Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

4Q 2008

REVIEW & OUTLOOK

Matt Thompson, Jack Siegel and Pierce Walmsley founded the firm that still bears their names at the end of 1969. As we enter our 40th year in the investment management business, and particularly as we close out the extraordinarily difficult year of 2008, we look back over the firm's history and draw on the deep experience among our investment professionals for perspective.

During the last three months of 2008, markets suffered another historic sell-off, making the third and fourth quarters the two worst back-to-back declines in 75 years. In the fourth quarter of 2008, Thompson, Siegel & Walmsley LLC ("TS&W") equity portfolios performed better than their benchmarks, in some cases by significant margins. Most portfolios outperformed for the full year as well, though those in the smaller capitalization ranges were down modestly more than their benchmarks. Our Co-CEO Larry Gibson, a 34-year veteran of the investment industry, described 2008 this way, "This year saw our investment process face greater challenges than ever. At times, it seemed like the rules had been suspended. What held us together was experience, professionalism, discipline and the belief that such periods of extreme irrationality are, by nature, temporary."

2008 was decidedly not a stock-picker's market. Our goal of consistently generating excess returns in client portfolios is under greatest pressure in periods of severe volatility. We recognize, though, it is in these periods that consistency and experience avail us most. Having been through a number of difficult markets in our near 40-year history, we also recognize that working through these challenging periods has imparted some important lessons: the value of being cautious but not overly defensive, understanding the characteristics of companies that succeed during recessionary periods, and most importantly, the central role of people and process.

Hard to Hide

The early 1970s, when TS&W was starting out, presented genuine challenges. After enjoying the longest continuous expansion since World War II during the 1960s, the U.S. witnessed two recessions lasting a total of 28 months in the first half of the 1970s. The unemployment rate rose from just 3.5% to 8.5%, yet contrary to the dominant economic theory of the time, inflation was also high, consistently above 10% in 1974-75.

Given the inhospitable business environment, it is not surprising that equity markets in 1973-74 had their worst performance declines since the 1930s. After peaking in January of 1973 with a value slightly above 120 points, the S&P 500 Index suffered sharp and unremitting declines that

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carried the index to a low of 62, a loss of 48.3% from peak. So, in the first five full years of TS&W's history as an investment firm (January 1, 1970 to December 31, 1974) the S&P 500 Index delivered total cumulative returns of -4.3%. Not an ideal time to start an investment management firm.

There are parallels between the excesses of today and those that drove the market down in the early days of the firm. Investors in the 1960s became enamored with the biggest of the blue chips, major corporations with stellar growth records, sometimes referred to as the 'Nifty Fifty'- or more ominously as 'one-decision growth stocks.' The belief was that you could buy and hold these stocks

and never have to worry about selling them, which is what many people tried to do. Matt Thompson continues to serve the firm he helped found and shape as Chairman of the Board. Matt recalls, "The Nifty Fifty companies became overvalued. We recognized that and focused our efforts on finding more attractively valued stocks. That cushioned the impact of the 1973-74 declines but it's hard to hide when prices get cut in half across the board."

This time around it wasn't the Nifty Fifty that led to the downturn but a similar supposed 'one-decision' investment: housing. As in the early 1970s, analysts at TS&W recognized the growing roots of this market bubble – the misguided assumption that house values only go up – and all the associated excesses: decaying lending standards, rising debt, etc. These concerns have been reflected by our substantial underweight in Finance. While foreseeing the problems that led to the crisis did not make the portfolios we manage invulnerable, those portfolios benefited from an almost total avoidance of the most toxic financial institutions.

In 2008, like 1974, it was hard to find stocks that were unaffected by the sell-off. The market in 2008 was driven by massive deleveraging, short-covering and record levels of volatility. Stock selection, our core competency, was almost irrelevant. Many companies' stock prices moved dramatically in the opposite direction of their fundamentals. Even the best companies were not immune: every sector and all but 24 of the companies in the Russell 3000® Index had negative returns for the year.

The problems of the 1970s were not identical to those today. As Matt put it, "We've been down this road before, but we're further down it now: the leverage and the complexity of the financial system today is unsurpassed, and the degree to which people didn't understand or recognize the risk in the system led to these massive declines."

The global financial system reached a critical point this quarter, when trading in credit markets came to a complete halt. Equities have historically offered better returns than bonds, but the market for bonds dwarfs the stock market and is the far more important source of capital for firms of all sizes. Some observers likened the credit creation mechanism to oil, lubricating the engine of the economy; others said it was more like oxygen. In any case, when credit ceased to function, the scale of the problem changed. The U.S. and other governments took unprecedented measures to inject capital into the system and prevent a systemic failure. That effort appears to have been successful, as trading in bond markets has restarted, though volume has not returned to pre-crisis levels. However, now we have moved from a credit problem to a general economic one.

A Cold Stove-Lid

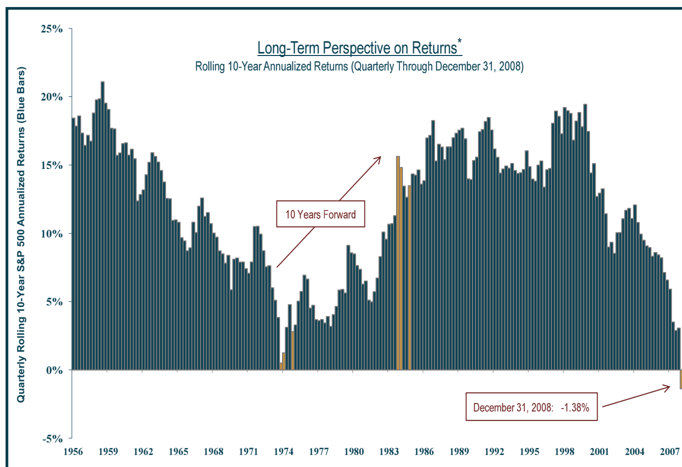
Over the last ten years, the S&P 500 Index returned -1.5%. This is the first time in over 50 years the ten- year return for the broad U.S. equity index was negative. This prompted some investors to view equities more negatively and to substantially reduce their allocations to stocks. TS&W is headed the other direction – we are adding, albeit cautiously, to equity allocations.

Perhaps one of the clearest lessons to be gleaned from the difficult markets in 1973-74 has to do with the tendency of investors to make decisions as if looking through a rearview mirror. In 1974, ten-year S&P 500 Index returns were also the lowest they had been in the post-war period to that point, and investors responded similarly. Matt remembers, "Investors had a bad experience and they didn't want to stay in equities. As a firm we had started out being conservative, risk averse, believers in diversification. Difficult markets made us even more committed to that philosophy. You need to be responsive to extreme departures from the norm but not overly influenced by your most recent experience. Of course, you learn that; the challenge is to apply it."

Investors who took that advice in 1974 – not to let their recent equity returns hold undue influence – were rewarded, as over the next ten years the U.S. equity market generated 15.6% annualized returns (see chart on the next page). As was the case then, TS&W now views the prospects for equity returns to be attractive. Matt goes on to say, "This is certainly a time for caution and most investors want to be less risky now; most clients want some anchor to windward. Our job is not to let them become too defensive."

Tom Thomson, TS&W's Director of Research and a 31-year veteran of the industry, echoed this sentiment, "Investors should avoid getting more defensive at this point – it is really too late for that. We are certainly cautious about the decline of the economy but are inclined to be incrementally more aggressive in making portfolio decisions."

Mark Twain put it this way, "We should be careful to get out of an experience only the wisdom that is in it - and stop there; lest we be like the cat that sits down on a hot stove-lid. She will never sit down on a hot stove-lid again - and that is well; but also she will never sit down on a cold one anymore."



3 Lowest Periods of 10-Year Annualized Return for the S&P 500 Index*		Subsequent Periods (Annualized)*		
		3-Year	5-Year	10-Year
September-74	0.5%	20.0%	16.9%	15.6%
December-74	1.2%	16.4%	14.8%	14.8%
September-75	2.8%	11.9%	13.8%	13.5%
December-08	-1.4%	?	?	?

*Past performance is not indicative of future results.

A Stock-Picker's Market

It became clear this quarter that the economy is in a serious recession. Credit is tight and the cost of capital remains high, as evidenced by stubbornly elevated corporate bond yields. That means though, that companies with stable cash flows that can fund growth internally will be at a competitive advantage. Strong balance sheets will create opportunities to acquire attractive franchises at distressed prices. Falling energy and commodity prices will also improve profitability for some.

TS&W portfolios today tend to be overweight Health Care and Technology. Medical device manufacturers that sell consumables to health care providers and subscription software companies, both have the benefit of relatively stable, recurring revenue streams. Conversely, portfolios are still underweight Finance. We remain cautious due to our concerns about capital adequacy, rising loan losses and crippled earnings power in this sector. This was among the most volatile parts of the market last year, as each of a series of rallies seemed to herald that the worst was over only to see stock prices fall even lower. TS&W requires that the stocks in which we invest exhibit signs of sustainable fundamental improvement. As a result, we may underperform in speculative rallies, but are less prone to the whipsaw effect that comes when the market realizes there is more bad news to discount.

While 2008 was not a stock-picker's market, we believe its nearly universal declines have created one. Valuations are at very attractive levels, and we see unprecedented opportunities to invest in high-quality stocks at discounted prices. We are sticking with our investment process and focus on fundamentals – especially balance sheet strength, cash flow stability and competitive position – as the key to uncovering such opportunities. We hold to our process based on our conviction, born of long experience, that periods of extreme volatility and irrationality are temporary. Over time, markets reward companies that show consistent fundamental improvement. It is just these companies we seek to include in the portfolios we build.

The lasting lesson of the early years of TS&W is the importance of a consistent, disciplined team united by philosophy and process. Matt Thompson put it this way, "The original partners built the TS&W team on mutual respect and strong philosophical beliefs. They emphasized consensus but were comfortable disagreeing. The key to long-term success then as now, is a consistent philosophy, the quality of the decision-making process and a strong team of high-caliber individuals. Over the history of this firm, we have built a strong, fundamentally-oriented team. The quality of the research we do today is the best it has ever been. Given the conservatism, core values and discipline of this firm, we are better equipped than ever to help our clients achieve their investment objectives."

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