TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

3Q 2008

REVIEW & OUTLOOK

On September 18, 2008 investors—if you can call them that—accepted a yield of 0% or, in a few cases, less than 0%, to purchase 3-month U.S. Treasury Bills. Think about that for a moment. Rational human beings—many of whom were worried about the growing threat of inflation only weeks before—were willing to lend their cash to the world's largest debtor for 90 days in exchange for nothing more than the promise that they would get their money back. In a few cases, investors actually paid Uncle Sam to take the money off their hands for three months. In financial circles, the interest rate on the 3-month Treasury Bill is known as the risk-free rate because the U.S. Government's power to tax its citizens and to create money eliminates the risk that it will default on its short-term debt. In normal times, investors demand a low, but certainly positive, rate of return on these nearly riskless investments. The latest quarter, however, was anything but normal. The price to escape risk was bid to record highs.

This headlong stampede for the short-term safety of U.S. Treasury Bills is one of many dramatic examples of the panic presently gripping world financial markets. Credit markets are, as of this writing, virtually closed, constricting the vital flow of capital between governments, financial institutions, businesses and individuals. Despite gigantic injections of cash by central banks, the rate that banks charge one another for overnight loans, a normally routine but economically vital transaction, has skyrocketed to previously unthinkable levels. High-quality corporate borrowers must pay extreme premiums to obtain even short-term credit. In short, fear has become the primary driver of investment decisions in debt markets worldwide.

Stock markets have become a tortured sideshow to this credit crisis, lashed by wild bouts of volatility as traders, long-term investors, leveraged hedge funds and even governments seek to flee from risk, cover short positions, prop up weakened financial institutions or, in a few cases, profit from the apparent loss of market sanity. A disciplined, long-term investment strategy focused on valuation, business fundamentals and catalysts for positive change simply is not effective in the short term when markets are in such an advanced state of disarray.

We understand that Thompson, Siegel & Walmsley LLC's ("TS&W") clients are anxious to hear our views on the current market situation and what we are doing to protect their capital and to position their portfolios for a future that presently seems more uncertain than ever. Most importantly, we want our clients to know that we are, as always, intensely focused on the tradeoff between risk and reward at both the individual security level and at the portfolio level. We are devoting all of our considerable experience, energy and passion to carefully evaluating the exposure to risk in client portfolios and to ensuring not that we are avoiding all risk, but that the risk we take is appropriate and consistent with our clients' long-term investment objectives and risk tolerance. In light of the rapidly developing financial and economic situation, we are continually reviewing our assumptions, forecasts and expectations about the securities we hold and the construction of client portfolios, with an eye toward weathering the storm in the near term and meeting goals of capital preservation, income and appreciation in the medium to long term.

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Obviously, market panic, disarray and intense volatility make it difficult to proceed with confidence. But this is where experience, perspective and investment discipline serve us best. The broad stock market has declined by more than 30% from its peak last fall, as the continued constriction of credit markets has been increasing the likelihood of an economic downturn. It is critical to note, however, that a downturn of this magnitude is not particularly unusual. Ned Davis Research has identified 33 bear markets since 1900, with a mean duration of 406 days and a peak-to-trough decline averaging about 31%. Bear markets are a normal—if painful—occurrence. They come along about every 3 to 4 years. It is true that market declines are maddeningly unpredictable. If we could all see them coming, they would not happen at all. It is also true that some bear markets are worse than others. The worst decline since the Great Depression was the 45% drop between January 1973 and December 1974. If we use that unusually dark period as a yardstick for the current market setback, we can reasonably assume that two-thirds of the decline has already occurred.

History also demonstrates that stocks will anticipate an eventual turnaround in the economy, beginning to rise well before the headlines herald the arrival of better times. On average, economic recessions last about ten months, but the stock market tends to reach a bottom four to five months before recessions end. Returns measured from these recessionary low points are usually substantial.

From this historical perspective, it becomes a bit easier to think clearly about opportunity. Investors are obviously anticipating a lot of bad news and this pessimism is being reflected in the prices. Rather than joining the madding crowd jamming into short-term Treasury securities offering little or no return, we prefer to lean into the gale-force wind of market sentiment and look now for good buys. As always, these must meet our investment criteria: they must be inexpensive, they must possess strong business fundamentals—especially healthy balance sheets and cash flow—and they must exhibit a catalyst or an element of positive change likely to drive the price higher over time. In addition, we carefully examine the tradeoff between the return opportunity and the downside risk that exists if we are wrong. While newly "cheap" stocks abound, many lack the positive drivers that will produce winning investments. We are working hard to bring those that meet all of our criteria to our clients' portfolios.

We know, from long experience, that a value investment approach, consistently applied and combined with prudent risk controls, has produced good investment results over market cycles. Amidst the roiling market frenzy, we were comforted the other day to see that at least one other value investor agreed. Warren Buffett, commenting on his purchase of a multi-billion dollar position in Goldman Sachs (one of several large investments he has made in recent weeks), said that "five years from now, ten years from now, we'll look back at this period and we'll say you could have made some extraordinary buys...the American economy over a period of time will do very well, and people that own a piece of it will do very well." Because he can bring huge slugs of liquidity to the table, the Nebraskan can cut attractive deals for himself, but this does not change his essential message—that these troubled times present an opportunity for careful, long-term investors.

To summarize, TS&W strongly believes that the current unsettled period is exactly the time when a disciplined approach is most valuable to investors willing to look beyond the short term. We remain committed to an investment philosophy and process that has worked well for TS&W clients in other bear markets. We are not, however, stubbornly staying the course and ignoring the momentous events swirling around us. We are carefully reviewing the assumptions, estimates and forecasts that go into all of our investments and reassessing our calculations of downside risks. To the greatest extent possible, we want to protect client assets, while ensuring that the risks we choose to take are well-considered and consistent with clients' long-term objectives. We urge you to contact us if you have specific questions, comments or concerns about your portfolio or TS&W's outlook and strategy. We deeply appreciate your confidence in TS&W during these extraordinary times.

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