



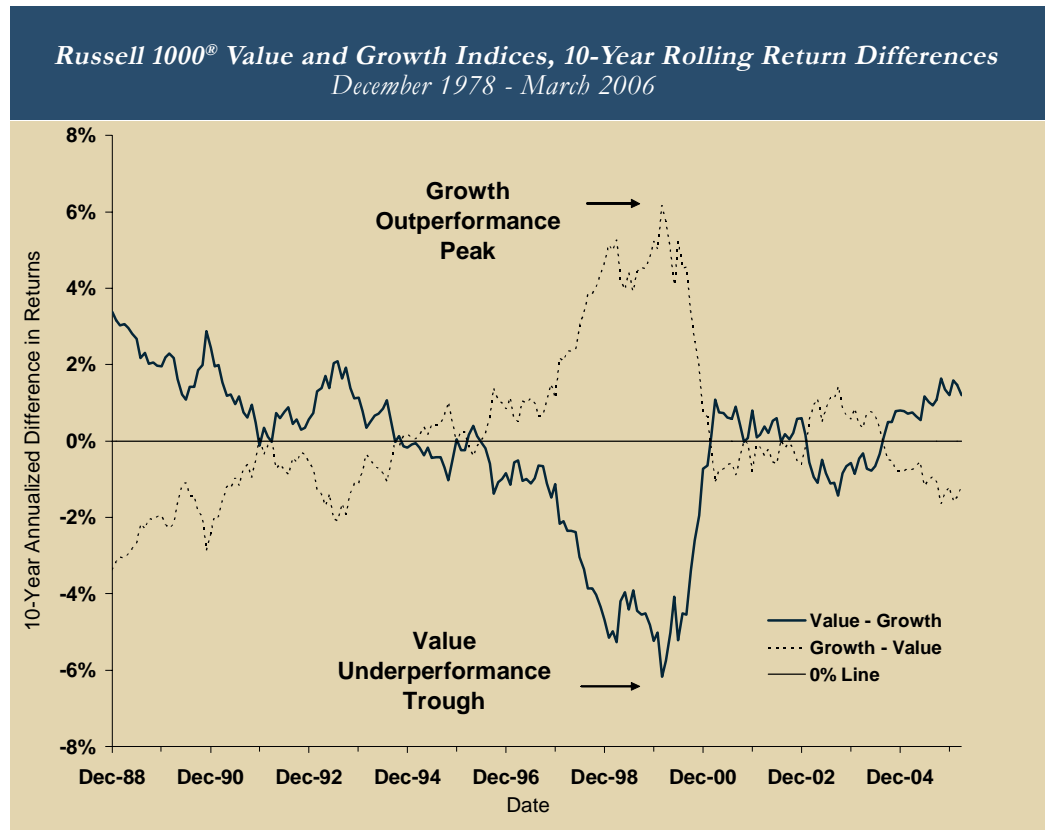
**First Quarter
2006**

No Kidding: Value Beats Growth

The value style of investing produces better risk-adjusted returns compared with the growth style over long time periods. This fact is well-documented in both academic research and in investment style index return data, but it is curiously underemphasized in decisions about portfolio construction and periodic rebalancing. For example, rather than optimizing style allocations based on long-term historical return and risk data and employing disciplined rebalancing practices, many investors attempt to capture excess returns by timing substantial shifts between styles (style rotation) based on periodic return differences and relative valuation observations. Such finger-in-the-wind recommendations are in vogue today after six years of value-style outperformance. Unfortunately, there is little in the way of empirical support for this approach. Thompson, Siegel & Walmsley, Inc. (TS&W) is a strong advocate of both style diversification and portfolio rebalancing, which can mean, at times, reducing allocations to the value style that we employ. We are concerned, however, that the *practice* of style investing appears to follow the philosophy of a noted comedian rather than a more disciplined approach.

Showing Up

“Eighty percent of success,” it has been said, “is showing up.” This baldly obvious nugget appears to explain the persistent belief that investment style returns move through distinct cycles that can be plotted and taken advantage of. This line of reasoning suggests that superior results are available to canny “style rotators” who simply “show up” with the right style at the right time. Presently, for example, some well-known strategists observe that the abysmal performance of growth stocks relative to value stocks over the past six years presents an attractive opportunity for a lurch toward growth investing in anticipation of an inevitable wave of growth stock superiority. Empirical support for this approach is sketchy at best. The graph to the right illustrates the performance differential between large cap value and large cap growth stocks over rolling ten-year (120-month) time periods. We used more than a quarter-century of monthly style index data ending in March 2006 to construct this graph. As you can see,



there have been long periods of performance favoring both styles, but from a historical perspective, the outperformance of large cap value stocks in recent periods is not excessive in terms of either magnitude or duration. This analysis also visually confirms how difficult it is to anticipate the timing of major performance shifts from one style to another. Squint, and you might discern a recent narrowing of the performance gap favoring value, but there are numerous other times when such squiggles proved to be indicators of nothing but noisy data.

It is essential to note that over this entire time period, large cap value stocks outperformed large cap growth stocks by an average of 1.2% per year, or a cumulative total of 36%, and did so with significantly lower risk. The return and risk advantage for small and mid cap stocks is even more pronounced in favor of the value style.

While large valuation disparities might serve as indicators for timing style switches—as was certainly the case with overvalued growth stocks in the late 1990s—valuation alone is rarely a good timing tool. Disparities can persist and reach extremes that are difficult to anticipate. Furthermore, we note that wide valuation disparities do not appear to exist currently, undermining that argument for making an aggressive shift toward growth.

Sleep Well, or Enjoy the Waking Hours?

It has also been observed that “the good people sleep much better at night than the bad people. Of course, the bad people enjoy the waking hours much more.” We think this perfectly explains the persistent allure of the growth style, even in the face of sub par return statistics. For example, many style-diversified portfolios are constructed around a 50/50 mix between value and growth styles as the default, or neutral, allocation. Objective analysis of long-term risk-adjusted style returns indicates that value style portfolios should account for the majority of portfolio assets in all but the most extreme market environments. Since it is not supported by the data, the 50/50 default allocation must be explained by the naughty seduction of catching “the next Google,” and the misplaced confidence that we will know just the right moment to exit. Any worry about risk can be dismissed easily enough: “I’m not afraid of death, I just don’t want to be there when it happens.”

To be fair, the growth style does enjoy periods of outperformance over the value style. As illustrated in the accompanying chart, growth stocks have historically done

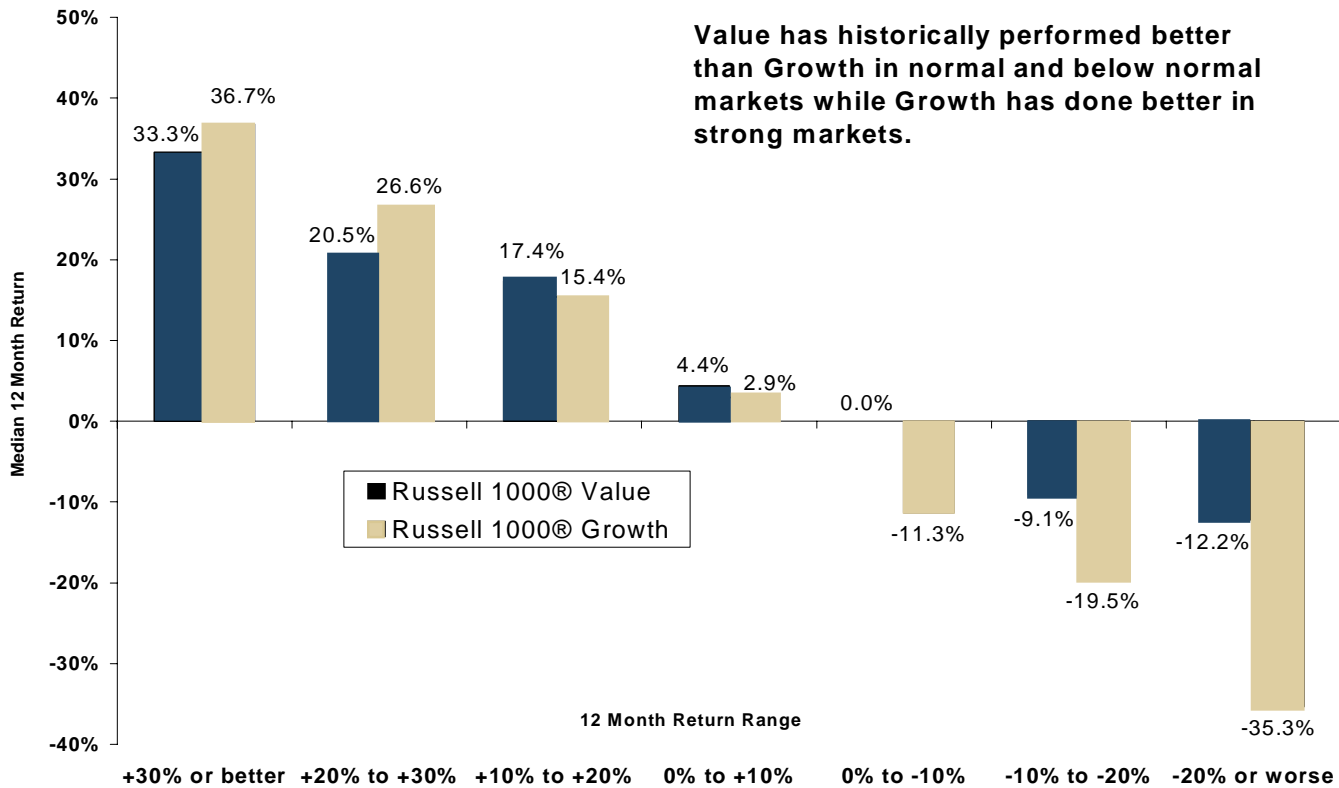
better when broad market returns exceed 20% over a 12 month period. Data from Ibbotson & Associates reveals that large cap stock returns have exceeded 20% in 31 of the past 79 years, or less than 40% of all calendar years. Even using the generously smoothed 120-month rolling time period data, large cap value outperforms 55% of the time. So, from a historical perspective, the facts argue in favor of an emphasis on value, not a 50/50 default position, with a smaller allocation to the growth style aimed at capitalizing on those less frequent periods of unusually high market return. From a forward-looking perspective, TS&W believes that the combination of current valuation and the outlook for corporate profit growth and interest rates suggests a period of mid-to-high single digit stock returns, not the sort of exuberant environment where growth stocks have historically produced better results.

A Better Philosophy

Thompson, Siegel & Walmsley, Inc. employs a disciplined, value approach to stock selection and portfolio construction. Specifically, we use quantitative tools to screen for stocks with the potential for high returns due to attractive valuation and indicators of positive change. Measures of valuation based on cash flow, which forms the basis for long-term intrinsic worth and is less sensitive to accounting manipulation, are the cornerstone of our valuation work. Our team of experienced research analysts conducts thorough fundamental analysis to select the stocks with the most attractive risk/reward ratio for our clients’ portfolios. Importantly, this approach does not incorporate a top-down “plan” to emphasize certain sectors, capitalization ranges, or types of stocks based on our hunches about the next big trend.

In recent months, we have reduced our emphasis on large, integrated oil “majors” in favor of somewhat smaller oilfield services and equipment names. These companies offer better value because we believe they will benefit from expanded exploration and production spending by the cash-rich majors. We have also reduced our exposure to telecom services and utility stocks, while boosting our investments in areas such as technology and non-bank financials. Materials stocks, especially metals and mining companies, and producer durables continue to offer attractive value, in our view.

Thompson, Siegel & Walmsley’s investment philosophy derives from Benjamin Graham, the father of value investing, and not Woody Allen, the Oscar-winning writer, director and comedian whose quotes grace these pages.



Source: Russell 1000® Value and Russell 1000® Growth return data from 12/31/78 - 12/31/05

Nevertheless, we do agree with Mr. Allen that “eighty percent of success is showing up.” Research clearly shows that market timing, or “showing up” only occasionally, does not work, because missing only a handful of the market’s best days results in substandard performance. Since choosing to show up each day necessarily means being present not only on the

market’s best days but also, unavoidably, on its worst, the investment style that enjoys the best results in weak markets and the best overall risk adjusted returns—the value style—should be the foundation of every investor’s portfolio. This insight may account for the 20% of success that Woody Allen neglected to explain.

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Thompson, Siegel & Walmsley, Inc.
 5000 Monument Avenue ♦ P.O. Box 6883 ♦ Richmond, VA 23230
 Phone 804-353-4500 ♦ Toll free 800-697-1056 ♦ Fax 804-355-9410
 Email: tswinfo@tsw-ic.com