



Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

What are the forces, the events, the trends, and the unexpected developments that will propel the financial markets in the year ahead? What factor will we agree, twelve months hence, was the piece of information crucial to understanding the year's ups and downs?

Will it be the realization of a widely expected period of robust economic growth? Will the rate of inflation and the level of interest rates increase—or decline—more than anyone expects? Will a continued slide in the foreign exchange value of the dollar or a further jump in energy prices shift the markets' focus to concern about the sustainability of growth? Will geopolitical developments like the stabilization of Iraq, China's strange blend of communism and capitalism, or the 2004 Presidential Election be the defining issues of the year? Or will the story of 2004 be about surprises that no one anticipates today?

The answer, of course, is that all of these factors and many more will be important to investors in the year ahead. Thompson, Siegel & Walmsley devotes considerable resources to understanding the forces that affect investment markets, and we rely on experience and careful observation to guide our investment decisions. We also recognize that much of what is to come is unknowable today. Our value investment philosophy and careful fundamental investment process provide Thompson, Siegel & Walmsley with a framework for prudently responding to constantly changing market conditions and

the inevitable surprises that accompany every new year.

Our goal as your investment adviser is to build and preserve your wealth. With this singular objective in mind, we assemble investment portfolios that reflect our outlook for the future and our core value investment philosophy. We believe the structure of these portfolios and our recent portfolio actions do a good job of illuminating our outlook for the future.

The common theme to these adjustments was an effort to improve the average quality rating and reduce the expected volatility of the portfolios we assemble for our clients.

As the stock market recovered from the low point reached on March 11, we trimmed or sold stocks that reached our sell targets and bought other stocks that became attractive based on our fundamental analysis and valuation disciplines. The common theme to these adjustments was an effort to improve the average quality rating and reduce the expected volatility of the portfolios we assemble for our clients. This reflected our belief that certain stocks and particular groups of stocks had fully recovered and that valuations were getting ahead of earnings prospects as the year progressed.

Our value discipline steered us away from some of the market's hottest spots. Lower-quality stocks, those with poor balance sheets, scant earnings, and no dividends, were the best performers in 2003. For example, one of the best performing stocks in the Russell 1000 Value Index, an important benchmark for value investors, was Sirius Satellite Radio, an unprofitable broadcaster with a market value 500 times its \$8 million in revenues. Whether stocks like Sirius are "value" investments is debatable only among the people concerned with assembling stock indexes. What is not debatable is that this sort of market leadership is usually temporary. The well-established, higher-quality stocks that earn consistent profits and reward owners with growing dividends produced good results, and we strongly believe that investors will increasingly focus on these stocks in the quarters to come.

WE EXPECT STOCKS TO PERFORM WELL IN THE COMING YEAR...

Thompson Siegel & Walmsley's investment team is optimistic about the year ahead. We believe that stocks—domestic large cap equities, small cap value stocks, and international equities—will provide returns significantly higher than bonds. Our positive view of stocks is based on several fundamental considerations. Corporate profits have grown at a healthy pace over the past six quarters, and should continue to expand in 2004, albeit at a slower rate. This is primarily attributable to a promising outlook for the U.S. and global economy. In particular, we suggested in our last letter to clients that employment trends, which were unusually weak through the first nine months of 2003, would be crucial to sustaining consumer spending and the pace of economic growth in the year ahead.

It is only since October that concrete evidence of a pickup in hiring has been evident in the employment data. With the unemployment rate working gradually lower, we believe the probability of solid economic growth and increasing corporate profits is significantly improved.

We favor market sectors that will benefit from an expanding economy including industrials and materials, and consumer discretionary companies in the media, retail, and leisure industries. For example, we recently added an investment in one of the nation's largest

railroad companies, gaining exposure to western coal reserves, agricultural exports and containerized import and export flows. We also bought shares in a national provider of consumer and commercial waste management services focused in faster-growing southern and western states. We believe companies such as these will benefit as the business and industrial side of the economy enters its recovery stage. Given the strong performance of consumer discretionary stocks last year, our emphasis in this area is tilted toward smaller-ticket items, which should be less affected by any slowdown in consumer spending as the tailwinds from the 2003 tax cut and the home mortgage refinancing boom abate. Unencumbered cash flow—money that can be used to boost dividends, expand businesses, or repurchase stock—and high returns on capital are shared characteristics of the stocks we find most interesting.

Value, as always, plays the leading role in our assessment of investment opportunities. We calculate fair value for individual stocks based on a realistic assessment of future earnings, dividends and valuation, and we invest in quality companies that trade at a discount to this measure. With the large cap S&P 500 Index up more than 25% for the

year, and more than 35% above its nadir in early March, it is reasonable to wonder if any stocks can be considered values. In aggregate, at the end of 2003, the stock market traded at nearly 20 times expected 2003 earnings, and provided a dividend yield of just 1.6%, hardly a launching pad for a series of annual above-average returns for the popular indexes.

Even so, good companies at attractive prices are, if not plentiful, certainly identifiable to those of us willing to look beyond the next quarterly earnings report and do rigorous analytical work. We screen a large universe of stocks for appealing value and quality characteristics, and then we perform extensive fundamental analysis to select investment candidates. Our investment process emphasizes a long-term perspective and identifies values that are overlooked from a short-term point of view. We encourage you to read a detailed review of our investment process at our newly designed website, www.tsw-ic.com, in the “Markets and Commentary” section.

We have recently found good value in energy and health care stocks, less volatile sectors that offer reliable earnings and dividend growth. Recent additions to our clients’ portfolios are companies that have solid long-term track records, trade at discount valuations, and offer interesting growth prospects. Clients’ portfolios enjoyed unusually strong dividend growth this year, an indicator, we believe, of the fitness and optimistic outlook of the companies we have selected. We expect these value stocks, along with electric and gas utilities, and even downtrodden telephone shares to reward investors in the year ahead.

...BUT THAT DOESN'T MEAN A REPLAY OF 2003'S REMARKABLE COMEBACK.

A growing economy and increasing earnings, of course, are not sufficient to produce another blow-out year for stocks. S&P 500 earnings rose more than 20% in 1994, but stock returns were woeful that year due to a sharp increase in interest rates.

In the nine years since then, and during most of the past two decades, declining interest rates were a potent impetus to stock prices. With the economy now expanding at a healthy pace after three years of aggressive interest rate cutting by the Federal Reserve, we believe that stock investors can no longer count on falling rates to add octane to market returns. Though we see few signs of a significant increase in the rate of inflation, short-term interest rates are likely to rise in the quarters ahead, especially if the foreign exchange value of the dollar continues to erode. This factor argues for more modest returns for the broad stock market in the year ahead.

In such an environment, we believe financial stocks—strong performers in 2003—may lose steam in the face of interest rate pressures in 2004, and we are deemphasizing these stocks in our portfolios. Though not overvalued, financial companies as a group are operating near peak levels of profitability, suggesting that some caution toward the largest sector of the U.S. market is in order.

The richly priced technology sector also is vulnerable to a rise in interest rates. According to First Call, a market data service, the technology sector

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of the S&P 500 now trades at 30 times earnings, a premium of more than 50% to the index average. While we do expect a cyclical recovery in capital spending—including spending on technology—we believe the market assessment of technology growth prospects is once again moving well ahead of reality. We have added two technology stocks to client portfolios in recent months, but both were in less cyclical businesses than stocks we sold, and both exhibit exceptional financial characteristics, healthy growth prospects and very reasonable prices.

As prices rose in 2003, we nudged our holdings toward stocks that pose less downside risk in the event of negative surprises. We have reduced or eliminated our holdings in economically cyclical names as they reached our price targets, and we have culled lagging performers where long-term fundamental challenges have reduced our price targets.

GOOD LONG-TERM RESULTS REQUIRE MORE THAN A KNACK FOR FORTUNE TELLING

In his best seller *Innumeracy*, Temple University mathematics professor John Allen Paulos deftly illustrates that “it would be very unlikely for unlikely events not to occur.” Thompson, Siegel & Walmsley enters 2004 well aware of the limitations of short-term forecasting. The undeniable truth is that the events we cannot anticipate will affect investors profoundly in the year ahead. 2004 promises to bring new developments in the unfolding war on terrorism and a contentious Presidential race that will almost certainly focus on economic issues. In a highly uncertain world, successful investing demands experience, creative thinking, a proven discipline for making sense out of constant change, and a commitment to meeting individual client needs. We also believe it demands an unwavering focus on finding value in individual stocks and bonds amidst the distracting daily noise of the financial markets. We have carefully cultivated these attributes at Thompson, Siegel & Walmsley over the last three decades, and we look forward to serving you in the unpredictable year ahead.

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