



# REVIEW & OUTLOOK

## WHAT THE DAYS NEVER KNOW

Ralph Waldo Emerson said, "The years teach much which the days never know," an observation that has special meaning for investors. It speaks both to the long-term thinking that comes with experience and to the patience and discipline that are required of successful investors. The first half of 2008 has illustrated this principle in microcosm, reinforcing the consistent, disciplined approach to investing that we practice.

The Dow Jones Industrial Average Index closed the second quarter of 2008 19% below its all-time high set in October 2007. This came within a hundred points of satisfying the classical definition of a bear market: a decline of 20% or more. Thompson, Siegel & Walmsley LLC's ("TS&W") portfolios have fared much better over this time period, in keeping with our objective to preserve capital in difficult markets. The second quarter exemplified this charge. While most of the market indices against which we benchmark performance declined, our clients' portfolios provided good downside protection and some strategies managed to deliver positive gross total returns. We attribute this success to our strict implementation of a sound investment process that helps us identify good companies at attractive prices, while avoiding the extremes of value traps and excessive speculation.

### Banks or Barrels of Oil?

That discipline has been especially valuable in a year that has been defined by its extremes. On the one hand, prices for energy and commodities, as well as

the companies that produce them, have risen higher and faster than many expected. On the other, financial services companies have generated a great deal of press and their stocks, though trending down, have remained highly volatile. These two aspects of the economy are, in one sense, sides of the same coin.

Over the last several years, virtually every part of the global economy has enjoyed simultaneous growth that has raised millions out of poverty and drawn people around the world closer together through travel and trade. It has also generated significant investable capital in many parts of the world; capital that is hungry for returns.

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It was, in part, global investors with excess liquidity searching for investment returns that inflated the U.S. housing bubble. Attracted by incrementally higher yields, they bought mortgage-backed securities in such large quantities that it actually changed lending behavior. High demand for these mortgages enticed lenders to relax their underwriting discipline, a trend that reached its nadir with the so-called "NINJA" loans: named for borrowers with no income, no job or assets. That failure of discipline proved disastrous to those who invested in those poorly written mortgages.

TS&W's portfolios have been underweight financial companies, especially banks, for several quarters now and have thereby managed to avoid roughly half the losses experienced by their benchmark indices in the last year. We took this position because the four-factor screen that sits at the front end of our investment process, as well as our analytical work, indicated that these companies were expensive and exhibited little in the way of positive change.

**“The market has vacillated between these two poles: some days abandoning financial institutions and pouring money into food and energy stocks, on others calling for an end to a commodity bubble and a market bottom for the banks.”**

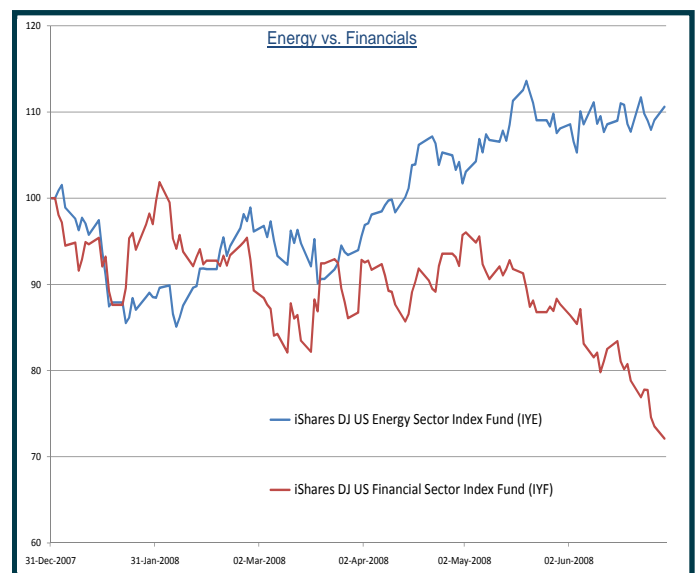
What was once an easy call though, has gotten tougher. Financials have lost more than 40% of their value since this time last year, prompting value investors to start shopping for bargains. The stocks certainly look less expensive; the question is whether their fundamental outlook has improved. Some are arguing that after \$400 billion in total asset write-downs, the worst is over for these firms. Historically, when the Federal Reserve has lowered interest rates, it has been a good time to buy banks because those cuts improve their profits. That said, banks are competing with each other to raise the capital needed to shore up their weakened balance sheets, pushing the cost of funds higher, while cash infusions from sovereign wealth funds or new stock offerings dilute shareholder value, putting further pressure on share prices.

Analysts and investors alike have predicted a bottom in these stocks several times already this year. Banks rallied in late January, again in mid-March and yet again in late April and early May. In each of these periods, TS&W portfolios tended to lag their benchmarks. TS&W analysts have been looking hard at the few companies in these groups that passed our front-end screen but found even fewer that could satisfy our rigorous fundamental requirements. As Wall Street analysts make their cases for a turn in the Financials, and the markets seem to respond in kind, the test is whether we lower our standards to follow the crowd or stick to our discipline even when it is out of favor.

A similar dilemma is present in commodities stocks. Investors have been fleeing the Financials for almost a year, but their hunger for returns has not abated. Many have turned toward assets whose prices keep going up: metals, food and energy. Here the fundamental story is well known: middle classes are rising in Asia, South America, Eastern Europe and parts of Africa. These people want to eat meat and drive cars just as Americans and other Westerners do and they now have the access to global markets and financial wherewithal to compete for the resources that make that possible. Their demand for such goods is real, but there is also likely a speculative component to the rapid rise in prices. Analysts are debating whether the demand for these goods justifies the speculation, or whether global excess liquidity is now inflating a commodity bubble. The catalyst for these stocks seems clear; the question is whether they are truly inexpensive.

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So which is it: are we near the bottom in Financials or is there another leg down yet to come? Are we entering an era of intense global competition for basic materials, or are we witnessing a commodity bubble on the verge of collapse?



Source: FactSet Research Systems, Inc.

## When All About You Are Losing Their Heads...

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The short answer is, we do not know. We do not know if the rise in commodities is just a bubble about to pop; nor do we know when financial companies will finally get their feet under them and start growing again. As individuals, the members of our investment team have a variety of opinions on these questions. It is part of our jobs to be knowledgeable about such issues. But as a firm, we do not identify our competitive advantage or our success in managing portfolios with an ability to make correct predictions about the future of global markets. Fortunately, we do not have to be right about macroeconomic trends or even about market themes to be successful as investors. Our bottom-up, stock-picking approach emphasizes good research on individual companies, savvy portfolio construction and solid risk management. These are things we think we can consistently do well, even in the midst of market uncertainty.

Though they continue to offer good downside protection in today's volatile environment, a closer inspection reveals that TS&W portfolios are well balanced between the extreme sentiments of the market. Portfolios today are not especially defensive in the sense of having heavy weights to sectors such as Financials, Utilities and Consumer Staples. On balance they have a bent toward growth in world trade. They are consistently underweight in Financials and overweight in Health Care and Technology stocks but tend to be only modestly overweight in Energy and Materials, and our selections there are driven more by company specifics than by a call on commodity prices.

We have found many smaller industry trends and individual stock stories to fill portfolios. Agriculture and machinery stocks continue to appear attractive, as the theme of global industrialization plays out. We have seen railroads benefiting from increased coal loadings and gaining market share from truckers struggling to remain competitive in the face of high fuel prices. We have found utilities whose unregulated energy production businesses now exceed the size of their utility divisions, affording them valuations in line with other utilities, but earnings growth more like other

energy producers. Though retailers have faced a tough environment, we have found success with discounters who are actually gaining from consumers' belt tightening. We are also, slowly and carefully, finding Financial Services stocks that meet our standards.

TS&W's investment process is straightforward. We seek to invest in stocks that exhibit both attractive valuations and positive fundamental change. Stocks have to pass an objective, quantitative screen before they are vetted by our team of skilled, experienced analysts and recommended for inclusion in client portfolios. The portfolio management teams consider these recommendations and, only when a consensus is reached, act on them.

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This consistent process provides a sound basis for investing in securities. Just as importantly, in times of high market volatility and the emotional extremes that accompany them, it is a discipline that keeps us focused on what we do best. Regardless of the temptation, if stocks do not pass our process, we do not buy them.

There is a tradeoff here. Because stocks often rally before their fundamentals improve, as has happened for banks three times already this year, we recognize that we are unlikely to pick a market bottom, either in individual stocks, specific sectors, or in the market as a whole. But, in exchange for the extra performance one might squeeze out of the market by being able to predict such events, we gain the confidence that comes with investing in stable situations that are clearly improving. Our experience dictates that real leadership persists, and we will have ample opportunity to profit from it once it appears.

What the days never know is the patience and discipline that are required to chart a consistent, long-term course. The alternative, to follow the call of market sentiment that shifts like the wind, is no process at all and, more often than not, leads to disaster.

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