

# REVIEW & OUTLOOK

In both our written market commentaries and in our asset allocation decisions for clients over the past few years, Thompson, Siegel & Walmsley LLC (TS&W) has expressed a strong preference for stocks over bonds. Reasonable valuations, robust global economic growth and expanding corporate profits have been consistent themes during this time. In addition, low and generally stable interest rates have strengthened the case for stocks in several ways:

- Low rates have promoted growth by keeping corporations' capital costs and consumers' borrowing costs down
- Plentiful, low-cost financing has helped to spur merger and acquisition activity by corporations, leveraged buyout funds and private equity investors, providing significant support for stock prices
- Low rates on short-term investments have encouraged corporations to return a significantly greater portion of their profits and accumulated cash to shareholders through dividend payouts and stock buybacks
- And finally, low yields have meant that bonds are a relatively less attractive option for investors seeking the most attractive risk-adjusted returns

During the second quarter, interest rates rose significantly. The yield on a ten-year Treasury note began the quarter at 4.64% and rose to 5.02% by quarter-end. Rates were pushed up by worries that higher energy and other commodity prices are causing consumer and producer price inflation to accelerate, albeit from very low levels. In addition,

non-government borrowers saw rates rise even more, as "credit spreads," the interest rate premium that lenders demand for corporate and other loans that carry default risk, moved up from historical lows in June. This tempering of investors' appetite for risk affects not only bond yields, but also the valuation of other risky assets, most notably stocks.

Given the central role played by low interest rates in the impressive stock market advance of the past few years, investors may wonder whether the latest rise in rates heralds the beginning of a more volatile and less rewarding period for stocks and whether significant changes in investment strategy are in order.

## We Still Like Stocks (and perhaps a few more bonds)

Stock returns have exceeded bond performance by an unusually wide margin in recent years, demonstrating that investors have been well-served by running asset allocations with a "rich" mixture of stocks relative to bonds. Over the four-year period ended June 30, 2007, the Russell 3000® Index, a broad measure of U.S. stock market performance, produced an average annual return of 14.4%, while the comparably broad Lehman Aggregate Bond Index

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returned just 3.1% per year. The average difference between stock and bond returns over the last 25 years has been just under 5% per year. We believe that

stocks will continue to return more than bonds, even though rates have risen and bonds have gotten cheaper. However, we expect the differential in returns to narrow, since the relative attractiveness of bonds has improved.

Concern about an increase in inflation has been a major factor in the increase in interest rates since the beginning of the year. Importantly, we expect inflation to remain generally tame, easing recent pressure on interest rates. The U.S. Consumer Price Index—including food and energy—was up 2.7% from the prior year's level in May, slightly above the Federal Reserve's "comfort zone," but still at the low end of its historical range. Already it appears that U.S. consumer price inflation is cooling off, and we expect further signs of this as 2007 progresses. Why?

- Central banks around the world began raising short-term interest rates some three years ago, which should act to curb inflation
- The slump in the U.S. housing market, and the related surge in subprime mortgage defaults, lowers the inflation rate because it puts downward pressure on rental rates, which account for about one fifth of the Consumer Price Index
- Energy prices, key drivers of the increase in the inflation rate since the beginning of this decade, no longer appear to be rising. Crude oil prices first reached the current \$70 per barrel level after Hurricane Katrina, nearly two years ago, and have fluctuated between \$55 and \$75 since then
- Finally, unit labor costs show little sign of sustained inflation. Although some forecasters claim that the disinflationary effects of global economic integration and technological productivity enhancement have run their course, we believe both factors will continue to keep wage inflation generally in check

Higher risk premiums, on the other hand, are probably here to stay. Cheap credit has become tougher to get.

Numerous subprime loan originators have curtailed their activities or gone out of business in recent months, and banks have been tightening lending standards at the behest of the Federal Reserve. Investors in leveraged buyouts and private equity deals have also begun demanding tighter debt covenants and higher yields on risky loans in recent weeks. This tightening of credit standards should slow the pace of consumer spending and merger and acquisition activity, thereby cooling stock price appreciation in the second half of 2007. This lower risk tolerance is an important reason why we believe the yawning gap between stock and bond returns is likely to narrow in the months ahead.

## Positioning Clients' Accounts – And Our Own

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The environment we have described, with generally stable inflation and interest rates and somewhat less tolerance of the most aggressive lending and investing tactics of the past few years, remains mostly favorable for stocks. With the broad stock market up more than 20% over the past year, however, compelling values are tougher to find, and we believe continued success will require a disciplined investment process that zeroes in on undervalued stocks with positive change underway. Stock returns over the next 12 months may be lower than in the preceding year, putting a premium on the ability to distinguish between winners and losers. We believe that a more

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selective stock market is a good habitat for TS&W's focus on cash flow, valuation and improving fundamental trends. Skittish markets like we have

experienced at several points this year demand that more attention be paid to downside risk, a consistent factor in TS&W's investment approach.

Our clients with balanced accounts will notice that our preferred asset allocation continues to emphasize stocks. However, with interest rates up some, bonds — especially corporate issues — are more appealing. We will likely be more aggressive in bond portfolios and in overall allocation to fixed income upon any further rise in yields.

Despite this slightly more guarded outlook for the broad stock market, we enter the second half of 2007 eagerly, thanks to an important step in TS&W's growth. In late spring, Thompson, Siegel & Walmsley changed its legal structure to a Limited Liability Company (LLC). As a majority-owned subsidiary of Old Mutual (US) Holdings Inc., the new organizational structure permits certain TS&W employees to invest directly in Thompson, Siegel & Walmsley for the first time. This is an exciting development for us, because it further aligns the interests of TS&W's clients and investment professionals and enables key employees to participate more fully in the bright future for our company and for our clients.

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