

REVIEW & OUTLOOK

Financial market returns surpassed most investors' expectations in the third quarter, but whether the summer surge can stand the test of time is a very open question. In the three-month period ended September 30, 2009, stock indexes delivered or approached record-breaking returns. The Russell 1000® Index, a broad measure of U.S. large cap stocks, gained 16.1% for the quarter, a result exceeded in the last decade only by this year's April to June period. The Russell 1000® Value Index posted its best quarterly gain ever, at more than 18.2%, and the 22.7% gain posted by the small cap Russell 2000® Value Index was the best in more than six years. The standout for the period was the Russell Midcap® Value Index, which shot up an amazing 23.6%, by far the best result since that index was created in 1986. Understanding why markets went up so fast, and what drove them, provides insight into whether or not the recent performance is sustainable.

Although the magnitude of these three-month returns was surprising, the source was not difficult to pinpoint. Corporate profit reports for the second quarter were significantly better than most investors expected. According to Starmine, a service that tracks analysts' earnings estimates, second-quarter results for large cap U.S. stocks were about 25% greater than consensus estimates, a very large positive surprise. More than two-thirds of large cap companies, the ones most intensely scrutinized by analysts, reported positive earnings surprises.

The earnings surprises came in spite of a nearly 15% decline in revenues compared to the prior year, and they tell us two things about the situation that prevailed as the third quarter got under way. First, investor expectations were still quite low, even after the stock market had begun a recovery in March. And second, in response to the troubling conditions that fostered such low expectations, companies had cut costs dramatically, enabling them to report earnings that were surprisingly

good even in the absence of sales growth. Couple this earnings boost with aggressive Federal Reserve monetary policy designed to keep interest rates at rock-bottom levels and stabilize large financial institutions and you had the recipe for a powerful stock market rally.

Bonds, especially corporate issues rated below investment grade, also produced strong returns in the third quarter. Thompson, Siegel & Walmsley LLC ("TS&W") fixed income and balanced portfolios benefitted from the outperformance of corporates. Thawing credit markets enabled many companies to refinance maturing debt or to lock in low rates on favorable terms. Investors also snapped up massive government issues funding quantitative easing programs and fiscal stimulus.

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Underpinning these pleasing earnings results were the first faint signs that the "Great Recession" that began in December 2007 may be bottoming out. Numerous economic indicators, most notably those leading indicators designed to provide insights about future levels of economic activity, either stopped falling or began to edge higher during the latest quarter. There are even signs the beleaguered housing sector, viewed by many as the source of the global financial crisis, has reached a tentative bottom. These glimmers of good news fed into market psychology and reawakened investors' risk appetites, an intangible factor that can push stock prices beyond the level that cool logic would suggest.

Although we certainly participated in the improving market, most TS&W stock portfolios finished the latest quarter with lower returns than the market indexes against which we measure

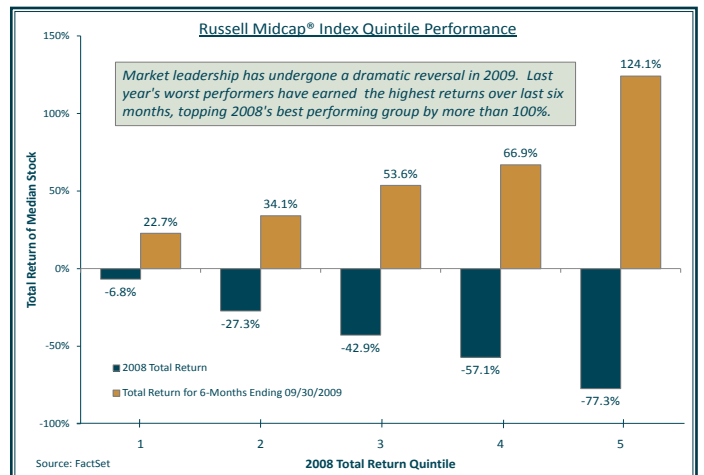
success. This shortfall in relative performance during a time of very strong absolute returns is primarily attributable to the characteristics of the stocks that led the market higher during the rally of the last six months. The best stocks to own this year—so far, at least—have been the very stocks that were the worst investments in 2008. In general, these are the companies that were at the epicenter of the financial crisis. They typically have weaker balance sheets or rely on external funding sources for day-to-day capital needs and are highly sensitive to changes in the level of economic activity. When the global credit markets froze up last year and economic activity slowed to a near standstill, these stocks were hit the hardest. Stocks in this group are the most volatile and risky investments because they tend to

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fall the most when markets are down and rise more rapidly than the average stock when markets head upwards and investors’ risk tolerance rebounds. While these stocks are not the only ones that went up in the latest quarter, they certainly led the way. Anyone hoping to outpace benchmark indexes over the last few months needed substantial exposure to this group to do so.

Bouncing Back

Two examples make the point dramatically. The graph in the right column examines the return pattern for the constituents of the Russell Midcap® Index. We divided the universe of more than 700 mid-sized companies into five equal groups (quintiles) based on 2008 total return, then compared the median total return for each quintile in 2008 to the median return over the six months ended September 30, 2009. The results perfectly illustrate that the stocks that best weathered the downturn in 2008 have been relative laggards this year, while the worst quintile of stocks in 2008, a group with a median decline last year of more than 70%, has had the best return this year, more than doubling from depressed price levels.



At the company level, examples of this radical reversal in market leadership abound. Crocs, Inc., the maker of those funny rubber clogs that were all the rage in 2007, lost its footing in 2008. As the capital markets shut down and consumers thought twice about discretionary purchases like bright purple foam slippers, Crocs’ sales, earnings and cash flow dried up and its share price fell from the mid \$30s to just over \$1.00 at year-end, a decline of more than 90%.

As 2008 ended, Crocs, like thousands of other companies weathering a severe recession, had lost access to its revolving credit line and was writing down inventories, closing facilities and sharply reducing its payroll. These draconian cost cuts, however, allowed the company to eke out an operating profit in the second quarter of 2009, even though sales continued to decline. In the six months ended September 30, Crocs shares were rubbery, bouncing more than 450% to \$6.65, a great return if your taste for risk was extreme and your timing was exquisite.

TS&W portfolios have also enjoyed a big bounce, but they lagged behind our benchmark indexes over the last quarter because we held comparatively few stocks like Crocs—companies that survived a near-death experience last year and have rebounded from extreme lows. Our investment process favors companies that generate substantial quantities of free cash flow on a sustainable basis, insulating them from credit market disruptions and providing financial flexibility.

This approach does not limit us to only defensive or non-cyclical stocks, but it does mean that a company with a faddish product or a frequent need to tap the capital markets for cash won’t often make the cut.

We seek to own companies that can prosper and earn good investment returns over a wide spectrum of economic scenarios—from a continued decline in GDP, to a bottoming process that produces limited expansion, to a more robust recovery. This has weighted our portfolios toward less speculative names, companies that tend to trail the high-flyers that excel in a market like we have experienced over the last six months. This is not to say our portfolios have fared poorly, in fact, absolute returns are quite strong. However, we believe the more meaningful test of investment performance will come in the months ahead, now that expectations and valuations have risen.

What's Next?

Some of the factors that have driven stocks higher over the past six months remain in place as we enter the fourth quarter. Corporate profits face relatively easy comparisons with the prior year, when the global recession was worsening; the Federal Reserve and other central banks continue to pursue a highly accommodative monetary policy, keeping interest rates low; and investors appear to be comfortable, taking risk once again. A large amount of cash sits in low-yielding money market funds and other short-term investments, hinting that some investors may be waiting to “buy the dips,” thereby keeping stocks on a generally upward track. These factors could extend the pattern of the last six months, with riskier stocks leading the markets higher.

However, there are good reasons to expect that market averages will struggle to maintain the torrid pace of the third quarter and that market leadership may be about to change once again. First, the powerful lift that rewarded many troubled companies for merely surviving the severe liquidity crisis and economic slowdown has probably run its course. Expectations are no longer at rock bottom levels. The notion that “green shoots” of economic recovery have taken firm hold is well established. Stocks may react poorly to economic data that fails to confirm an improving trend or points toward the dreaded “double dip.” This is especially true of the unemployment rate, which, at nearly 10% and rising, is close to its highest level in a quarter-century. A continuation of the poor employment

trend will call into question the likelihood of a consumer-led economic recovery. Stocks with the highest sensitivity to consumer spending stand to lose the most ground if fears emerge that the green shoots are withering.

Investors will increasingly look for signs that profit growth is driven by an improvement in sales rather than cost-cutting alone. Notwithstanding easy comparisons with the year-earlier period, some companies may find it harder to beat investors' upgraded expectations. In addition to higher expectations, stock valuations are also up. Many of the stocks that were so badly slammed in 2008 have returned to valuation levels equal to or exceeding those from before the financial crisis began. Crocs, for example, trades at about twenty times cash flow, a lofty valuation in any environment. This spike in valuation could lead investors to reexamine this year's laggards, the less economically sensitive, lower risk stocks that did better in 2008.

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TS&W's consistent investment process keeps us focused on stocks with attractive valuations, strengthening fundamentals with a particular emphasis on free cash flow, and catalysts that can drive valuation higher. Over time, stocks meeting these criteria outperform broad stock market indexes. We do not alter our approach to conform to market trends that, as we have seen many times before, can change direction quickly. In periods of rapid change in market leadership, TS&W's steady approach may lag temporarily behind market benchmarks. However, these periods are typically associated with significant uncertainty, and the present time is no exception. Our analysts and portfolio managers are finding numerous investment opportunities that meet our requirement for a highly favorable risk-reward tradeoff. We feel strongly that this consistent approach is essential to investment success—outperforming market benchmarks and meeting our clients' expectations over time.

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