TS&W Thompson, Siegel & Walmsley, Inc.
INVESTMENT MANAGEMENT

3Q 2006

REVIEW & OUTLOOK

A TIME OF TRANSITION

Although we are not in the business of economic forecasting here at Thompson, Siegel & Walmsley, Inc. (TS&W), we do follow economic developments closely, since changes in the economic environment can have major consequences for the valuation of stocks and bonds. Economic news in the third quarter warranted particularly close attention because the economy showed clear signs of moderating growth during the period.

Economists generally revised their economic growth projections downward over the last three months as the extent of the weakness in our nation's housing sector became clearer and as the effects of the Federal Reserve's tighter monetary policy worked through the economy.

Activity within TS&W investment portfolios since early this year reflects a moderating economic outlook. In broad terms, we have reduced the economic sensitivity of client portfolios and bolstered exposure to stocks with less cyclical characteristics, trimmed back on energy holdings, and added to financial stocks. Economic data are likely to continue to send mixed signals in the months ahead, but TS&W maintains a positive outlook for stocks and bonds heading into the final quarter of the year. We base this viewpoint on our continued ability to identify stocks with attractive long-term return potential as well as our expectation of further expansion of corporate profits and cash flow, a favorable inflation and interest rate environment, and reasonable equity valuations. Our value investment philosophy and disciplined process are identifying opportunities in some new areas while restraining us from reacting to every wiggle of the economists' charts.

The Economy Downshifts

Stock and bond market indexes showed strong gains in the latest quarter, but the numbers concealed considerable underlying turmoil as investors scrambled to make sense of economic data. Cyclical issues retreated, particularly the energy and basic materials stocks which have performed so well in recent years, while financials, technology stocks, and sectors less sensitive to the business cycle, including health care, consumer staples and utilities, advanced. Market action during the quarter was punctuated by sharp reversals, often in reaction to the latest economic data release or statements by closely-watched Fed officials. Our performance during this unsettled time generally lagged behind the market indexes, but our experience suggests such periods of transition are usually short-lived.

On balance, the economic data pointed to a slowing economy. Growth in output, as measured by gross domestic product (GDP), dropped from 5.6 percent in the first quarter of 2006 to 2.6 percent in the second. Third quarter GDP has yet to be released, but the economic data that are available for the more recent months suggest that growth in output was more moderate throughout the summer. The housing sector, a driver of economic growth only a year ago, has become the weakest link in the economy, and a major impediment to economic growth. Home sales and new residential construction activity have tumbled more than 20 percent below year-earlier levels and stories about "the housing bubble" dominate the financial news shows. If the contraction in housing persists or worsens, pessimists argue, it could create enough of a drag on the economy to bring the expansion to a halt. However, information from groups such as the National Association of Home Builders, as well as studies by the FDIC and the Office of Federal Housing Enterprise Oversight lead us to believe that a housing triggered recession is unlikely. Moreover, key indicators, including the unemployment rate and personal income measures, continue to point to generally favorable conditions for consumers and homeowners.

> "Thompson, Siegel & Walmsley, Inc. maintains a positive outlook for stocks and bonds heading into the final quarter of the year."

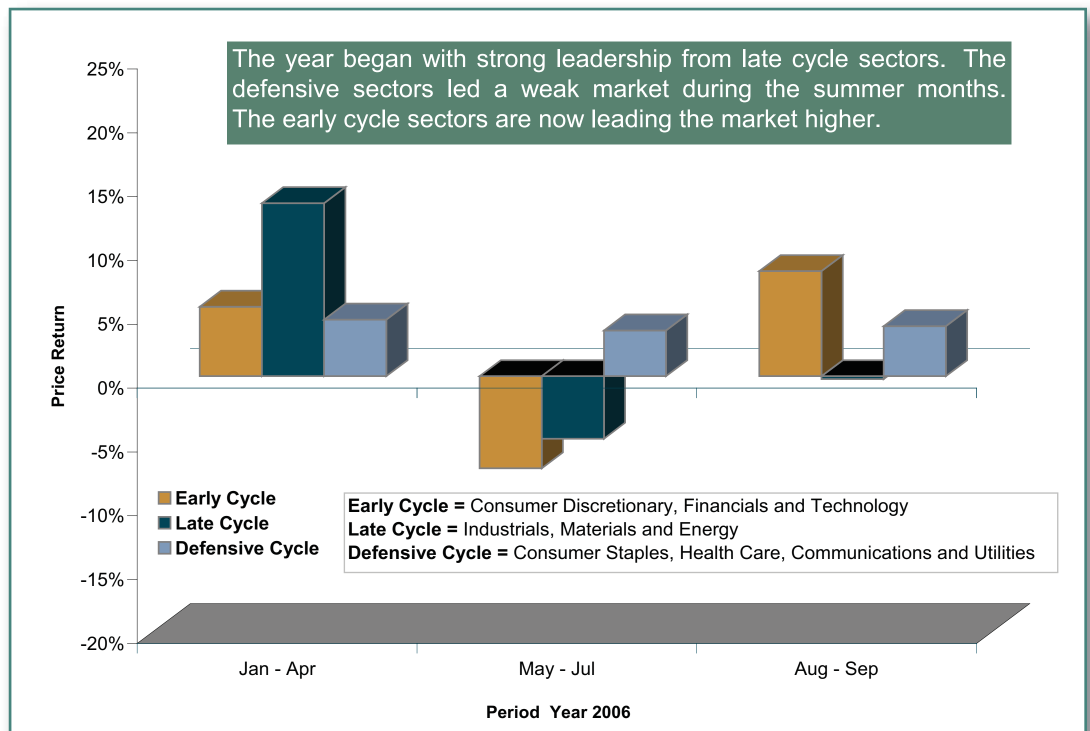
Continued on next page

This shift to a slower growth environment is due in no small part to the efforts of the Federal Reserve to curb inflation. From June 2004 to June 2006, the Federal Reserve's Open Market Committee (FOMC) steadily tightened monetary policy, raising its federal funds rate target from 1 to 5¼ percent. The FOMC left its fed funds target at 5¼ percent when it convened in August and again in September 2006, satisfied that inflation pressures should moderate as the pace of economic growth slowed. This action sent an encouraging signal to bond and stock markets, which immediately anticipated a more accommodative monetary policy. Bond yields dropped sharply in the final weeks of the summer, boosting returns for investors with balanced portfolios and relieving pressure on consumers with heavy debt loads.

A Consistent Approach in a Time of Change

An old joke about economists states that if one hundred of them were laid end-to-end they would not reach a conclusion. This may be because economic data are contradictory at times, such as today, when the economy is in transition from one phase of the business cycle to the next. Although the economists may be uncertain about what's ahead, the stock market has cast its vote. As the graph below illustrates, stock market leadership has changed dramatically since late spring. The best returns have shifted away from cyclical stocks to sectors that are viewed as less dependent on economic growth.

Thompson, Siegel & Walmsley Inc.'s disciplined and consistent methodology for selecting investments is based on valuation measures derived from corporate cash flow, earnings, and relative price movements. All stocks meeting these criteria are subjected to rigorous fundamental analysis by our team of analysts and portfolio managers, and our investment team carefully monitors the progress of each portfolio holding. In recent years, a strong economy and a long-term positive view on energy and commodity prices have supported our preference for economically sensitive basic material, industrial and energy stocks. While we still hold to our long-term view, the mounting evidence of slower economic growth in the near term is causing us to place more emphasis on stocks that should perform better in an environment of moderate growth and stable inflation. Our clients are seeing this preference reflected in changes to their portfolios.



Recent changes to TS&W portfolios can be described by three broad themes:

- First, we have trimmed our exposure to the energy sector. TS&W has held significant positions in major integrated oil companies, exploration and production companies, drillers, oilfield services and equipment firms, and refiners over the past few years, and they have contributed strong returns to client portfolios. We began to lighten our exposure to the sector this summer as the outlook for growth in future cash flow became less favorable relative to share prices. While energy companies will most likely continue to enjoy a prolonged period of prosperity, the return prospects from these stocks are not as bright in a period of slower economic expansion.

- Second, TS&W has toned down the cyclical bias in portfolios we manage by reducing holdings in basic materials and transportation stocks, in favor of companies whose cash flows are less dependent on a brisk pace of economic expansion, including health care, telecommunications and electric utilities, and consumer staples. After spending much of the 1990s and early 2000s in market exile, cyclical issues have been market leaders for the past two years and are no longer inexpensive.

- Finally, we have boosted our clients' exposure to financial services companies. These stocks are attractively valued and we expect banks and other credit providers to benefit from a more favorable interest rate environment as the economy cools and inflation worries recede. Importantly, we do not expect the economy to weaken enough to cause a sharp uptick in consumer or corporate credit losses.

These changes represent some new directions for our clients' portfolios, but they are the product of a consistent investment discipline and philosophy. We continue to focus our efforts on identifying stocks with the best available combination of value and long-term return potential. Strong and growing cash flow, a relatively stable measure of corporate value, is the key investment parameter in this approach. We are confident that our methodical process enables us to position client portfolios for good results as the economy downshifts.

> "Moderate growth and mild inflation can be very attractive for both stock and bond investors..."

Looking Ahead

We suspect economic data will continue to send conflicting signals in the months ahead as the U.S. economy moves through a period of transition. TS&W's assumption is that U.S. economic growth will continue at a sustainable pace and that corporate profits and cash flow will rise, albeit at slower rates than in the last three years. Inflation pressures, a prominent market concern earlier this year, should gradually abate. Moderate growth and mild inflation can be very attractive for both stock and bond investors, especially if such an environment keeps long-term interest rates at favorable levels and prompts the Federal Reserve to resume a more accommodative monetary policy.

Under these circumstances, stock valuations—which have generally contracted as earnings rose over the last three years or so—might expand, producing solid returns even as corporate profit growth slows. Smart security selection and disciplined risk controls, however, will be of paramount importance. Slower economic growth may cause more firms to fall short of optimistic market expectations for earnings growth and encourage more investors to adopt a defensive stance or place bets on a harsher economic contraction. Fully diversified portfolios are likely to withstand the market's ups and downs better than more concentrated strategies.

In this environment, it is essential to maintain an investment discipline and avoid knee-jerk reactions to fluctuating economic data or the latest market gyration. TS&W relies on a tested value philosophy and a rigorous investment selection process—not the weekly economic data calendar—to adjust client portfolios to the evolving economic reality. While our efforts can leave us temporarily out of step with the markets' staccato beat of course corrections, we are confident that our clients will continue to enjoy good results under a wide range of economic outcomes.

ADV OFFERING: *The Securities and Exchange Commission (SEC) requires us to offer, at least annually, our ADV Form – Part II. The ADV is a disclosure form that we must file annually with the SEC. You are not required to take any action regarding this standard disclosure document. Should you wish to receive a copy, please inform your Financial Advisor or send a written request to the return address on the back page.*

The views expressed in this paper are those of Thompson, Siegel & Walmsley, Inc. (TS&W) and are subject to change with market conditions. This paper is for informational purposes only and should not be construed as investment advice, or an offer to sell or a solicitation of an offer to buy any security which may be referenced. TS&W manages portfolios for numerous clients, each with unique circumstances and objectives. Not all securities mentioned may be appropriate for all accounts. Accounts may not hold all stocks listed in this commentary. Historical economic and performance information is not indicative of future results. Registered in U.S. Patent and Trademark Office.

6806 Paragon Place ▪ Suite 300 ▪ Richmond, VA 23230

A Member of the Old Mutual Group

If you have any questions on the content of this publication please feel free to contact:

Thompson, Siegel & Walmsley, Inc.
6806 Paragon Place, Suite 300 ▪ P.O. Box 6883 ▪ Richmond, VA 23230
Phone: 804-353-4500 Toll Free: 800-697-1056
Fax: 804-353-0925
Email: tswinfo@tswinvest.com