

# Investment Management of Virginia, LLC

*First Quarter, 2011*

## Summary

Most measures indicate that the U.S. economy is now entering the third year of its advance, perhaps slowing a bit from the recent trend. Equity markets, long seen as a leading indicator of economic activity, generally have moved up, albeit in fits and starts, ahead of the pace of economic expansion. Most economists anticipate that U.S. growth will continue but decelerate into the 2% range by mid-2011.

Thus far, the monetary stimulus by the Federal Reserve appears to be achieving its intended results. Equity markets have risen, corporate profits have expanded, business and consumer confidence have moved higher, domestic consumption has improved, capital spending has accelerated, and the unemployment rate has declined. Another intended consequence of quantitative easing was higher inflation. FOMC members are mindful, however, that commodity prices have risen and that global turmoil has increased, driving energy prices higher.

Lending conditions appear attractive for both individuals and institutions. Demand for commercial and industrial loans is rising, and large corporations appear to be returning to the commercial paper market. Consumer credit is also expanding, albeit at a more measured pace and with several, unique distinctions.

Third-year recovery years often are challenging for the stock market. During the current stage of economic recoveries, market emphasis generally shifts away from the beneficiaries of rapid economic repair, rotating toward businesses that historically have delivered more consistent business performance. Against this backdrop, we believe equities remain attractive for the long-term, especially when comparing total return potential with that of fixed income alternatives. We do, however, anticipate greater volatility.

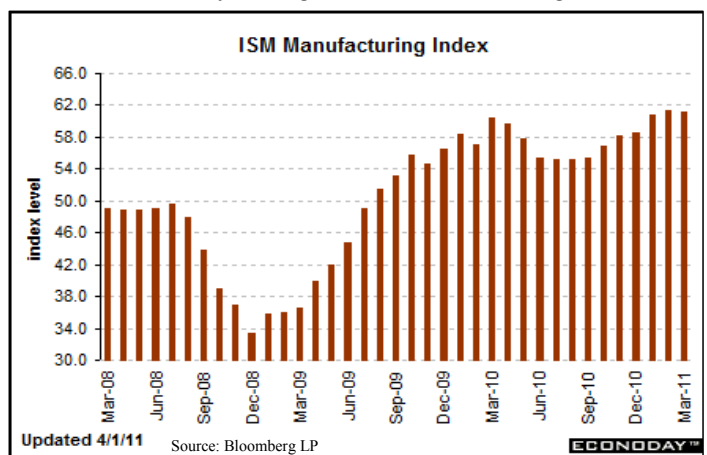
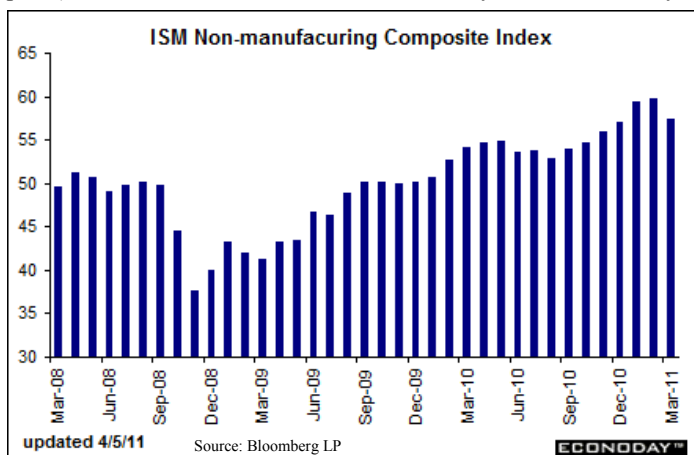
## Economic Trends

It has been exactly two years since the U.S. economic downturn showed initial signs of a bottoming and “sub-par” recovery. Given persistent weakness in housing, jobs, and other statistics, some would ask, “What recovery?” Nonetheless, most measures reveal that the U.S. economy is now entering the third year of its advance, perhaps slowing a bit (normal) from the recent trend. Equity markets, long seen as a leading indicator of economic activity, generally have moved up, albeit in fits and starts, ahead of the pace of economic expansion. However uneven or “sub-par”, the latter, of course, has occurred in the context of unprecedented government support.

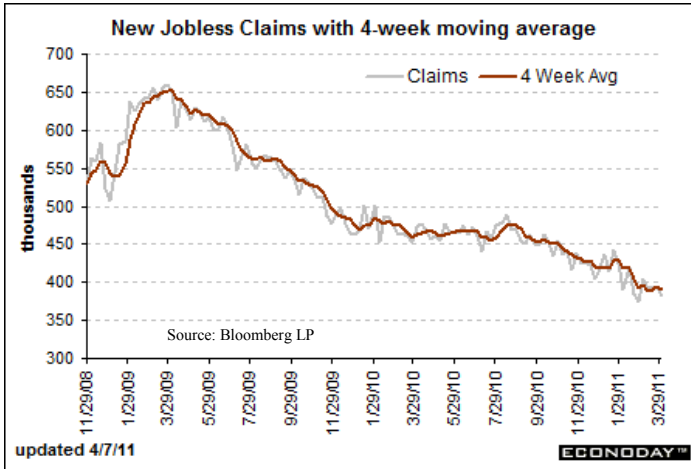
In response to an environment characterized by declining home values, declining wealth, stagnant income growth, high unemployment, generational low capacity utilization, and low confidence, the Federal Reserve stepped in, employing a variety of measures and stimuli (some with precedent, others without) to promote job growth, price stability, and ultimately faith. Employing what are known as “QE” plans (quantitative easing plans), the Fed has infused vast sums of money into the economy

and markets to raise the wealth index, stimulate business and consumer confidence, strengthen demand, reverse declining trends in prices, lift profits, and, ultimately, create economic capital growth and job growth. Thus far, the monetary stimulus appears to be achieving the intended results. Since the implementation of quantitative easing, equity markets have risen, corporate profits have expanded, business and consumer confidence have moved higher, domestic consumption has improved, capital spending has accelerated, and the unemployment rate has declined to 8.8% from over 10%. Another intended consequence of QE was higher inflation; so far, increased demand and strengthened pricing power appear to have countered the specters of broad-based deflation and collapse. Now that the pump has been primed, and looking ahead, a number of Federal Reserve Governors and Board members have begun to speak about future steps for restraining undesirable levels of inflation, should they appear.

During the recovery, leadership, among sources of growth, has changed hands several times now. Early on, manufacturing uncharacteristically strengthened first, as strong orders and



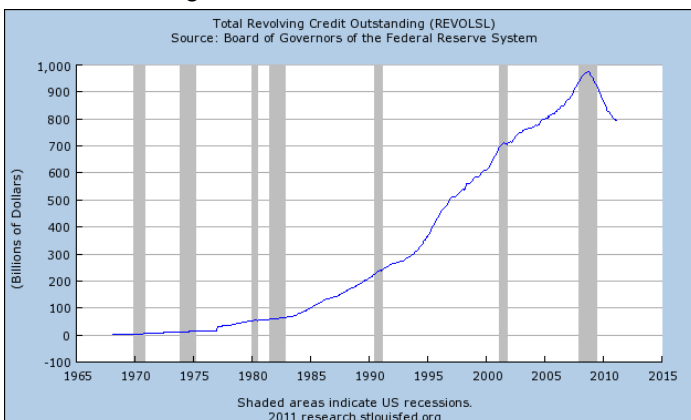
shipments destined for export markets prompted inventory rebuilding. However, in the fourth quarter of 2010, U.S. consumer spending jumped to an annualized 4% growth rate, non-residential fixed investment expanded at a 7.7% rate, and equipment and software spending, a proxy for capital spending, grew by 7.7%. By that time, growth in both the manufacturing and service sectors was expanding. On the heels of these favorable trends, U.S. non-farm payrolls have grown by 478,000 jobs year-to-date through March. Although we are encouraged by this growth, numerous challenges remain, including high and rising oil and food prices, high government debt obligations, Japan's tragedy, slowing world growth, and a depressed residential housing market. Most economists anticipate that U.S. growth will continue but decelerate into the 2% range by mid-2011.



### Financial Conditions

Though the yield curve has steepened recently, interest rates generally remain below those of early 2010, and lending conditions appear attractive for both individuals and institutions. Short-term U.S. Treasury Bill rates remain exceptionally low at just 0.04% for 3-month bills and 0.12% for 6-month bills. Demand for commercial and industrial loans is rising out of the ashes, and large corporations appear to be returning to the commercial paper market. In fact, commercial paper outstanding for non-financial companies has increased nearly \$40 billion since the last week of February.

Consumer credit is also expanding, albeit at a more measured pace and with several, unique distinctions. Non-revolving credit, which includes auto loans and personal loans (e.g., student loans), increased by 7.7% in February. However, consumers remain vigilant with revolving credit, which consists mostly of credit cards. Revolving credit contracted for the 28th time in 29

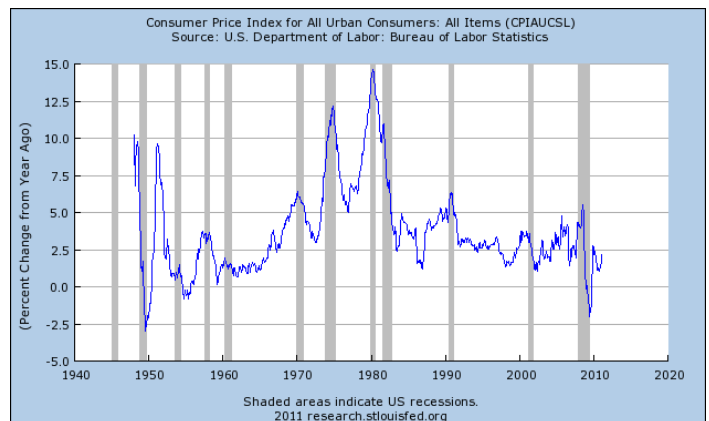


months, down \$2.7 billion in February and nearly \$200 billion from its peak. These data reflect consumers' continued determination to shed debt. Additionally, recent anecdotal evidence suggests that consumers may be limiting spending activity due to rising concerns over inflation and higher energy prices.

### Monetary Trends

The minutes of the March 15th Federal Open Market Committee (FOMC) policy meeting reveal moderate disagreement regarding future policy actions and the timing/implementation of an exit strategy from the current, extremely loose monetary policy. Nonetheless, the Fed likely will not change its policy stance on the current phase of quantitative monetary accommodation (reflation), which concludes at the end of June. Presently, the FOMC anticipates a continuation of the recovery, even as the pace of activity has slowed. They are mindful, however, that commodity prices have risen and that global turmoil has increased. Although most committee members see higher commodity prices as transitory, the following language suggests that this trend, and the potential for unwelcome inflation in general, have their attention: "... a significant increase in longer-term inflation expectations could contribute to excessive wage and price inflation, which would be costly to eradicate. Accordingly, participants considered it important to pay close attention to the evolution not only of headline and core inflation but also of inflation expectations."

Year-over-year CPI (Consumer Price Index) inflation of 2.2% sits squarely in the range of the Fed's earlier stated target. On the other hand, year-over-year PPI (Producer Price Index) inflation of 5.8% presents a host of potential strains. So far, producers have seen limited success in pushing prices forward; this trend challenges profit margins. Should producers find it possible to raise prices, inflation flow-through could be even more burdensome to consumers – particularly as interest rates move up, which they must do in the U.S. at some point. Interest rates have been rising around the globe for a while now, and just recently, the European Central Bank raised its primary rate.



### Technical Market Trends

Technical market measures often gyrate between the extremes of over-bought and over-sold throughout the year. At the end of 2010, many of our technical market screens were signaling short-term over-bought conditions. Weighed against other longer-term measures, which still screen positively, these short-term over-bought readings are not necessarily cause for alarm for long-term investors. Still, over-bought conditions often presage a consolidation or settling period, following material equity market advances. That seems to be what we are experiencing now, with over-bought readings abating somewhat in the first quarter of

2011, moving to a more neutral position, from negative, as the markets digest last year's gain and await the announcements of quarterly earnings results.

### Sentiment Indicators (Contrary Indicators)

Much like technical trends, sentiment indicators are short-term tools, reflecting the emotional extremes of a mass survey of investors or advisors. Entering January of 2011, bullishness (American Association of Individual Investors) had been the highest since January, 2007, and Bearishness measures had retraced to levels not seen since early 2006. Since then and over the course of the first quarter, sentiment measures have improved to a neutral position, as extreme bullishness dropped from 63% to 28%, and bearish sentiment rose from 18% to over 40%. These improvements are constructive for the markets longer-term.

### Equity Market Earnings & Valuation

Nearly unchanged from year-end, current earnings multiples for the various S&P indices appear fairly valued. The multiple for the S&P 500 Index remains near its long-term average of 15x trailing earnings, while the index has advanced ~5% year-to-date. However, actual earnings and earnings expectations have improved. At year-end, 2010 S&P 500 earnings were estimated at \$83.71, with estimates for 2011 coming in at \$95.16. Actual 2010 operating earnings came in higher, at \$86.74, and 2011 bottom-up earnings estimates have moved up to \$97.38. The improvement in real earnings (2010 actual > 2010 estimate) has helped push the market higher thus far in 2011.

Third-year recovery years often are challenging for the stock market. Simply put, it is difficult for most companies to compound earnings year-over-year at the same trajectory as in the initial years, when earnings comparisons are easy. During the current stage of economic recoveries, market emphasis generally shifts away from the beneficiaries of rapid economic repair, rotating toward businesses that historically have delivered more consistent business performance. Against this backdrop, we believe equities remain attractive for the long-term, especially when comparing total return potential with that of fixed income alternatives. We do, however, anticipate greater volatility.

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Earnings Per Share							
Next Expected EPS Date: May 31							
	2006	2007	2008	2009	2010	2011	2012
Mar	20.53	22.61	18.79	13.01	19.76	22.08	25.89
Jun	22.32	24.32	19.33	16.79	21.65	24.43	27.51
Sep	22.81	21.92	18.09	17.15	22.60	25.26	-
Dec	22.51	17.35	12.42	18.31	22.72	26.42	-
Yr.	88.17	86.20	68.63	65.27	86.74	97.38	110.88
Yr. to Yr.		-2 %	-20 %	-5 %	33 %	12 %	14 %

**S&P 500 INDEX BOTTOM-UP ESTIMATE**  
 Source: Thomson Baseline  
 (Quarterly numbers may not add to annuals)

### Conclusion

Economic growth appears to be stumbling forward, although it is uneven across sectors. Monetary and financial conditions appear generally supportive for corporations, consumers, and modest economic growth. Numerous challenges persist, as developed nation economies remain fragile, and emerging economies strive to restrain excessive growth. Most companies appear to be in strong financial condition, and the purse-strings that govern the capital budgeting process appear to be loosening, perhaps enabling further healing and growth. Valuations appear reasonable.

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

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[www.imva.net](http://www.imva.net)

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