TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

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REVIEW & OUTLOOK

# IS IT SUSTAINABLE?

Sustainability has become a popular buzzword among environmentalists in recent years. In this context, sustainability is defined as "meeting the needs of the present without compromising the ability of future generations to meet their own needs."[1] The destruction of rainforest habitat or the overfishing of species like bluefin tuna and codfish are examples of practices that are clearly not sustainable in an environmental or economic sense. Energy sources like solar and wind power are considered to be sustainable because they are not reliant on carbon-based fuels that cause pollution and that are subject to depletion.

> *"We believe that today at least some of the factors that have driven financial markets higher over the past year are not sustainable."*

The concept of sustainability is an important component of Thompson, Siegel & Walmsley's ("TS&W") investment approach and is particularly relevant in the current investment environment. Although we are not pursuing an environmentalist agenda, we think about sustainability in a similar way. We use a quantitative screen to highlight stocks that are inexpensive relative to their free cash flow and that exhibit signs that positive change is occurring. We scrutinize this limited group to ascertain why a given stock is cheap and what is changing. We do not invest unless we are confident that the changes we observe are sustainable over an appropriate investment horizon, typically 18 to 36 months.

We believe today at least some of the factors that have driven financial markets higher over the past year are not sustainable. For example, not all companies exhibiting strong free cash flow can sustain themselves on a diet of sharply reduced costs and curtailed capital spending. This suggests that understanding the sustainability of the fundamental drivers of return will again be a discriminating factor for investors in the months ahead.

## The Bounce Continues

Over the past twelve months, financial markets around the world have staged a remarkable rally from the crisis-induced lows of early 2009. The Russell indices of U.S. large-, mid- and small-cap stocks are up between 51 % and 65% over the last year. Foreign stocks, in many cases, are up even more, while bonds have notched total returns ranging from more than 8% for high-quality tax exempt issues, to nearly 30% for investment grade corporate bonds and more than 50% for non-investment grade corporates. Although stock market averages are still below the all-time high levels reached in 2007, this recovery in prices has replenished portfolios and significantly boosted investor confidence. If we were fishermen, we might observe that our nets were once again bursting with tuna.

TS&W stock portfolios have also enjoyed strong absolute returns over this period, although we have generally lagged behind the market indexes, which is typical for our investment style in a blistering

[1] United Nations General Assembly, "Report of the World Commission on Environment and Development: Our Common Future", March 20, 1987.

market rally. Our objective is to outperform our benchmarks over the course of a market cycle, but we are typically off the pace during the most explosive segment of the expansion phase.

There are good reasons why stocks and non-government bonds are up and why they may continue to move higher. Corporate profits and cash flow, which are the fuel that powers stock market rallies and relieves worries about corporate credit-worthiness, have been remarkably strong. Large cap company quarterly earnings were up nearly 200% in the 4th quarter of 2009, benefitting from an easy comparison with the depressed level of the prior year. Although the earnings recovery was clearly gaining strength through the second half of last year, analysts' estimates of 4th quarter results were still too conservative.

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By our count, more than two-thirds of small cap stocks topped profit estimates in the 4th quarter and an even greater percentage of mid and large cap stocks did so. Less than 1 stock in 6 failed to meet or exceed consensus expectations. Analysts have responded by raising profit forecasts. Expectations for the full year 2010 now call for 20-30% growth in earnings per share for broad market averages. With the U.S. and global economies continuing to show evidence of gradual improvement, the profit surge should continue when first quarter results begin to roll in later this month. The combination of strong year-over-year profit growth, positive earnings surprises and rising growth estimates is a powerful driver for stocks.

In addition to profits, free cash flow, which we define as operating profit after tax less capital spending, has also been exceptionally strong. Due to the profit rebound and lower capital spending, corporate free cash flow hit record levels in 2009 according to the government's Bureau of Economic Analysis. Companies have used excess cash flow to strengthen balance sheets and could begin to consider increased investment spending, higher dividends or share repurchases and even acquisitions if confidence continues to recover. This too contributes to the market's bullish mood.

## Over-Fishing?

Although we do not downplay the impressive recovery in corporate profits and cash flow, the healing of balance sheets or the improved creditworthiness of public corporations, TS&W believes there are important questions surrounding the sustainability of the rally. For example, the equity market recovery has been underpinned by unprecedented government stimulus programs enacted in a coordinated fashion around the world. However, extraordinarily low interest rates, record fiscal stimulus and central bank support for markets on a scale never employed before cannot be sustained indefinitely without compromising the long-term vitality of the economy and financial markets. The ability of economies around the world to prosper as government support is inevitably withdrawn is an open question.

The question of sustainability is also pertinent on an individual stock level. Scott Miller, one of TS&W's veteran equity analysts, recently reviewed the 2009 results of a leading apparel retailer. This particular stock exhibited many of the attributes that have pushed the market higher over the past year. Due to very strong 4th quarter earnings relative to expectations and free cash flow that more than doubled from the prior year, this stock ranked well in the proprietary quantitative screen that TS&W uses to generate potential investment ideas.

As he dug into the fundamentals, however, Scott noted the company had slashed expenses, brought new store expansion and other capital investment to a halt, and aggressively reduced inventories such that the working capital variance alone produced over $150 million of incremental cash flow. These moves certainly boosted profits in the short run and could lead to growth for a few more quarters. The market reaction was positive, sending the stock price up.

The problem, however, is that this kind of growth is the business equivalent of drift-net fishing for bluefin tuna. It can reap a huge bounty in the short run, but quickly depletes a healthy fishery. To thrive, a national retailer needs to spend money on advertising and keep its stores fresh and shelves well-stocked with inventories that appeal to consumer tastes. Long-term growth requires capital investment to outfit and stock new stores. Maximizing short-term cash flow simply is not a sustainable practice for a healthy company. The issue of sustainability cooled Scott's interest in the stock. He ended up recommending a different apparel retailer that has continued to invest for long-term growth through the downturn with sustainable, rather than artificially inflated, free cash flow characteristics.

TS&W invests in stocks that are inexpensive relative to their cash flow, exhibit positive change, and, critically, can sustain that change over a market cycle. These are not always the top performers in the recovery phase of a market cycle like we are currently experiencing, but we believe more often than not, they will generate returns that exceed market benchmarks over time. We are continuing to find stocks that meet these criteria, but selectivity is becoming more important as markets move higher.

## A Realistic Future

The global stock market rally of the past twelve months probably has farther to go, barring an unforeseen shock. Corporate profits and cash flows should continue to recover along with the global economy. Governments and central banks remain committed to fiscal and monetary stimulus for now, and stock valuations are not excessive in an aggregate sense. Investor sentiment has rebounded to normal, or perhaps even bullish, levels. Around the world, the appetite for risk is back.

Experience has taught us, however, that times of plenty are the right times to think harder about sustainability. Is excessive government spending today "compromising the ability of future generations to meet their own needs"? Is aggressive market intervention by central banks courting resurgence in inflation or short-circuiting healthy market mechanisms? Can individual companies provide good long-term returns to shareholders if they cut costs and capital spending in a short-sighted effort to "beat the number" in the current quarter?

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TS&W cannot provide precise answers to these important questions, but we believe sustainability issues like these will take on increasing importance as 2010 progresses. What we know is that inexpensive stocks with sustainable positive change underway have the best likelihood of providing healthy returns for our clients. Rather than attempt a general prediction of the longevity or scope of the market advance, we carefully review investment ideas one at a time to ensure they meet our criteria. We believe that in addition to value and positive catalysts, emphasis on sustainability will help to discriminate between the best fishermen and those simply content to fill their nets for today.

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