



Investment Management of Virginia, LLC

Fourth Quarter, 2007

Summary

- **Fourth Quarter Summary** Against the backdrop of Federal Reserve rate cuts and monetary injections, the equity markets rallied to new highs early in October. These gains were relinquished in November and December as a result of deteriorating earnings, rising energy prices, and softening economic conditions.
- **The Federal Reserve's Two Problems** The Fed faces two major challenges: 1) slowing growth in a maturing economic cycle, and 2) deterioration within the financial system that may restrain economic growth.
- **Rates and Central Banks** U.S. Fed rate cuts and European Central Bank intervention are providing liquidity to the credit markets.
- **Recession** Recent reported and anecdotal economic data indicate a continued weakening in economic conditions, raising recessionary risks.
- **Housing Update** The housing downturn continues with no visible, near-term end in sight. With inventories high and pricing continuing to weaken, housing affordability is rising once again.
- **M&A, Fund Flows, and Buybacks** De-leveraging in the U.S. financial system has curtailed mergers and acquisitions (M&A) activity. Mutual fund outflows have been reported at the highest levels since 1987-1988. Thus, support for the equity markets has declined, even though reports indicate record corporate share buybacks during 2007.
- **Equity Market Performance** The S&P 500 Index (total return) advanced 5.49% in 2007. The S&P 400 and S&P 600 indices were up 7.98% and down 0.30%, respectively. Growth re-emerged as a leader over Value across all size categories.
- **Equity Market Valuations** Corporate profits have been deteriorating, owing largely to massive write-offs in the financial sector. Nonetheless, equity valuations appear attractive at 15.8 times trailing earnings and especially attractive when compared to a 3.73% 10-year U.S. Treasury yield.

Fourth Quarter Summary

Following a sharp equity market sell-off in June and August and a rebound throughout September, the fourth quarter of 2007 began with restored market confidence. The catalysts for support included multiple Fed interest rate cuts and the anticipation of further, prospective interest rate reductions and stimulus. October delivered another Fed rate cut, record highs in the equity markets, and optimism for an easing of the “liquidity” crunch in the debt markets. This optimism proved short-lived, however, as weak third quarter earnings (predominately from the financial sector) and the tightening in credit markets brought declines in the equity markets throughout November and December. With corporate earnings deteriorating, energy prices rising, consumer sentiment faltering, and underlying economic conditions slipping, the equity markets became particularly sensitive to Fed action.

The Federal Reserve's Two Problems

The first of the Fed's problems is an economic cycle problem. After five years of economic expansion, it is normal for growth to slow. Real, year-over-year GDP growth peaked in 2004, at 4.1%, and slowed to below trend growth in the second half of 2006. Corporate profits peaked in the third quarter of 2006 along with profit margins. The Fed's economic challenge rests in engineering a “soft landing” with stable growth and without rising inflation.

The Fed's second problem is financial in nature. First came the bursting of the speculative housing bubble, resulting in a huge overhang of supply, which then led to credit market tightening. The severity of the credit crisis was accentuated by the proliferation of leveraged financial instruments that were sold throughout the global financial system. Consequently, the de-leveraging of the financial system has landed the bulk of the problems in the lap of the U.S. banking system. This trend has resulted in shocking write-offs against earnings, raising concerns of capital adequacy in U.S. lending institutions. The fear is that, with bank earnings under pressure and credit availability limited, banks will tighten lending standards to a point that would restrain economic growth in an already below trend growth environment. Thus, the financial problem has become the Fed's problem.

Rates and Central Banks

Since August, the Fed has reduced the Federal funds rate by 1% and the discount rate by 1.5% in an attempt to maintain liquidity in the short-term credit markets. The Fed's December quarter-point cut disappointed the markets and was followed by a steep stock market sell-off. However, the next day, the Fed introduced a Term Auction Facility (TAF) designed to provide credit relief to banks at lower interest rates than could be obtained from the regular discount window. Shortly thereafter, the European Central Bank (ECB) announced a record \$500 billion in loan availability to banks in order to bring down the cost of money. Clearly, the Fed and ECB would prefer to augment credit availability through multiple avenues. Judging by the decline in the 3-month U.S. Dollar LIBOR rate, this coordinated central bank intervention appears to be having positive effects on the target.



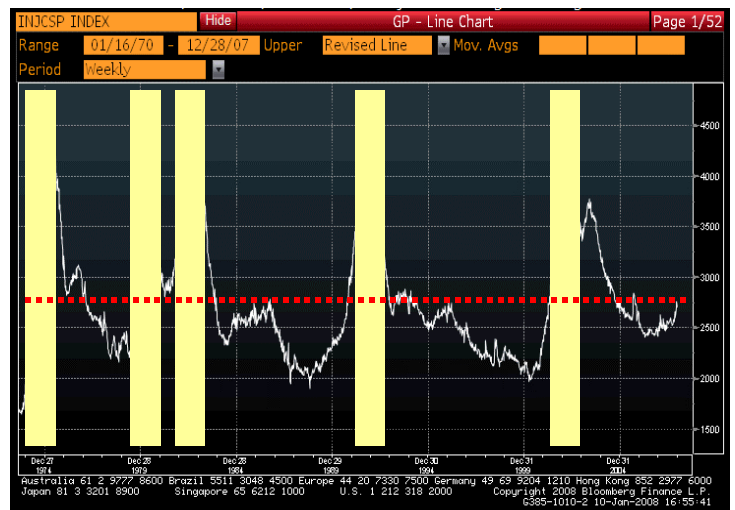
3-Month LIBOR Source: Bloomberg LP

Even though the bond markets have pushed intermediate-term rates to artificially low levels (the U.S. 10-year Treasury Note yield is currently 3.8%), the equity markets see the need for more short-term rate reductions from the Fed. Since the beginning of this year, economic indicators have weakened further, potentially supporting the call for lower rates. According to Bloomberg, futures prices indicate that the probability of a January 30th half-point rate cut recently jumped to 90% from 34% at the beginning of the year. Futures show a 100% chance of at least a quarter-point reduction.

The subject of fiscal stimulus as an additional tool for providing economic stimulus has only recently emerged. Speaking at the Brookings Institution in Washington, former Treasury Secretary Robert Rubin said a fiscal stimulus package is justified to keep the U.S. economy from slipping into recession; an amount on the order of \$100 billion has been suggested.

Recession

In past commentaries, we stated that economic data leaned toward a mid-cycle slowdown and that turbulence in the markets and the economy increased uncertainties, making the economy more vulnerable to shocks. Specifically, unemployment claims and the Institute of Supply Management Survey (ISM) of manufacturing and service purchasing managers were cited as indicators to watch. Within the past year, these indicators have demonstrated fits and starts but continued to emerge from any pause with moderate strength – until recently. Weakness in third quarter earnings, led by massive losses at major financial institutions, appears to have delivered a disruption to near-term economic growth and stability. Recent data indicate that weekly continuing unemployment claims have edged higher, to a more critical level, suggesting slower future economic growth.



Unemployment Claims Source: Bloomberg LP

Similarly, the ISM manufacturing survey dropped to a level indicating contraction. Specific ISM components suggested further weakness in orders, order backlogs, and employment, with continued upward pressure in pricing. While these measures have yet to move to traditional recessionary levels, anecdotal evidence of continued weakness implies that conditions likely will worsen before improving, in the absence of economic stimulus.

Global strength remains positive, particularly in emerging economies. Developed economies, such as Japan, the United Kingdom, and those of the European Union, are showing signs of sluggishness as a result of the tightening in credit markets and strength in their local currencies. Strengthening foreign currencies and a weak U.S. dollar provide U.S. multinational corporations with a competitive advantage in the global marketplace. According to General Electric's CEO, Jeffrey Immelt, "Global infrastructure is a wind at our back."

Housing Update

The downturn in housing continues. According to the National Association of Realtors (NAR), existing single-family home sales edged up by 0.4% in November but declined 19.9% over the last year. The supply of homes for sale remains high, with inventory equivalent to 9.9 months of sales, down from a high of 10.4 months and up from the unsustainable low of 3.6 months, established in January of 2005. The median sale price for a single-family home declined by 3.7% in the past year, through November. Similarly, November pending home sales decreased 2.6%, verifying the data reflected in the National Association of Home Builders traffic index, which are the weakest since 1990. According to NAR's chief economist, "The exact timing and the strength of home-sales recovery is a bit uncertain." One positive outcome of the housing recession is that housing affordability is rising again after declining for the better part of the previous decade.

M&A, Fund Flows, and Buybacks

The "tale of two markets" describes the equity markets of 2007. The first market saw new record highs in both the Dow Jones Industrial Average and the S&P 500 Index. It received much of its strength from leveraged capital generated by record mergers & acquisitions (M&A) activity and leveraged buyouts (LBO), along with the target premium placed on takeout candidates. Financial write-offs, higher costs on risk capital, tightened credit, and a slowing economy ended that market. The second market, in the back half of 2007, focused on de-leveraging. As a result of slower economic growth, tight credit, and reduced LBO financing availability, the leveraged capital that had earlier pushed markets higher disappeared. Trim Tabs (an independent research firm) estimates that new offerings will rise in 2008 in order to provide needed capital; however, they expect new cash takeovers to decline by 50% from the record 2007 total. Nonetheless, most corporations have strong balance sheets and strong cash balances. Going forward, it is likely that M&A deals will occur for strategic purposes, rather than to reap the short-term rewards of financial engineering.

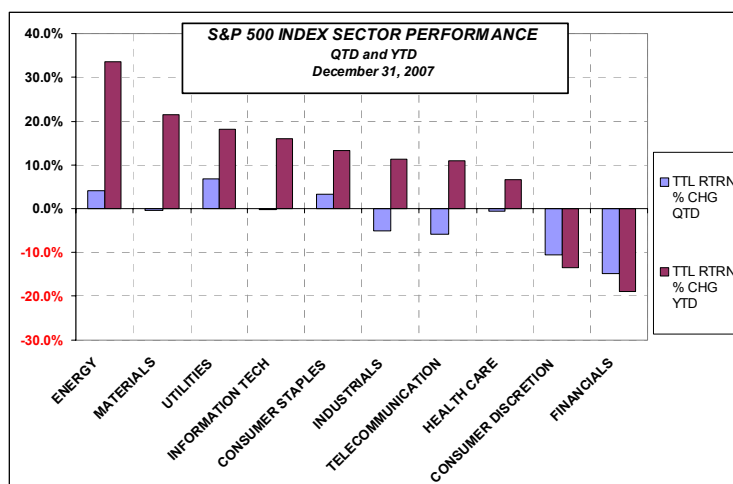
According to the Investment Company Institute (ICI), mutual funds that invest primarily in the U.S. had a net outflow of \$3.73 billion in October and an additional outflow of \$15.34 billion in November. Estimates indicate that net redemptions increased in December. Trim Tabs reports that the U.S. equity fund outflows of 2007 doubled the previous record annual outflow (2002). Additionally, net redemptions recorded from May through December of last year mark the first time since the period encompassing October of 1987 through May of 1988 that U.S. equity funds posted eight consecutive monthly outflows. Certainly such a huge reduction of investment capital helps explain the

negative pressures on the U.S. equity markets in the short-term. History shows that such extreme negative pessimism and reaction often coincide with short-term market bottoms.

Estimates indicate that new, corporate stock buybacks in the fourth quarter of 2007 were the highest on record. Reports from Standard & Poor's show that S&P 500 companies bought back \$2.5 billion daily in the second quarter of 2007 and a record \$2.8 billion daily in the third.

Equity Market Performance

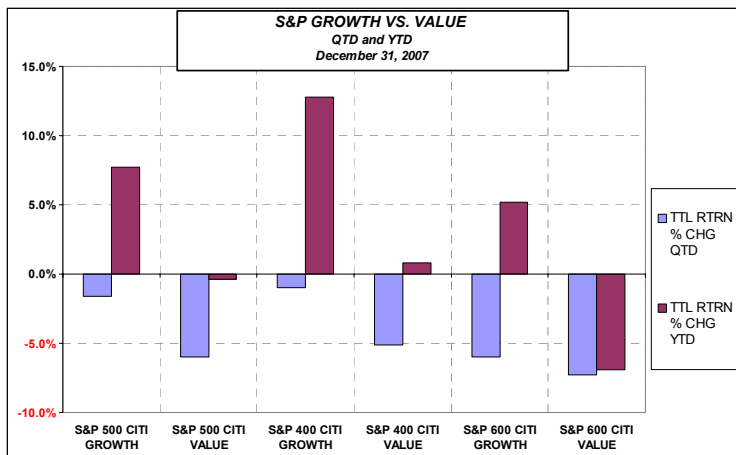
The S&P 500 Index ended the fourth quarter down 3.33% and closed 2007 with a total return of 5.49%. Energy, Materials, Utilities, Information Technology, Consumer Staples, Industrials, Telecommunications, and Healthcare led full-year performance with positive returns. Utilities, Energy, and Consumer Staples exhibited positive returns in a weak market during the final quarter of 2007. Financials and Consumer Discretion produced significant negative returns for the final quarter and full year in 2007.



Source: Thomson/Baseline

The S&P 400 Mid Cap Index was down 2.73% for the quarter and up 7.98% for all of 2007, while the S&P Small Cap Index was down 6.45% and 0.30% for the quarter and full year, respectively.

For the past several quarters, we have cited the re-emergence of market strength in growth styles of investing versus value styles. Last quarter's commentary stated that, for both QTD and YTD timeframes, Growth had outperformed Value in all size categories as measured by the S&P/Citi Large, Mid, and Small Capitalization Indices. This statement holds true once again, for the fourth quarter of 2007. (See Chart on page following.)



Source: Thomson/Baseline

Earnings and Market Valuations

Corporate profits, as reported by the Commerce Department, are decelerating, and after four consecutive years of double-digit earnings gains, S&P 500 Index earnings growth began to slow in the second quarter of 2007. This trend is not surprising and is normal for the back half of a market cycle. What was surprising for the markets was the huge write-off by financial institutions in third quarter earnings. Total S&P earnings declined 4%, but those of the financial and consumer discretion sectors plunged 27% and 22%, respectively. All other sectors reported positive earnings growth. Fourth quarter S&P Index earnings are expected to be weak, again driven by large financial sector write-offs.

With the equity markets in retreat, the U.S. Treasury bond market rallied amidst the flight to safety. The 10-year U.S. Treasury note, that yielded 5.32% in June, now yields 3.73%; the yield of the 2-year note has fallen from 5.13% to 2.52%. Using conservative forward earnings estimates and a current S&P 500 Index value of 1,384, the comparative earnings yield for equities exceeds 6%. While U.S. Treasuries may provide safety as long as market sentiment remains negative, equity markets appear to offer a better opportunity over the long-term. Given the current market environment and economic backdrop, a tilt toward larger companies with international exposure, higher earnings visibility, and better balance sheet quality seems an appropriate strategy.

Conclusion

Clearly, the risks of sliding into a recession have risen with job deterioration, weaker consumer spending, and faltering earnings. On the other hand, global economies, though sluggish in some markets, are providing strength for U.S. multinationals. The ultimate question is not whether a recession will materialize but how much downside risk is in the equity markets. 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.

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