

Investment Management of Virginia, LLC

Fourth Quarter, 2008

Summary

Third quarter Real GDP declined 0.5%; and the just completed fourth quarter is expected to be down significantly, with consensus estimates of Real GDP declining 4.3%. The fourth quarter should be the worst negative quarter during this cycle, followed by continued contraction during the first two quarters of 2009. Indications are pointing in the direction of improved positive growth in the back half of the year and going into 2010, albeit with below historical average growth. Ongoing weakness in housing and falling equity markets have resulted in the most rapid decline in household net worth on record. Additionally, rising unemployment is raising the fear of job instability. Consequently, personal consumption is expected to be lethargic as consumers retrench, reduce debt burdens, and rebuild personal balance sheets.

In total, between the Federal Reserve and the U.S. Treasury Department, the U.S. government has pledged \$8.5 trillion toward various programs and guarantees designed to free capital and credit flows, reflate asset prices, and ultimately stimulate growth. While the process is slow, evidence indicates that credit is easing and mortgage rates are falling, leading to positive developments. High inflationary pressures have diminished, energy prices have fallen (particularly gasoline), and personal savings rates are being restored. Additional government stimulus plans are anticipated in the near-term.

Market panic and deleveraging drove the 2008 S&P 500 Index return to the lowest since 1937. A worldwide flight to "safe" assets drove U.S. Treasury rates to generational lows, yielding negative real returns (and negative absolute returns in some cases), and investor and consumer sentiment measures fell to levels never recorded. Equity market valuations are the lowest and cash on the sidelines the highest since 1990, and the S&P 500 Index dividend yield is more than that of the 30-year U.S. Treasury. Historically, these conditions favor significantly improved equity market returns looking forward.

Finding a Trough

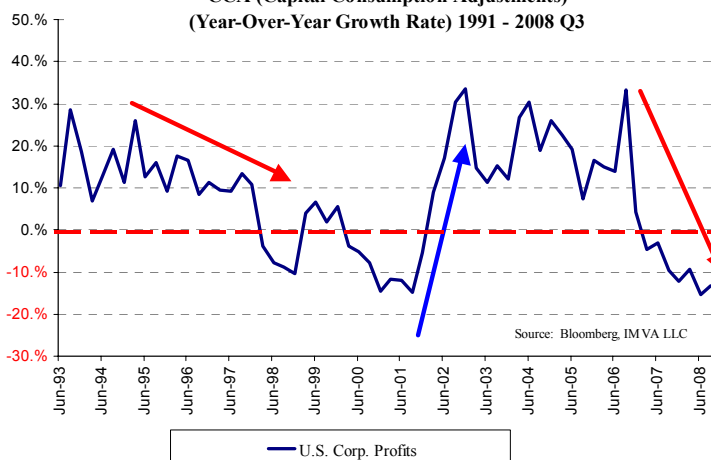
Third quarter Real GDP declined 0.5%, the worst since 2001. Real GDP is expected to be significantly lower in the just completed fourth quarter, declining at an estimated rate of 4.3%, the biggest decline since 1982. Many believe that the fourth quarter should be the worst quarter in this economic cycle; however, GDP is expected to continue contracting through the first half of 2009, though at lesser rates of decline each quarter. Four consecutive declines would be the longest economic slide since quarterly records began in 1947. Consequently, corporate profits have continued to decline and profit margins to tighten. Consensus forecasts call for a reacceleration of Real GDP

growth in the last two quarters of the year and into 2010. If so, corporate profits would be expected to reaccelerate also.

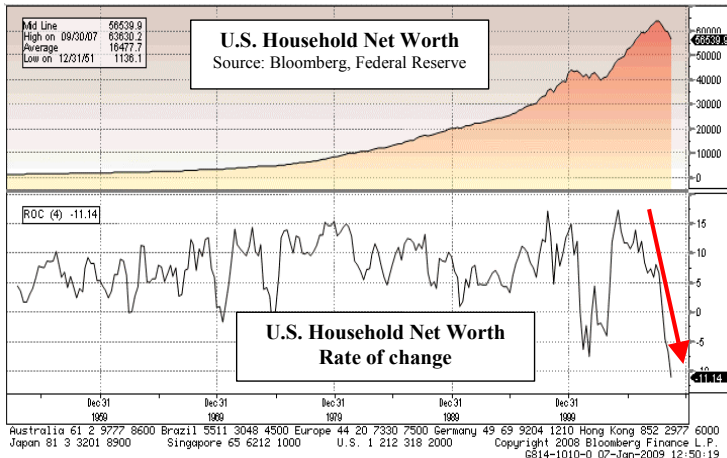
Amidst higher inflation, volatile energy prices, negative real income growth, higher unemployment, personal debt deleveraging, and an uncertainty in future job security, weak personal consumption has been the primary component driving negative GDP growth. The year-over-year consumer price index (CPI) peaked in July at 5.6%, gasoline topped \$4.00 per gallon, third quarter personal income grew only 0.2% with disposable income measuring -4.2%, and jobless claims climbed to the highest level since 1982. Third quarter personal consumption fell by 3.8%, the biggest plunge since 1980. An extremely weak holiday season indicates that personal consumption likely remained a drag on Real GDP in the fourth quarter; weakness in residential and non-residential construction, along with continued weakness in inventory building were other detractors. Near-term positive contributors to GDP growth will likely be higher government spending, declining import growth, and improved exports.

Although painful, economic recessions kill inflation and produce some positive outcomes. Since mid-summer, oil prices have tumbled more than 70%, gasoline prices have fallen as low as \$1.40 in some areas, the November CPI reported deflation measuring -1.7%, and a retrenchment in nominal consumer spending pushed the savings rate up to 2.8% from 2.4% in October. In November, inflation-

U.S. Domestic Corporate Profits with IVA (Inventory Adjustments) and CCA (Capital Consumption Adjustments) (Year-Over-Year Growth Rate) 1991 - 2008 Q3



adjusted spending on durable goods increased 0.6% and climbed 1.5% on purchases of non-durable goods. Nonetheless, the simultaneous negatives of declining median existing home prices, down 22% from 2006, and falling equity market values, with the S&P 500 down 37% in 2008, combined to produce the most rapid 12-month rate-of-change decline in U.S. household net worth since record keeping began in 1952. In the third quarter alone, household net worth declined \$2.8 trillion.



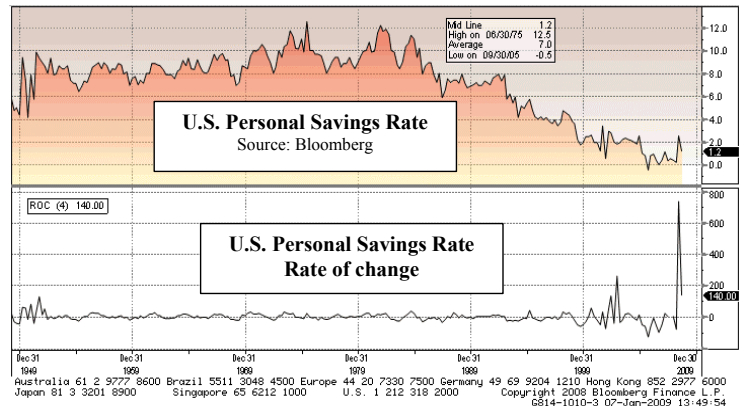
Positive Implications Despite a Grim Environment

Since late October, with the passage of TARP (Troubled Asset Relief Program), funding for the “Detroit Three,” and the Federal Reserve’s purchase of mortgages and asset-backed securities, credit markets have begun to ease. In total, between the Federal Reserve and the U.S. Treasury Department, the U.S. government has pledged more than \$8.5 trillion toward various credit facility programs, cash savings guarantees, debt purchase programs, and other stimulus packages. Additionally, the Fed Funds target rate has been cut to 0%-0.25%, with the most recent bank-to-bank lending rate at 0.08%. LIBOR (London-Interbank Offered Rate), often the benchmark for business and personal loans, has fallen from nearly 5% to 1.26%, currently. U.S. Treasury interest rates across the entire yield curve have been pushed to lows not seen since the 1930s, in some cases. The 30-year U.S. Treasury rate recently reached a low of 2.5%, the lowest rate on record.



Inflation fears of last summer have turned to deflation fears today. Oil prices are down, and versus mid-2008, the drop in gasoline prices is worth substantially more than last year’s stimulus package. New home sales that once annualized at a rate of 1,389,000 now have sales of 407,000, regressing to 1990 levels. While weak sales provide no assistance to a weak economy, the glut of homes for sale appears to be slowly dwindling. Barclays Capital reports that the supply of available homes for sale in 29 major metropolitan areas fell 3.6% in the month of November from the month earlier. Mortgage applications to purchase or refinance homes recently rose to the highest level since 2003. Mortgage applications for fixed rate loans are up 180.5% year-over-year, and 30-year mortgage rates have dropped from 6.47% in October to 5.07% by the end of December. Clearly, quantitative easing by the Fed places monetary policy in a reflating mode.

This cycle will likely be different from typical recessions and recoveries. First, it is probable that stimulus plans will be directed toward infrastructure spending, which would be slow to materialize. This is especially true for emerging markets, such as China’s. U.S. consumers are retrenching and deleveraging personal balance sheets. Personal savings rates are beginning to climb after several years of low to negative growth. Lastly, consumer pent-up demand is low. These factors, combined with tightened lending standards, the probability of increased future corporate regulations, and the possibility of higher taxes in years to come, lead to the probability of a below average recovery. As stated in our fall quarter commentary, “... the cyclical economic recovery, when it arrives, is expected to be slower, lower, and longer than historical averages.”



Market Valuation: Equity vs. Debt Instruments

Throughout 2008, we have continued to see attractive valuations, yet market values continued to move lower in the fourth quarter. For the full year 2008, the S&P 500 declined 37.00%, the S&P 400 was down 36.23%, and the S&P 600 fell 31.07%. For the fourth quarter, the three indices declined 21.94%, 25.55%, and 25.17%, respectively.

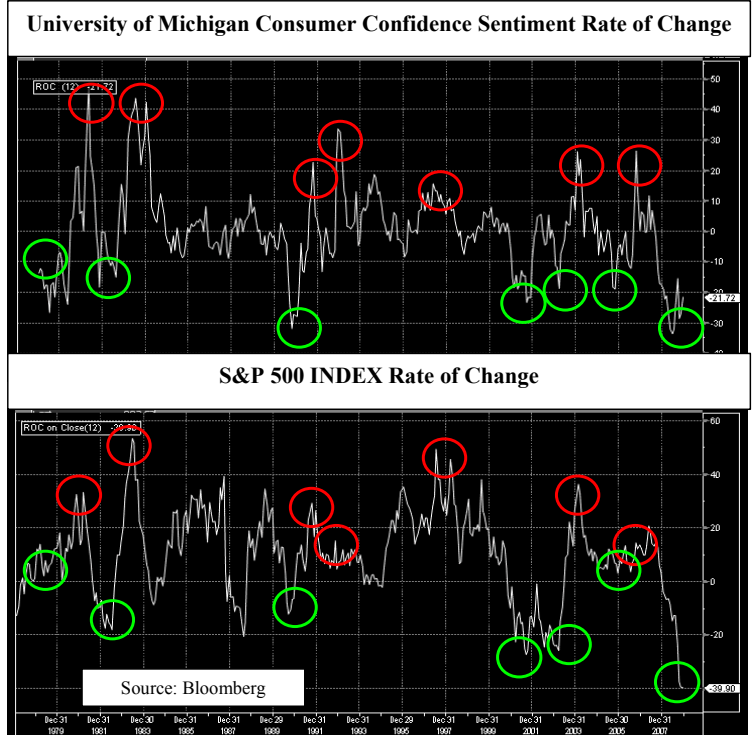
Earnings support market valuations, and earnings power continued to deteriorate throughout the year. Peak earnings for the S&P 500 Index were \$90.61, according to

Bloomberg. However, current trailing earnings are \$69.90 and still declining. At present, trough earnings estimates for the S&P 500 Index range between \$50 on the low end and the mid \$60s on the high end, representing a 35% - 45% earnings retrenchment and roughly a 15x multiple at current price levels. We will be watching corporate profits closely, as it is common for corporate profits from a macro perspective to trough before per-share index earnings trough. For instance, during the last recession, corporate profits turned up in the fourth quarter of 2001, long before S&P Index earnings turned up.

Valuation is also affected by investor sentiment, and sentiment has been at record lows by many measures. Sentiment is a contrary measure in which extreme bullishness usually represents high valuation levels. Conversely, extreme bearishness may portend attractive valuation measures. One often overlooked measure of market sentiment is the measure of consumer confidence. By comparing market returns to consumer confidence, we can see that an extreme rate-of-change decline in consumer confidence could mark a point of attractive valuation in the equity markets. The historic low level of consumer confidence indicates to us that future equity returns appear to show great potential. (See the chart in the next column.)

Another sign of the dramatic negative sentiment is reflected in the current popularity of “safe” assets. With negative real rates of return on U.S. Treasuries and a yield curve ranging from 0.02% on a 1-month U.S. Treasury Bill, to a high of 3.00% on a 30-year maturity U.S. Treasury Bond, we believe the flight to safety is overdone. For the first time since the mid 1950s, the dividend yield of the S&P 500 Index exceeds the yield of the long-term U.S. Treasury Bond. Separately, cash balances represent a potential catalyst that may eventually propel equities. The \$8.5

trillion held in cash, bank deposits, and money market funds is equal to 74% of the value of U.S. companies, the highest ratio since 1990, according to Federal Reserve data. While economic data was horrible in 1990, and fear was extreme, the hoard of cash on the sidelines moved rapidly into equities once the worst of the downturn passed. By the end of 1991, the S&P 500 Index rose 47.09% despite continuing lukewarm data, such as rising unemployment. Likewise, the current market’s rebound potential lies in the tide of cash that may eventually seek better investment returns. The timing of this reallocation is obviously unknown, but history indicates that risk tolerance will eventually rise.



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