



Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

Thanks, I Needed That

A 1970's aftershave commercial ended with a blubbing gentleman receiving an unexpected slap across the face. Brought to his senses, he straightened his tie, and in a confident voice uttered the classic tagline, "Thanks, I needed that."

A good hard slap in the face is no longer socially acceptable, but we wonder if the financial markets did not have the equivalent of a "Thanks, I needed that" moment in the first quarter of 2004. If so, the month of March may have been just the bracing shot of reality we all needed to keep our emotions in check and to set up the markets for a sensible, though not euphoric, year.

The year 2004 certainly began with investors in a giddy mood. Economic growth was surging, but inflation, the alter ego of rapid expansion, was quiescent, and the Federal Reserve voiced clear support for keeping interest rates low for a "considerable period." Corporate profit reports for the final quarter of 2003 were also terrific, and Wall Street analysts were scrambling to raise profit estimates that were too cautious. There was even a hint of that old NASDAQ musk in the air. Timeworn rationalizations for lofty tech stock valuations were making the rounds once again. Low quality companies with weak or non-existent earnings, no dividends and shaky balance sheets led the performance parade, suggesting that investors were setting aside any risk aversion.

A More Sober Assessment

Against this heady background, the stock market's lackluster first quarter performance, punctuated by a swoon in March, might have seemed like an unexpected slap in the face. The S&P 500 gained just 1.7% in the year's first three months, while the NASDAQ and the Dow Jones Industrials posted slight declines. Only small cap stocks earned strong gains, extending a lengthy period of outperformance over large caps. Interest rates slipped lower, allowing bond returns to beat most stock benchmarks. Bonds again defied a nearly universal conviction

that global demand would begin pushing inflation, and interest rates, higher in 2004.

Stocks labored, and bonds gained, because the first quarter ended with investors in possession of a list of negatives that was every bit as compelling as the positives seemed to be at the beginning of the year. By one line of reasoning, the economy's recent growth is transient, held up only by the temporary effects of last year's tax cuts. Employment data has yet to exhibit the vigorous pickup associated with previous upturns in the business cycle. Unemployment, though closer to historical lows than highs, has become a leading issue in the Presidential Campaign, focusing intensive media coverage and sudden Congressional outrage on longstanding trends like the "outsourcing" of jobs to low-cost foreign labor.

Energy prices also headlined the worry list as crude oil surged above \$35 per barrel and gasoline set all-time price records in much of the country. In another era this news would have spooked fixed income investors, sending interest rates up. But the jump in energy costs is having little effect on prices of producer and consumer goods to date. Instead, investors worry that corporate profit margins will be squeezed between rising input prices and fierce price competition from imported goods. Commentators are also fond of pointing out that higher gasoline prices act like a "tax" on consumers, draining spending from other products and slowing economic activity.

Oil is linked to another prominent concern: terrorism and the unstable politics of the Middle East. The Madrid terrorist bombings, and subsequent threats against US targets, renewed a sense of vulnerability that had receded somewhat since the September 11, 2001 attacks. The bombings clearly altered the outcome of Spain's election and appear to have cost the US an important ally in our effort to stabilize Iraq. Geopolitical uncertainty on this scale is never a plus for financial markets, and it reinforces the steadying appeal of bonds and high-quality stocks.

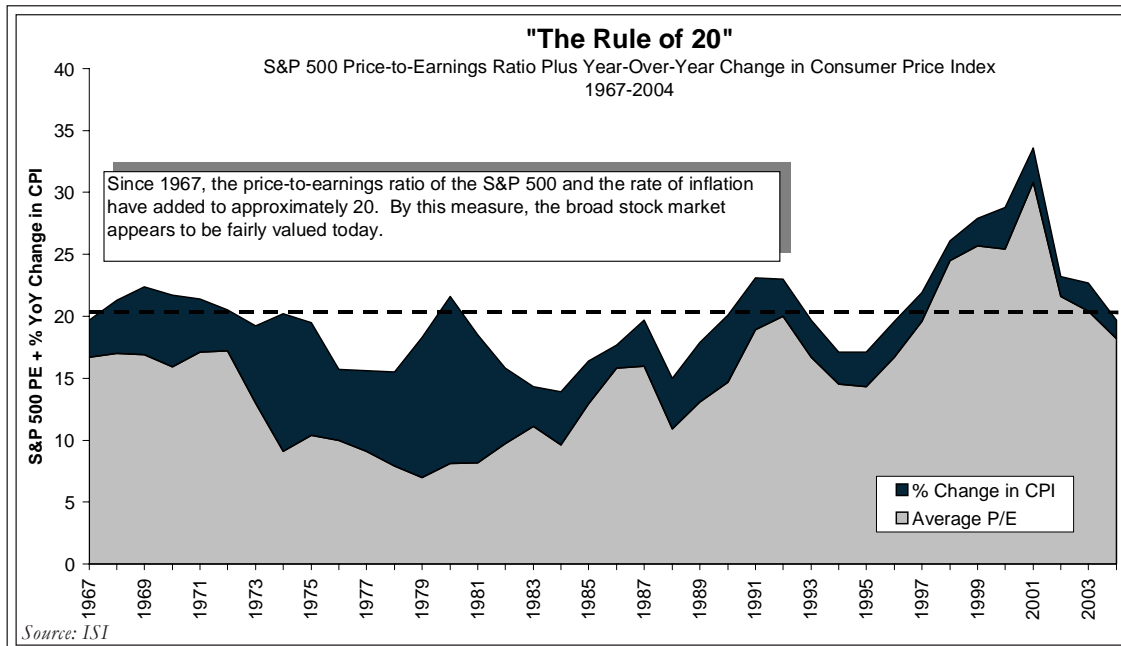
below. This measure of stock market valuation suggests that stock market bargains are becoming harder to find.

Quality Takes the Lead

What we have just described, you may have noticed, is another episode in the perpetual financial market struggle between good news and bad news. It appears that the scales have tipped slightly in favor of the negative news since the first of the year, and as always, the effect on short-term market performance

is meaningful. We believe, however, that the outlook for the US markets, and particularly for stocks, is, on balance, positive.

We also believe that the first quarter marked a change in stock market leadership. The best performing stocks in



The first quarter's mediocre stock market performance may also be attributable to nothing more than the need for investors to catch their collective breath. Even after a sluggish quarter, stocks have enjoyed a remarkable run. Over the last twelve months the S&P 500 Index of large cap US stocks is up more than 35%. Small cap stocks are up more than 60% in the past year, and international shares are 58% higher.

After an upturn of this magnitude, the broad large cap stock market appears to TS&W to be fairly valued. Since 1967 the price-to-earnings ratio (P/E) of the S&P 500 and the rate of inflation as measured by the Consumer Price Index have added to twenty, on average. During periods of high inflation, the stock market's P/E ratio has been low, and during periods of low inflation, including recent years, P/E's have expanded. The relationship is illustrated graphically

last year's recovery rally were the low-quality names that were depressed the most in the long bear market. As investor confidence returned with improved economic news and recovering corporate profits, these downtrodden dogs stood to gain the most. With positive and negative factors now striking a rough balance, we think the return advantage will shift to higher quality stocks. Specifically, we believe that high-quality companies that generate substantial excess cash flow will continue to reward value-oriented investors over the next market cycle.

Cash flow is related to profits but includes "noncash" expenses like depreciation and amortization. Companies use their cash flow to refresh and expand their capital assets, to acquire other businesses, and to pay down debt. Management may also deploy cash to reward shareholders through share repurchases and

dividends. We believe that strong cash flow trends are the single most important indicator of quality in an investment candidate, and we devote considerable analytical effort to understanding and projecting cash flow trends. TS&W is expanding our team of investment professionals who perform the detailed fundamental analysis necessary to identify companies with the strongest financial characteristics.

We are interested not only in how much cash flow a business can generate, but also in how skillfully management uses that cash to create shareholder value. Dividends are a useful window into a corporation's use of cash and attitude toward shareholders.

Through much of the 1990s, for example, dividends were of little interest to investors, and dividend growth fell well short of profit growth. The Federal government taxed dividends at a higher rate than capital gains, and some investors saw rising cash payouts as a signal that companies were unable to generate growth. Many analysts and investors preferred growth through acquisition or share repurchase. Few of the most popular stocks of that era paid dividends, and rising P/E ratios made a far greater contribution to the total return from stocks than dividends. As evidence of the declining influence of dividends, only 369 of the S&P 500 companies currently pay a dividend, compared to 469 in 1980.

TS&W believes that attitudes toward dividends will grow more positive. With the change in Federal tax laws last May, qualified dividend income is taxed at the same favorable rate as long-term capital gains, 15%. Corporate boards, aware that investors prize income, and eager to reward shareholders in the wake of corporate scandals and poor stock market results over the last five years, are responding by boosting dividend payouts. TS&W's emphasis on value and quality generally causes us to favor stocks with healthy dividend streams, or companies that are likely to boost their dividends. Companies in our large cap portfolio have an average yield more than 30% above the broad stock market and have raised their dividends by an average of nearly 9% percent over the last year. The favorable tax rate on dividends will expire at the end of 2008 unless it is made permanent by Congress.

Some aspects of the recent tax law could be changed if a new administration takes over after the November election.

Dividends should be an important component of total return to shareholders in the market environment that we expect over the next few years. Unlike the prior decade, when an expanding P/E multiple—propelled by falling inflation and interest rates—accounted for much of the stock market's return, we expect the market P/E multiple to remain near the current level. The rate of inflation is unlikely to move much lower. This means that corporate profits, which have historically grown at around 7% annually, and dividends will drive stock returns. Profit growth should continue at a double-digit pace for one or two more quarters, but comparisons to the prior year become difficult later in 2004, and 2005's growth pace is likely to be slower. Overall stock market returns may fall short of double-digit historic averages in this environment. If so, we believe companies with sufficient free cash flow to expand their dividend payments and enhance earnings per share through share repurchases should offer a performance edge.

Summary

Although 2003 ended with an abundance of good news—a relatively healthy economy and expanding corporate profits—this was largely reflected in stock prices. Ragged first quarter performance reflects a sober re-examination of market fundamentals; a “Thanks, I needed that” moment. The stock market's progress from here is likely to be gradual, driven by the rate of growth of corporate profits. In a market where P/E multiple expansion is unlikely, a value discipline and a focus on free cash flow will be important discriminators of performance. Bonds should provide modestly positive returns for the balance of the year but are vulnerable to a pickup in the inflation rate. We continue to believe that both small cap value stocks and international equities offer good opportunities for return and for diversification. TS&W is bolstering its professional investment staff, adding experienced analysts to ensure that we are well equipped to deal with the challenging investment landscape we presently face. We appreciate your continued confidence and patronage.

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