TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

1Q 2007

Review & Outlook

The stock market was light on returns in the first quarter, but it certainly didn't lack excitement. Despite all the hype, Thompson, Siegel & Walmsley LLC (TS&W) found the first quarter market action to be about what we expected—a challenging environment where slowing economic growth accentuated volatility. Most portfolios managed by TS&W outperformed their respective benchmarks, producing solid, low-single-digit returns. Although we retain an optimistic outlook for the financial markets this year and we believe stocks will continue to provide the best returns, TS&W is positioning our clients' accounts for more turbulent markets over the months ahead, as slower economic growth and decelerating corporate profit growth bring risk back into focus.

Stocks Inch Forward

Stock market returns in the first three months of 2007 were, for the most part, pedestrian. This is, arguably, a good result following the strong finish to 2006. The Russell 1000® Index of large cap stocks returned 1.2%, and the growth and value style benchmarks were nearly the same. The S&P 500 Index eked out a 0.6% total return, while the Dow Jones Industrial Average Index suffered a fractional loss. The broad Lehman Aggregate Bond Index topped large cap stocks with a workman-like 1.5% return.

Small cap stocks posted a slightly better quarterly result than did larger companies, extending a long winning streak. The standouts for the quarter, however, were mid cap issues which we define as medium-sized companies with a market capitalization between $2 and $15 billion. The Russell Midcap® Value Index returned 4.9% in the latest three months. Mid cap stocks have been the top performing capitalization segment of the domestic stock market over the past one and five years.

Rise of the Mid Caps

Mid cap companies have traditionally been an important part of Thompson, Siegel & Walmsley LLC clients' large cap portfolios, and they are coming into their own as a distinct asset class for investor consideration. With a market capitalization between $2 and $15 billion, about 820 stocks meet our definition of "mid cap." These companies, ranging from Campbell Soup, Cigna and MasterCard on the high end to trendy shoemaker Crocs, catalog retailer Coldwater Creek and a selection of REITs on the low end, make up about one-quarter of the total capitalization of the U.S. stock market. There is obviously some overlap here with what is commonly considered the "large cap" portion of the stock market, and large cap value investors like TS&W frequently dip into this enticing pool to find undervalued investments.

While many mid cap companies enjoy above-average growth profiles similar to small caps and may sometimes be less intensively scrutinized by Wall Street analysts than the market's giants, they are frequently mature and diversified enough to offer the stability and ample cash flow that investors prize. The mid cap segment of the market is becoming a popular hunting ground for large corporations intent on meaningful strategic acquisitions and for the influential private equity firms competing to invest large pools of capital. Thompson, Siegel & Walmsley LLC has successfully managed mid cap value-only portfolios for the last five years and is in the process of finalizing a vehicle that will be available to all of our clients.

The full story of the first quarter goes well beyond the return statistics. A notable increase in volatility and a volley of disquieting news headlines brought a renewed sense of riskiness to stocks after a period of tranquility stretching back to the summer of 2006. For example, the S&P 500 Index recorded a daily price change of three-quarters of one percent or more, either up or down, on roughly one of every five trading days in the last quarter, up sharply from the final three months of 2006. The market was buffeted to the downside by a quick 10% correction in China's highflying Shanghai market, comments from former Federal Reserve Chairman Alan Greenspan about the possibility of a recession in the United States, and the slow-motion train wreck taking place in the subprime residential mortgage market. Recent economic data have pointed to somewhat softer growth, but inflation readings have remained stubbornly above the Federal Reserve's comfort zone. A surge in energy prices attributable to—what else?—political tensions in the Persian Gulf, and immediately noticeable at the gas pump, has done nothing to ease investors' concerns.

Getting Too Risky?

The cover of the March 12 edition of Time magazine asked "Is the Stock Market Getting Too Risky?" Time, which has occasionally been a good contrary indicator of financial market trends, noted "the wild behavior of financial markets in recent days" and highlighted "the mini-panic that began in Shanghai." The magazine's ominous coverage has been mirrored repeatedly in media coverage of the weakening U.S. housing market. There is little doubt that the markets suddenly "feel" riskier, but are they?

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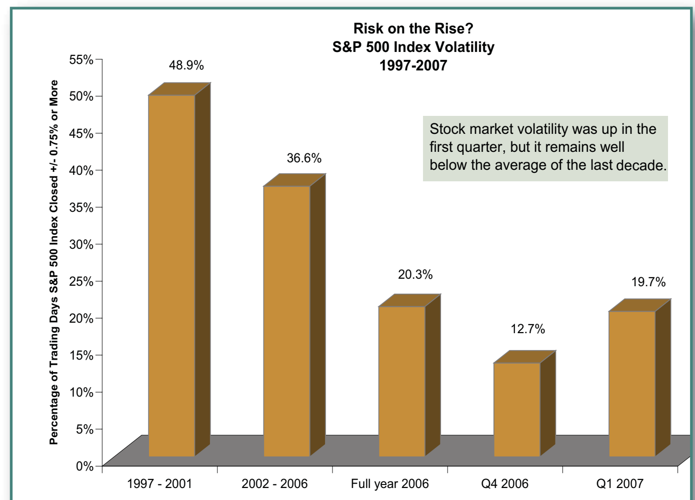
The sense that the U.S. stock market has become sharply more volatile depends entirely on one's perspective. As the adjoining graph illustrates, market volatility did jump in the first quarter of 2007, but only in relation to the unusually placid fourth quarter of 2006. Recent fluctuations are tame when compared to the level of daily skittishness seen over the prior



Source: Factset. Data as of March 31, 2007.

decade. TS&W believes that investors should be prepared for further increases in stock market volatility in the months ahead, and we have taken steps to position portfolios accordingly.

A marked slowdown in the rate of growth of corporate profits, a normal cyclical development that we have expected for some time now, could trigger rising stock market volatility over the next year. Corporate profits have expanded at an annual rate of more than 10% for fourteen consecutive quarters, making the current profit cycle one of the best in the past half-century. Year-over-year corporate profit growth most likely slipped to a single-digit pace for the quarter just ended and is forecast to be below 10% for the full year 2007. TS&W believes, however, that market expectations for earnings growth, especially for the second half of this year, may be too high, suggesting a greater number of earnings warnings and disappointments in the quarters ahead. The adjustment process that brings market expectations to heel often triggers bouts of pronounced volatility.

TS&W's investment process concentrates on cash flow, which is closely related to but more transparent than corporate earnings, and on stock valuation. Valuation, in turn, is a reflection of investors' expectations for a given stock's future cash flow. Over the past few quarters we have reduced our clients' exposure to stocks for which high valuations imply lofty expectations. In addition, we have trimmed back on those more cyclical names that might experience slower cash flow growth as the U.S. economic expansion moves into a more mature, slower growth phase.

Client portfolios today hold fewer materials, producer durables and energy names than a year ago and have more exposure to stocks in the consumer staples and utility and telecommunications sectors, which are less dependent on the economic cycle for profit and cash flow growth. We have increased clients' exposure to financial stocks because attractive valuations suggest that market expectations for these companies are muted.

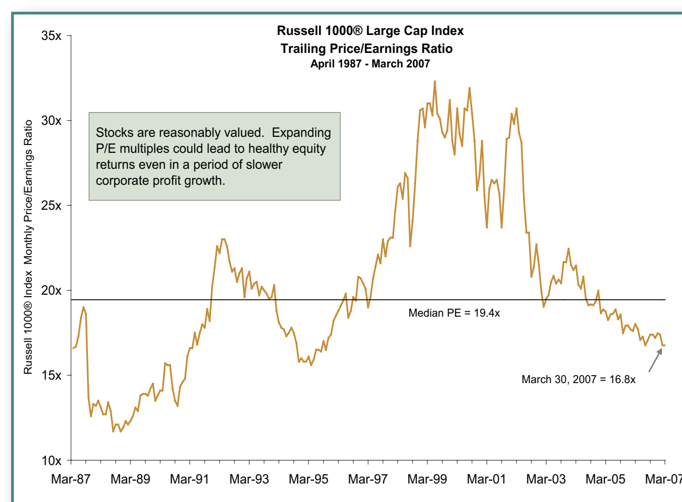
Overall, it is important to note that we have not retreated from stocks by significantly increasing either cash or fixed income exposure in client portfolios. TS&W continues to believe that stocks will produce better returns than other financial assets, notwithstanding the bouts of volatility we expect.

Cause for Optimism

After a long and mostly beneficial bull market in residential real estate, it comes as no great surprise that the excesses of the housing sector are being cleansed in a pattern familiar to all students of market economics. The obliteration of the low-quality residential mortgage market is quite real. Some financial institutions may have more "fessing up" to do about the quality of their loan portfolios, and we fully expect to hear more tales of wrongdoing and chicanery. This sort of activity is sadly reminiscent of bull markets past. Although we are carefully monitoring developments in the housing sector, TS&W rejects the most negative housing market scenarios. We believe that most housing markets will remain generally stable unless interest rates move sharply higher or employment levels erode significantly. We assign a low probability to both of these possible economic outcomes.

The environment we foresee is actually a beneficent one, wherein steady economic growth, moderate inflation, a low unemployment rate and stable interest rates promote healthy, if somewhat slower, corporate profit growth and sustain both consumer and investor confidence. The inflation rate could be stubborn due to high energy and commodity prices—consequences of robust global economic growth—but U.S. inflation remains relatively low by historic standards, and we do not foresee a surge in prices that would force the Federal Reserve to resume its campaign of interest rate hikes. The inflation rate will be a key economic variable to monitor in the months ahead.

Thompson, Siegel & Walmsley LLC's focused, fundamental investment discipline is especially well-suited to today's market. We are identifying stocks that should fare well in the positive, but more turbulent environment ahead. Stock market valuation, illustrated in the adjoining chart, is well below the median level of the past two decades. Even if earnings growth slips to only 5% for the year, large cap stocks now trade at less than 15.5 times 2007 earnings. From this level, modest profit growth combined with increasing dividends and even a slight uptick in PE multiples would produce good stock returns over the next year. The continuing flurry of private equity investment and corporate merger and acquisition activity indicates that we are not the only ones who see value in the stock market today. Corporate takeovers and pressure on boards of directors from outside investors should continue to be a positive catalyst for stocks, especially in the small cap and mid cap space. Although more normal levels of volatility will make the ground seem shaky at times, the economic and valuation foundation is solid for both bonds and for stocks.



Source: Factset. Data as of March 31, 2007.

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