term as the shares react to headlines, but we would need to see demonstrable evidence of either a significant supply response or demand destruction before we changed our positive long-term view. On the supply side, the long lead times and visibility of new mines give us a high degree of comfort that there is not going to be a surge of new supply that drives prices sharply lower.

The demand side of the equation could change if high commodity prices led to a dramatic slowdown in China's industrial production or infrastructure build-up. We keep a close eye on demand trends, but so far global demand for metals remains robust.

Q: The price of gold has more than doubled since 2001 and now stands at a 25-year high. What do you think about the investment merits of gold?

MT: The price of gold and other precious metals is related to commodities such as energy and the base metals, but there are important differences as well. For most commodities, both supply and demand are of equal importance in determining the price. Except for a relatively small amount of base metals that are reclaimed through scrap recycling, most commodities are consumed once and then exit the supply equation. Gold, however, is not a consumable commodity. It is treated more as a store of wealth than as an input into other products. The fact that the total stock of gold in existence gradually expands as new gold is mined, means that the demand for gold is the most important determinant of the price. In reviewing gold stocks, we consider the same types of factors used to review all mining stocks, such as the number of years of reserves a given company owns, the quality of those reserves, and the expense of extracting them. Anticipating the demand for gold, however, is a tougher job, and this difficulty explains our current preference for steel stocks and base metal miners.

Q: Mark, some observers point to the increases in commodity prices, especially for metals, as evidence that the inflation rate is about to rise sharply. How do you respond to that contention?

MT: Higher raw materials prices do create price inflation at the source, but currently, the effects are diluted at every step along the supply chain. Some points along the supply chain feel disproportionate price pressure relative to others. For example, a manufacturing company that we spoke with recently is unable to pass along rising steel prices because of excess capacity in its industry. Until output rises to the point where this capacity is fully utilized, profit margins in that industry will be under pressure. A central focus of our company-specific analysis in every sector of the economy is to separate the companies that can pass along higher costs or offset them with productivity gains from those that are experiencing margin pressure.

Q: Thanks Mark.

MT: My pleasure.

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