Investment Management *of* Virginia, LLC

Second Quarter, 2012

Summary
Having advanced 25.9% over the six-month period ending, March 31, 2012, the equity market (S&P 500 Index) gave back some earlier gains through June 30th. The S&P 500 Total Return Index finished the second quarter down 2.8%, having been down as much as 8.9% intra-quarter. The S&P Mid Cap 400 and S&P Small Cap 600 indices finished the quarter with declines of 4.9% and 3.6%, respectively.

Looking back over the past decade, much of the fuel for global growth came from expanding credit. More recently, many countries have been reigning in credit and trying to reduce debt. Given these trends, worldwide GDP growth is expected to remain sub-par through what may prove to be a long deleveraging process.

Through a low interest rate policy, the FOMC and other global central banks are striving to inflate financial assets, thus creating wealth and increasing confidence in the financial markets. These policies, including "operation twist," are consistent with successful actions taken in the 1950s and early 1960s, when deflationary risks also materially threatened asset valuations.

Price-to-earnings valuations peaked at more than 30 times earnings at the turn of this century. Today, 12-month trailing price-to-earnings valuations measure approximately 13 times for both the DJIA and the S&P 500 Index. While market price multiples have contracted, individual businesses have prospered, driving earnings, dividends, and book values higher.

Deleveraging – We've Only Just Begun
Having enjoyed a 25.9% advance over the six-month period ending, March 31, 2012, the equity market (S&P 500 Index) changed horses after Day 1 of the second quarter of 2012, ultimately giving back some earlier gains through June 30th. While this market pullback was unsettling and volatile, market corrections of this magnitude are not outside the realm of normal. The S&P 500 Index finished the second quarter down 2.8% on a total return basis, having been down as much as 8.9% intra-quarter. The S&P Mid Cap 400 and S&P Small Cap 600 indices finished the quarter with declines of 4.9% and 3.6%, respectively. These indices remain positive on a year-to-date basis.

Negative headlines from around the globe, mostly stemming from Europe, raised investors' anxiety over the course of the latest three-month period. Now two years and nearly twenty summit meetings into its period of financial disorder, the Eurozone appears to be drifting deeper into a recession. Its unemployment rate is expected to rise above 11%, and the interest rates of its most indebted/at risk countries (Greece, Spain, and Italy) threaten to rise beyond control. Consequently, when small steps were taken toward the creation of a European banking union by the full 27-member European Union at the 19th summit, global equity markets applauded the outcome, marking sizeable gains on the final day of the second quarter. Taming Europe's budgetary and political dysfunctions will require much more work, coordination, and patience on the part of investors.

In the interim, the effects of European turmoil touch other economies around the globe. Consider, for example, that approximately 20% of China's exports are destined for Europe. With Europe moving deeper into recession, China's GDP growth rate is now expected to decelerate for the fifth consecutive quarter and register the weakest growth in almost three years. China is also South Korea's largest export market, and exports from South Korea to China are flat year-over-year. In a similar vein, South Korean sales to the U.S. and Japan dropped 3.5% and 3.6%, respectively, over the most recent month. Here at home, manufacturing orders and backlogs have slowed.

Looking back over the past decade, much of the fuel for global growth came from expanding credit. More recently, many countries have been reigning in credit and trying to reduce debt. Although U.S. government debt burdens have yet to be meaningfully addressed, corporations and individuals continue to pare back. Given these trends, worldwide GDP growth is expected to remain sub-par through what may prove to be a long deleveraging process.

Economic Trends
During the second quarter, expectations about future U.S. economic development diminished. While forecasted annual growth hovered above 2% early in the first quarter, recent data and trends have pushed economists' estimates to a range of 1.5% - 2%. Manufacturing orders and backlogs declined over the quarter, and industrial production fell 0.1% during the month of May. More

specifically, non-defense capital goods orders, proxies for future business spending, have softened to the slowest rate since the recession. Along with weaker fixed investment spending among businesses, consumer spending also has slowed. Retail sales, excluding autos and gasoline, declined 0.1% during both April and May. Warmer than average winter weather was reported to have pulled orders forward, explaining some of the recent softness. However, uncertainty in the global markets is the main culprit, as is demonstrated by weaker exports and export orders. In response to these uncertainties, employment growth has weakened and jobless claims have risen.

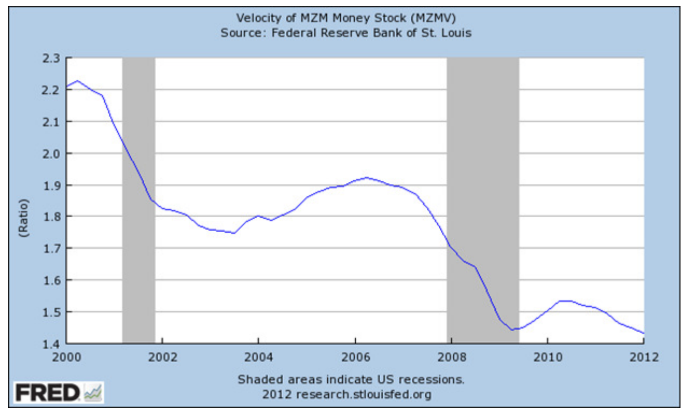
On the bright side of the ledger, personal incomes increased 0.2% for the months of April and May, following a 0.4% increase in March. Real disposable income increased by 0.3% in May, aided by a drop in energy prices. In the first six months of 2012, domestic auto sales rose from an annualized rate of less than 9 million units (last June) to an average of almost 11 million units. More significantly, the type of strength seen in auto sales earlier in the year may be moving over to housing. According to Lennar Corporation, a leading national residential home builder, *"Evidence from the field suggests that the 'for sale' housing market has, in fact, bottomed and that we have commenced a slow and steady recovery process… we are experiencing net positive price and volume trends in most of our markets."* With respect to home resales, the National Association of Realtors reported that May's national median existing-home price rose 7.9%, the third consecutive month of year-over-year price gains. Interestingly, a tightening supply of home listings was reported to have constrained sales. In similar veins, private construction spending has rebounded somewhat; and bank lending, through commercial and industrials loans, has accelerated at double-digit year-over-year growth rates. Although these trends are uneven across various markets, we find them encouraging on the whole.

Still, other domestic challenges remain. Near-term, we have what promises to be a bare-knuckled presidential election in November, perhaps followed by another round of voting on U.S. debt limits. Longer-term, we must identify concrete measures for scaling the "fiscal cliff" of debts the U.S. has accumulated.

Financial Conditions/Monetary Trends

As stated by the Federal Open Market Committee (FOMC) in its June 20, 2012 minutes, *"… strains in global financial markets continue to pose significant downside risks to the economic outlook."* Through a low interest rate policy, the FOMC and other global central banks are striving to inflate financial assets, thus creating wealth and increasing confidence in the financial markets. These policies, including "operation twist," are consistent with successful actions taken in the 1950s and early 1960s, when deflationary risks also materially threatened asset valuations. Over the last year, price inflation has slackened, clearing a path for developing market economies to join in this stimulative process and lower interest rates. Brazil, South Africa, China, and other Asian Pacific countries have implemented increasingly expansive monetary policies.

Despite this round of rate reductions, the world continues to deleverage. As a result, trillions of dollars remain idle on account or deposited in central bank accounts, earning little to no return. This inefficient use of money can best be illustrated by the chart on the historic velocity of money. Simply stated, monetary velocity is the ratio of nominal GDP, or economic activity, divided by the supply of money. As seen in the chart, velocity, or the output of GDP for every $1 of monetary input, has declined as the U.S. economy has reduced its reliance on credit. This metaphorical "pushing on a string" is a material cause of the ongoing subpar U.S. and world growth.



Sentiment Indicators/Market Trends

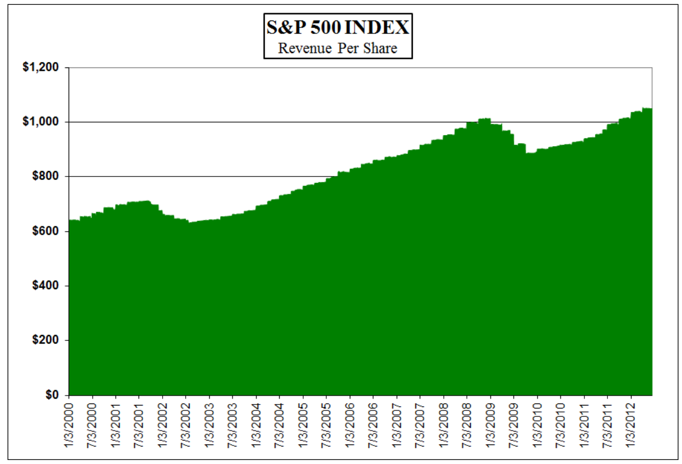
Early in the year, sentiment and market trends appeared to be short-term over-bought, as indicated by extreme measures in Bull/Bear ratios, put-to-call ratios, volatility indexes, and other contrary indicators. Moving into the second quarter, over-bought conditions edged downward toward a more neutral stance. Trepidation over the reported deterioration in economic activity and fears of a more material global relapse led to an eventual equity market consolidation. Generally, equity markets recorded a 3%-5% pullback by the close of the second quarter. Historically, the typical ebb and flow of a full market cycle will deliver short-term market corrections, and these retracements often are viewed as normal and even constructive. Of course, current times are not necessarily typical; so sudden bursts of anxiety tend to create greater volatility over shorter periods versus most data series of the past. By the end of the quarter, the majority of the contrary measures we find useful had moved to over-sold conditions. While not perfect science and certainly not perfect timing tools, these measures may signal the approach of a positive shift in investor emotions.

Equity Market Valuations & Earnings

Regardless of the methodology used, it's hard to argue that equity markets are expensive. In cases slightly better than "meltdown" scenarios, the markets look fairly valued. In better case scenarios, they appear very attractive, especially when compared to prevailing interest rates of return. Yet equity mutual funds still report huge outflows, and investors appear to want to chase negative real returns in bonds.

A recent Wall Street Journal article cited a survey indicating that only 15% of Americans trusted the stock market. When looking backward, from the turn of the new millennium, equity market gains have been volatile but paltry in the end. A review of the history of 10-year rolling market returns since 1920 offers hope. Simply stated, better long-term forward market returns tended to occur following poor 10-year return periods. For example, the worst 10-year period (1928-1938) reflected a price decline of 48.6% in the Dow Jones Industrial Average (DJIA). By contrast, by the end of 1942, the DJIA had advanced 98.1% over the prior 10 years.[1] Similar patterns of weak and then strong returns have followed this time series, with exceptionally disappointing 10-year returns looking back from most years between 1974 and 1978 and, more recently, 2008-2009. Recognizing that the past never repeats itself exactly, we hope that, the further we move through and eventually away from the recent and ongoing turmoil, investors can be rewarded for maintaining or building exposure to the markets.

Viewed from a different perspective, price-to-earnings valuations peaked at more than 30 times earnings at the turn of this century. Today, 12-month trailing price-to-earnings valuations measure approximately 13 times for both the DJIA and the S&P 500 Index (SPX). Apparently, equity markets have been discounting the economic deleveraging over this decade. While the market discounting mechanism has been hard at work, both the DJIA and the SPX have more than doubled their index earnings with significant revenue gains. More importantly, while market price multiples have contracted, individual businesses have prospered, driving earnings, dividends, and book value higher throughout the period. Should these same, or other, businesses be able to successfully execute their business plans over the coming months and years, what will be the worth of these businesses in five or ten years, given today's market valuation?



Source: Bloomberg LP, IMVA Research

Conclusion

Without question, uncommon obstacles obscure the outlook for near-term worldwide economic growth. At the moment, many domestic U.S. economic trends appear to have strengthened, but we are no island. The world's many regions and economies share an unprecedented degree of interconnectivity. Equity market valuations appear attractive, but meaningful, sustained advances won't occur until the markets sense that global leaders have the will and means to navigate better the turbulence brought about by the process of deleveraging.

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

[1] Percent return represents cumulative price appreciation only, not compounded, and it excludes the effects of dividends for the Dow Jones Industrial Average.

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