TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

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REVIEW & OUTLOOK

*"I get my ideas from everywhere. But what all of my ideas boil down to is seeing maybe…two things and having them come together in some new and interesting way…" - Stephen King**

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The single most common question asked of writers is where they get their ideas. Stock analysts don't get the question quite as often, but it is one worth asking. Investors find it hard at times to come up with good ideas, especially when market conditions are difficult, as they have been over the last six months.

One of the ways we've been generating ideas this year is through the Jack Siegel Book Club. John T. (Jack) Siegel, one of the firm's founders, was a vocal advocate of being well read and drawing inspiration from many sources. The discussion group we started in his name in 2007 strives to keep that tradition alive at Thompson, Siegel & Walmsley LLC (TS&W). Each month, as a firm, we read and discuss a book that is intended to inform, invigorate and challenge our thinking; in short, to make us better thinkers and decision-makers. In that spirit, we have been deliberately eclectic in creating our reading list. Some selections have addressed statistics, economics and finance directly; others examined neuroscience, psychology, history, even wilderness survival. It is surprising how observations from apparently unrelated disciplines provide powerful insights for investing.

A Focused Field

One insight we discussed, for example, came from *Paradox of Choice* by Barry Schwartz. Schwartz makes the argument that, while choice is good, too much choice can paralyze decision-makers. Investors face this problem every day. There are about 3,000 public companies actively traded in the U.S. and even more overseas. An analyst who wanted to research them all would hardly know where to start.

At TS&W, we are fortunate never to face this investor's equivalent of writer's block. The process we use to manage equity portfolios comes with its own built-in idea generator. We run a quantitative screen every week that winnows a universe of thousands of stocks down to a manageable list of just those that have what we consider to be the essential features of attractive investments: inexpensive valuation and evidence that a significant positive change is underway – a "catalyst". Our basic quantitative work gives us a starting point of 200-300 stocks, what we like to call our "stocked pond" ready to be fished.

A focus list of a couple hundred stocks is certainly more manageable than one of thousands, but it still is not a portfolio. Taking those raw ideas and turning them into actionable investment recommendations requires skill, judgment and a good measure of creative thinking. We have a team of experienced analysts who craft those

Catalyst –
An agent for change.
An investment catalyst is a reason why a company's outlook may be better than expected. A catalyst can cause earnings to rise more or faster than expected, or allow the market to recognize what we believe is the company's true value.

*Source: www.stephenking.com, January 2008.

recommendations. They analyze financial statements, read industry research reports and meet with company management teams. Our quantitative screening work can tell us that a company is inexpensive and that something positive is happening there, but that leaves a lot of unanswered questions. Our research process focuses on three of those questions: why the stock is inexpensive, what the catalyst is (if there is one), and whether that catalyst is sustainable. Answering each of these questions requires a good measure of both science and art.

In 2007, our quantitative screens led us to spend more of our time focused on companies in Health Care and Consumer Staples, two areas where growth has been stable and valuations attractive. Our fundamental research and this year's performance have both confirmed that these were the right places to focus our efforts. More recently, our quantitative work has pointed us toward the energy sectors while suggesting a weakening case for more economically sensitive sectors such as Materials & Processing and Producer Durables.

Unfolding the Map

Another book we read this year was *Deep Survival*, which is about the psychology and physiology of survival situations: how people get into them, and how some manage to get back out. Author Lawrence Gonzales tells the story of Ken Killip who, when he got lost in Rocky Mountain National Park, kept telling himself he knew where he was. The only problem was he couldn't seem to find the lake where he thought his map said there would be one. Killip, an experienced and well-equipped outdoorsman, was ignoring the landmarks that should have told him he was on the wrong mountain altogether. If he had not stopped trying to "bend the map" to fit his idea of where he was, it might well have cost him his life.

Many sophisticated investors felt lost in 2007, and more than a few were trying to bend the map. A review of nearly 3,000 U.S. stocks revealed that almost 60% lost value over the year, and more than a third were down more than 20%. TS&W products enjoyed a solid year of positive performance, making for a favorable comparison against market benchmarks, many of which were down for the year.

One of the primary contributors to TS&W's good results this year was managing to avoid the pitfalls: housing, subprime mortgages and a credit crisis that roiled financial markets. Were some investors engaging in a map bending exercise? Our screens had indicated for some time that these groups were expensive and that there was not much positive change happening there. Our fundamental research into the stocks confirmed that a rapidly rising housing market had led to risky mortgage lending practices, especially to less-qualified borrowers. The landmarks were there, but you had to be willing to look at the map with fresh eyes to see them for what they were and navigate around them.

> **"The goal of preserving capital in difficult markets is one of TS&W's founding principles and we have a demonstrated ability to achieve it."**

One of the things people who are lost have a hard time doing is simply turning around. Every investor makes wrong decisions. The question is whether they can recognize them quickly, turn around and get back on track. Our portfolios were no exception to this rule; however, our limited patience with the few disappointments we had, helped us avoid bigger losses in 2007. Corporate earnings, having experienced one of the most robust periods of profit growth in decades, are growing more slowly now. In some cases, they are shrinking. We expect to see more companies falling short of expectations in months to come and we will continue to be vigilant on this front.

Knowing Our Edge

Another insight came from *Fortune's Formula: The Untold Story of the Scientific Betting System that Beat the Casinos and Wall Street*. John Kelly Jr. was a mathematician at Bell Labs when he got interested in the mathematics of risk and probability. He proposed a theoretical rule for maximizing one's winnings in games of chance. He said, in essence, that gamblers should place bigger bets when they have an edge. This so-called "Kelly Criterion" was later successfully applied to investing when it was realized that an investor's best source of expected return is their information edge. Knowing what your edge is, is critical to generating consistent returns.

As bottom-up investors, we believe our edge is found in independent thinking about individual stocks. We build portfolios one stock at a time on a foundation of fundamental research, rather than tilting a portfolio to succeed or fail on the accuracy of a particular macroeconomic forecast. Analysts are encouraged to think freely about stocks and bring their best ideas to the table, whether or not they conform to the consensus economic opinion. A closer look at our performance reveals that our best, most profitable decisions are made picking stocks, rather than economic sectors.

> **"We are interested in less economically sensitive companies with robust, diversified and dependable earnings growth, and we are seeing those companies more attractively valued."**

That said, we are often asked, especially this time of year, about our outlook for the markets or the economy. The financial press has been fairly negative as of late, and we recognize that the market environment in 2008 may be challenging. Reports confirm that the economy continues to slow. Seemingly tireless American consumers are finally easing their pace of spending.

We also see some bright spots and reasons to think that economic growth can continue, albeit at a slower pace. Interest rates are low. The Federal Reserve seems intent on lowering them further to support growth, and fiscal policy makers appear poised to introduce an economic stimulus package. Export growth has been especially strong, as a weakening dollar has helped make American products more competitive on price. We also see many companies whose profitability is high yet sustainable.

The level of volatility that markets experienced in the last few months of 2007 may continue in 2008. The goal of preserving capital in difficult markets is one of TS&W's founding principles, and we have a demonstrated ability to achieve it. In 2007, our clients' portfolios were well ahead of their benchmarks for the year, partly because when the markets were down, those portfolios were down less.

We are optimistic about 2008. Periods of volatility inevitably create opportunities as investors are overcome by negative sentiment and punish some stocks unfairly. Sixty eight percent of companies are less expensive today than they were a year ago in terms of their price-to-earnings ratios. Having avoided those stocks that were discounted the most, we are well-positioned to search through them to find the real bargains. We are interested in less economically sensitive companies with robust, diversified and dependable earnings growth, and we are seeing those companies more attractively valued. We are fortunate to have an investment team and a process that are able to consistently generate good investment ideas, in tough times as well as easy ones.

French scientist, Louis Pasteur, said, "Fortune favors the prepared mind." So, how does one prepare the mind to find fortune? Having a methodology that focuses our attention and efforts where they are most likely to be rewarded, gets us going in the right direction. Being willing to read the map and reorient ourselves when necessary, keeps us on track. Knowing what our edge is and sticking to it, ensures that our best efforts are expended in the endeavors that are most likely to succeed for the firm and our clients.

We also believe in following wise counsel. We're doing that by heeding the advice of one of our firm's founders: reading challenging books by great, innovative thinkers in many disciplines. For the complete list of books, please visit www.tswinvest.com.

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