

Investment Management of Virginia, LLC

Third Quarter, 2011

Summary

Money appears to be accumulating selectively throughout the financial system. Savings and checking deposits are surging at mid-teens growth rates, and the broad money growth aggregate (MZM) is expanding at a high-teens rate, with the aggregate balance now surpassing \$10.5 trillion. Corporations appear to be strengthening their balance sheets as well. Similarly, refinancing by individuals accelerated during the last quarter. Together, these data reflect the ongoing deleveraging process that originated in 2007 and the “paradox of thrift” – as cash piles up throughout the financial system, receiving negative real rates of return, it is not being reinvested in ways that promote economic growth and job creation.

Recent equity market “bullishness” registered only 25%, while “bearishness” reflected 48% – quite a change versus earlier readings of 63% and 16%, respectively. Of course, sentiment is viewed as a contrary indicator. Perhaps the most dramatic swing can be seen in the S&P 100 volatility index (VXO), which has surged to an extreme level, matched only three other times over the last twenty-five years. Ultimately, each of these periods/readings reflected attractive equity market values and presaged attractive future market returns. However, in each case, the market’s advance was slow to materialize.

Fresh economic results offer glimmers of hope that the current fear and loathing in the markets are overblown. Valuations screen attractively, but improvements in equity prices depend largely on earnings growth. Only a decade ago, exuberant investors, who had high expectations of the “New Paradigm”, seemed happy to pay 30x equity market earnings. Since then, earnings have doubled, dividends have increased, and the market P/E ratio is now only 12x (based on trailing earnings).

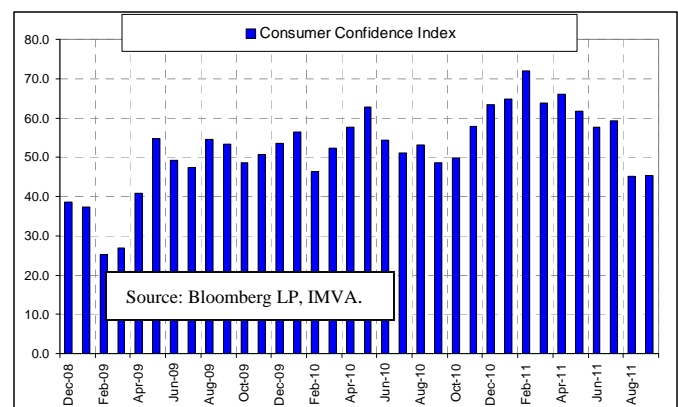
The Paradox of Thrift

One man’s spending enables another man’s savings and investment. The same is true for countries, as we have seen in the relationship between the U.S. and China. However, the global accumulation of debt, followed by the Great Recession of 2007-2009, disrupted this relationship, such that the “and” has largely been replaced with an “or”, creating the paradox of thrift. Generally, mass deleveraging by individual consumers and an obese financial system has directed dollars into savings and balance sheet repair, as opposed to further spending, reinvestment, job creation, etc. Concurrently, much of the institutional debt, primarily that of banks, merely has been transferred to government balance sheets, restricting, in turn, potential, corrective policy responses. Historically, recessions have met their end at the hands of three policy attacks: interest rate reductions, increased federal and state government spending, and targeted tax reductions. Given current debt burdens, along with cries for austerity measures toward spending, only one remedy among the three appears easy to enact – and short-term interest rates have already been reduced to zero. A crisis in confidence, brought about by this dilemma, weighs heavily on the markets.

Much of 2011’s market volatility appears to be in reaction to numerous governmental policy missteps and/or inaction. Very recent news provides hope for some resolution. Nonetheless, thrift is expected to keep near-term GDP growth in developed countries below par and soften future growth in developing nations.

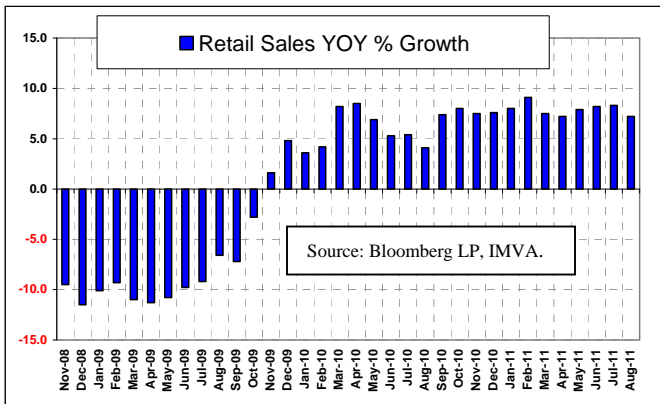
Economic Trends

Early in 2011, we anticipated slowing economic growth in the first half of the year, followed by an uptick in the back half, “barring any shocks.” Soon thereafter, turmoil in the Middle East disrupted commodity markets, creating surges in oil and gasoline prices, which reduced discretionary spending among consumers. Japan’s tsunami then disrupted the global supply chain, and the knock-on effects have only recently shown signs of recovery, e.g., September’s industrial production in Japan just showed its first increase since March. Despite these shocks, U.S. and world growth appeared to trudge forward, building on improved consumer and business confidence, until late July – at which point, domestic political debates in advance of the August debt ceiling deadline seemed to usher in a general lack of faith in everything, including the U.S. Government and its ability to deal rationally with a growing deficit and a flagging economy. Credit



downgrades, both here and abroad, along with inaction on the part of European policymakers, crushed consumer confidence, and calls for a double-dip recession ensued.

However, as the old saying suggests, we must pay attention to what they (consumers) do, not only what they say. Retail sales for August were in fact respectable, above gloomy expectations. Auto sales remained steady despite continued supply shortages. Construction spending advanced, and the Architectural Billings Index rose. Amidst shaky confidence (as has been reflected in the markets worldwide), September economic data appear to have improved as well: purchasing manager reports for both the manufacturing and service sectors reflected gains; auto sales reached the highest level since April; machinery orders and manufacturing export orders increased; and, job creation data improved. Also reassuring, North American



rail carloads reached a 2011 high in the week that ended October 1, and truck tonnage has now grown, year/year, for 21 consecutive months, (including 9.2% growth in August). Southwest Airlines also reported that September traffic rose at a faster clip than capacity. To be sure, the market is focused upon systemic risks in Europe, among other things. That said, much of the current data is indicating rising strength in the U.S., albeit below trend. These data are inconsistent with the call for a recession. Perhaps, Fred Smith, Chairman of FedEx Corporation, captured our feeling best in his September quarterly announcement: *“While there has been considerable speculation that the economy has or will soon enter a recession, this is not our view at present. We expect sluggish economic growth will continue largely due to a lack of confidence that U.S. and European policymakers will effectively address current economic challenges.”*

Financial Conditions/Monetary Trends

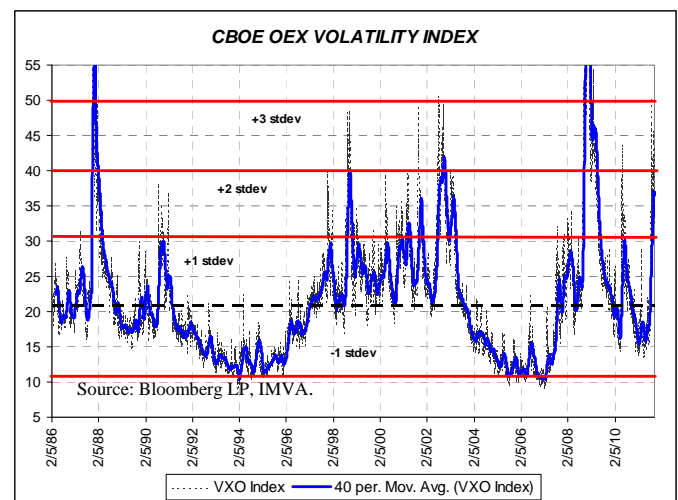
Following its August meeting, the Federal Open Market Committee (FOMC) voted to keep the federal funds rate at 0.0-0.25% and opined that *“economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.”* In September, the FOMC initiated a strategy known as “Operation Twist”, first employed during the Kennedy Administration in 1961. This program is intended to put downward pressure on

longer-term interest rates and help make broader financial conditions more accommodative.

Money appears to be accumulating selectively throughout the financial system. Savings and checking deposits are surging at mid-teens growth rates, and the broad money growth aggregate (M2) is expanding at a high-teens rate, with the aggregate balance now surpassing \$10.5 trillion. Corporations appear to be strengthening their balance sheets as well, replacing higher rate outstanding debt with lower rate obligations (reduces interest expense outlay, raises cash balance). For example, 3M Corporation is about to retire a 4.5%, 3-year debt instrument, issued in 2008, and is expected to replace it with an estimated 2% obligation, maturing in 5 years. Similarly, refinancing by individuals accelerated during the last quarter. Together, these data reflect the ongoing deleveraging process that originated in 2007 and the paradox of thrift – as cash piles up throughout the system, receiving negative real rates of return, it is not being reinvested in ways that promote economic growth, jobs, etc. Many suggest that the Fed’s actions are intended to promote investment into riskier assets in order to push money into the broader financial system and promote capital formation.

Market Trends/Sentiment Indicators

Nearly all of the market trend indicators we follow register over-sold in the extreme. For example, recent “bullishness” registered only 25%, while “bearishness” reflected 48% – quite a change versus earlier readings of 63% and 16%, respectively. Perhaps the most dramatic swing can be seen in the S&P 100 volatility index (VXO), which has surged to an extreme level, matched only three other times over the last twenty-five years – the market crash of 1987, the 2002 recession, and the period between late 2008 and early 2009. Ultimately, each of these periods/readings reflected attractive equity market values and presaged attractive future market returns. However, in each case, the market’s advance was slow to materialize.



Equity Market Valuations & Earnings

Versus historical ranges, U.S. equity market valuations appear uncommonly attractive, likely already pricing in (as certainties) continued gridlock in Washington, a full-blown

European financial crisis, and global contagion. Throughout this repricing process, the S&P 500 Index, the S&P Mid-Cap 400 Index, and the S&P Small-Cap 600 Index, respectively, have declined from earlier 2011 highs approximately 20%, 26%, and 26%. The P/E (price-to-earnings multiple) for the S&P 500 now stands at 12x trailing earnings while the Mid-Cap and Small-Cap indices have each moved to the low end of their historical norms. Forward earnings estimates, however, have also turned lower, raising a cautionary flag. Continued negative earnings revisions have never facilitated an advancing market. Although recent anecdotal economic news would indicate that we are not facing a 2008-style collapse in earnings, third quarter earnings reports and guidance, which have only just begun to come in, should provide critical insight as to whether equity markets are, in fact, attractive.

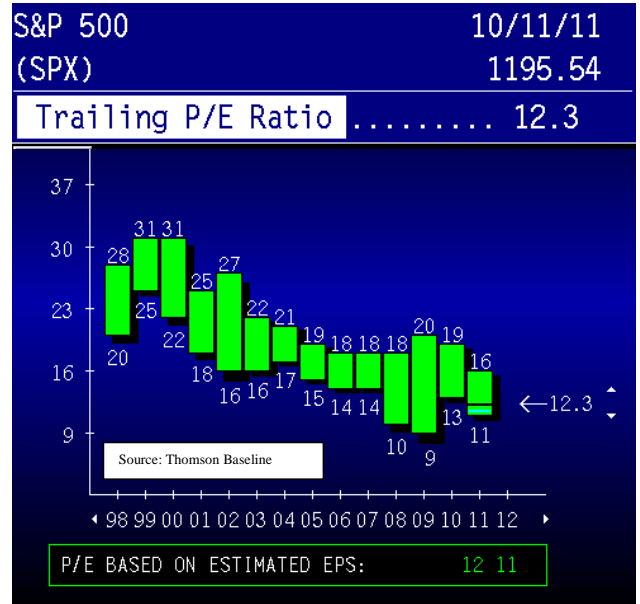
For yield sensitive investors, we would point out that the dividend yield of the S&P 500 Index exceeds the 2% yield on the 10-year U.S. Treasury Note. Furthermore, in many cases dividend yields on common stocks exceed the prevailing yield from corporate bonds issued by the same underlying company, a situation not seen since the 1950s. Over the last decade, the S&P 500 Index, the S&P Mid-Cap 400 Index, and the S&P Small-Cap 600 Index have each more than doubled their earnings while dividends have increased at least one-and-a-half times. Valuations obviously have not kept up, as the market multiple that an investor is willing to pay for a dollar's worth of earnings has compressed by more than half.

Conclusion

To be certain, we live in challenging times. Generally, developed nations are overly indebted to the degree that potential spending and growth trends may suffer.

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Developing nations, who generally appear to be in relatively better financial condition, depend upon spending from the developed world. That said, recent economic results offer glimmers of hope that the current fear and loathing in the markets are overblown. Valuations screen attractively, but improvements in equity prices depend largely on earnings growth. Only a decade ago, exuberant investors, who had high expectations of the “New Paradigm”, seemed happy to pay 30x equity market earnings. Since then, earnings have doubled, dividends have increased, and the market P/E ratio is now only 12x (based on trailing earnings). With creative leadership that begins to address our various obstacles, we would expect to see sentiment improve and equities respond.



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

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