



Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

To Our Clients

There is plenty of airtime on America's cable television financial networks for just about any investment manager with an opinion, a nice suit, and plane fare to New York. With the financial markets moving up again, we expect more managers will seek this shot at fifteen minutes of fame. Thompson, Siegel & Walmsley's investment team has not sought this limelight, but if we did sit down across from an attractive financial network personality (AFNP), the conversation might go like this...

AFNP: Welcome. How is business at Thompson, Siegel & Walmsley these days?

TS&W: Well AFNP, the stock market has been moving up for nine months now, which indicates that the worst phase of the bear market that began in 2000 is probably over. That's not to say that the future will be completely trouble-free. There is plenty of uncertainty over the health of the U.S. economy, geopolitical challenges and unexpected events like the rise of a new Asian flu bug. I've got to admit, though, with stocks up more than twenty percent since early March, we don't miss the pessimism that prevailed earlier in the year.

AFNP: I'm happy for you. But seriously, since the stock market bubble popped in March of 2000, there have been four other 20% rallies. How can you be so sure it's different this time around? The S&P 500 is still more than 30% below its peak. Even so, stocks aren't exactly cheap. Large caps trade at more than 18 times your own estimate of operating profits for the next four quarters, and your clients can't retire on the market's 1.7% dividend yield, can they?

TS&W: The quick success in Iraq had a lot to do with the market's rally, but it wasn't without support from the fundamentals. That's the difference between this year's stock market performance and the false rallies we experienced in 2001 and 2002. The first quarter of 2003 was the fourth straight with higher corporate profits, and the growth rate in earnings, at better than 10% on a year-over-year basis, was surprisingly

good. Energy prices have started coming down, and there are signs that the economy is picking up steam. Early in the year our stock portfolios were positioned to benefit from an improving economy and better market performance. We are getting that now, and TS&W's clients have participated in the market's recovery.

AFNP: But wouldn't you agree that the stock market has come an awfully long way in a short period of time?

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TS&W: History shows that strong returns are frequently concentrated in fairly short periods of time. That's why we advise against market timing. Back in March, when news about the impending war in Iraq was most pessimistic, stocks were a great buy. Our value-driven investment process was turning up good buying opportunities. Now, some stocks are moving close to our price targets, and we are trimming or eliminating those with the least promising return outlook. We are moving toward stocks that are less sensitive to the economy and offer better dividend yields. These areas are undervalued, and this is where we see the best opportunities right now.

AFNP: It sounds like short-term trading to me. Are you some kind of gunslinger?

TS&W: Far from it. We have employed a disciplined, value-based philosophy for more than 30 years. Right now, we agree with your observation about stock valuation. We

have a moderate growth outlook for both the economy and for corporate profits, so we can't make the argument that stocks in the aggregate are cheap. The market has moved to the upper end of a trading range, and stock returns from here are likely to be more subdued.

AFNP: *What do you mean by a trading range? Are you using technical analysis?*

TS&W: Some of our best friends are technical analysts, but we stay focused on value and on fundamentals like earnings, cash flows and balance sheets. As we see it, the market as a whole is in

for more ups and downs. The pattern of market behavior we expect will look different from the strong, secular bull market we enjoyed from 1982-2000, which was fueled by the dramatic decline in interest rates over the same time frame. We don't think the next decade will produce the kind of price-to-earnings multiple expansion that we saw in the 1990s. There will still be good opportunities for disciplined investors to make money, and we think the long-term trend in stock prices will be upward, but we expect the short term to be punctuated by downdrafts in the market averages. Over time, stock returns will depend on good old-fashioned corporate profit growth, based on transparent, gimmick-free accounting, I might add.

AFNP: *You value investors have a tendency to get conservative too early. I just read a report showing that stocks with prices under \$5, stocks with no earnings, and stocks with an S&P stock rating of "C" were the best performers in the latest quarter, not the high quality names. The*

Internet stocks are also on the move again. Yahoo!, Amazon and Ebay have all enjoyed great momentum since the beginning of the year. What about biotech and nanotech? We could be on the ground floor of another big NASDAQ rally! Aren't you going to miss the boat again?

TS&W: I hope so. There has been a surge in the most speculative stocks, which is a good reason to be selective and defensive. But the stock rally of the last three months has been more broad-based, which is a healthy sign. Of 130

industry groups within the S&P 500, only 17 declined in the first six months of the year. Small cap stocks are up the most this year, but among large caps, both the value and the growth groups have done well, and the performance gap between the competing styles is minor, a big difference from the bubble days, when only a handful of racy tech stocks led the markets upward. In the bubble days a lot of investors forgot about value, but, as we have all seen, value always matters in the long run. Our view is that the economy will grow steadily, but slowly, over the next year or so. In that

environment high quality stocks—those with strong competitive positions, healthy finances, and generous cash flow to fund

growth and dividends—will be the best performers, especially if some unforeseen event rattles investors' confidence again.

AFNP: *Well, I hate to rain on your parade, buster, but the economy is about as flat as Saddam Hussein's vacation villa. GDP grew by just 1.4% in the first quarter, not enough to keep the unemployment rate from expanding. The jobless rate is at 6.4%, the highest level since 1994, manufacturing employment has declined for 34 straight months, and more than 2.5 million manufacturing jobs have been lost in the last year and a half. Households have more debt than ever and consumers are worried about their jobs. Where is the growth going to come from?*

TS&W: Employment is clearly a weak spot in the economy, but it is a lagging indicator of activity, and we are watching hiring trends closely. We aren't expecting a big surge in economic growth, but rather a

period of modest expansion that should produce 6-7% annual corporate profit growth over the next few years. Alan Greenspan makes it clear that the Federal Reserve is committed to giving the economy enough monetary juice to stimulate consumption and investment, and Congress has just chipped in a big tax cut for good measure. The reduction of the tax on dividends and long-term capital gains to 15% is more good news for stocks. From a tax perspective at least, stock returns are being treated more favorably than bond income. Despite all of its ups and downs, the stock market

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is a pretty good leading indicator of the economy, and it's pointing to better times. Even the upward slope of the yield curve, the fixed income experts' fancy term for the relationship between short and long-term bond yields, suggests faster growth.

AFNP: *The stock market may be making an optimistic case, but bonds are telling an entirely different story. In case you weren't counting, the Fed's short-term rate cut last week was the thirteenth in a row. Long-term interest rates were at the lowest levels since the mid-1950s a couple of weeks ago. Maybe the old formulas for stimulating the economy just aren't going to work this time around. Interest rates went to zero in Japan, and that country's economy and stock market have been basket cases for fourteen years. It seems to me that Greenspan and the Fed governors are more worried about deflation than inflation. Couldn't that be the reason the monetary floodgates are wide open?*

TS&W: The Fed is worried about deflation. Most consumer goods companies can't pass along higher input costs and are having to cut prices to drive sales. With little pricing power, corporations are struggling to keep costs down, which means they are reluctant to boost hiring. And capital spending has been slow to respond to lower borrowing rates because many industries already have ample production capacity, and many companies need to repair their balance sheets before they turn their attention to expansion. That's a key reason why we expect relatively slow economic growth. But don't forget, except for certain products and industries we haven't seen deflation, just very low inflation. The Consumer Price Index was unchanged in May, and the so-called "core rate," which doesn't include food and energy prices because they are so volatile, is up 1.6% over the past year. The last time I checked, low inflation is good for investors in both bonds and stocks. Bond yields are at 45-year lows, but so is inflation. When you adjust for that fact, the real return to bondholders—especially corporate bondholders—still looks pretty good.

AFNP: *Maybe, but most of our viewers still consume food and energy and their bills are rising. Energy prices, indus-*

trial commodities and even gold are up sharply over the last year. Greenspan testified less than a month ago that the high price of natural gas threatened to slow economic growth. And what about housing and health care costs? The latest report on the consumer price index showed that medical care costs were up 4.0% over the last year, and average sale price for new homes were up 6.5% in the first quarter. The weaker dollar will eventually start pushing import prices up, too. That doesn't sound like deflation to me. Isn't it possible that the fast money supply growth and huge Federal budget deficits could lead us back to rapid inflation? After twenty years of generally falling interest rates, wouldn't bond investors be in for a nasty surprise if the inflation rate started to heat up?

TS&W: Is my microphone on? Bondholders would be hurt by a pickup in inflation. Investors need to keep in mind that Treasury bonds aren't completely risk-free. When the Fed announced on June 25 that short-term rates were being reduced by just a quarter point instead of the half point cut that many folks were looking for, bonds got clobbered. Some people saw it as a sign that the long string of rate cuts is over. The fact that the central bank cut rates at all, however, is evidence that the monetary watchdogs don't consider inflation to be a major threat right now. The producer price index was negative in both April and May, so inflation does not appear to be in the pricing pipeline. Even so, we are keeping our bond portfolio maturities toward the shorter end of the spectrum, so that a rebound in rates would not be too detrimental to our clients. Stretching maturities for a few basis points of extra yield does not seem to be worth the risk to us.

AFNP: *So you think interest rates are going up?*

TS&W: Rates may end the year a bit higher than they are today, but we don't expect a dramatic move. Actually, we think bond returns will be acceptable, especially investment grade corporate bonds. We just think that a portfolio of high-quality stocks is a better place to be right now. Bonds outperformed stocks dramatically from 2000 to 2002. Thanks to that bull market in bonds, short-term interest rates are lower than stock dividend yields for the first time in a decade. That's

a rare event that has historically indicated that stocks are good value. Our portfolios have a dividend yield of around 2.0%. Even if corporate profits grow at the low end of our expectations, say around 6% per year—which is below the long run average—we expect these companies to boost their dividend streams. Without any expansion in valuations, and perhaps even some contraction if inflation heats up, we expect high single-digit returns from stocks over the next few years. That will be a bit below average from an historical point of view, but for investors who can live with normal market volatility, stocks should be a good place to be.

AFNP: *I thought you said you have been doing some selling lately. Which is it? You can't possibly be raising cash. The average yield today on a taxable money market fund today is .64%; that's down from over 6.0% in January 2001. Surely you can do better than that for your clients?*

TS&W: It all goes back to investment philosophy and discipline. Low cash yields should motivate savers to move gradually back into the stock market from the sidelines over the next few years, which is a plus for stocks. Investors who are waiting for an all-clear signal in the markets will be disappointed. We have never stopped believing in the merits of long-term investing. But the stock market won't be a one-way street. We hold funds in cash reserves from time to time when stocks move up strongly, as they have in the last three months, and approach or surpass our price targets. As new

opportunities emerge offering attractive rates of return, we are in a position to take advantage of them. Taking advantage of the opportunities that lie ahead will require a disciplined, value-based approach. It's a formula that has worked for TS&W's clients for more than three decades.

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AFNP: *If you are so focused on price, how can you account for problems like SARS, under-funded pension plans and instability in the Middle East?*

TS&W: There are always issues to worry about, which is exactly why price matters. I'm personally very worried about the state of the financial news media. Remember AFNP, it's the unexpected developments that produce risks and opportunities in the financial markets. We think Thompson, Siegel & Walmsley has the right combination of experienced man-

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agers and dedicated investment analysts to adjust our clients' portfolios to changing market conditions. We don't have all of the answers, but finding good companies to invest in while managing overall portfolio risk is an approach that works no matter what tomorrow brings.

AFNP(flashing a winning smile): *Well there you have it folks, they don't have all the answers. And we're out of time. Thanks for joining us TS&W.*

TS&W: It's been our pleasure.

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