



First Quarter
2005

Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

To Our Clients

By the time you receive this note, Thompson, Siegel & Walmsley's research team will be submerged in the quarterly ritual of corporate press releases, management conference calls and legal disclaimers that has come to be known as "earnings season." Our analysts will spend hundreds of hours studying the details of quarterly corporate earnings announcements and participating in conference calls and webcasts. They will listen to corporate management teams describe the business climate of the past ninety days and offer carefully hedged "guidance" for the future. They will participate in lengthy question and answer sessions that provide, in many cases, the only opportunity for outsiders to hear corporate managers respond to unscripted inquiries. For experienced analysts, these events can even produce insights into management confidence or competence that are not apparent in dry financial statements and regulatory filings.

The quarterly earnings announcement circuses have been mostly pleasant events for investors in recent years, as a healthy economy propelled corporate profits to record highs. Last year, for example, operating profits for the S&P 500 companies rose 21%, enabling the stock market to shrug off worries about terrorism, the war in Iraq, energy prices and rising short-term interest rates.

- ◆ Companies in TS&W's large-cap stock portfolios enjoyed somewhat better growth, and we were aided by favorable reactions to quarterly earnings announcements
- ◆ Three fourths of the companies in our portfolio posted "positive surprises" (Wall Street lingo for an earnings report that exceeds the widely held expectation) in the fourth quarter, and only one company "missed estimates," reporting results that were only one cent per share below analysts' best guesses
- ◆ More than two-thirds of our portfolio companies raised their profit forecasts for 2005

Since our portfolio trades at a more attractive valuation level than the broad stock market, this strong profit growth translated into good returns for clients.

THE RETURN OF EARNINGS JITTERS

The broad stock market's nervous decline in the first three months of 2005 signaled increased concern about the outlook for corporate earnings. Most analysts—including TS&W's research team—expect earnings to increase this year, but the all important growth rate is expected to slow sharply, and many forecasters believe the pleasant experience of positive quarterly earnings surprises and rising profit forecasts will grind to a halt. Current forecasts by Wall Street's prognosticators call for S&P 500 profits to be lower in the fourth quarter of 2005 than those reported for the final quarter of 2004. Since profit growth is one of the most important propellants of stock prices, the slowing growth trend will lend the quarterly earnings season a dash of anxiety that has been largely missing for the past few years.

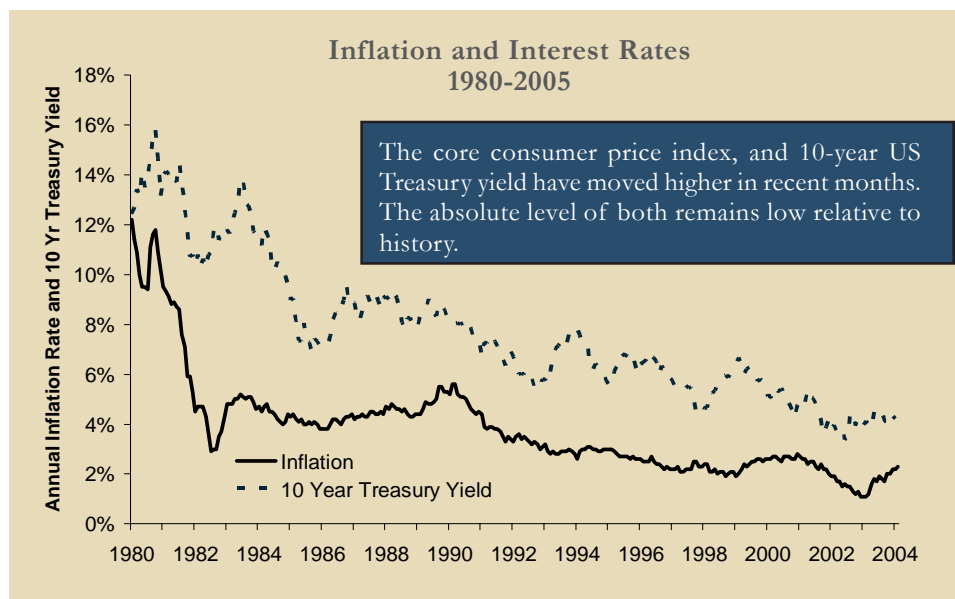
From our point of view, the slowdown in earnings growth is the natural outcome of a maturing economic cycle, not the leading edge of serious deterioration in business conditions. Three factors—high energy prices, rising inflation and interest rates, and the natural tendency of growth rates to slow as the earnings base becomes larger—are at the heart of the current anxiety over profits. A brief review of each of these

factors underscores Thompson, Siegel & Walmsley's belief that conditions remain generally positive for stocks.

Energy prices have moved relentlessly higher since 2002, fueling worries about inflation, pinched profit margins and a stagnating economy. But circumstances today bear little resemblance to the memorable "energy crisis" days of the 1970s and early 1980s. Although bottlenecks exist, global energy supplies do not generally face the artificial constraints that led to price spikes in the past. The increase in energy prices today is attributable to strong demand in a generally healthy global economy. An increasing appetite for energy in India and China, for example, is an indicator of rising industrialization and living standards in those emerging economic powerhouses, which bodes well for long-term global economic growth. In developed countries like the US and Europe, energy, while important, is much less of a pivotal factor in the economic equation than it was in the past, muting the overall impact of higher oil, natural gas, and petroleum product prices. While higher energy prices may limit the pace of growth over the next year, oil and gas prices alone will not tip the economic cycle into a downturn.

Interest rates have risen from the historic lows of last year, leading some observers to conclude that the economic expansion will falter and stocks will slump. It is important to recall, however, that little more than a year ago deflation, a sustained decline in broad price levels, was a major concern, and pessimists worried that the Federal Reserve had run out of tools for stimulating the economy. Instead, seven quarter-point increases in the federal funds rate by the central bank since last summer have nearly restored short-term rates to a level considered normal for a healthy economy. Rates remain at the lower end of the post-World War II era range, and do not currently present a major deterrent to capital investment or consumption. (See chart above)

Recent price reports have revealed a pickup in the **inflation rate**, due in part to higher energy prices. The pessimistic view of this development is that a powerful wave of inflation will drive interest rates up sharply, ultimately curtailing economic growth. Although prices for certain industrial commodities are in an uptrend, TS&W does not believe that a sustained acceleration in broad price levels is at hand. Increasing labor productivity driven by technological advances, progress toward reducing global trade barriers (such as the removal of US tariffs on imported clothing) and curtailment of money supply growth by the Federal Reserve indicate to us that inflation will remain at non-threatening levels. This, in turn, suggests that the increase in interest rates will be modest, and that the Federal Reserve will be able to conclude its tightening cycle later this year.



The **slowdown in earnings growth** this year will be, in the main, the natural consequence of a maturing economic cycle. We expect overall corporate profit growth to settle into a mid-single-digit pace (6-8%, with natural fluctuations from quarter to quarter) that is in keeping with the long-run growth capacity of the economy and is sustainable over a period of several years or more. This does not mean that every company, every industry, or even every economic sector will enjoy smooth, uninterrupted growth, but it does point to a long expansion like the extended profit growth cycle of the 1990s.

THE LONG-TERM PERSPECTIVE

The quarterly earnings reporting season has, in recent years, taken on a perceived importance out of proportion with the actual impact of three months' results on the long-term value of any business. Stock and bond prices often react sharply to both the substance and the tone of these information blitzes, especially in the event of any divergence from previous guidance or the "consensus" expectations of Wall Street analysts. Although we gather information that is useful to our fundamental research process, three-month updates rarely cause our analysts to change their recommendation on a particular stock or bond. According to Tom Thomson, TS&W's Director of Research and a veteran of more quarterly earnings announcements than he is willing to admit, many companies have improved their financial disclosure in recent years, but "there is still a lot of noise in most quarterly announcements and the chatter that follows them that is irrelevant to our thought process."

While stock prices sometimes react dramatically to minor changes in a company's forecast, Tom notes that "intrinsic value doesn't fluctuate wildly." An increasing portion of today's trading volume is driven by market participants employing complex strategies that seek to profit from short-term price movements triggered by events such as earnings announcements. These traders are typically less interested in a long-term investment thesis that may play out over several years and may dump stocks or buy them with little regard for intrinsic value. This phenomenon works in TS&W's favor. We comb the data from quarterly announcements for information that might change our long-term assessment of value. "That just doesn't happen often," says Tom, "no matter how excited the talking heads on cable television might become." Factors like price trends, earnings surprises and the direction of changes in Wall Street earnings forecasts contain important information and can be affected by quarterly news. We consider this information, but it does not lead TS&W to buy or sell stocks unless our determination of value, which is based more on long-term factors, has also changed.

We expect the quarters ahead not only to produce an abundance of sound and fury, but also to bear more subtle evidence of three important long-term themes that will profoundly affect stock values:

First, the long-term decline in **interest rates**, which has arguably been the most dependable financial trend for an entire generation of investors, has probably come to a close. We should stress here that this does not imply an immediate return to soaring interest rates, but it does suggest that investment themes based on declining rates may have largely played out. For our clients, this means a gradual retreat from financial stocks like insurance companies and banks. The financial sector is the largest component of market benchmarks by a wide margin, and it has produced superb returns for investors for most of the past two decades. Selected good opportunities still remain among financial stocks. However, we believe that profit margins have peaked for most of the financial sector and that stock performance may lag behind other sectors as a result.

We also believe that demand for **industrial commodities** including oil, natural gas, metals and chemicals will remain strong for an extended period, due to the rapid industrialization and rising living standards of developing nations like China and India. Commodity producers epitomized the "old economy" that was so widely spurned in the 1990s, so capital investments in capacity expansion have been limited. When global demand growth surged in the past few years, these companies

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- Tom Thomson, TS&W Director of Research

enjoyed high rates of capacity utilization and the power to raise prices, expanding profit margins and cash flows. New supplies of products like copper and ethylene will come on line gradually in the next few years, prolonging the rising profit trend. We continue to find good investment opportunities in these areas despite recent price gains.

Finally, as we have emphasized in the past, we believe that **dividends** will be an important contributor to investment returns for years to come. Stocks in our clients' portfolios have produced above-average dividend growth in recent years, and we expect that trend to continue. However, while we have consistently regarded dividend yield to be an attractive feature for stocks, TS&W's disciplined investment process does not simply seek out the highest yielding shares. Instead, we look for companies that possess the financial capacity and the demonstrated intent to reward shareholders by prudently reinvesting cash at enticing rates of return or returning it to shareholders via dividends or share repurchases. We believe it is this kind of stock, purchased at the right price, that will produce the best total returns for our clients in the years ahead.

SUMMARY

Higher energy prices, rising inflation and interest rates, and a slower corporate profit growth outlook dogged the stock market and rattled bonds in the first three months of 2005. There is little doubt that these preoccupations will produce plenty of noise as the year wears on. In our view, however, these factors arise from a generally healthy global economy. They do not currently presage an adverse environment for investors. An increasingly visible crowd will focus on the short-run impact of these factors as they are revealed in quarterly earnings reports and management comments about the future. TS&W, on the other hand, will search the same reports for clues about long-term intrinsic value. At those points where the interests of the short-term opportunists inevitably diverge from the slowly evolving trend in intrinsic value we expect to find investment opportunities that will pay off for our clients.

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