TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

3Q 2007

REVIEW & OUTLOOK

The volcanic island of Tristan da Cunha, located in the Atlantic Ocean about 1,750 miles southwest of Cape Town, South Africa, is one of the most remote spots on earth. Though unlikely, it is possible that a handful of Tristan da Cunha's 269 residents have not heard about the downturn in the U.S. housing market, the "meltdown" in the subprime mortgage market or the financial crisis that briefly, but forcefully, engulfed global credit markets this summer (the dead of winter on Tristan da Cunha). Since our marketing team has yet to establish a beachhead on Tristan da Cunha, we have elected to forego a rehash of the very well hashed events of July and August and focus this quarter's note to clients on Thompson, Siegel & Walmsley LLC's (TS&W) investment strategy for the months ahead.

Four Important Effects

This summer's market eruption produced both a sharp contraction in the availability of credit and a reevaluation of risk by global investors. In addition, financial market action stirred central banks around the world to shift from a tight monetary policy stance focused on fighting inflation to a more accommodative posture aimed at easing financial market strain. It is also important to note the degree to which problems in one segment of the U.S. economy affected investors and markets around the globe, providing a dramatic reminder of the interdependence of far-flung economies and financial markets. Each of these four dimensions of the summer's seismic events influences our investment strategy as we enter the final quarter of 2007.

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Credit Crunch

Credit had been both plentiful and cheap since the summer of 2003. This condition produced not only the robust global economic expansion which continues today, but also a buildup of ill-advised loans—with its epicenter in the U.S. home mortgage market. This summer's "credit crunch" marked the end of this cheap credit cycle. Lenders who made the most aggressive, least credit-worthy loans (often lacking the basic "due diligence" that was once a minimum standard) have found their ability to finance their operations—and thus to make new loans— severely curtailed. The flood of cheap money that drove the record-breaking leveraged buyout and private equity boom of the last five years has slowed to a trickle. Even borrowers with relatively good credit are finding that the cost of credit is up sharply as banks tighten lending standards.

We expect this sudden "repricing" of credit to cool the pace of U.S. economic growth. According to Fannie Mae, approximately $600 billion of subprime adjustable rate mortgages (5.5% of total U.S. mortgage debt outstanding) will reset before the end of 2008, sharply increasing monthly payments for millions of households*. This, in turn, will lead to some belt tightening by consumers and add to already increasing default rates for lenders. Investment spending by business is also likely to slow, both because of the higher cost of credit and because businesses are likely to adopt a more cautious outlook until credit market issues get sorted out.

TS&W does not expect this credit contraction to lead to an economic recession, but we do believe the risks of a recession have risen and that slower economic expansion will cause corporate profits to grow at a slower rate. In this environment, selectivity will be

*Source: "Economic & Mortgage Market Developments", Fannie Mae, September 13, 2007 essential to good portfolio performance. In recent months, we have increased our investments in areas like technology, consumer staples, health care and certain industrial groups like oilfield services and aerospace and defense, where we believe companies are likely to enjoy consistent growth, even if the overall economy slows.

Diminished Appetite for Risk

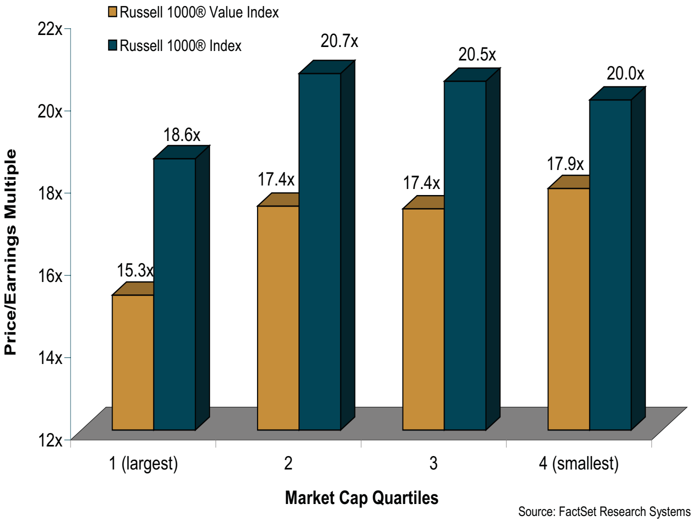
Cheap credit encourages excessive risk-taking. Although risk-taking is an essential part of a healthy economy, very low borrowing costs can lead investors to misprice and misjudge risk. This summer's sudden credit contraction increased the probability of losses on investment strategies predicated on ultra-low borrowing costs and ample availability of credit—especially those that employed aggressive leverage to amplify returns. A headlong flight-to-quality as investors sought to exit anything with even a hint of exposure to the "credit contagion" produced a notable pickup in market volatility.

Risk management has always been an important component of TS&W's investment philosophy. Diversification, a simple but frequently overlooked tool, is our primary technique for managing risk. This does not mean owning hundreds of securities in a portfolio, it means including stocks that do not move up or down in lockstep with one another. We study the effects of numerous economic factors on individual companies and groups of stocks in an effort to pinpoint risks and gauge client portfolios' response to different scenarios. We also measure historical price movements in relation to the broad market to help determine position sizes. In recommending stocks to our investment teams, TS&W's analysts not only search for attractive returns, but also quantify the expected tradeoff between risk and return at both the company and the portfolio level which also aids in setting position sizes.

We believe larger companies offer an attractive investment opportunity in a market that has become more risk averse. Bigger companies typically possess diverse product lines and service offerings and sell into numerous end-user and geographic markets, enabling them to produce consistent results even when certain business lines are slumping. Large companies also tend to get a high percentage of their sales from foreign markets. Overseas sales, which are currently enjoying a lift from rising foreign currency exchange rates, can offset slower domestic growth. For example, 3M Worldwide (3M) is a major producer of roofing granules, a product used to make shingles for houses and other buildings. This business has been hit hard by the housing downturn in the US, but the impact on 3M's overall operations has been minor. 3M produces thousands of products, from electronic materials to Post-it® notes, and makes more than 60% of its sales abroad. 3M should continue to grow at a healthy pace even if some of its markets, like roofing granules, endure an extended slump.

After underperforming small- and mid-cap stocks for several years, large companies were better performers in the latest quarter and are likely to continue to be market leaders. In addition to the attributes described above, large companies currently offer attractive value relative to smaller ones. The accompanying graph illustrates that the largest 25% of stocks within the Russell 1000® and Russell 1000® Value indices have the lowest average price-to-earnings ratios. TS&W has been adding larger companies to client portfolios to take advantage of both better valuations and the benefits of exposure to foreign markets.

The Largest Stocks Are Now the Cheapest
Weighted Average Price-to-Earnings Ratio
September 2007



Source: FactSet Research Systems

Fed to the Rescue?

The Federal Reserve's (Fed) half percentage point reduction in the short-term bank-to-bank lending rate it controls was a welcome acknowledgement that the central bank understands the potential harm to the economy from an unchecked credit contraction. Since the Fed acted, stock markets have rallied, interest rates for short-term loans have returned to more normal levels, leveraged buyout deals that were stalled by malfunctioning credit markets have been completed, and the premium over risk-free rates paid by corporate borrowers has settled down. This decisive action probably means that the crisis phase of the summer's events has ended. Nevertheless, TS&W does not believe that the Fed produced an "all-clear" signal for global capital markets with a single stroke of its rate-cutting pen. Further rate cuts are likely in the months ahead as the Fed responds to slower economic growth. This reality has encouraged us to evaluate critically our investments in financial stocks, which are the most direct beneficiaries of Fed action.

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The full effects of the credit squeeze are still working their way through the economy. Banks and other financial institutions are likely to face rising loan delinquencies, foreclosures and credit costs. Some of these problems are reflected in the low valuations of financial stocks, but TS&W believes it is still too early to add aggressively to our financial holdings. Although the mythic "portfolio manager's playbook" calls for buying financials after a Fed rate cut, we are sticking with a cautious view on the sector for now.

We are also keeping a close eye on inflation, which is a potential byproduct of easier Federal Reserve monetary policy. Recent consumer and producer price index readings have been reassuring, and there is little sign of a sustained increase in labor costs, however, commodity prices, including prices of grains, oil, iron ore and gold, remain elevated. This indicates that central banks do not possess an entirely free hand in using easy money to combat the credit contraction. Although TS&W expects inflation rates to remain moderate and bond yields to be generally well-behaved, we are maintaining exposure to certain commodity producers that benefit from rising prices and to industrial companies that serve industries like mining and agriculture. We believe rapid expansion in developing markets like India, China and Brazil will keep commodity prices high. The developing countries tend to inflate the prices of the commodity goods they import and deflate the prices of the consumer goods they export. We expect this trend to continue.

An Interconnected World

The struggles this summer of Australian hedge funds, German regional banks and Dutch money market funds saddled with an alphabet soup of exotic, securitized debt instruments made in the U.S. remind TS&W that markets are more interdependent than ever. This global marketplace is tremendously beneficial in most ways, and we have already pointed out our current preference for companies that do business in growing markets abroad and benefit from the foreign exchange rates that increasingly favor U.S. multinationals. At the same time, we recognize that, like opportunity, risk has taken on a global character, and our analysis must increasingly take into account complex global relationships, foreign competition and economic trends beyond our borders. The days of having an exclusively domestic focus are long gone.

Even isolated Tristan da Cunha cannot escape the realities of global markets. The big news this summer on the tiny island concerned a Brazilian oil drilling platform that broke loose from a tug and ran aground on Tristan da Cunha, where it will remain until winter's storms subside. The rig is an ugly reminder that both the rewards and the risks of a truly global economy find their way into even the most isolated locales. On the bright side, Tristan da Cunha's latest lobster harvest broke records, and the housing market seems to be holding up just fine.

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