

REVIEW & OUTLOOK

What We Have Not Done

In 1915, Harvard physiologist, Walter Bradford Cannon, identified the fight or flight response, the innate survival mechanism by which humans respond to fearful or threatening events. The instinctive fight or flight response drives us to take decisive action at moments of great danger or stress. Our ancestors spent no time thinking about the “risk-reward ratio” of an approaching saber-toothed cat. They ran. They also learned to use prey animals’ fight or flight response to drive them into traps or ambushes that greatly improved their success as hunters. Although we face very different risks in today’s world, the same powerful instincts urge us to act when we perceive danger. In investing, however, it is very often the actions we *do not* take in the face of market turmoil and stress that enable us to avoid traps, survive and thrive.

The first quarter of 2008 presented investors with the modern-day equivalent of a saber-toothed cat attack. Large cap stock indexes, including the Russell 1000® Index and the S&P 500 Index, as well as small and mid cap indexes, declined by nearly 10%, making the period the worst quarter since the vicious bear market of 2002. Daily volatility, a good barometer of investors’ skittishness, also reached levels not seen since 2002. The panicky flight from Financial stocks, punctuated by the stunning collapse of Bear Stearns in mid-March, has been well documented, but investors fleeing from the carnage among the financials found few satisfactory places to take cover. Every economic sector within the S&P 1500 Index, which covers the full range of stocks from small cap to large, posted a negative return for the quarter. Investors were even forced to rethink the risks of safe havens like bonds and money market funds, as confidence and liquidity dried up. In essence, the cave men were in full retreat.

Multiple Perspectives Aid Decision-Making

You probably know Thompson, Siegel & Walmsley LLC (TS&W) through one or two of our investment disciplines, such as our Large Cap Value or Small Cap Value portfolios. You may not know, however, that TS&W manages a wide and growing range of investment products that give us broad insights into global financial markets.

In addition to our small cap and large cap value products, TS&W manages mid cap and all cap portfolios that fill out the range of U.S. market capitalization. In addition, we manage a core portfolio that matches our value investment philosophy against a broad-market index for clients who do not have style-specific mandates. We manage approximately \$1 billion in taxable and tax-exempt fixed-income assets that provide strong insight into the twists and turns of global credit markets, and a tax-advantaged closed-end fund that marries our equity and fixed income products. TS&W has also managed international equities for more than fifteen years, and our analysts and portfolio managers are accustomed to viewing industries from a global perspective. In recent years, TS&W has added alternative strategies to our lineup, including hedge funds and a market neutral strategy that employs both long and short investments.

The analysts and portfolio managers of these distinct investment portfolios work closely together, sharing ideas, insights and judgments. Their varied perspectives keep us open to new ideas and concepts and help us to interpret an increasingly complex investment landscape. We believe each of our clients benefits not only from our focus, but from the breadth of our experience and diverse frames of reference.

Each quarter, Thompson, Siegel & Walmsley LLC (TS&W) attempts to describe the actions we take to position our clients' accounts to benefit from market opportunities and to defend against risks. After a quarter during which heading for the hills sometimes felt like the most attractive option, we would like to highlight three actions we did not take, as a way of illustrating our strategy for preserving capital and positioning for the future during a period of intense market turmoil. During the latest three months we did not stray into the business of forecasting the economy or begin buying and selling stocks based on our predictions of GDP or interest rates. We did not start buying stocks just because they looked "cheap" according to rote use of valuation measures. And finally, we did not pass over promising investments just because gloom and doom dominated the headlines. These "inactions" are all manifestations of our disciplined investment philosophy and process; they are guidelines that we follow during good markets and bad.

Slowdown or Recession?

It is now clear that the housing slump that began in late 2006 and the credit market problems that ensued have slowed economic growth in the U.S. At the same time, surging prices for commodities, especially food and energy, have boosted the inflation rate for consumers and created input cost pressures for many companies. Some economists believe the U.S. has entered a recession, while others argue we face a period of "stagflation," the debilitating combination of spiraling prices and sluggish growth that plagued markets in the 1970s. Tenuous comparisons with Japan's "lost decade" of the 1990s, or even the Great Depression, were commonplace during the latest quarter. Other experts argue the slowdown will not be severe enough to meet the technical definition of a recession.

At TS&W, we do not get bogged down trying to find just the right terminology to define the current economic situation. Although judgments about the impact of economic conditions are a factor in our analysis of the companies we own or consider for purchase, we are not in the business of forecasting the economy. Having declined nearly 20% from the highs reached last fall—and in many cases much more—stock

prices already confirm a pronounced economic slowdown. Aggregate corporate earnings growth and analysts' profit forecasts also began declining last fall and were sharply lower in the final quarter of 2007.

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Given the tendency of analysts to overshoot both on the upside and on the downside, it is reasonable to expect aggregate corporate earnings estimates to come down for at least the first six months of this year, and maybe longer.

Just as stock prices began to fall before predictions of the current economic slump became widespread, we know that stocks will move up in anticipation of the next recovery. Rather than guessing at the timing of an economic turnaround, however, we examine individual companies for drivers of positive change, or catalysts, that are typically confirmed by improved price or earnings trends. A stock price that stays flat or merely falls less rapidly than peers in a plunging market may give evidence that positive change is occurring at a company. Stable or rising estimates of future earnings or quarterly earnings reports that exceed the consensus forecasts of analysts are also concrete signs of positive change and they relieve us from guessing at broad macroeconomic trends that can be difficult to discern until they are well past.

When a Cheap Stock is Not a Good Value

In the late 1990s, when irrational exuberance held sway in the stock market, TS&W pointed out that a great company was not always a great investment if the price of the shares was too high. In much the same way, a stock that appears to be "cheap" is not always a good value. TS&W's focus on fundamental factors at the individual stock level restrains us from buying stocks, or holding onto them, just because valuation measures, like the price-to-earnings ratio or the dividend yield, suggest they are cheap. Over the years,

we have seen countless examples of cheap stocks that just got cheaper as the fundamentals eroded. We make an important distinction between cheap stocks and bargains. A bargain—something that is worth more than the current price—is what we look for. Not all cheap stocks are bargains.

The Financial stocks provide a great illustration of this today. Many commercial and investment banking stocks, insurers and real estate investment trusts look temptingly cheap on the basis of traditional valuation

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measures. What is more, the Federal Reserve is acting aggressively to shore up the ailing Financial sector with direct cash injections and to support the economy by reducing short-term interest rates. In the past, the old adage “don’t fight the Fed” suggested buying the financials whenever the central bank moved so decisively. Although we are directing a great deal of analytical attention to the Financial sector, and there are probably some good bargains to be had, we have not become aggressive buyers because the outlook for profit growth and the ultimate level of write-offs remain highly uncertain. Since Financial stocks account for a large share of the overall market, our underweight stance detracts from relative performance on days when speculative moves (or short covering) send the Financial stocks higher. We expect to have plenty of good opportunities to invest in banks and other Financial stocks, as the outlook for their earnings power becomes clearer.

The Trouble with Doing Nothing

The fight or flight response overrode our earliest ancestors’ potentially lethal tendency to freeze in the face of danger. A similar set of emotions is produced by a sharp market correction or episodes of breathtaking volatility, like those encountered in the first quarter. Investors may find it difficult to act decisively when prices fluctuate wildly or when stocks seem to plunge in defiance of fundamentals or logic. Stocks often become mispriced during market declines.

Mispricing also occurs around points of inflection in the business cycle, as fearful (or extravagantly leveraged) investors come under pressure to liquidate or as changing economic conditions displace yesterday’s winners and new companies assume market leadership. As painful as it can be, market activity like this produces valuable opportunities to refresh and renew our clients’ portfolios. We do not ignore these opportunities just because the headlines are gloomy.

A disciplined process that takes the emotions out of investment decision-making enables TS&W to evaluate new ideas during market declines with the same rigor that we employ in sunnier times. It also prompts us to move quickly when deteriorating fundamentals signal a stock or a sector may be in for a prolonged decline. Our focus is on identifying individual stocks and sectors that will lead the market higher six to twelve months from now and avoiding long-term losers.

To be more specific, we continue to believe that Energy stocks will provide good performance in the months ahead, but with the price of oil at record highs, our exposure to this sector is not much above market weights. We have added to positions in the Technology sector, where we are significantly overweight relative to the market because many companies in this diverse group offer the combination of value and positive change for which we look. Health Care, a traditionally defensive sector, is attractive today, but we believe careful discrimination among stocks is essential to avoiding the legal and patent challenges that plague many pharmaceutical companies. We have also been adding to positions in the presently disfavored Consumer Discretionary area. Contrary to the popular perception that anything related to the U.S. consumer

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is in deep trouble, some stocks in this group are positioned to grow and gain market share in an environment of rising prices, more discriminating shoppers and stressed competitors.

Looking Ahead

One final thing we will not do is venture a guess as to whether global markets reached their lows for the current cycle in the first quarter or if further declines lie ahead. Such guesswork is a fool's errand. We do anticipate continued volatility and confirmation in the months ahead that corporate earnings growth has slowed precipitously. By summertime, politics will move to center stage in the run-up, to what is sure to be a heated Presidential election, adding to market uncertainty. We expect economic news will alternate

in the coming months between the symptoms of an economic slowdown, falling home prices, mortgage foreclosures and slower consumer spending on the one hand, and signs of rising inflation on the other. We doubt the economic outlook will become clear anytime soon. All this uncertainty will place a premium on careful stock selection and sector positioning. With a deep, experienced research and portfolio management team and a proven, repeatable investment process that keeps Professor Cannon's fight or flight response at bay, we are confident that TS&W can continue to navigate a successful path for our clients, whatever surprises may lie ahead.

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