



# Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

## To Our Clients

The Friday morning research meeting is the flywheel of our work at Thompson, Siegel & Walmsley. Each week, in a cramped space we loftily call “the research area”, about two dozen TS&W analysts, portfolio managers, research associates and client service specialists gather to tune our investment strategy. Fueled by

coffee and carbs, our weekly exercise in raucous investment democracy combines discussion of “top down” global financial and economic trends with detailed “bottom up” analysis of industries and companies. Investment ideas new and old are vetted and tested by an experienced and naturally skeptical crowd. Egos and half-baked notions are checked at the door lest they become the target of the well-placed arrows of “peer-review.”

Our discussions are focused and passionate. Voices are some-

times raised, but shared respect insures that all ideas are given a hearing. There are other meetings during the week at TS&W, to be sure, but the weekly research meeting is the heart and soul of our company.

Thompson, Siegel & Walmsley has employed a straightforward recipe for investment success since our founding thirty-five years ago. Working within a team framework, we select undervalued stocks and bonds based on our shared belief that value investing will produce superior returns for our clients—with below average risk—through the ups and downs of market cycles. Success in this endeavor requires the discipline—and the patience—to buy when prices are low, often after a setback or market tempest temporarily sends the investing crowd elsewhere, and to sell when good news brings the crowds back and prices are bid too high. To do this demands independent thinking and the conviction that results from a disciplined research process dedicated to thoroughly understanding and projecting

the fundamental elements of any business: sales, profits, cash flow, the competitive landscape, and the allocation of owners’ and lenders’ capital.

Rather than rely on Wall Street’s often biased view, or entrust the work to a programmed “black box”, TS&W employs a team of experienced investment professionals who craft detailed forecasts of earnings and cash

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flow, determine companies’ intrinsic

values, and implement investment strategy for our clients. We strongly believe that the success of our team of research analysts, portfolio managers and support personnel determines whether our clients will meet their investment objectives. For this reason, TS&W has gradually expanded its investment team in recent years through the addition of experienced equity and fixed income analysts whose only jobs are to develop new investment ideas and to collect and interpret intelligence on our existing holdings. Our research team is now larger and more experienced than at any time since our founding. We believe this investment in talented, focused professionals gives Thompson, Siegel & Walmsley an edge in an increasingly challenging investment environment.

Our clients can see the fruit of our research team’s broadened efforts in their portfolios. For example, new stocks added to client portfolios in recent

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months possess the same value and quality characteristics that we have always sought, but they represent a larger universe of companies that is beyond the range of ordinary Wall Street research and ‘index-driven’ investment strategies. In short, we are casting a wider net in order to find better opportunities, all within our tested value investment philosophy.

## **WHAT LIES AHEAD**

To say that the financial markets present both challenges and opportunities is to repeat a well-worn cliché. Whenever there is general agreement about the nature of challenges, or when negative views are widely heralded, prices often reflect the gloom and ample opportunities exist for investors with the discipline and analytical skill to unearth them. The real challenge lies in identifying the opportunities or, as we say, separating the values from the value traps.

The uncertainty facing financial markets today falls into two broad categories and is widely acknowledged. The first worry is a side effect of strong economic growth. Economic expansion in the US, and especially in developing markets like China and India, has naturally rekindled a modest level of inflation—an economic concern that was nearly forgotten only a year ago. Higher prices for everything from gasoline and milk to steel nails and health care benefits could dampen consumer spending and corporate profit margins, restraining stock prices. Wages, the largest expense item for most companies, are also likely to move up as labor markets tighten and the productivity benefits of heavy technology investments begin to wane.

As the inflation rate exhibited an upward drift, market interest rates, which have hovered near record lows for some time, moved higher, setting off Wall Street alarm bells. Rising interest rates cool economic growth by discouraging activities like home building and capital spending, and by pinching consumers who have borrowed too much. Higher rates also affect financial institutions, now a larger portion of US

equity indexes than at any time in history. Banks and credit card companies, for example, may find it more difficult to maintain relative profit growth as their cost of funding rises.

Interest rates also exert influence on stock prices in a more subtle way. Market history illustrates that price-to-earnings ratios, or PEs, the price that investors are willing to pay to own a dollar of corporate profits, generally rise when interest rates fall, and vice versa. This tendency was confirmed in the 1990s, when PE multiples doubled as interest rates declined, and again more recently, when PEs contracted as interest rates moved upward. The broad stock market’s current valuation, expressed as a PE ratio, is reasonable relative to the level of interest rates. We expect stable to modestly rising interest rates over the balance of the year, suggesting that PE ratios are unlikely to contribute to stock returns in either a positive or a negative way.

Political factors may also buffet markets. The US presidential election seems likely to keep investors guessing about issues like tax policy, regulation, and spending priorities right through November 2—and perhaps beyond. A change in administration, not widely anticipated on Wall Street at this time, often brings short-term uncertainty that can affect both stock and bonds prices. The Middle East offers almost limitless scenarios for chaos and disruption, and terrorism has moved from the category of one-time exogenous event to a source of ever-present anxiety. Although these worries reside outside the scope of traditional financial analysis, they influence stock and bond prices by undermining investors’ delicate confidence.

## **THE IMPORTANCE OF GOOD IDEAS**

Thompson, Siegel & Walmsley believes these challenges are largely reflected in market prices for stocks and bonds and that financial market conditions remain generally favorable. Economic growth in the US and abroad should maintain a healthy pace, allowing corporate profits to continue to expand, al-

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beit at a slower rate in the quarters ahead. US payrolls began to grow again during the second quarter, easing concerns that consumer spending would falter in a “jobless recovery.” Although inflation and interest rates have moved up from recent lows, they are still below long-term averages and do not, in our judgment, portend a quick downturn in the business cycle. The Federal Reserve may continue to gradually increase short-term rates to levels more consistent with healthy economic growth, but we believe most of the adjustment in long-term rates has already occurred.

Importantly, individual stocks and bonds are not affected uniformly

by the broad trends that will affect markets over the months ahead. While some companies will see their earnings growth falter as input prices rise or see their valuations contract under the influence of higher interest rates, other companies will take advantage of strong demand and rising prices to keep profit growth on the upswing. Companies that can buck the trend toward slower profit growth, or that can exceed low expectations, will offer good opportunities. Corporations that use capital wisely and emphasize share-

holder value over growth for growth’s sake, will be in great demand. This places a premium price on careful analysis and security selection. Discriminating between winners and losers will be of critical importance in a period when overall market returns are likely to be modest.

The capacity to conduct independent research and to develop fresh investment ideas will be an important determinant of success in the challenging environment we expect. We believe Thompson, Siegel

& Walmsley’s ability to anticipate change and to react appropriately to unexpected

events has been greatly enhanced by the methodical expansion of our investment team. Experienced, motivated, creative people, working within a proven investment and client service framework, enjoy a high probability of success. Just don’t try to reach them on a Friday morning. They will be in a meeting.

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*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. Historical economic and performance information is not indicative of future results.*



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