TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

4Q 2009

REVIEW & OUTLOOK

December 2009 marked the end of a decade whose name is still a matter of debate (aughts? naughties? zeroes?). This seems fitting given the difficulties and division the events of this period have fomented. Looking back ten years though, it is striking how strong a consensus there was for the productivity miracle being wrought by advances in technology. Remember the goldilocks economy? Of course, as is so often the case, consensus turned out to be about as wrong as prognostication can be. Ten years, two bubbles and two crashes later, equities are more or less right where they started, unemployment is at a generational high and government involvement in the economy is at levels not seen since the Great Depression and before that, the Civil War.

The Treasury Two-Step

As complex as some aspects of the crisis were, the logic of the market decline was brutally simple: investors who needed cash – and seemingly everyone did – had to sell whatever they could. Prices for virtually every asset fell to the point where investors had both the cash they needed and the confidence that their remaining investments were no longer overvalued. Of course, government intervention played a big role in determining where that level was.

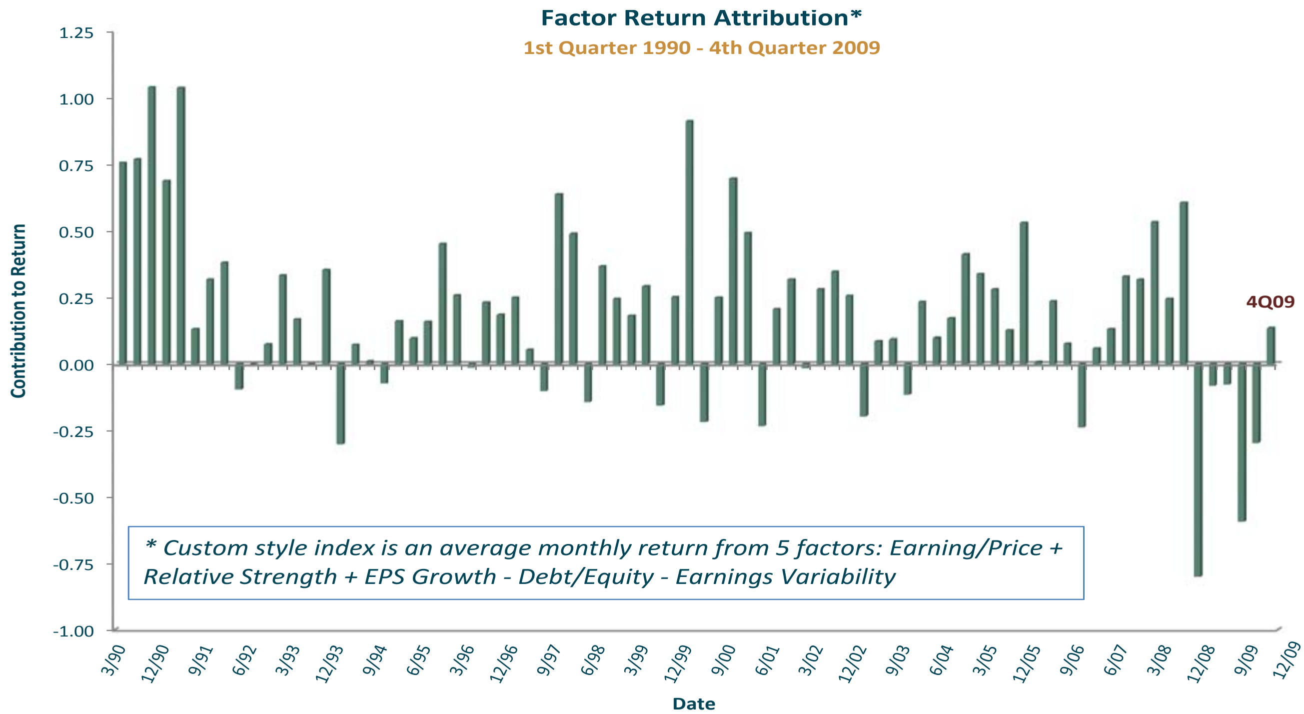
The market rebound was equally simple in its logic. When the government stepped in with massive injections of capital into the financial system and stimulus into the economy a great deal of risk was removed from the market. Risky assets were now heavily undervalued. Investors moved rapidly from a state of panic, in which almost any risk was too much, to an "all-in" risk-seeking mentality. They snapped up shares of companies with high debt levels, declining earnings, low return on equity, companies that had weeks or months earlier been priced as if they were going out of business. By just about whatever measure of risk you used, in 2009, risk outperformed.

Style Headwind

As discussed in previous letters, rapid market reversals and low-quality rallies tend to be challenging for Thompson, Siegel & Walmsley LLC ("TS&W"), as it takes time for our bottom-up process to adapt to new environments, and we have a quality bias. These conditions were difficult for many managers this year, but an unusual confluence of events made this period especially problematic for us.

TS&W's process and philosophy are biased towards low P/E, positive relative strength and EPS growth and away from high debt/equity and high earnings variability. The chart on the next page illustrates this bias is a consistently rewarding combination of factors.

The graph on the next page shows output from a software package called Northfield that we use mainly to measure and manage risk. Northfield breaks down returns into their component parts to help us analyze what factors are driving market or portfolio performance. As anyone who has heard us describe our investment process knows by now, we invest in companies that are inexpensive and where something positive is happening. Put in the terms of Northfield's analysis, TS&W invariably emphasizes stocks with low price-to-earnings valuation (inexpensive) that have above average earnings growth and good relative price strength versus the market (positive change). At the same time, we avoid stocks with heavy debt and volatile earnings. As the graph shows, over the last twenty years this combination of factors has been a



Source: Northfield

consistently positive contributor to market returns. In the relatively rare instances when these factors turned negative, they did so only modestly and briefly – never more than a quarter at a time.

At least that was true until 2008-2009 when, for an unprecedented five quarters in a row, our style of investing worked steadily against us and with a magnitude that, at some points, was as big as or bigger than at any other time in the last two decades. These factors converged in the second and third quarters of 2009 to form a stiff stylistic headwind for our process, and while our portfolios still enjoyed solid absolute performance, they lagged their benchmarks significantly.

We believe this type of event is unlikely to be repeated not only because it is historically unusual, but also because analytically, it seems that over time market prices should respond positively to low valuation and improving earnings. Investors should be averse to high debt and volatile earnings patterns.

Wind Change

It appears that the longest recession in the post-war period finally ended in the third quarter, and a cyclical recovery is now in place. This is an industrial and corporate led recovery. After cutting costs dramatically, many companies are lean and hungry and it will not take much top line improvement to make a significant impact on earnings.

Consumers, on the other hand, continue to face considerable challenges, including rising gasoline prices, high unemployment rates, consumer credit contraction and high debt loads. Household balance sheet repair will take time, and savings rates may be higher long after that process is complete. We will continue to emphasize consumer companies with good financials and strong competitive positions, but portfolios are becoming less oriented toward discount retailers as this theme has mostly played out. Our reward-to-risk hurdle rate will be higher for names in this group as a result.

Most TS&W portfolios are overweight health care stocks, which were resurgent this quarter as passage of a reform bill in the House and debate over the more moderate Senate version helped remove uncertainty by sketching the outlines of the forthcoming law. Moreover, after several quarters of underperformance, many of these stocks appear heavily undervalued compared to the market. Our analysis suggests some pharmaceuticals stocks for example, are valued mostly on current product sales, with little or no value attributed to their pipelines of future drugs.

TS&W portfolios continue to emphasize technology stocks too. We are finding financially strong companies contributing to the development of increasingly powerful handheld devices, cloud computing and other potentially revolutionary technologies.

Their rediscovered appetites for risk apparently sated, investors in the fourth quarter refocused on the fundamentals, sifting through earnings reports and market data for clues as to which companies will actually be able to deliver on the promise of the mid-year rally – which companies will thrive in the months and years to come. This is the type of environment in which our process is at its best.

Now for the Hard Part

Some observers, us included, objected that the market rally this year seemed to be ignoring the fact that the underlying problems of the economy had not yet been addressed. Frankly, that did not matter. Markets had sold off due to excess unpriced risk in the system, and once that risk was effectively removed by government intervention, markets were bound to recover. The much tougher challenge, the one we really began to face in a serious way in the fourth quarter, is what happens now. The government was effective in ending the liquidity crisis, but its intervention did not eliminate the risk. It just shifted that risk out of the markets and onto its own balance sheet, which is to say, onto the taxpayer.

There is a fair amount of division over the question of where the economy is headed next. Interestingly, two significant camps have formed on extreme ends of the spectrum of possible outcomes. Some analysts are calling for high levels of inflation or even hyperinflation as a natural consequence of the dramatic increase in government spending. Others still predict pernicious deflation due to the lack of new credit creation and to both consumers and institutions deleveraging. However far apart these camps are on the specifics, there seems to be widespread agreement things are going to be bad for a long time, which ought to give us pause.

There is no doubt that the U.S. faces challenges as great as at any time in at least a generation. Among the biggest is how the government will extricate itself from its deep involvement in the economy. The need to eventually withdraw support from the housing market and the financial system must be balanced against the risk of sparking a second slowdown.

Still, it would seem that if the consensus is wrong, then it is most likely to be surprised by events turning out better than expected.

Ten years ago, Warren Buffet was in a distinct minority predicting (correctly as it turned out) that bonds would outperform stocks over the first decade of the new millennium. Today, Buffett is again in the minority but this time by acquiring railroad company Burlington Northern, an investment he characterized as "an all-in wager on the economic future of the United States."

On an earnings call with a Swiss luxury goods company, recently, the CEO was asked to respond to the assertion that recovery in the U.S. would be slow. His response was interesting. He said, "I will never bet against the United States of America. A lot of people have gone bust that way. …They've got a habit of fixing things. …I believe the United States will be back quicker than most people think. …Will there be structural changes? Yes, but that's the American way. …The competitiveness, [will] be back. We may… have to rely upon a technological revolution for the next growth in productivity, and if it comes, it's going to come out of the United States."

The American economy is among the most resilient and flexible in the world. The speed with which companies responded to the downturn was startling, even painful, yet many are now well positioned for whatever the future will bring. The implication of the problems that still loom over the national and global economy are that the bias we consistently show toward stable and improving companies will be more important and more likely to be successful than ever. We are confident that as companies distinguish themselves as good stewards of capital, our process and our focused team of analysts and portfolio managers will be able to uncover and capitalize on the investment opportunities they represent.

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