



Investment Management of Virginia, LLC

First Quarter, 2012

Summary

The S&P 500 Index notched a total return of 12.6% in the first quarter of 2012, the best quarterly performance since the third quarter of 2009 and the strongest first quarter finish since 1998. With two consecutive, double-digit quarterly gains, the Index now has returned 25.9% over the six months ending March 31.

Despite ongoing risks of recession in Europe, actions taken by the European Central Bank seem to be enabling that region to muddle through its financial disorder(s). Back home in the U.S., domestic economic expansion, an element heretofore lacking throughout this recovery cycle, appears to have awakened and may be returning to its traditional role as an engine of global growth. In fact, U.S. household spending alone exceeded China's total reported GDP in 2011.

Interest rates are the lowest they have been in many decades. After netting out taxes and adjusting purchasing power for inflation (let's assume the Fed's inflation target of 2.5%), a new 10-year U.S. Treasury purchase, yielding 2.22%, potentially provides a negative real return.

Using trailing earnings of \$102.76 and a closing market value, as of March 31, 2012, of 1408.47, the earnings yield implied by the S&P 500 is 7.3%. That compares to the 2.2% yield from the 10-year Treasury note. Additionally, the S&P 500 Index, whose dividend yield is currently 2.0%, has a long-term profile of significant growth in dividends. In our view, the long-term opportunity for investing in strong and improving corporations presently appears favorable.

Green Shoots At Home

The S&P 500 Index notched a total return of 12.6% in the first quarter of 2012, the best quarterly performance since the third quarter of 2009 and the strongest first quarter finish since 1998. With two consecutive, double-digit quarterly gains, the Index now has returned 25.9% over the six months ending March 31. Of course, this remarkable ascent began after the dismal third quarter of 2011, an exceptionally weak market environment characterized by high fears of an extremely negative outcome in Europe and pessimistic expectations regarding the U.S. economy.

Despite ongoing risks of recession in Europe, actions taken by the European Central Bank seem to be enabling that region to muddle through its financial disorder(s). As Christine Lagarde, Managing Director of the International Monetary Fund, recently stated, "In terms of global economic outlook, we are certainly not – and I do say not – in as bad a situation as we were only three months ago and there have clearly been some significant improvements..."¹ Nonetheless, European softness persists and has translated into weakened exports from eastern hemisphere countries, particularly China, and South American countries. In early March, China's Premier, Wen Jiabao, pared the official growth target for 2012 from 8% to 7.5%. By comparison, the U.S. economy has shown surprising strength, derived primarily from spending sources here at home. Domestic economic expansion, an element heretofore lacking throughout this recovery cycle, appears to have awakened

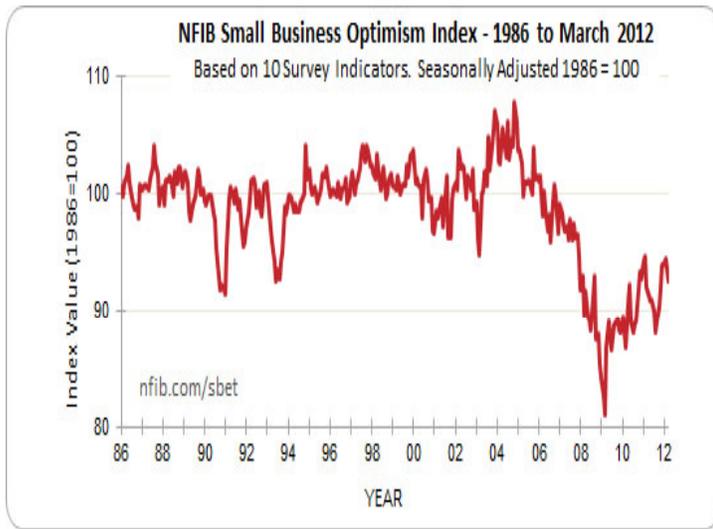
and may be returning to its traditional role as an engine of global growth. In fact, according to the Commerce Department, U.S. household spending exceeded China's reported GDP in 2011 (\$10.7 trillion versus \$7.3 trillion). A continuing domestic, consumer rebound would bode well for European and Asian growth prospects.

Economic Trends

Over time, U.S. manufacturing output has declined, as a percentage of U.S. GDP, to approximately 12%. With a significant portion of this manufacturing destined for export, fewer dollars have been available from this once rich source to be recycled through the U.S. economy. Moreover, many of the sectors of the economy that in recent decades have been expected to fuel domestic growth – housing, construction, retail, financial services, etc. – have been operating at sub-par levels. Now that strength appears to be surfacing in some of these sectors, hopes for an improved pace and scale of recovery are emerging. In fact, despite recent woes, U.S. corporate profits are now at an all-time high; and capital spending has increased. Generally, confidence has improved (particularly small business confidence), resulting in increased consumer spending, faster employment growth, and higher household incomes. The potential exists for this activity to translate into the self-sustaining period of private capital formation that Fed Chairman Bernanke spoke of as an objective when implementing quantitative easing in 2010.

Still, as Mr. Bernanke recently stated, it is "far too early to declare victory" for the U.S. economy in 2012. Although

¹ IMF Press Conference, March 20, 2012, New Delhi, India.



- The staff revised upward its forecast for inflation in 2012, owing to higher prices for oil, other commodities, and imports. Prices are expected to level out in the second half of 2012.
- There appeared to be little support for implementing additional quantitative easing measures.

While the markets found the Fed's lack of enthusiasm for additional quantitative easing measures disconcerting, we would note that MZM (Money of Zero Maturity) now stands in excess of \$10.8 trillion, having grown at better than 9% over the last year. Simultaneously, the European Central Bank expanded its balance sheet to levels exceeding that of the U.S. Federal Reserve's. Additionally, China's money growth aggregate has been reported to be growing in excess of 13%. Taken together, these measures continue to provide stimulus around the globe.

Sentiment Indicators/Market Trends

Often we have noted that sentiment indicators generally are contrary indicators and work best at the extremes. Presently, most sentiment measures, including Bullishness/Bearishness and put-to-call ratios, appear neutral – readings are off the bottom but away from the extremes. Although market trends also appear neutral, we would not be surprised to see some corrective action, given the 25.9% advance over the last six months. These actions could come in the form of consolidation (sideways movement), a broad-based market pullback, or internal leadership rotation among sectors and capitalizations. For example, generally, small and mid-capitalization stocks – which did so well between October 1 and mid-February – recently have performed less well versus large capitalization stocks. Barring any exogenous shock or event-driven panic, we would view these types of corrective actions as normal and constructive.

Equity Market Valuations & Earnings

Investing, as defined by Warren Buffett in his 2012 letter to Berkshire Hathaway, Inc., shareholders, is the process of transferring money/purchasing power now with the expectation of receiving more money/purchasing power (after taxes have been paid on gain) in the future. Prior to making these types of decisions, investors would do well to compare the relative valuations of various asset classes – equities, bonds, etc. – versus their respective historical ranges and each other.

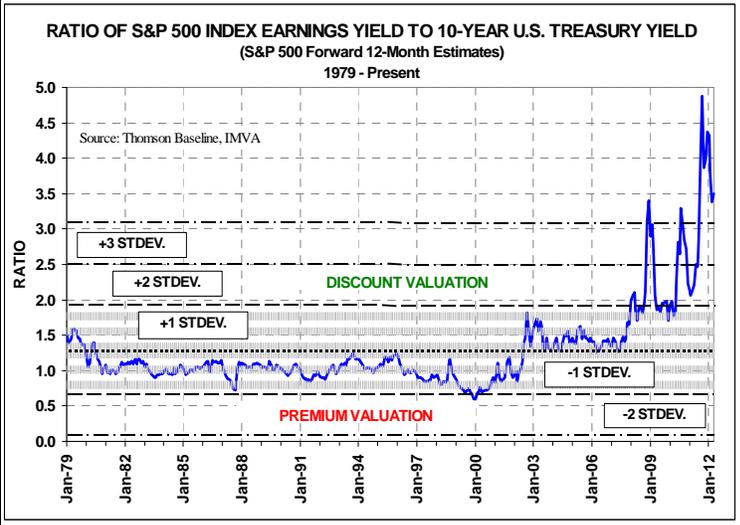
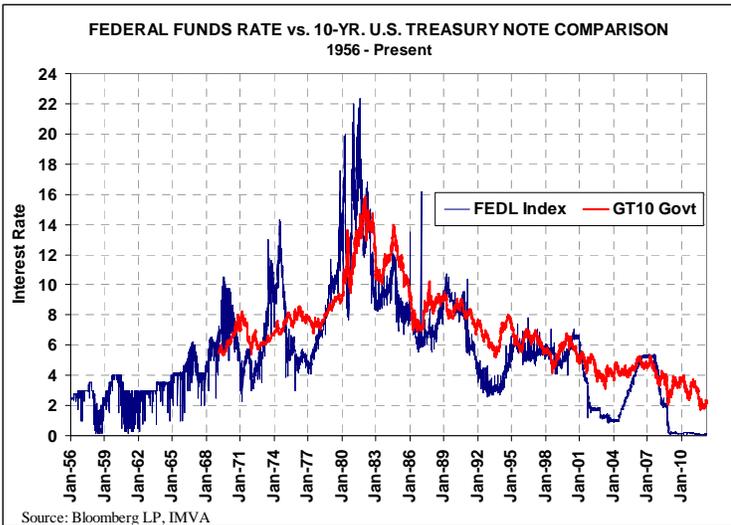
As seen in the long-term interest rate chart (Federal Funds rate and 10-year U.S. Treasury Note), interest rates are the lowest they have been in many decades. After netting out taxes and adjusting purchasing power for inflation (let's assume the Fed's inflation target of 2.5%), a new 10-year U.S. Treasury purchase, yielding 2.22%, potentially provides a negative real return. Simply put, as investors have rushed into bonds over the last few years, yields have dropped and valuations have become less attractive.

real GDP growth forecasts have edged higher since year-end, from below 2% to over 2%, nominal GDP forecasts of 4.0-4.5% remain at levels that represent only 60% of average historical growth rates. Statistically, nominal GDP growth and corporate sales growth have a high degree of correlation. Weakness in the former would make us worry about the latter. Recent data, although improved, reflect a mixed picture. On the one hand, March retail sales data showed improvement; recent manufacturing and service ISM reports indicate continued expansion (albeit at moderating levels); the Architectural Billings Index reported the highest spike in inquiries since 2007, led by the commercial sector; and, employment trends seem to be improving. On the other hand, auto sales, construction spending, and housing trends reflected somewhat weaker readings. Perhaps the partner of a local architectural firm may best have captured the cautious but improved tone when he recently said the following: "At least the phone is ringing with inquiries, and while it may not be enough to generate new jobs... you never know."

Financial Conditions/Monetary Trends

The April 3rd minutes of the Federal Open Market Committee (FOMC), highlighted these points of interest:

- "Many participants noted that strains in global financial markets had eased somewhat, and that financial conditions were more supportive of economic growth than at the time of the January meeting."
- "The staff revised up its near-term forecast for real GDP growth. Although the recent data on aggregate spending were, on balance, in line with the staff's expectations at the time of the previous forecast, indicators of labor market conditions and production improved somewhat more than the staff had anticipated."
- "With the economy facing continuing headwinds, members generally expected a moderate pace of economic growth over coming quarters, with gradual further declines in the unemployment rate."



Using earnings yield (earnings/market price) as the equity market yardstick, we can make a reasonable comparison between the equity market valuation and, in this case, that of U.S. Treasuries. With S&P 500 Index trailing earnings of \$102.76 and a closing market value, as of March 31, 2012, of 1408.47, the earnings yield implied by the S&P 500 is 7.3% ($\$102.76 / 1408.47$). That compares to the 2.2% yield from the 10-year Treasury note. Additionally, the S&P 500 Index, whose dividend yield is currently 2.0% (just a hair below that of the 10-year U.S Treasury), has a long-term profile of significant growth in dividends.

The final chart illustrates the relative comparison between the S&P 500 earnings yield and the 10-year Treasury since 1979. Of course, market earnings need to expand. The long run correlation between the direction of earnings and stock prices is quite evident. Furthermore, this illustration does not imply that equity investments should replace fixed income assets intended for providing liquidity and stability.

Conclusion

Economic data appear to have improved, especially here at home, but they remain mixed, uneven, and fragile across sectors and regions. Interest rates remain attractive for borrowers, as seen by the University of Pennsylvania's lowest ever yield on the issuance of 100-year bonds (4.7%). Corporations, with \$3.7 trillion in cash on their balance sheets (8.1% of total market capitalization), low borrowing rates, and record earnings, appear to be in good shape. Still, investors remain skittish, and reasonably so given recent volatility. In our view, the long-term opportunity for investing in strong and improving corporations presently appears favorable.

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

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