



Investment Management of Virginia, LLC

First Quarter, 2008

Summary

- **Navigating the Volatility** The U.S. economy rapidly deteriorated in the first quarter and appears to be in, or on the brink of, recession. However, in general, the further one gets from Wall Street, the better business trends appear to be. Business activity outside of the U.S. remains solid.
- **Unconventional Measures – Unconventional Times** Fed assistance is in place, and progress has been made. Liquidity is abundant; however, credit availability remains restrictive for lesser credit quality borrowers. On the other hand, the credit facilities for creditworthy non-financial institutions are working normally.
- **Unconventional Recovery – This Time is Different** The unwinding of the massive institutional and personal leverage created in the past several years will continue to take its toll. Due to the complexity of this current downturn, the character of the eventual recovery is likely to be unconventional.
- **Glass Half Full** Corporate earnings, ex-financials, have performed well, predominately driven by strength in global and emerging markets. It is clear that, in the wake of U.S. weakness, global economies have been more resilient than history would imply.
- **Extreme Volatility/Fear - Market Implications** Daily changes of 1% or more in the S&P 500 Index have occurred on 53% of trading days this year, the most since 1938. Investor sentiment has been low, by almost any measure, throughout the quarter. Cash is abundant.
- **Equity Valuation** We expect volatility to remain elevated, but we reiterate our view that much of the downside risk in the equity markets has been discounted. The real risk is in earnings, which will require close observation on a company-by-company basis.

Navigating the Volatility

The past three quarters have been marked by tumultuous activity in the financial markets, including significant economic deterioration in the quarter just ended. What began as a seemingly typical housing boom-bust cycle downturn last summer has transformed into a severe stress test for our “new” financial system. Current financial problems grew out of an exuberant housing market, fueled by excessive borrowing and “creative” financial engineering. Banks have been at the epicenter of these trends, and they have paid the price, with losses reported by global financial institutions totaling \$245 billion, to date. The result is that financial institutions are

hoarding cash and restricting lending to only the highest quality borrowers.

The lock-down of lending capital has taken its toll on both consumer and business confidence. Additionally, energy prices have surged, and personal income has not kept pace with higher inflation. Oil is over \$100/bbl, up from the low \$50s in January 2007, and grocery prices are up 5.8% year-over-year. Recent reports from the government indicate that employment trends have weakened abruptly toward recessionary levels. Real GDP grew 0.6% in the fourth quarter and is now expected to be flat to negative over the next couple of quarters. Nonetheless, non-financial, creditworthy businesses have been faring reasonably well with ample available credit, growing revenues, and growing reported earnings, which is atypical of past economic contractions. U.S. businesses participating in global enterprise are experiencing a strong competitive advantage as U.S. exports have been accelerating, and foreign economies have remained robust, particularly Asia ex-Japan. For example, China’s trade report shows that, year-to-date through February, year-over-year export growth to the U.S. is up only 0.4% while import growth from the U.S. to China is up 41.2%.

In sum, the U.S. economy rapidly deteriorated in the first quarter and appears to be in, or on the brink of, recession. Housing is in a recession throughout certain regions of the U.S.; the “Detroit three” component of our auto industry is in recession; banks are in troubled waters. However, in general, the further one gets from Wall Street, the better business trends appear to be. Business activity outside of the U.S. remains solid.

Unconventional Measures – Unconventional Times

A conventional economic downturn usually starts with a robust economy followed by the Federal Reserve’s raising interest rates and banks’ tightening credit, which causes a recession. The Fed then begins an easing cycle to accelerate growth. The current U.S. downturn is anything but conventional. During this cycle, banks helped create the credit problems, causing deterioration in financial earnings and a lock-down of credit.

In a surprise announcement on August 17th, the Fed cut the discount rate by 50 basis points and acknowledged that an “extraordinary” policy shift was needed in response to “tighter credit conditions and increased uncertainty.” Since then, the Fed has reduced the discount rate six more times, to 2.5% from 6.25%, and cut the federal funds target rate to 2.25% from 5.25%, reducing the cost of capital for businesses as well as individuals. The Fed introduced the Term Auction Facility, the Term Securities Lending Facility, and the Primary Dealer Credit Facility, along with coordinated financial intervention with foreign central banks, all targeted at providing liquidity

to the heart of the financial system. OFHEO (Office of Federal Housing Enterprise Oversight) increased liquidity in support of the U.S. mortgage market through Fannie Mae and Freddie Mac. For consumers, a \$150 billion fiscal stimulus package is on its way. Lastly, through a \$29 billion loan package, the Fed supported J.P. Morgan's buy-out of a distressed Bear Stearns. In sum, the Fed has injected billions of dollars into the financial system to provide credit availability, increase confidence, aid the functioning and stability of financial markets, and reduce the risk of systemic damage to the financial system. According to fed funds futures, there is a 95% probability of at least another 25 basis points cut on April 30.

Fed assistance is in place, and progress has been made. With short-term interest rates below 2%, the positively sloping yield curve serves as "rehab" for banking profits through a favorable net interest margin, over time. But, rational pricing of asset-backed securities remains elusive, and the commercial paper market for financial institutions remains weak. Liquidity is abundant; however, credit availability remains restrictive for lesser credit quality borrowers. On the other hand, the credit facilities for creditworthy non-financial institutions are working normally. So much so, in fact, that higher rated issuers of debt are taking advantage of long-term borrowing opportunities at exceptionally low rates in anticipation of higher interest rates later in the cycle. General Electric, AT&T, and UnitedHealth were among 39 companies that sold 30-year investment-grade bonds during the first quarter. According to Bloomberg, 57% of the U.S. debt sold in the past two quarters matures in 10 years or more, which compares to 39% since 1999.

Unconventional Recovery – This Time is Different

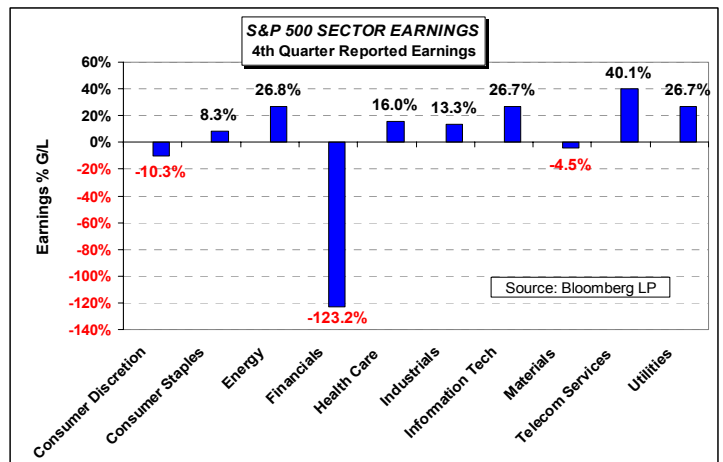
The unwinding of the massive institutional and personal leverage created in the past several years will continue to take its toll. As in past cycles, some businesses will fail, and over-extended individuals will suffer. However, due to the complexity of this current downturn, the character of the eventual recovery is likely to be unconventional. First, a typical recovery is orchestrated by increased discretionary spending, generally led by housing, autos, and retail spending. But, with record housing inventory on the market and a record 2.8% national vacancy rate, new home construction may not be an economic driver for some while. Wachovia Economics reports that 40% of nationwide foreclosures have been investor owned; 88% of homes standing empty are second homes, according to a Census Bureau report. With a general deterioration in real personal income and wealth, it is hard to envision pent-up demand for discretionary spending. Since 2002, discretionary spending trends showed that individuals were "buying up," with greater spending on luxury goods. Recent trends indicate that individuals are "buying down."

A second difference may be found in current inflationary trends, e.g., higher food and energy prices. While it is likely that slowing economic growth will dampen future inflationary pressures, recent food and energy pricing pressures have their own unique dynamics that may alter historical trends to some degree. Regardless, and also contrary to past cycles, we expect that the Fed will be raising rates at the first signs of strength in the financial system. The Fed's next battle will be

fighting inflation and a weak U.S. dollar which will require a "take-back" of excess monetary stimulus.

Glass Half Full

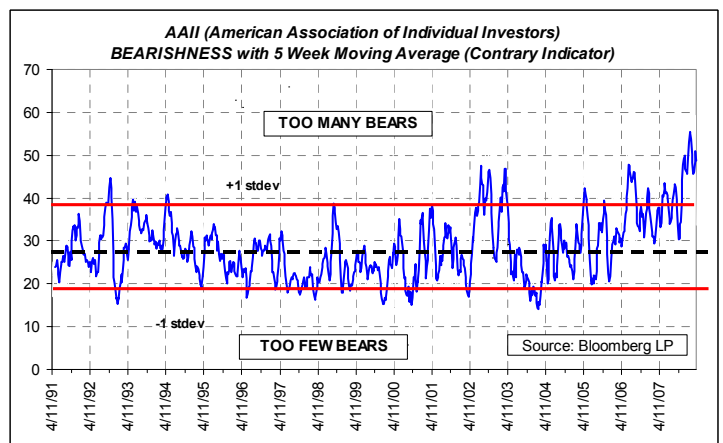
Corporate earnings, ex-financials, have performed well, predominately driven by strength in global and emerging markets. It is clear that in the wake of U.S. weakness, global economies have been more resilient than history would imply, driven by stronger domestic demand. Still, signs of weakness have materialized in Japan, the U.K., Italy, and Spain, with some decelerating growth in Asia. The strength of the build-out in emerging economy infrastructure is a key driver fueling U.S. multinationals and is a key data point to monitor.



Extreme Volatility/Fear - Market Implications

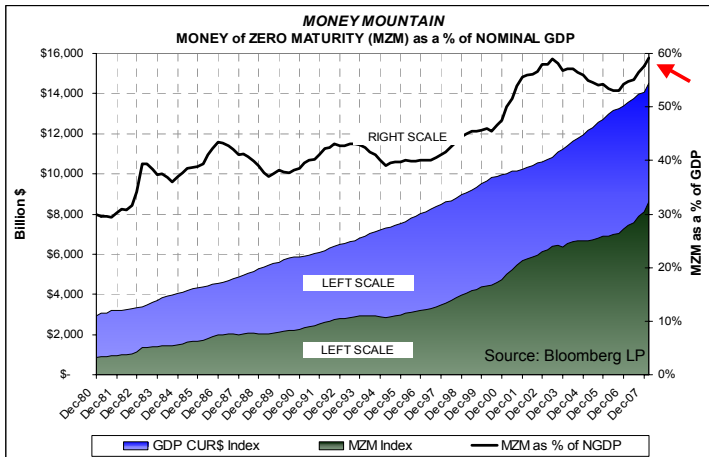
Peak to trough, the S&P 500 Index declined 18.3% during the past two quarters. Yet, when comparing the current S&P 500 Index reading of 1370.40 with the index price as of the Fed's initial discount rate cut on August 17th, the S&P 500 is down only 5%. According to Standard and Poors (S&P), daily changes of 1% or more in the S&P 500 Index have occurred on 53% of trading days this year, the most since 1938. First quarter returns were negative in all capitalization categories with the S&P 500, S&P Midcap 400, and S&P Smallcap 600, down 9.4%, 8.8%, and 7.2%, respectively. Furthermore, negative returns were registered in all S&P sector categories.

Investor sentiment, which can be a contrary indicator, has been low by almost any measure throughout the quarter. Equity mutual fund investors continue to demonstrate extreme fear, with net withdrawals creating additional selling pressure on stocks. According to Merrill Lynch & Co., equity fund



managers have raised cash percentages to heights not seen since March 2003, interestingly, the very month of the last market cycle's trough. Separately, the American Association of Individual Investors notes that recent "bearishness" measures are the highest since October of 1990, which also corresponded to an equity market bottom. While not a precise timing tool, extremely negative market sentiment directly correlates with past time periods of political, economic, or market crisis, generally signaling excessive fear and extreme discounting in equity valuations. In the past, these periods of discounting often have portended attractive forward equity returns for long-term investors.

The swell in the accumulation of liquid cash with zero maturity (MZM) has reached an unprecedented high of 59% of Nominal GDP. Non-financial corporations are cash rich too.



A February 2008 study by S&P showed that total cash held by industrial companies has nearly tripled since 1998. Again, the timing is uncertain, but any catalyst that would unlock a portion of this *Mountain of Money* could generate strong buying power for equities.

Equity Valuation

In last quarter's commentary we wrote, "With the S&P 500 reflecting a 15.8x trailing earnings multiple, an estimated 6% forward earnings yield, and a dividend yield of 1.9%, in an environment of a 3.73% yield on 10-year U.S. Treasuries, it appears to us that much of the downside risk has already been discounted in the equity markets." Since then, the S&P 500 declined another 4% but is now 9.5% up from its low. We expect volatility to remain elevated, but we reiterate our view that much of the downside risk in the equity markets has been discounted. The real risk is in earnings, which will require close observation on a company-by-company basis.

Conclusion

A crisis of confidence has contributed to rapid deterioration in U.S. economic activity over the past two quarters. Recently, the Fed has taken directed and deliberate actions to restore the structural integrity of and confidence in the financial system. Abundant liquidity is gradually being unlocked. Sentiment measures are some of the most negative on record. In our opinion, equity valuations are attractive and represent some of the best valuations relative to Treasuries in several decades. Bonds will likely suffer when the rate cycle heads upward again. We believe that a bottoming process is in place, and we like the prospects for equities on a long-term basis.

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