

REVIEW & OUTLOOK

Crack the Whip

There is a children's game many of us have played called "crack-the-whip." A group of kids holds hands to form a line. One child, the head of the whip, starts running, leading the others in a twisting course across the playground. If you are at the end of the whip, the centrifugal forces make it hard to hold on, especially at the turns. Of course, you expect to lose your grip at some point. That is part of the game. When you fall, you get back up and chase the group to latch back on to the end of the line.

When the market turns, at a bottom for instance, a similar dynamic is at play. Prices decline when sellers outnumber buyers, and they must continue to decline until they reach equilibrium. Selling pressure mounts in a kind of feedback loop where, the further prices fall, the more people expect them to fall and want to sell. Eventually though, the last natural seller succumbs to the pressure to let go. When that happens, the imbalance shifts. The next buyer who comes along will have to raise her bid to find a willing seller. As prices move up, expectations follow.

On March 9, global markets hit a bottom and began a sharp rally. Investors who sold out at the end of February look now like they got shaken off at the turn. Some are still chasing the market for a chance to get back in the game.

The dynamics of market turns may be predictable, but their timing is not. No one has demonstrated the ability to call market reversals consistently. It is not simply a matter of getting out at the right time; you also have to know when to get back in to make a timing strategy work. Market sentiment creates powerful forces that are often wrong, and that can be especially strong precisely when the market is about to turn. Consistency is the key to a successful investment process. If you play the game of market

timing you should expect to be out of the market at critical moments. Thompson, Siegel & Walmsley's ("TS&W") approach is to construct portfolios that are not so easily whipped around by market sentiment by consistently selecting inexpensive stocks exhibiting positive change.

Snap Back

TS&W portfolio returns were strongly positive this quarter. Portfolio holdings retained their value relatively well in the recent market declines, yet still participated nicely in this quarter's rally. Some of our best performers were machinery stocks that benefitted from resurgent growth in emerging markets, energy names that rallied on rising commodity prices, and technology companies, especially those in the wireless communications industry.

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TS&W's portfolios have performed roughly in line with their benchmarks so far in 2009, with some ahead and others modestly behind. Most underperformed in the second quarter as the snap-back most favored the kind of stocks in which we are least likely to invest. For example, stocks priced below five dollars enjoyed average returns of 55.7%, while those priced above \$22 returned just 11.7%.

So-called "low quality" stocks also outperformed. Standard and Poor's assigns many stocks a letter grade intended to reflect the "growth and stability of earnings and dividends..." In the second quarter, the fifty stocks in the Russell 3000® Index rated A+ had an average return of 8.9%, while the 362

stocks with C ratings were up 25.1%. In other words, companies that had delivered consistent growth were at a distinct disadvantage in this rally.

We are often asked in what type of market we are most likely to underperform. We invariably identify the kind of market of which this quarter was a textbook case: a low quality, speculative rally in which earnings and valuation are secondary, or altogether irrelevant. We expect that these types of markets will occur from time to time but believe that they are, by nature, transitory. TS&W's investment process works consistently, across our equity portfolios and through time. Given the nature of that process, performance this quarter was in line with our expectations.

Better than Expected

The appetite for risk that had virtually disappeared in January and February returned in a hurry starting on March 9 of this year. Credit conditions improved dramatically, and the riskiest stocks began to rally hard.

What changed? In some respects it is easier to enumerate the things that did not change on March 9. The unemployment rate continued to rise, corporate earnings still declined, foreclosures and bankruptcies kept climbing, and housing prices dropped just as before. Yet, clearly, market sentiment did change. This was sparked by the results of the government stress test on 19 large banks, which suggested that they were not in imminent danger of failure, contrary to widespread opinion. If that were so, then the complete financial meltdown scenario might be taken off the table and most companies, especially those priced for bankruptcy, would face prospects far better than had been expected.

That phrase, "better than expected," which adorned financial press coverage of so many economic announcements and earnings reports, was really the hallmark of changing sentiment. Analyst expectations for corporate earnings and other economic indicators had been stubbornly optimistic throughout 2008 and generated one disappointment after another as a result. In early 2009 though, forecasters overshot in the other direction, becoming overly pessimistic and, consequently, easier to surprise on the upside. A

report might be bad, but if you had expected worse, then bad might actually be good.

The fact that leading economic indicators and company earnings are falling less rapidly is positive. Nevertheless, slowing declines are not what we look for in our investments. Rather than trying to anticipate a bottom, our discipline is to find stocks for which truly positive developments are underway. Even in this environment, those companies are out there.

Around the Corner

We are still in the midst of the worst recession of the post-war period, and it is unclear when the contraction will end. TS&W does not expect a rapid "V"-shaped recovery when it does. Growth is likely to be muted in comparison to other recoveries. Monetary stimulus will not be as effective, due in part to slow credit creation from weakened and wary financial institutions. Unemployment and savings rates will also likely stabilize at higher levels than in recent memory, inhibiting a return to pre-crisis growth rates.

While inflation is likely to present a problem again at some point, this does not appear to be a serious threat at this time. Bond markets are not anticipating excessive inflation, and while inflation

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expectations seem to be on the rise, inflation has not manifested itself in measurable ways outside of basic materials and energy prices. High unemployment, excess capacity, and consumer deleveraging should act as a buffer to excessive inflation. The Federal Reserve and other major central banks are also, by nature, predisposed to fight inflation and are well-equipped to do so.

The prospects for recovery in the U.S. are better than in other parts of the developed world. As painful as they have been to experience, the asset write-downs and recapitalizations at large financial institutions, the rapid rise in unemployment, even the decline in both consumer and capital spending; all were

necessary responses to the financial crisis. The speed with which they have occurred gives evidence of the flexibility and transparency of the U.S. economic system.

TS&W's portfolios are positioned for a slow-growth environment, holding many companies that have strong balance sheets, stable, recurring streams of revenue, and more visible earnings growth. That said, a number of more cyclical stocks have been ranking in our screens, and recent portfolio additions reflect this trend.

Portfolios are still underweight banks as mortgage write-offs continue and commercial real estate starts to create headwinds. Some portfolios have reduced or even eliminated their underweight positions in Financials though, adding to data processors and

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technology providers. Portfolios remain overweight Health Care and Technology sectors. Within Health Care, we are emphasizing pharmaceuticals, as negative sentiment has created attractive opportunities to invest in stocks that are improving their pipelines and cutting costs. We find semiconductor and hardware companies with mobile device exposure attractive as we see growth opportunities as handsets become more powerful. While we continue to have a consumer trade-down theme in play in the Discretionary sector, we have added more economically sensitive names to portfolios in this area. We see recovering growth in Asia, especially China, as a potential catalyst for some materials producers.

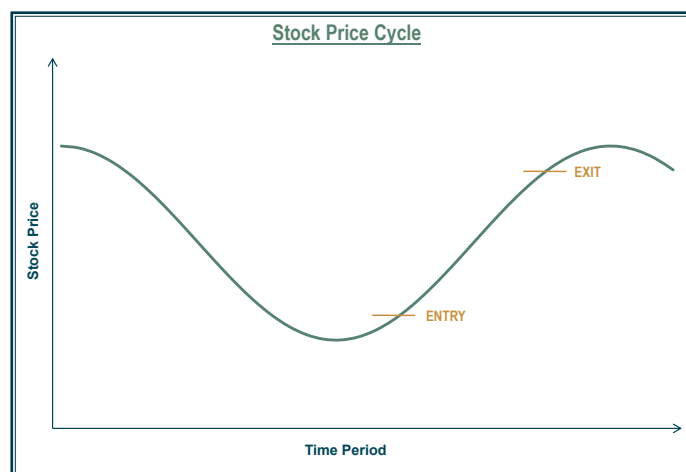
Catching the Turn

The graph to the right illustrates the part of a stock's price cycle where we focus our efforts. Like all value managers, we look for stocks that are inexpensive. However, rather than buying these companies as their situation worsens and the stock price falls, our process emphasizes companies that have begun to exhibit signs of positive change. In

most cases, this development will have already started to show up in the price movement of the stock when we start researching it. We are not trying to time the absolute bottom, either in individual stocks or in the market as a whole. We recognize we may not capture all the potential profits available to an investor who manages to pick the low point of a stock, but we don't believe there is a reliable way of doing that. We are willing to exchange that hypothetical missed return for the confidence and risk control that comes with buying into a situation that has stabilized and is clearly improving.

We expect that investors will, at times, behave irrationally, favoring stocks for purely speculative reasons. We expect that markets will turn rapidly on the whims of changing sentiment. As long-term, disciplined, process-driven investors, we are not trying to chase the crowd or catch the turns. Consequently, we do not expect to get shaken out at the bottom of a market or sucked in at the top.

We believe the game of crack-the-whip is best left to the kids.



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