Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

Thompson, Siegel & Walmsley clients have benefited from a strong recovery in the stock market since March. We continue to find good investment opportunities, particularly in dividend paying stocks. However, we are cautious about the market's more speculative sectors.

The Bulls are Running Again

"The top bull riders in the world tangle with hulking, snorting temperamental beasts that can weigh as much as 2,200 pounds!" Yep, that's the teaser for the Outdoor Life Network's (OLN) broadcasts of the Professional Bull Riders' "Ford Tough" series. OLN also televised Pamplona's famed Running of the Bulls this summer, proving once again that Americans have an insatiable appetite for wicked bulls, wacky sports, and wanton carnage. It is hard to avert your eyes from these train wrecks in the making if you happen upon them while trolling the vast wasteland of cable TV. The goal is to hang on longer and more stylishly than everyone else to a mad-eyed critter named "Hammer" or "McNasty" or to sprint through narrow streets at the head of a surging mob of inebriated thrill seekers. Nobody really expects to beat the bulls; they just hope to outrun the other guy and dodge the occasional slashing horn. The same sort of mad dash and wild ride sometimes characterizes the investment markets.

Stock prices continued to rise and the economy showed long-awaited stirrings of life during the third quarter, pushing the ugly bear market of 2000-2002 further into the shady recesses of repressed memory. The large cap S&P 500 index is now up more than 25% from the lows of early March, and the mercurial NASDAQ, hero of the late 1990s and villain of the new millennium, has gained nearly 60% from its year-ago low point. Market psychology has swung to a belief that a new bull market is off and running. Performance patterns reveal that investors are once again eager to take on risk, overlook bulging measures of valuation, and forego current income for the uncertain, but enticing, prospect of future growth.

The strong performance of stocks over the last six months and the equally important revival of investor confidence are based not on whim, but on a measure of real improvement in fundamentals like sales, earnings, and cash flow, and on a powerful jolt of stimulus from Uncle Sam. Corporate profits have been surprisingly robust this year, providing relief from three years of management scandals and EBBS accounting games (Earnings Before Bad Stuff—honestly, the BS has nothing to do with bulls). Second quarter profits for the S&P 500 companies rose more than 9% from a year earlier, and nearly two-thirds of companies reported earnings that exceeded Wall Street analysts' cautious estimates. Profit forecasts are creeping upward, with double-digit year-over-year gains now expected for the third and fourth quarters of 2003 and for all of 2004.

The jump in profits is related to an upturn in economic growth. Gross Domestic Product, the broadest measure of national economic output, rose 3.3% in constant prices in the second quar-

ter, paced by consumer spending and defense outlays. A modest improvement in capital spending added an encouraging new source of growth in the latest quarter, but, for the most part, the resourceful American consumer still carries the economy. Consumers continue to spend on new homes, new cars and all the retail trimmings. This consumption is being funded both by borrowing and by growth in income. Disposable personal income is up over the past year, thanks in part to the tax cut, and consumer credit outstanding has continued to grow as well, indicating that consumers remain comfortable with a low savings rate and historically high household debt levels. As long as consumers borrow and spend, the economy should remain strong. Most economists are expecting GDP growth to jump to 4% or more in the second half of the year.

We expect continued GDP growth over the next year, but we believe the rate of expansion will slow and will be below that of previous recoveries.

Uncle Sam has done just about all he can do to keep consumer spending on the move. Since early 2001, the Federal Reserve has cut short-term interest rates from 6.5% to 1.0% and has flooded the banking system with cash, feeding an unprecedented tidal wave of mortgage refinancing that has kept consumers flush with cash. Low interest rates were an important reason why consumer spending stayed strong during the 2001 recession. Normally, consumers reign in spending, pare back debt, and add to savings when the economy is weak.

The Federal government's taxing and spending policies are also giving a boost to the economy and to the stock market. Defense spending accounted for nearly half of second quarter GDP growth. This year's tax cuts put money in consumers' pockets over the summer and provided a strong inducement to buy stocks through the reduction in federal taxes on dividends and long-term capital gains. An investor choosing between bond interest taxable at ordinary income rates or stocks with modest capital gain potential and a growing dividend stream can easily make a compelling case for stocks.

Of course, a bull market is never based solely on improving fundamental factors like earnings and interest rates. Stocks would have risen in 2002 if that were the only requirement, but investors, stunned by two years of terrorist attacks and CEO misdealing, wanted no part of risky stocks last year. Investor emotions play a powerful role in short-term market moves. To really run, the stock market needs a shot of Red Bull® Energy Drink , the mysterious juice that prods the herd to bellow BUY! For reasons impossible to pin down precisely, investors' attitudes toward risk brightened about the time the war in Iraq got underway. A distinct shift in investor psychology is like the shiver of excitement that ripples through the streets of Pamplona when the bovine hooves clatter in the distance. It's hard to resist jumping into the fray when the crowd is off and running.

A look at the stock market's leaders tells the tale. Stocks with a history of high volatility have been the best place to be this year: the biggest gains have come in stocks with prices below $5.00, stocks with little or no profits, and stocks with no dividend payout. Despite the tax code's new inducement to own dividend-paying stocks, investors have run in the other direction. Within the large cap Russell 1000 index, the stocks with dividend yields less than 1.0% have decisively outperformed the stocks with yields exceeding 1.0% since the beginning of the year. This result is surprising since the tax code's preferential treatment of long-term capital gains versus dividend income was eliminated, with both sources of return now taxed at only 15% for many taxable investors. A

reasonable conclusion is that investors are becoming more comfortable with risk once again. Even the outcry for more conservative accounting rules seems to have faded as stock prices moved up.

Too Much Bull?

Thompson, Siegel & Walmsley's clients have benefited from this year's "running of the bulls." Nevertheless, we grew less eager to run with the herd as the third quarter progressed—and stock prices rose—because we believe the conditions that fostered this year's strong gains may be unsustainable. We have responded by selling stocks that surged past our price targets, especially in the more cyclical segments of the market, and investing in more defensive, less cyclical issues that offer better value and more stability if the bulls turn nasty in the months ahead.

Unless employment trends begin to pick up soon, we expect overall economic growth rates to decelerate by early 2004.

Our primary concern rests with the strength of the economy. We expect continued GDP growth over the next year, but we believe the rate of expansion will slow and will be below that of previous recoveries. While government spending will continue to expand and business spending on new plant and equipment should maintain its modest upward track, the most important variable, as always, remains the consumer. Consumption is by far the largest component of the economy.

From a long-term perspective, we position our clients to benefit from the higher returns we expect from good quality stocks purchased below intrinsic value and we recommend against trying to "time the market."

We see several factors leading to a slowdown in the pace of consumer spending over the next 12 months. First, the fact that consumers did not cut back on spending as they normally do in a recession suggests that any spending recovery will be muted. The huge crest of the cash infusion from mortgage refinancing has almost certainly passed, as mortgage rates moved up from recent lows this summer. In addition, the boost to personal incomes from the Federal tax cut this summer was largely a one-time addition to economic activity. Consumers' willingness to borrow to finance their spending may also be set to taper off. Higher interest rates are one factor in this, as is the record level of indebtedness relative to household net worth. However, the willingness to borrow is also closely related to consumer sentiment measures, which are, in turn, heavily influenced by the job market.

Since the latest recession ended in November 2001, the number of unemployed workers has continued to increase, an unusual pattern for the recovery phase of the business cycle that has led to the description of the current expansion as a "jobless recovery." The apparent lack of job creation, which is debated by economists reviewing different sets of government employment statistics, nonetheless seems to be eroding consumer confidence. If it persists, this may lead to a slowdown in consumer spending, especially on big-ticket discretionary items like furniture, electronics, and autos. Unless employment trends begin to pick up soon, we expect overall economic growth rates to decelerate by early 2004.

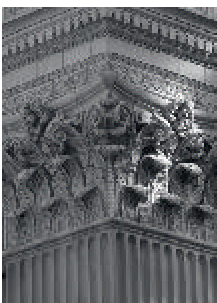
Third and fourth quarter corporate profit growth is likely to be impressive, due, in part, to comparisons with weak results last year. But sluggish economic growth would probably translate quickly

into a slowdown in corporate profit growth. Employers, plagued by a general lack of pricing power in a low-inflation economy, have aggressively cut costs in recent years, largely through job cuts. This efficiency kick has helped corporate profits as the economy picked up steam over the past two years, but the benefits of cost cutting can only go so far without a stronger pickup in demand. The profit growth targets that Wall Street envisions for next year will be difficult to reach in a "jobless recovery," in our view. For this reason, we are basing our forecasts for next year on more modest 6-8 % growth in corporate profits. The discrepancy between our outlook and Wall Street's more bullish consensus, plus a big jump in stock prices, leads us to a more defensive stance than we held just six months ago.

Taming the Bull

Bull riders and Pamplona's *corredores* must hang on for dear life, run like the devil, or just get out of the way. Fortunately, investors can adjust more incrementally to the bull's passions. Thompson, Siegel & Walmsley continues to believe that, over the long run, which we define as a three-to-five year period, stocks are likely to produce higher returns than bonds. From a long-term perspective, we position our clients to benefit from the higher returns we expect from good quality stocks purchased below intrinsic value and we recommend against trying to "time the market." We continue to identify attractive stocks to buy. Healthy dividend payers, or stocks with strong prospects for dividend growth are particularly attractive in the period of modest growth that we expect. As interest rates have risen over the past three months, moreover, we have become more constructive on fixed income securities, and we have lengthened portfolio maturities accordingly. Also, we continue to believe that small cap and international stocks offer attractive valuation and diversification benefits.

In the short run, however, we seek to lean against the surging crowd. That would be a bad idea on the streets of Pamplona, but on Wall Street it is a good way to avoid mounting market risk. Over the years we have seen that market psychology can push the value of financial assets well above or far below the levels suggested by a dispassionate analysis of fundamental factors. Our job is to take advantage of these powerful slumps and surges in animal spirits. It can be daunting to buy stocks when prices have been trampled, just as selling is difficult when the bull carries prices higher. This is when the consistent value discipline that we employ is most advantageous.♦



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