Investment Management of Virginia, LLC
The Energy Portfolio
4th Quarter, 2011

The Energy Portfolio improved from the first quarter but still had a very disappointing year. The Portfolio Composite was up 13.9%, net, for the quarter.[1] The S&P Energy Index was up 18.2% over the same period. For the year-to-date period, the Energy Portfolio Composite was down 21.5% while the S&P Energy Index was up 4.7%. The Philadelphia Oil Service Index (OSX) and the E&P Index (EPX) were up 14.2% and 18.9%, respectively, during the quarter. The OSX was down 10.5% for the year, and the EPX was down 9.2% for the year. WTI crude oil prices advanced 25% to close the year at $98.83 per barrel; natural gas prices fell another 18% to close the year at $2.99 per mcf. For the year, oil was up 8% while natural gas was down 32%.

As these commodity prices indicate, domestic natural gas remains the evil twin to the benevolent global oil market, and any energy company with material U.S. natural gas exposure was, generally speaking, a dramatic underperformer. Our overall stock picking could have been better, but our legacy positions in several E&P companies had an outsized negative effect on our results.

Although the natural gas rig count has declined steadily over the course of 2011, the overall rig count has continued to increase. Most of the new rigs are targeting oil or natural gas liquids, but these wells still produce a lot of natural gas. For example, one of the most economic plays in the country is the Mississippian in Oklahoma and Kansas. Average wells in this play produce slightly less than 50% oil on a BTU basis. While oil is the target, yielding 80-90% of the cash flow for each well, a lot of dry gas is still produced. One of our mistakes over the last few years rests in our failure to understand how much the associated gas from "oil" wells would impact domestic gas production. Even with a declining natural gas rig count, domestic natural gas production is up almost 7% year/year, dramatically outstripping demand. While there are sources of incremental demand on the horizon (increased power generation, new chemical plants, transportation demand, LNG exports), these factors will not really kick in for several more years. Thus, 2012 looks like it could be another relatively weak year for the domestic natural gas market.

So, where does that leave us for 2012? We believe that oil prices will stay strong. Outside of North America, we expect supply growth to continue to disappoint. Emerging market demand growth, especially from China, should be enough to keep the market tight. International natural gas prices (basically the LNG market) should stay tied to oil, remaining strong. Domestic natural gas prices should remain weak for most of the year, with perhaps some strengthening into next winter if production finally rolls over. This environment bodes well for domestic service providers and domestic E&P companies that are either leveraged to oil or making the transition to a more oily production profile. We also expect to see a continuation of the trend of majors and national oil companies forming joint ventures with domestic E&P companies. International service providers should continue to see moderate but steady improvements in revenues and margins.

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[1] Past performance is no guarantee of future results, and no representation is made that results similar to those shown can be achieved. To receive a complete list and description of Investment Management of Virginia, LLC's composites and/or a presentation that adheres to the Global Investment Performance Standards (GIPS), contact John H. Bocock at (804) 643-1100, or write Investment Management of Virginia, LLC, PO Box 1156, Richmond, VA 23218-1156, or jbocock@imva.net.