Investment Management of Virginia

**Small Capitalization Portfolio**
**4th Quarter, 2018**

The Small Capitalization Portfolio Composite was down 24.61%, net of fees, for the quarter. This was behind the 20.20% decline for the Russell 2000 Index.[1] For the year, the Small Capitalization Portfolio Composite finished slightly ahead of the Index, down 9.05%, net of fees, versus down 11.01% for the Russell 2000 Index. The Small Capitalization Portfolio Composite also remains ahead of the Russell 2000 Index since inception.[2]

## The Portfolio[3]

During the quarter, we were more active than usual given the market volatility. We initiated positions in Helios Technology Corp. (SNHY), American Woodmark Corp. (AMWD), and Lattice Semiconductor (LSCC).

Helios Technologies (SNHY, formerly Sun Hydraulics Corp.) is a global provider of hydraulic cartridges for industrial presses, heavy-duty machinery, and industrial automation. Long known as a premier supplier of hydraulic system components, offering a premium product for a premium price, SNHY recently has diversified into electronic controls and displays via strategic acquisitions. The recent market sell-off, combined with a transitory supply-chain issue, gave us an opportunity to buy a growing, high-quality industrial company at a potentially sizeable discount to its intrinsic value.

American Woodmark (AMWD) is a leading supplier of kitchen cabinets in the U.S. With its 2017 acquisition of RSI Home Products, AMWD expanded into a lower price-point yet higher margin category that sells primarily through Lowes and Home Depot. AMWD is now the #1 or #2 player in the markets it serves and benefits from both new home sales and the repair and remodel (R&R) aftermarket. AMWD has high returns on invested capital, solid free cash flow generation, and high inside ownership. With the recent market sell-off, coupled with the housing slowdown, the stock pulled back to attractive valuation levels.

Lastly, we made an initial purchase in Lattice Semiconductor (LSCC). LSCC designs and sells low power, programmable logic products into consumer, communications, industrial and automotive markets. The company is benefiting from growth in the Internet of Things (think robotically controlled forklifts or new refrigerators that are now connected to the internet). We think LSCC is well positioned for continued growth in this new market. Private equity investors tried to take LSCC private two years ago, but the U.S. Government blocked the sale due to concerns over sensitive intellectual property. While this stance limited the potential acquirers of LSCC to U.S. companies (i.e. no buyers with Chinese exposure), we think LSCC can continue to grow on a stand-alone basis or be

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[1] Past performance is no guarantee of future results, and no representation is made that results similar to those shown or discussed can be achieved. To receive a complete list and description of Investment Management of Virginia, LLC's composites and/or a presentation that adheres to the Global Investment Performance Standards (GIPS), contact Investment Management of Virginia at (804) 643-1100.

[2] Inception of the portfolio is 1/1/94.

[3] The transactions/securities discussed in this section are generally portfolio-wide transactions for the accounts in this Portfolio and have not been selected by any performance criteria. It should not be assumed that all accounts in the Portfolio had the same transactions or that transactions in the future will be as profitable or will equal the performance of the securities mentioned.

purchased by a large U.S. focused semiconductor company. LSCC has a new, high quality management team in place. They appear to be intent on rapidly de-levering the company's balance sheet to offset the effects of a 2015 acquisition.

We added to positions in McDermott International (MDR), Alexander & Baldwin (ALEX), KVH Industries (KVHI), Iberiabank (IBKC), Park City Group (PCYG), Quidel Corp (QDEL), Stamps.com (STMP), and Prestige Consumer Healthcare (PBH). We added to MDR early in the quarter ahead of quarterly results. Generally, the stock has been negatively impacted by weakness in the energy sector and continuing problems with the recently acquired Chicago Bridge & Iron (CBI) legacy projects. Despite setbacks, we think MDR's management can fix the problem projects and prompt a re-rating within the market. We added to ALEX as the stock traded around book value. Recall ALEX owns Hawaiian real estate – much of which has been on its book for decades. Given the general lack of available land in Hawaii, we believe that there may be a sizeable disconnect between stated book value and market value. Further, ALEX went through a REIT conversion in 2017 and did not pay a regular dividend in 2018. It will begin to pay a regular dividend again in 2019, and at that time, income-focused REIT investors may revisit the stock. We added to QDEL on market weakness and a weaker flu season. The stock has been further impacted by an adverse court ruling in California. We have spoken with management multiple times on the matter and think the appeals court will rule in QDEL's favor. If (when) it does, QDEL could be a very attractive takeout candidate.

We added to KVHI on market weakness as it was a small position. Fundamentally, the core maritime business is growing nicely, and their autonomous driver technology continues to show promise (albeit is a 2020 event at the earliest). We added to IBKC, a high-quality, growing regional bank, on weakness when the stock was around book value. We added to Park City Group, which had a strong quarter. We added to STMP on market weakness as the President's report on the U.S. Postal Service did not have any negative implications for the company. Lastly, we added to Prestige Consumer Healthcare. PBH's business remains steady and predictable, and we used the market weakness to add to our position in this defensive, counter-cyclical company.

During the quarter we liquidated Forum Energy Technologies (FET), Gannett Company (GCI), and Knowles Corp (KN). FET had a substantial loss, and the outlook for the near-term did not look favorable. We sold GCI after it reported quarterly results. The core newspaper business continued to be in secular decline; but, most importantly, its digital marketing business slowed in the quarter. GCI continues to cut costs to maintain profitability, but with the growth in digital slowing, we don't see meaningful near-term upside potential. Lastly, we sold KN late in the quarter. KN had performed adequately, but growth was hindered by weak microphone sales to its largest customer, Apple. We think KN will continue to see sluggish growth for the next twelve months as consumers put off buying phones ahead of the roll-out of 5G Wi-Fi.

We trimmed Green Dot (GDOT) and Acacia Corp (ACIA). GDOT had a solid quarter, and the stock reached our maximum position size. GDOT remains one of our largest holdings. ACIA also had a strong quarter, and we used the strength to trim our position and reinvest into some of the names mentioned above.

**The Equity Market**
The equity market turned treacherous in the fourth quarter. Almost all asset classes around the world were weak, and the U.S. stock market had the worst December since the Great Depression. We hear a litany of concerns on all forms of media, day and night, but the fundamental issue for U.S. markets is the prospect of a recession and what that downturn might do to corporate earnings. The depth of a possible economic slowdown could be affected dramatically by Federal Reserve policy/decisions and collateral damage from a trade war with China. All of these issues must be evaluated with the understanding that political considerations may degrade objective thinking in each case. There are myriad political issues/risks to consider, but dysfunction in Washington, D.C. and a no-deal Brexit, including an implied threat to the basic underpinning of the European Union, are near the top of the list. Computerized trading, the spread of populism/protectionism, and global warming/volatile weather are a few more things to keep you awake at night. Climbing the wall of worry seems more Sisyphean than profitable, these days!

Over any reasonable investment horizon, the expected level of corporate earnings and the multiple that investors will pay for those earnings are what determine stock prices. A wide range of extremely well informed opinions on both of those numbers for 2019 are easy to find, so there is no "right answer". But, it appears the recent repricing (losses) have been prompted by fears of lower earnings in 2019, and perhaps a lower multiple on those earnings. Computerized trading programs and limited liquidity in the market are probably exacerbating the moves in the market, up and down. The equity market, and the Treasury yield curve, is most likely correct in forecasting some sort of economic slowdown, but no one knows if this slowdown will devolve into a recession. Only time will tell. But, we have seen valuations contract to levels that seem very reasonable. In late December, Abby Joseph Cohen, the highly respected strategist at Goldman Sachs, observed that the S&P 500's valuation had reached levels that reflect the fundamentals (primarily, expected earnings growth and interest rates)[4]. The market can, of course, overshoot to the downside, or future earnings may be worse than she expects, but valuation is probably not the issue, at this point.

What if we do go into a recession, then what happens? We all remember the carnage from the 2007/2008 Great Recession, but most recessions are less malevolent for stock prices, and some have even produced positive stock returns.[5] The general rule is that stocks will underperform the year before a recession, especially in the prior six months. Stock performance during recessions since WWII has been mixed, and, as you would expect, performance is usually strong coming out of a recession.[6] If history is any guide, we will be most of the way through a recession by the time the National Bureau of Economic Research (NBER) makes that determination, as happened with the recessions identified in 2008, 2001, and 1990. To complicate matters, the years leading up to a recession can be very profitable for investors. In sum, recessions, and the six months preceding them, are generally bad for stocks, but that pitfall is extremely hard to predict, and missing the run-ups, both before and after, can hurt long-term returns.

[4] Interview on Bloomberg Surveillance, December 21, 2018
[5] "Stock Performance Before, During & After Recessions", Ben Carlson, March 15, 2015
[6] "What History Says About Recessions and Market Returns", Connected Wealth, April 17, 2018

Looking on the bright side, current investor sentiment is very low; the Federal Reserve Board and Chairman do not want to cause a recession; neither the U.S. nor China wants an ugly trade war; and equity valuations, relative to modest earnings expectations and low interest rates, appear reasonable. Perhaps some of the doom and gloom is “fake news”.

**INVESTMENT MANAGEMENT OF VIRGINIA, LLC**
**SMALL CAPITALIZATION PORTFOLIO COMPOSITE**
**ACCOMPANYING NOTES**

| Year[A] | Total Return Gross (Percent) | Total Return Net[B] (Percent) | Benchmark Russell 2000 (Percent) | Composite 3 Yr. St. Dev.[C] (Percent) | Benchmark Russell 2000 3 Yr. St. Dev.[C] (Percent) | Number of Accounts | Composite Dispersion[C] (Percent) | Composite Assets End of Period (Millions) | Strategy Assets End of Period[D] (Millions) | Model Assets End of Period[D] (Millions) | Non-Fee Paying Composite Assets End of Period (MM) | Percentage of Non-Fee Paying Composite Assets | Total Firm Assets End of Period (Millions) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2008 | -26.66 | -27.07 | -33.79 | N/A | N/A | 18 | 0.76 | 13.33 | 24.81 | N/A | 0.61 | 4.59% | 285.31 |
| 2009 | 39.21 | 38.57 | 27.17 | N/A | N/A | 17 | 4.12 | 14.06 | 29.22 | N/A | 4.55 | 32.37% | 335.79 |
| 2010 | 32.00 | 31.51 | 26.85 | N/A | N/A | 15 | 0.74 | 13.39 | 38.39 | N/A | 2.64 | 19.74% | 427.21 |
| 2011 | 1.89 | 1.41 | -4.18 | 24.19 | 24.99 | 16 | 0.74 | 13.41 | 38.85 | 45.11 | 2.47 | 18.43% | 409.51 |
| 2012 | 24.37 | 23.70 | 16.35 | 19.84 | 20.20 | 22 | 0.55 | 15.46 | 58.06 | 73.37 | 2.77 | 17.94% | 526.95 |
| 2013 | 36.11 | 35.24 | 38.82 | 15.86 | 16.45 | 53 | 0.80 | 29.85 | 139.01 | 184.94 | 2.26 | 7.56% | 697.44 |
| 2014 | -6.44 | -7.10 | 4.89 | 11.98 | 13.12 | 50 | 0.68 | 27.70 | 106.25 | 162.01 | 2.40 | 8.65% | 549.17 |
| 2015 | -12.27 | -12.88 | -4.41 | 13.59 | 13.96 | 41 | 0.66 | 22.58 | 64.53 | 93.92 | 2.19 | 9.71% | 437.32 |
| 2016 | 25.83 | 24.99 | 21.31 | 15.12 | 15.76 | 33 | 0.80 | 25.71 | 67.55 | 41.43 | 1.95 | 7.57% | 484.18 |
| 2017 | 4.90 | 4.25 | 14.65 | 14.74 | 13.91 | 26 | 0.70 | 30.23 | 62.09 | 12.09 | 2.04 | 6.74% | 491.22 |
| *2018 | -8.56 | -9.05 | -11.01 | 17.31 | 15.79 | 25 | 0.46 | 24.91 | 54.44 | 7.73 | 1.68 | 6.75% | 448.68 |

* 2018 performance returns are for the period ending 12/31/18.
A. Inception of the composite was 1/1/94. Creation of the composite was 1/1/94.
B. Fee schedule: 1.00% per annum on the first $1 million of assets; 0.75% per annum on assets greater than $1 million. Fees are negotiable.
C. N/A for the current year signifies that the information is not available until year end. N/A for previous years signifies that the information was not required.
D. Supplemental information. In addition to composite assets, strategy assets include separately managed accounts that do not meet the criteria for inclusion in the composite and wrap accounts. Small Capitalization Portfolio model assets are managed by other firms based on model portfolios submitted by IMVA.

Investment Management of Virginia, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Investment Management of Virginia, LLC has been independently verified for the periods January 1, 1993 through September 30, 2018. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Small Capitalization Portfolio composite has been examined for the periods January 1, 1994 through September 30, 2018. The verification and performance examination reports are available upon request.

1. **Basis of Presentation**
Investment Management of Virginia, LLC ("IMVA") is a registered investment adviser under the Investment Advisors Act of 1940. IMVA was originally established as Scott & Stringfellow Capital Management, Inc., a division of Scott & Stringfellow, in 1982. In March 1999, Scott & Stringfellow became a wholly owned subsidiary of Branch Banking & Trust Company (BB&T). IMVA became an independent investment adviser in July of 2000 when the principals of Scott & Stringfellow Capital Management, Inc. purchased IMVA from BB&T. Total firm assets exclude model programs. Additionally, as supplemental information, as of December 31, 2018, the firm provides models to programs managing a total of approximately $12.56 million in assets based on those models (this figure includes the Small Capitalization Portfolio model assets and all other model portfolio assets at IMVA).

2. **Composite Criteria**
The Composite consists of institutional, endowment, retirement, and individual accounts. Tax-exempt and taxable accounts are included. The Composite seeks a strong total return through capital appreciation in small capitalization companies. The primary investment criteria are strong upside potential at a reasonable price. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Performance results of the Composite are based on U.S. dollar returns.

3. **Calculation Methodology**
The Composite results are time-weighted rates of return net of commissions, custodial fees, and any other expenses incurred in the management of accounts. Accounts may be shown gross or net of withholding taxes on foreign dividends based on the custodian. These returns have been presented both gross and net of investment advisory fees. Quarterly composite rates of return, which are net of investment advisory fees, are calculated at the account level. For each account, the fee percentage is subtracted from the account's gross monthly return, during the month the fee is incurred, to obtain a monthly account return net of investment advisory fees. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Additional information regarding policies for valuing portfolios, calculating performance and preparing compliant presentations is available upon request.

4. **Comparison with Market Index**
Results of the Composite are shown compared to the Russell 2000 Index. The Russell 2000 Index is comprised of the 2,000 smallest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest publicly held companies incorporated in America, as defined by total market capitalization. The Russell 2000 represents approximately 1% of the Russell 3000 Index total market capitalization. For comparison purposes, the Russell 2000 is a fully invested index, which includes reinvestment of income, and the performance has been linked in the same manner as the Small Capitalization Portfolio Composite. The returns for this unmanaged index do not include any transaction costs, management fees, or other costs. Investment Management of Virginia, LLC takes no responsibility for the validity of the index and/or other performance numbers provided by reputable outside sources. The S&P 400 Index was used prior to 12/31/00 as a comparison index. It was replaced with the S&P 600 Index on 12/31/00 because this index was a more accurate representation of the market capitalization of the securities in the client accounts. The S&P 600 Index was dropped as an index as of 3/31/12 due to low usage of that index by institutional investors.

5. **SEC Advertising Disclosure Footnotes**
All performance composite returns are reported **net** and **gross** of investment advisory fees charged by Investment Management of Virginia, and reflect the reinvestment of dividends and other earnings. The investment returns will be reduced by commissions, custodial fees, and any other expenses incurred in the management of accounts. Accounts may be shown gross or net of withholding taxes on foreign dividends based on the custodian. Net performance reflects the deduction of actual quarterly fees for each account in the composite with the exception of one non-fee paying account in the composite for the periods prior to 9/30/2006. An implied 100 bps fee was applied to calculate net performance for the account. Gross of fees performance returns are presented before investment management fees.

6. **Additional Information**
A complete presentation of any composite and/or a list of all composite descriptions is available upon request. Such inquiries should be addressed to George McVey, Investment Management of Virginia, LLC, 919 E. Main Street, Suite 1600, Richmond, Virginia 23219, or contact him through email at gmcvey@imva.net.

**Past performance is no guarantee of future results, and no representation is made that results similar to those shown can be achieved. All portfolios have the potential of profit and/or loss on the investment securities.**