TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

2Q 2010

REVIEW & OUTLOOK

- *Markets declined this quarter as uncertainty overcame optimism*
- *We see the economy stabilizing at slower growth rates*
- *The market appears to be paying attention to fundamentals again*
- *Overreaction in uncertain environments creates opportunities*

OPPORTUNITY'S COST

Ansel Adams' photograph *Moonrise, Hernandez, New Mexico,* depicts a sleepy southwestern town and its tiny cemetery at the precise moment on an early autumn evening when the setting sun illuminated the crosses and grave markers with an unearthly light. It has become an iconic image, but the story behind the picture is equally interesting.

According to Adams, he was driving home from a long day of shooting when he noticed how the light was striking the little graveyard. He jumped out of his car, set up his tripod and large format camera, prepared and loaded a photographic plate and took the picture. After the first exposure he prepared a second plate as quickly as his experienced hands were able, yet by the time it was ready, the light had changed and the moment had passed.

In order to capitalize on opportunity, one has to have an eye trained to see it for what it is and the skill, experience and conviction to seize it before it disappears. Markets often overreact to uncertainty, creating opportunities for investors who are prepared to take advantage of them. We saw just that sort of volatility, and the opportunities that come with it this quarter.

The rally that started in March 2009 stalled in April 2010 with a market correction that carried the S&P 500 Index down nearly 15% from its April high. During the rally, stock fundamentals did not really matter. During the correction though, the companies we favor, those with strong free cash flow and improving fundamentals, enjoyed intermittent episodes of outperformance that became more sustained in the last few weeks of the quarter. We are hopeful that this pattern signals that fundamentals will matter more going forward. However, the bipolar risk trade remained the primary driver of market returns this quarter, and this pattern of either "risk on" or "risk off" that has been in place for the last couple of years could well continue.

After more than a year of risk on, a market that had been buoyant in anticipation of a robust and rapid recovery was weighed down by mounting evidence of a slowdown in global growth. Worries about a sovereign debt crisis in Greece and the possibility of contagion to other European nations, an overheating Chinese economy, the impact of the ongoing Gulf oil spill and a host of weak U.S. economic data all combined to raise the specter of a double-dip recession and flip the switch to risk off again.

What Recovery?

We have to wonder, *is the current environment materially riskier than three months or a year ago?* We do not think so. In fact, by most measures, circumstances have markedly improved. In our view, neither the market's exuberance during the rally nor its despondency during the

correction fairly reflects economic reality. The recovery, as we are seeing it through the companies we follow, may be slower than many would like, but it is real and it can continue.

Banks and other financial institutions are improving their capital positions by writing down non-performing loans and earning their way out of leverage. Credit markets are thawing. Employment is slowly beginning to recover, as is housing. Government stimulus is working, yet inflation still appears tame. Companies are replenishing inventories and many have experienced robust earnings growth from depressed levels a year ago. Even consumer spending has been surprisingly strong at times this year. The International Monetary Fund is now forecasting 4% global GDP growth for 2010.

The recovery is real, but it is not invulnerable. Credit conditions have improved but there is a sharp division between those who have access to it and those who do not. Borrowers with excellent credit can borrow at attractive rates, while less creditworthy borrowers cannot get loans at all. This is troubling because the entrepreneurial class, an important source of new employment and other economic activity, often comes from the latter group. Banks are getting conflicting messages on this front: politicians want them to lend, regulators want them to improve their balance sheets.

The U.S. economy is also susceptible to a global slowdown. European Union governments are now adopting austerity measures in order to avoid sovereign debt crises in some of their weaker members. These measures, however prudent, may have the unintended effect of slowing economic growth.

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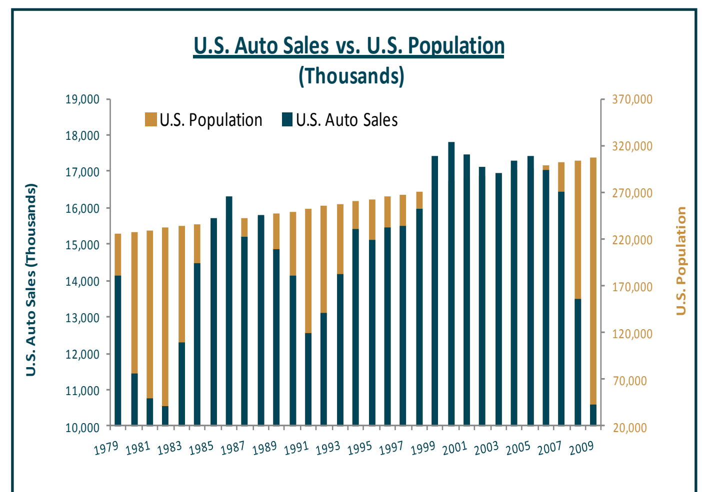
The biggest threat to the recovery though may well be what started the slowdown in the first place. In simplest terms, the cause of the financial crisis was excessive debt. Since the acute stage of the crisis, we have actually increased our debt load as a nation, as government debt has risen rapidly while consumer debt has fallen only slightly. All this debt has to be paid down. Consequently, we continue to prefer companies that do not have a lot of debt and that will not get hurt as the world goes through this process.

That said, given the steep economic decline we have experienced and the shallow recovery thus far, it is difficult to envision the deterioration required to form a double-dip recession from here. As just one example, U.S. auto sales have consistently ranged between thirteen and seventeen million units a year over the last thirty years, as shown on the graph below.



In early 2009, they dropped to an annual rate of nine million, a level not seen since the 1981-1982 recession. Sales have recovered but third quarter estimates project an annualized rate of 11.8 million units, similar to the level during the 1991 recession*. For perspective, keep in mind that the U.S. population in 1991 was around 253 million and today it is about 307 million. People can certainly delay the purchase of a new car, but eventually old vehicles have to be replaced with new ones. Sales may not return to longer-term averages quickly, but it is hard to imagine a scenario in which they decline significantly from here either. One need only look at inventories or industrial production, capital goods manufacturing or a host of other series to see a similar pattern. Thus, while many forecasters and investors seem to be anticipating extreme outcomes, we see a strong case for a stabilizing, albeit slow-growth economy.

*Source: autonews.com

Better and Worse

Most Thompson, Siegel & Walmsley LLC ("TS&W") portfolios outperformed their respective indices in the second quarter correction. In a number of strategies, consumer discretionary stocks performed well, especially discount retailers that benefit from consumers moderating their spending habits.

> *"We believe the stocks we hold today have… the ability to do well in a wide variety of scenarios."*

Improving credit conditions for large, growth-hungry companies are providing a spur to merger and acquisition ("M&A") activity. Our focus on finding inexpensive stocks with strong cash flows often leads us to companies that are also attractive targets for acquisitions. We have seen M&A pick up this year, and several of our portfolios have benefitted from holding companies that were acquired at a premium by larger firms.

We expected the very low valuations in some of our health care names to provide some downside protection to portfolios – and to some extent they have. But despite the clarity on regulatory reform provided by passage of the health care bill, the stocks have not acted as defensively as we would have expected, partly due to their exposure to European government spending. Exposure to companies that were directly, indirectly or even tangentially related to the Gulf oil spill also hurt some portfolios.

On balance, we are positioned more cyclically than earlier this year, but we maintain a cautious stance toward debt. As we have for some time, we favor Health Care and Technology for their reliable cash flow generation, while we remain underweight Financials, which face both earnings and regulatory pressure. We are interested in the move toward cloud computing – the phenomenon in which more and more computing and storage is done in centralized server farms rather than on local computers. Even large companies are pursuing the opportunity to outsource some IT functions and thus cut expenses. As companies move sensitive information to third party servers, data security will be increasingly important, and we are looking for beneficiaries of that trend as well. We are interested in pharmaceutical companies for the first time in years. These companies are inexpensive due to worries about how new regulations might reduce profitability. We see these companies as reasonably valued based on the cash they have on hand and the cash flows they are currently generating, which means that investors get any future value deriving from drugs in development or clinical trials effectively free.

Stocks appear fairly valued, but not especially cheap, partly due to what we would regard as overly optimistic earnings projections for many companies. We are working hard to ensure that our portfolios are inexpensive compared to their benchmark indices and believe this disparity can provide us with a tailwind whether markets move up or down from here.

Which Way from Here?

There is a great deal of uncertainty about where the economy goes from here. Regardless of how the recovery process plays out though, our emphasis on current cash flows and earnings growth means that we focus on companies that objectively can succeed in the current environment rather than on more speculative plays. Although our portfolios are generally positioned to do best in a stable, slow growth environment, we believe the stocks we hold today have a great deal of flexibility and the ability to do well in a wide variety of scenarios. As we have said before, TS&W's competitive advantage is not economic forecasting – we are stock-pickers. We have to understand the environment in which we operate, but we are not banking on a particular view of it to be successful. Given how widely forecasts of our economic future vary – between deflation and inflation, between robust recovery and double-dip recession – we believe that is a real advantage right now.

We are also highly alert to the fact that uncertainty always creates opportunities and we are searching diligently for them. As Louis Pasteur put it, and Ansel Adams was fond of quoting, "Chance favors the prepared mind."

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