



Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

To Our Clients

Richmond, genteel capital of the Old Dominion, counts NASCAR among its many charms. Richmond International Raceway, a three-quarter mile D-shaped oval, is known as “the Action Track” because it frequently produces thrilling “three-wide” racing and breathtaking pileups. Yes, despite our buttoned-down image, many on the Thompson, Siegel & Walmsley (TS&W) team are fans of “swappin’ paint” and “gettin’ a little loose down in turn two.” We also know that some drivers favor the high-banked super speedways like Daytona and Talladega, while others excel on the tighter, more treacherous tracks in Richmond, Bristol, and Martinsville.

The current financial market track is well suited to Thompson, Siegel and Walmsley’s disciplined, value investment style. Stocks seemed to be idling along under the yellow caution flag in the third quarter of 2004. The broad market made little progress in the face of gradually tightening Federal Reserve monetary policy and a big increase in oil prices that slowed the pace of the economic expansion and gave rise to anxiety about the rate of corporate profit growth. The uncertainty of the tightly contested Presidential race may also be contributing to the stock market’s inability to get “dialed in.”

Under these conditions Thompson, Siegel & Walmsley clients’ portfolios have generally outrun broad stock and bond market benchmarks. We entered the year with the expectation that stocks would outperform bonds, which was not much of a stretch considering bond yields were at the lowest level since 1963. We also believed that higher quality companies—those generating cash from operations

that exceed their appetite for new capital—would be the best performers, and that dividends would make a significant contribution to return. Surprisingly, the lackluster results from the broad stock market so far this year do not exceed even the modest return from government bonds. Nevertheless, the qualities above helped TS&W clients’ portfolios notch solid gains. Cyclical issues that exhibited surprising earnings strength, energy stocks, and a diversified portfolio of stocks with lower price-to-earnings ratios and higher dividend yields than the market average made meaningful contributions to our results.

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A LITTLE BIT SIDEWAYS

Thompson, Siegel & Walmsley believes the financial markets will continue to offer moderate returns in the quarters ahead. Corporate earnings, which are an important driver of stock prices, should begin to grow

more slowly in the fourth quarter and into 2005. S&P 500 profits gained nearly 30% in the first two quarters of this year, an impressive pace, but one that is not sustainable. Top line growth will gear down as the economy settles into a more mature phase of the business cycle. Profit margin pressure from higher raw material prices and a tighter labor market will make it increasingly difficult for companies to grow profits at a faster rate than sales. Illustrating the point, “earnings warnings” from companies falling short of Wall Street forecasts became more commonplace in late summer.

We expect corporate profits to settle into a 5 – 6% annual growth rate, slightly below the long run average. A period of slower profit growth is not necessarily bad for stocks, however. Good returns should still be available in situations where current stock prices underestimate future profits. Higher priced stocks, which reflect lofty growth expectations, present substantial risks in this type of environment. Sharp declines in software and semiconductor stocks during the summer months underscore this point.

Interest rates, another important determinant of stock market performance, should creep gradually higher over the next few years as the business cycle unfolds. We expect this upward pressure on rates to limit expansion in broad market valuation or even lead to some compression in price-to-earnings multiples. This does not mean, however, that all stocks will experience flat or falling valuations. In fact, we believe that a portfolio of stocks purchased at valuations below the market average will experience stable or even rising earnings multiples. This explains some of the good performance our clients’ portfolios have enjoyed this year.

In this period of gradually expanding profits, dividends will make an important contribution to return. Thompson, Siegel & Walmsley client portfolios produce higher dividend yield than the broad market indexes, and offer better dividend growth potential as well. We seek out companies that generate cash from operations that exceeds their reinvestment needs, and management teams that demonstrate a commitment to returning cash to shareholders through growing dividend streams and share repurchase programs. Many of our portfolio stocks have posted substantial dividend increases over the past year, and we expect this trend to continue because the share of profits currently being paid out is comparatively low. Microsoft, one of our holdings in the technology sector, may have provided an example for large corporations this summer by doubling its regular dividend and announcing a huge one-time payout to

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shareholders and an aggressive share repurchase program.

We are also exploring investment opportunities among faster growing companies whose shares have become under-valued due to anxiety about slowing earnings momentum. These stocks, which may offer less immediate dividend income, might become leading performers if the market’s pace picks up in the fourth quarter. In selecting faster growing companies for our clients’ portfolios, Thompson, Siegel & Walmsley adheres to a firm value discipline.

DOWN ON PIT ROW

Race fans know that a timely pit stop for a splash of gas can be the difference between a win and a disappointing finish. Fuel, or specifically the price of oil, is a big concern for investors, as well, as we enter the final laps of 2004. With global oil prices now at the highest level

in history, more than \$50 per barrel, the daily financial press consistently cites fluctuations in oil prices as the leading explanation for stock price movements. This is mostly just lazy journalism. Natural gas prices rose nearly 30% and oil gained more than 50% in 2003 without disrupting stock or bond market rallies.

The strong uptrend in oil and other commodity prices has helped to push the inflation rate up at a 2.7% annual pace. While no one likes to pay more at the pump or to heat their home, we do not believe that high oil prices are enough to cause the stock market to spin out of control or to leave the US economy on empty. Rising commodity prices are a function of robust global demand for raw materials, most notably originating in China, and years of underinvestment in oil and gas and other raw material production. The fact that long-term interest rates have moved little in the face of higher oil prices suggests that rampant inflation is not likely to arise from the increase in commodity prices.

Unlike the financial media or Wall Street analysts, whose attention is increasingly centered on short-term fluctuations, the bond market provides a relatively level-headed assessment of the economic outlook. Bond returns have been modestly positive this year, a better result than most stock indexes have managed, and a surprise to many observers who believed this spring that bond prices were headed sharply lower. Instead, the bond market is forecasting a relatively healthy economic scenario. Short-term interest rates, under the control of the Federal Reserve, are clearly headed upward as concerns about deflation recede. Longer term rates, however, are steady, suggesting that worries about inflation have little traction. Reflecting generally good business conditions, yields on corporate bonds have

moved closer to government bond yields, indicating that the defaults and accounting scandals that terrorized investors between 2000 – 2002 are less of a concern. Although long-term rates should move gradually higher, Thompson, Siegel & Walmsley continues to believe that bonds will offer investors positive total return and that the track conditions for the overall economy are quite good.

The closely contested Presidential election will also weigh on investors' minds in the weeks ahead. Despite press assertions to the contrary, not all NASCAR fans agree about the race for the White House. Whatever our political leanings, we do not believe that the Presidential election will have a significant impact on the financial markets over the next two quarters. With regard to tax policy, we strongly believe that the lower Federal tax rate on long-term capital gains and qualified dividend income

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adopted in 2003 should be preserved and made permanent.

S&P 500 dividends rose more than 8% in 2003 and were up 15% in the first half of 2004, and capital investment is growing at a robust pace, providing clear benefits to the economy. We would view a retreat from this investor-friendly policy as a significant negative. Once the election results are in, other policy changes that might impact sectors like health care, energy or telecommunications will undoubtedly be the subject of lengthy debate in a closely divided Congress. We plan to wait until the battle lines are drawn before adjusting clients' portfolios.

THAT'S JUST RACIN'

To some, automobile racing amounts to little more than stepping on the gas and turning left. The reality, of course, is far more complex, as it is in successfully nego-

tiating the tight turns and shifting slipstreams of the financial markets. Thompson, Siegel & Walmsley's view of the road ahead is favorable. The economy and corporate profits will grow, albeit more slowly. Interest rates and inflation should rise, but we expect them to do so modestly. Stock valuations are reasonable, but should not be expected to increase much. Although dividends offer a reassuring positive theme, a host of issues from the War on Terror to sluggish employment growth can quickly impose the need to change course.

We rely on three basic principles to successfully steer our clients' assets. The foremost is our value orientation. Our clients' stock portfolios are priced at a significant discount to the broad market average. Over time, and especially when unexpected events lead investors to slam on the brakes, a value portfolio will deliver returns with less volatility than other approaches.

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Thompson, Siegel & Walmsley also emphasizes capital preservation. Broad diversification and the discipline to sell stocks when prices get too high or when business fundamentals deteriorate, cushion our clients against periodic pileups. Our objective is to participate in rising markets and to avoid large losses when markets fall back.

And finally, Thompson, Siegel & Walmsley employs a patient approach to investing. We believe that investors with a long-range perspective can take advantage of price distortions caused by Wall Street's preoccupation with short-term price movements. The growing clout of hedge funds, the investing equivalent of top fuel dragsters, creates opportunities for a strategy seeking value built over a 3-5 year time horizon. This focused approach has enabled Thompson, Siegel & Walmsley to build and protect our clients' wealth since David Pearson, a super speedway man, drove his Ford to the Grand National Championship in 1969.

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