



Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

To Our Clients

“It is well that war is so terrible, or we should grow too fond of it.”

- Robert E. Lee

War is always an unwelcome event, whatever your nationality, political persuasion, religious affiliation or investment allocation. The war in Iraq brings us face to face with intense emotions careening from hope, pride and patriotism one day to sadness, anger and anxiety the next. As much as we might wish to shut out thoughts of war and focus our efforts on familiar facts like stock prices, dividends, interest rates and quarterly profit reports, the war intrudes on every calculation, every conclusion. It is simply not possible at this time to separate the effects of war from our judgments about the economy, the financial markets or investment portfolios. The war in Iraq, and its eventual aftermath, will be an important factor in investment decision-making for months to come. In this note, we will share with you our view of the impact of war on our clients' investments and our plans and processes for coping with the unwelcome reality of war.

Shock and Ambiguity

In the age of precision-guided munitions, night vision technology and real-time satellite imaging it is ironic that, more than anything else, war obscures investors' vision and promotes uncertainty. The grit from this sandstorm flies into everyone's eyes.

The Federal Reserve's Federal Open Market Committee (FOMC), which sets monetary policy and is chaired by Alan Greenspan, met recently to consider the Central Bank's interest rate stance. These highly anticipated meetings often result in changes in short-term interest rates or statements that provide insight into the Fed's view of the economy. Following its March 18 meeting, the FOMC noted "the unusually large uncertainties clouding the geopolitical situation in the short run." The central bankers further stated that "the Committee does not believe it can usefully characterize the current balance of risks...rather, the Committee decided to refrain from making that determination until some of those uncertainties abate." If the Fed's top minds, armed with the most timely and complete data on the status of the economy and backed by an army of ana-

lysts, are scratching their heads, it is understandable that many consumers, businesses and investors are reluctant to forge ahead with conviction.

Uncertainty manifests itself in financial markets as volatility, the sudden and substantial price fluctuations that cause heartburn for investors. Stock market volatility has been on the rise for several years and reached

a record high in 2002.

Although most market indices ended the first quarter within a few ticks of their

While new scenarios and potential outcomes are possible, the fact of war does not cause us to alter our approach to investing.

starting point, the average daily price change remained at record levels. The stock market began the year on an optimistic note but slumped as investors contemplated the ramifications of war. In the quarter's final two weeks, the stock market first staged a massive "war rally," jumping nearly 12% in eight days after the threatened war against Iraq became a certainty, and then retreating under fire after "embedded" reporters brought us face to face with the confusing and terrifying reality of war.

This erratic market behavior is not solely due to the outbreak of war in Iraq. Numerous factors, including mixed economic readings, uninspiring corporate profit reports, surging energy prices, the burgeoning Federal budget deficit and President Bush's tax cut proposals, are all mixed into the first quarter's market hash. The war, however, impacts all of the fundamental factors that direct the stock and bond markets, and it is a crucial element in investor psychology as well.

Psychological Ops

Psy-ops, the military's term for radio broadcasts, leaflet campaigns and misinformation aimed at discouraging enemy troops, might also describe the war's psychological effect on financial markets. Memories of the first Gulf War and its aftermath are relatively fresh in investors' minds. Gulf War I presented a best-case scenario for war: a quick, decisive victory was achieved by a global coalition with limited cost to the U.S. and the prompt restoration of strategically important oil supplies. The beginning of the first Gulf War deflated oil prices and sparked a powerful rally that drove the stock market up more than 30% in 1991. That war cemented the status of the United States as the world's only remaining superpower, boosting the foreign exchange value of the dollar and drawing capital flows from around the world for the next decade. Gulf War I had the additional benefit of showcasing dramatic improvements in military technology, perhaps sowing some of the first seeds of the "tech bubble" that was to bloom in the late 1990s. Positive investor psychology in the wake of the first Gulf War overcame a stubbornly sluggish economy and a barely remembered plunge in corporate profits. Investors could be excused for recalling the first Gulf War fondly.

Today's Gulf War lacks the global consensus and U.N. backing of the earlier version, and it has a far more difficult and complex objective. Our present commitment in the Middle East will be longer and more expensive than our 1991 engagement. After little more than a week, some critics ominously predicted "another Vietnam" in

which coalition forces would bog down, face a hostile populace, sustain massive losses and fall far short of "best-case" objectives. References to Vietnam, however premature and inaccurate, are chilling to investors who have studied that war's impact on our economy, our markets and our national psyche. This time around, even our marvelous military technology, far advanced from Gulf War I, lacks the dramatic power to dazzle us.

The current conflict is unique in another important way. This highly televised war inundates investors with more information, much of it spurious, and more instant analysis, much of it off target, than any conflict in history. Need another opinion? Just change the channel. This information torrent spurs the financial markets' volatility. A quick resolution of the military conflict would provide investors with a long-awaited psychological lift. If all-out war lasts into the summer months, on the other hand, investors sentiment toward stocks would slip even further. Thompson, Siegel & Walmsley has always sought

A quick resolution of the military conflict would provide investors with a long-awaited psychological lift.

to resist the markets' emotional extremes by sticking with a disciplined investment process. This separation

between emotion and investment decision-making is especially important today.

Bogged Down?

The economic effects of this war will be difficult to discern. The most immediate effect, already in clear evidence, is the hesitation in economic activity that accompanied the buildup to hostilities and the onset of the war. It seems clear that the economic recovery that was taking shape in 2002 will suffer a pause in the first half of 2003. Consumer confidence plunged in March to the lowest level in almost ten years, and sales of big-ticket discretionary items and business capital spending seem to be on hold. Unemployment remains a stubborn problem, largely because businesses are reluctant to expand hiring in the face of so much uncertainty. Energy prices have moved sharply higher thanks to a combination of war worries, political unrest in Venezuela, ethnic violence in Nigeria, and cold winter weather. Higher energy costs sap consumer budgets and erode

business profits. Evidence is beginning to accumulate that corporate profits may be disappointing in the first quarter, breaking a three-quarter string of rising earnings.

Longer term, the war's economic impact is likely to be modest. Wars are expensive, and much of the money spent—President Bush has asked for an extra \$75 billion from Congress to “prosecute” the war—will add directly to gross domestic product. A victory that secured the Gulf region for Western interests would help to stabilize energy prices, an undeniable positive. But as the first Gulf War demonstrated, a brief conflict adds practically no stimulative juice to the economy.

A longer war, on the other hand, does not necessarily imply a drawn-out pause for the economy. As the conflict lengthens, consumers will recover from the “CNN effect” and “Code Orange” homeland security alerts and will begin to dine out and shop again. Business spending and hiring should resume a gradual upward pace, spurred by helpful monetary policy and the stimulative impact of rising government expenditures. But not all of the war's effects are beneficial to the economy. The Bush administration's tax cut proposal, partially aimed at bolstering the financial markets through elimination of the tax on dividend income, might be rejected by Congress if a long war leads to significantly higher cost estimates. Past wars, particularly Vietnam, have also been associated with bouts of inflation. While prices might move up at a slightly faster pace due to the war, there is little evidence today to suggest a replay of the debilitating inflation of the Vietnam era.

In summary, we expect the economy to endure a temporary stall, and to resume a modest growth trajectory later this year. Interest rates will eventually rise, but not to a level that threatens economic growth. The eco-

nomics fundamentals that contribute to financial market health should continue to be mostly positive.

Tactics and Strategy

Rapidly changing market conditions and uncertainty are constant factors in long-term investing. As we have described, the outbreak of war adds a significant new source of anxiety and uncertainty, and it demands careful consideration of its multiple effects. While new scenarios and potential outcomes are possible, the fact of war does

not cause us to alter our approach to investing. Thompson, Siegel & Walmsley's philosophy—our strategy, to use a mili-

tary term—and our tactics—the daily processes that we employ to find opportunities and control risk—are helpful guides in a chaotic environment. We are long-term, value-oriented investors. We employ clearly observable facts, like prices, interest rates, historic profits, cash flow, dividends and balance sheet measures, along with carefully constructed projections, to set target prices for stocks. We evaluate company prospects and base our decisions about value over a long-term horizon. We strongly believe that a consistent, disciplined approach, grounded in a rational appraisal of long-term value, will produce good long-term results, no matter how chaotic the short-term environment may seem.

Currently, the stock market appears to be bound in a fairly tight trading range. Over the past few months, the volatility that we discussed above has created numerous opportunities

for both purchases and sales that we believe enhance our clients' long-term return potential. In the consumer sectors we have shifted from companies driven by sales of big-ticket durable goods toward companies offering less expensive, more frequently consumed products. We have also capitalized on price declines in a long bear market to add new names in the health care, transportation and industrial sectors. We continue to work hard to

It seems clear that the economic recovery that was taking shape in 2002 will suffer a pause in the first half of 2003.

We expect the economy to endure a temporary stall, and to resume a modest growth trajectory later this year.

identify and avoid companies with deteriorating business fundamentals.

We are confident that the stocks in our clients' portfolios represent good long-term value. This does not mean that prices will rise immediately. In fact, with such an unsettled market landscape, it would be folly to anticipate a sustained surge in prices. In this sort of market, patience is an especially important attribute for the successful investor. Studies have shown that investors attempting to jump into the market only when the "all clear" siren sounds typically miss much of the capital appreciation that is the main attraction for stockholders. Market timers sitting on the sidelines are also missing out on a rising dividend stream.

Dividends are a concrete indicator of the relative value advantage that the financial markets are assigning to stocks. The dividend yield on most of our portfolios exceeds the return on money market funds or short-term Treasury bills by a wide margin, indicating that investors who can ignore the news-driven daily gyrations of the stock market are being fairly compensated while waiting for better times. Even a ten-year Treasury bond yields less than two percentage points more than a portfolio of good quality stocks today. The companies in our portfolio are producing healthy cash flows, and many

have recently boosted their dividends, a positive signal about the future. If the proposed reduction in the tax on dividend income is enacted, dividends, which have historically accounted for a significant portion of the total return from stocks, will become even more prized.

The war-torn investment landscape that we confront today demands attention to risk, but it does not call for the complete avoidance of calculated risk. Our clients' portfolios are broadly diversified. The companies that

we invest in are well managed, financially sound, and attractively valued. We stick with our valuation discipline and carefully review all stocks that fall short

of our fundamental or performance expectations. TS&W makes independent judgments on every stock that we own, based solely on the work of an experienced investment team acting in the best long-term interests of our clients. We believe these are appropriate tools for controlling the risk to which our clients are exposed, while building attractive return potential.

We will all be thankful when Gulf War II reaches its conclusion. The cessation of hostility and the safe and successful return of our servicemen and women will be a joyous occasion. Even on that happy day investors will confront uncertainty and risk. We look forward to the challenge. ♦

The dividend yield on our portfolios exceeds the return on money market funds by a wide margin. Investors who can ignore the news-driven daily gyrations of the stock market are being fairly compensated while waiting for better times.

The views expressed in this paper are those of Thompson, Siegel & Walmsley, Inc. and are subject to change with market conditions. This paper is for informational purposes only and should not be construed as investment advice, or an offer to sell or a solicitation of an offer to buy any security, which may be referenced. Market conditions are subject to change. Historical economic and performance information is not indicative of future results. This report was prepared by Thompson, Siegel & Walmsley, Inc. with information it believes to be reliable.



Thompson, Siegel & Walmsley, Inc.
5000 Monument Avenue ♦ P.O. Box 6883
Richmond, VA 23230
Phone 804-353-4500 ♦ Toll free 800-697-1056
Fax 804-355-9410
Email: tswmarketing@tsw-ic.com