

Investment Management of Virginia, LLC

Fourth Quarter, 2011

Summary

Entering the fourth quarter, worries about the U.S. economy's backsliding into recession seemed to reach an extreme just as a number of economic reports – retail and auto sales, construction spending, architectural billings, etc. – began to show encouraging data. Since then, U.S. economic results appear to have improved further.

Given the FOMC's recent assessment of the economy, the committee continued to call for loose monetary policy (the target range for the federal funds rate remained at 0% to 0.25%) and the continuation of the Maturity Extension Program (Operation Twist). Presently, the Fed anticipates that economic conditions will warrant these low rates through mid-2013.

Currently, the dividend yield of many U.S. companies exceeds the 1.9% yield of the 10-year U.S. Treasury. Furthermore, corporations generally appear to be in the best financial condition in many years. Extremely low interest rates provide corporations with a generationally low cost-of-capital.

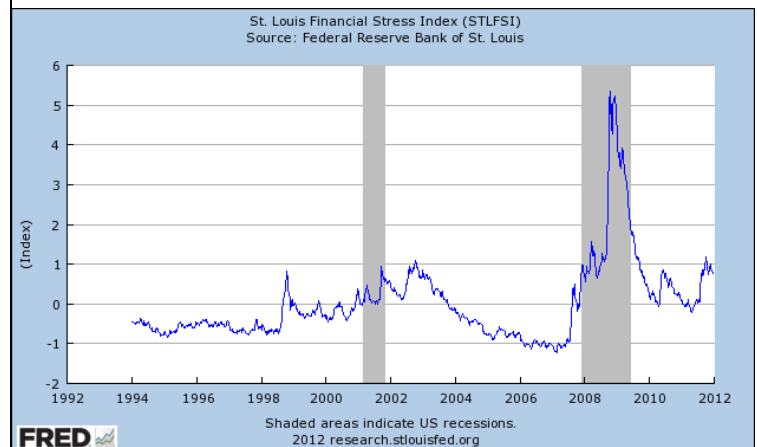
The probability of finding an immediate and complete solution to Europe's financial troubles is low. In the interest of helping Europe and the global economy muddle through, 48 central banks around the world have cut interest rates in the past several months. Over the same timeframe, U.S. economic data have improved. The equity markets have responded but remain inexpensive versus historical ranges, in our view.

Predictions and the Wall of Worry

As Yogi Berra once said, "It's tough to make predictions, especially about the future." That sentiment certainly applied to the beginning of 2011, and it also applies today. As most global economies appeared to be strengthening at the beginning of 2011, who could have envisioned the year's ensuing upheavals in the Middle East (which raised energy prices), the tsunami's devastation of Japan and the extensive flooding in Thailand (which disrupted the global supply chain, curtailing growth), the heightened acrimony and gridlock in Washington (which resulted in the unprecedented downgrade of U.S. Treasury debt), and the rising levels of dysfunction across Europe (which created great uncertainty as to the viability of the European Union)? In sum, over the course of 2011, optimistic predictions and high hopes gave way to a mounting wall of worry as various shocks, systemic and exogenous, emerged.

Europe and indebted euro members now form the epicenter of global financial stress, remaining prisoners to the "paradox of thrift." Somehow, they must simultaneously implement austerity, reduce the overwhelming public debt obligations, and achieve growth. Put another way, they must spend productively but save more than they spend. Most economists already have concluded that Europe is in recession. Recent reports on weak European retail sales and industrial production, as well as the significant slowdown in foreign trade with South America and Asia, support such projections. According to the Federal Reserve and many economists, the biggest global risk looms in the

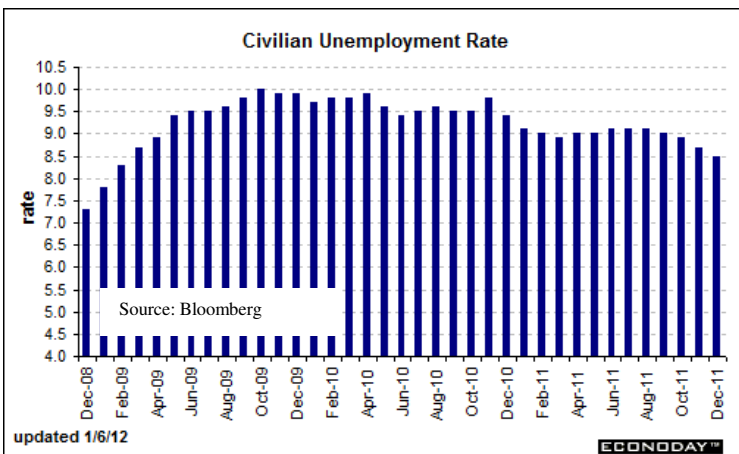
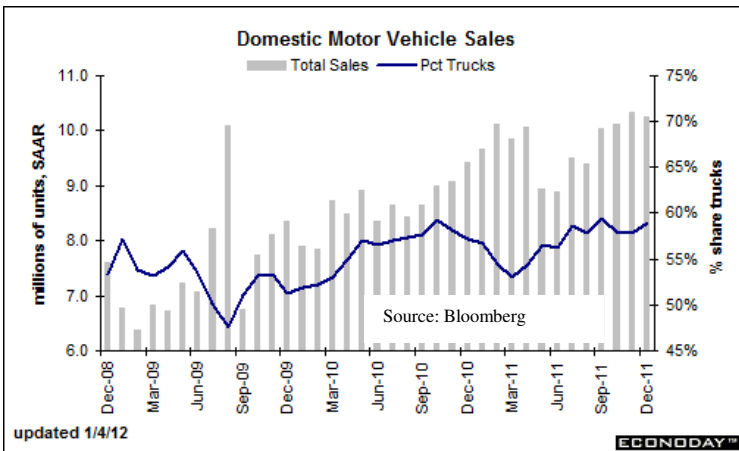
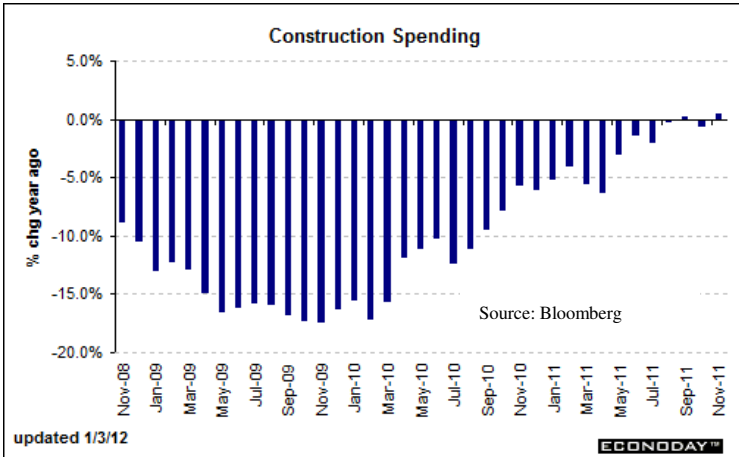
potential for a "financial crisis" in Europe, as opposed to a recession. Although financial stress is elevated, as can be seen in the chart below, Europe may continue to muddle through the long process of deleveraging without triggering a panic. Moreover, here at home, many reports on economic growth continue to surprise to the upside, and U.S. equity markets have taken small steps up that wall of worry.



Economic Trends

Entering the fourth quarter of 2011, equity market prices festered at what turned out to be the low point for the year. Worries about the U.S. economy's backsliding into recession seemed to reach an extreme just as a number of economic reports – retail and auto sales, construction spending, architectural billings, etc. – began to show encouraging data. Since then, U.S. economic results appear

to have improved further, showing progress in consumer confidence, various purchasing managers' indices, factory orders, and employment trends (led by the private sector). Additionally – and notably – real estate trends offered glimmers of hope. Home sales, housing starts (particularly multi-family), construction spending, and construction job growth, all appeared to improve, and the December Architectural Billings Index report revealed positive growth for first time in four months, stating that “multi-family residential and commercial sectors are most healthy.”



Following lackluster GDP growth throughout most of 2011, fourth quarter growth is expected to reflect a reasonably healthy 3%-4% advance. However, before extrapolating these data forward, we must acknowledge some quirks in

the details. First, inventory depletion subtracted roughly 1% from third quarter growth. So, with inventory/sales ratios near historic lows, inventory rebuilding is expected to have added significantly to fourth quarter results; this momentum likely will slow. Secondly, owing to global headwinds, forward growth should be more modest. Most economists project that real U.S. GDP growth – absent a deepening financial crisis in Europe – will hover in the 2% range throughout 2012.

Financial Conditions/Monetary Trends

The December 13th announcement by the Federal Open Market Committee (FOMC) stated the following: “*The economy has been expanding moderately, notwithstanding some apparent slowing in global growth. While indicators point to some improvement in overall labor market conditions, the unemployment rate remains elevated. Household spending has continued to advance, but business fixed investment appears to be increasing less rapidly and the housing sector remains depressed. Inflation has moderated since earlier in the year, and longer-term inflation expectations have remained stable... The Committee continues to expect a moderate pace of economic growth over coming quarters and consequently anticipates that the unemployment rate will decline only gradually.*” Given this assessment, the committee continued to call for loose monetary policy (the target range for the federal funds rate remained at 0% to 0.25%) and the continuation of the Maturity Extension Program (Operation Twist). Presently, the Fed anticipates that economic conditions will warrant these low rates through mid-2013.

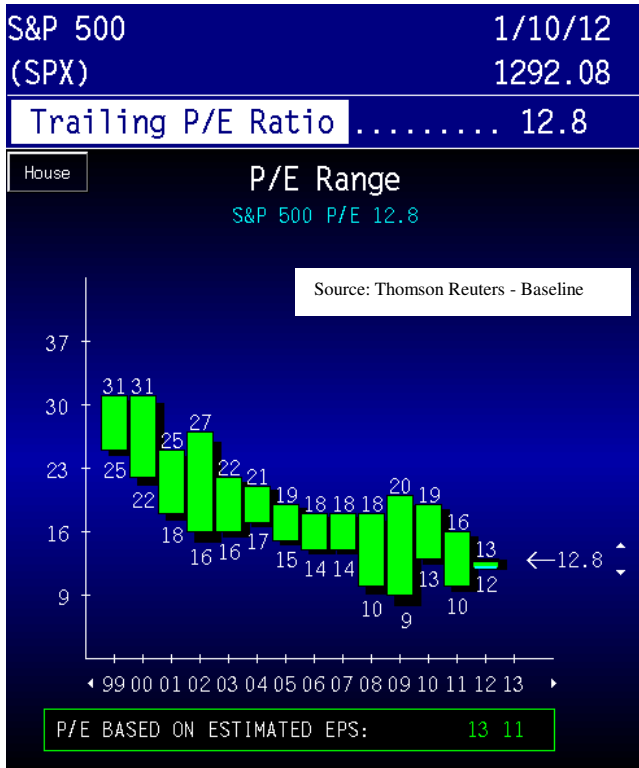
While acknowledging some improvement here at home, the Fed cautioned that “*strains in global financial markets continue to pose significant downside risks to the economic outlook.*” The financial stress chart on the preceding page would appear to support this caution. Created by the Fed, the stress index folds 18 different data series – including Treasury yield spreads, corporate yields, LIBOR rates (London Interbank Offering Rate), Treasury-Eurodollar (TED) spreads, and other data points – into a single, composite measure and index. Given recent upticks in this index, on the back of mounting troubles in Europe, it is not surprising that the Fed has accelerated U.S. money supply growth (the aggregate figure is now above \$10.6 trillion).

Market Trends/Sentiment Indicators

Three months ago, we observed that nearly all of the market trend/sentiment indicators we follow registered over-sold readings in the extreme. At that time, defensive sectors, e.g., utilities, tended to command the greatest level of attention from equity market investors. Following a broad-based market recovery in the fourth quarter, these indicators now sit in a neutral position. Recently, the cumulative number of advancing stocks has expanded, reflecting greater investor interest across various economic sectors. We are encouraged by this trend.

Equity Market Valuations & Earnings

From the October 3rd equity market lows, the S&P 500 Index, the S&P Mid-Cap 400 Index, and the S&P Small-Cap 600 Index advanced 14.4%, 18.0%, and 23.0%, respectively (excluding dividends). Despite great improvements, these indices finished 2011 below their early August levels. Generally, U.S. equity market valuations appear attractive versus long-term, historical measures, likely discounting continued gridlock in Washington, a European recession, and global economic deceleration. History demonstrates that during the third



and fourth years of most recoveries it is normal to see earnings growth moderate. Repeatedly, during past periods of similar market conditions of decelerating growth, equities provided positive long-term results, as long as earning did not collapse. Recent economic and market reports would indicate that we are not facing a 2008-style collapse in earnings.

From a longer-term perspective, we view equities even more favorably. Currently, the dividend yield of many U.S. companies exceeds the 1.9% yield of the 10-year U.S. Treasury. Furthermore, corporations generally appear to be in the best financial condition in many years. Extremely low, global interest rates provide corporations with a generationally low cost-of-capital.

Conclusion

The future remains cloudy, but we can say with confidence that the probability of finding an immediate and complete solution to Europe's financial troubles is low. Muddling through with a series of small steps and limited successes seems to be the more probable scenario. To that end, 48 central banks around the world have cut interest rates in the past several months, commencing a new rate reduction cycle. Over the same timeframe, domestic U.S. economic data have improved, hopefully portending modest growth. The equity markets have responded but remain inexpensive versus historical ranges. Interest rates are low, earnings appear to be growing, and investor sentiment is subdued; these conditions are normally positive for equities.

For an in depth review of our Market Pillars and Charts, visit: <http://www.imva.net/market-pillars/>.

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