



Fourth Quarter  
2004

# Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

## To Our Clients

**I**nvestment portfolios managed by Thompson, Siegel & Walmsley, Inc. (TS&W) enjoyed good results in 2004, and our investment team believes that conditions favor another good year for investors in 2005. Interest rates should remain at levels that encourage the continued expansion of economic activity; corporate profits are likely to increase, though at a slower pace than in 2004, and valuation levels are not high enough to discourage sensible investors. The list of risk factors reads much like 2004, headed by the possibility that interest rates increase more than we expect or that corporate profits come in short of the targeted growth rate. On balance, we believe the evidence supports a cautiously optimistic outlook, and we are positioning client portfolios accordingly, emphasizing attractively valued stocks. We also believe that the year ahead, like the one just past, will reward insightful stock and bond selection, a patient and disciplined attitude toward valuation, and the occasional willingness to lean against the wind of consensus opinion.

### GETTING IT RIGHT

2004 will go into the market history books as a good year, but for much of the time the outcome was in doubt. At midyear the Federal Reserve began raising short-term interest rates, embarking on what it promised would be a gradual reversal of four years of historically expansionary monetary policy. By the end of the year, the central bank had hiked interest rates five times, and it strongly hinted at more to come. The Fed's new-found stinginess was attributable, in part, to a sharp increase in energy and other commodity prices, which was spurred by robust global demand and Middle East turmoil. Through the first three quarters of 2004, these conditions offset very strong profit growth and held the stock market in check.

It was during this anxious setting in mid-September that ENSCO 64, a jackup drilling rig operating in 300 feet of

warm Gulf of Mexico water, met Hurricane Ivan, a Category 5 killer. This was the sort of chance encounter that might have sent stock and bond prices reeling. In case you haven't heard, no one was injured, but Ivan won, setting the demolished ENSCO 64 and several of its cousins adrift in the Gulf and temporarily curtailing production in one of the United States' most important oil and gas fields. Oil prices surged as the extent of damage

from Ivan became clear, ultimately topping out at more than \$56 per barrel on October 25th, nearly twice the year-earlier

level. On that same day the stock market was in negative territory for the year, and the financial wind whistled with dire predictions of a 1970s-style economic slowdown with surging inflation and interest rates, a slump in corporate profits, and a sharp slowdown in consumer spending induced by soaring energy prices.

***On balance, we believe the evidence supports a cautiously optimistic outlook, and we are positioning client portfolios accordingly, emphasizing attractively valued stocks.***

---

---

Instead of collapsing, however, the stock market enjoyed a remarkable year-end rally sparked by healthy corporate profits, tame interest rates, welcome clarity in the Presidential election, and a retreat in oil prices that eased investors' darkest fears. By the year's end, stock market indices had posted solid gains, much as we expected. While there was plenty of bad news in 2004—from natural disasters to manmade conflict—the surprises that affected the financial markets were mostly fortuitous. Contrary to widely held expectations, interest rates, as measured by the 10-year Treasury note yield, were essentially unchanged for the year. S&P 500 profits for 2004 are expected to be up by about 20% versus 2003, better than nearly anyone, including TS&W, predicted at the beginning of the year. Investor attitudes were an important factor in the markets' year-end rally as well. It appears that investors have recovered the generally optimistic—if not exuberant—stance toward stocks that was shattered during the long 2000–2002 bear market.

***The pace of economic growth will be the most significant determinant of the market outcome for 2005.***

The best performing sectors in 2004 were well represented in our clients' portfolios. Industrial cyclicals, basic materials producers, energy companies, and utilities aided our clients' results. TS&W's disciplined value investment style produced modest gains while the stock market stumbled through the first nine months of the year, and we participated in the robust advance in the final quarter to achieve a highly satisfactory result for the full twelve months.

### **MORE OF THE SAME IN 2005**

---

In some respects, Thompson, Siegel & Walmsley's outlook for 2005 resembles our viewpoint of one year ago. The many indicators we analyze suggest that conditions are favorable for stocks to produce moderate gains, while bond returns are likely to remain at low levels due to the diminutive stature of yields available today. Not only is this warm-milk outlook similar to last year's prediction, it is not distinctly different from

the general consensus among market participants. This admission leaves us faintly uneasy, given the poor forecasting track record of the crowd. To assume that events will play out as favorably for the financial markets in the year ahead as they did in the year just past, seems a bit naïve to us. Therefore, in order to bolster our own confidence, and hopefully yours as well, we offer a more detailed discussion of our outlook and our approach to dealing with unexpected events.

The pace of economic growth will be the most significant determinant of the market outcome for 2005, because healthy growth will be needed to drive further gains in corporate profits. Earnings have recovered from a cyclical downturn with two years of above-average growth. Broadly speaking, however, profits cannot grow faster than the overall economy indefinitely. Corporate America's profit margins are now close to peak levels, and labor productivity gains are slowing. This indicates that for most companies profit growth will be dependent on revenue growth and, hence, on the pace of the economic expansion.

We expect the economy to continue to post temperate growth in the year ahead. After three years of expansion, the US economy has entered a phase in which growth appears to be self-supporting. Job creation—the missing ingredient in the economic expansion a year ago—has picked up some steam. This is important, because a healthy labor market supports consumer spending—the biggest driver of US economic activity. TS&W believes the unemployment rate will continue to decline slowly in 2005.

Economic growth thus far has not been fast enough to spawn a worrisome pickup in inflation, which has allowed medium and long-term interest rates to remain low even as the Federal Reserve boosts short term rates. We believe that the economy is more sensitive to movement in interest rates than ever before;

---

---

and that a sharp increase in interest rates would quickly slow the pace of economic expansion. This rapid transmission mechanism was on display in 2004, when a springtime surge in interest rates led to an economic “soft spot” over the summer months that, in turn, pulled rates back down. Interest rates should remain in a reasonably tight range over the next year, as we believe the Federal Reserve will pursue tighter monetary policy with caution, raising short-term rates only when it is certain that it can do so without putting the economy into a stall.

It is at this intersection of interest rates and economic growth that the foreign exchange value of the US dollar comes to prominence. The dollar’s decline was a major economic story in the second half of 2004, although its implications are mixed. A cheap dollar spurs exports and boosts profits for many US multinational corporations. On the other hand, a weak currency increases import prices, which can be inflationary, and puts upward pressure on interest rates. TS&W does not believe that the erosion of the value of the dollar against major trading partners’ currencies will be a serious problem unless a precipitous decline develops. A decline of that magnitude is not likely, but we expect the dollar to remain an important topic of speculation and conversation among financial pundits and policy makers in the year ahead.

If the US economy can manage another year of low-inflation growth, as we expect, corporate profits should increase, albeit not as quickly as in 2004. We emphasize the outlook for profits because valuation, a critical variable in investment returns that is prone to short-term excesses, is presently neutral. A case can be made that stocks are attractively valued by pointing out that the earnings yield and dividend yield of the market is high relative to interest rates. The price to earnings ratio of the broad stock market, a basic gauge of valuation, declined in 2004, as earn-

ings, the “E” in the “P/E”, rose faster than prices. That said, we do not expect rising valuation—like the increase in P/Es that drove stocks up in the 1990s—to play a major role in returns in the months ahead. In this environment, valuation decisions on individual securities will be a critical determinant of investment success. We are confident that our team of experienced research analysts can continue to identify good value opportunities, even if the broad stock market offers little or no upward change in valuation.

#### PLANNING FOR THE UNEXPECTED

---

The crew of ENSCO 64 was long gone by the time Hurricane Ivan arrived, thanks to careful weather forecasting and monitoring, and a common-sense plan for getting out of the way if the worst came to pass. Our situation is not so different from the offshore drilling platform. The daily search for investment value requires patience and hard work, “drilling deep” into layers of financial data. Storms can blow up quickly in the financial markets, and our forecasts are subject to updating and revision as new information emerges.

The inputs that drive our valuation work on individual securities change more gradually than market psychology, providing our team with a stable platform for decision-making, especially during periods of “Category 5” market volatility. We are sellers when exuberance takes market prices well beyond a dispassionate calculation of fair value, and we are eager to buy when nervous investors drive prices well below our value calculation. This approach—an active search for value across sectors and among individual securities—applies to our fixed income strategy as well.

Income, both from stocks and from bonds, is an important counterweight to market volatility. We continue to believe that the old-fashioned cash dividend will be an important factor in total return from stocks

*We do not expect rising valuation to play a major role in returns in the months ahead.*

---

---

in the next few years. Stocks in our clients' portfolios delivered good dividend growth in 2004. More than twenty of the companies we owned for our clients increased their cash dividend at a double digit pace last year. We expect similar dividend growth in the year ahead because balance sheets are in good shape, payout ratios (the portion of profits returned to shareholders as dividends) are relatively low, and corporate boards are likely to heed pressure to increase payouts to shareholders. The large one-time payout of \$3 per share by Microsoft in December was an illustration of this trend, and we think other companies faced with limited investment opportunities will follow suit in 2005. The cash that has built up in corporate coffers might also be used to retire shares or to fund acquisitions—an appealing strategy in a period of slower growth.

Finally, Thompson, Siegel & Walmsley employs procedures designed to limit the consequences of estimates or forecasts that are off-target. While our approach is not as drastic as ENSCO 64's emergency evacuation plan, we are prepared to abandon individual stocks when trends in relative price performance and

earnings estimates indicate that a serious storm is approaching. Limiting the losses to which our clients are exposed to in a declining market is an important aspect of our investment philosophy.

#### ANTICIPATING A HAPPY NEW YEAR

We are continuing to build Thompson, Siegel & Walmsley, Inc. through the addition of experienced and motivated investment and administrative team members. It is the focused efforts of these people that give us the most confidence in our optimistic out-

***We continue to believe that the old-fashioned cash dividend will be an important factor in total return from stocks in the next few years.***

look for the year ahead. Our investment results in 2004 and our expectation

of a good year in 2005 are tempered, however, by concern for the risks facing US troops serving in Iraq and Afghanistan and for the victims of natural disasters in the Indian Ocean basin and in our own hemisphere. These realities remind us that for all of its opportunity, the world is still a risky place, and we are all influenced by situations and events that may take place far beyond our time zones and comfort zones. We wish all of our clients and other friends a safe, happy, and prosperous 2005.

---

*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.*



Thompson, Siegel & Walmsley, Inc.  
5000 Monument Avenue ♦ P.O. Box 6883  
Richmond, VA 23230  
Phone 804-353-4500 ♦ Toll free 800-697-1056  
Fax 804-355-9410  
Email: [tswmarketing@tsw-ic.com](mailto:tswmarketing@tsw-ic.com)

---

---