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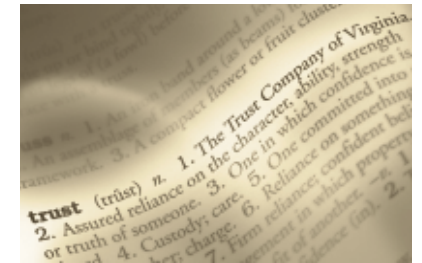
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The
TRUST
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CREATING VALUE THROUGH TRUST

Quarterly Review

First Quarter 2008



Equity Market Strategy

At this writing, the weakness in markets in the first quarter has been partially overshadowed by the strength, at least on a near-term basis, of these markets since mid March – punctuated by the 3% or so advance on the first day of the new quarter. Equity markets have benefited from strength in the dollar over the past few weeks, some weakness in commodities, the ongoing view that the Fed will continue to do what is necessary to support the financial system, and that investors finally seem to view the wreckage in financial services as having been sufficiently discounted over the past year. Having said this however, the decline in the S&P 500 for the quarter was fairly brutal, losing 9.44%, the Dow Industrials 7.0%, and the Morgan Stanley EAFE, a measure for international markets lost 8.75%.



the extent of earnings weakness. We doubt that this period of softness in the economy will be very protracted, and that earnings declines will not be as severe.

As long term investors, we always have to wrestle with questions of strategy when the economic environment threatens earnings and earnings growth rates. This would usually take the form of potential changes in asset allocation within ranges that would continue to address long-term account objectives. At the far end of options for managers, allowing cash levels to drift higher might also seem to be a viable option. These steps imply some ability of managers to “time” markets – selling longer-term positions to provide some protection for portfolios and at an opportune time, and re-introducing that cash or moving back to the original asset allocation. So, can we show evidence that such a ploy can truly add value and be successful? The evidence, again for longer-term investors, is not very good.

Equity Market Strategy cont. from pg. 1

markets off of lows tend to be the most significant in terms of percentage change.

At this time, it is certainly true that economic activity is slowing, both here and in other markets as well. Whether or not this slowing will be labeled a recession, earnings will nevertheless be weaker over the next few quarters. It is likely, however, that much of this contraction has already been discounted by markets, and that the important decisions are how to position assets for the coming 12 months and further into the future. This is the focus of our strategy and efforts at this point in time – that of determining the most appropriate asset allocation for our accounts, making sure we are positioned in the right asset classes, and making sure our stock selections are successful in adding value to our investment management process. ■

- Allan Keyes, Chief Investment Officer



The National D-Day Memorial in Bedford serves as a profound and stirring tribute to the Valor, Fidelity and Sacrifice of the Allied Forces on 6 June 1944.

On that day-to-remember, nearly 4,400 soldiers, sailors and airmen died defending the freedoms that we enjoy today. The largest land and sea invasion in history, Operation Overlord is considered

by most historians to be the watershed event of the Twentieth Century. Dedicated in 2001 by the President of the United States, the Memorial expects to welcome its one millionth visitor by mid-year.

Upcoming events include: Saturday, May 24 – the Jefferson Choral Society concert; May 26 – a poignant Memorial Day ceremony; June – the 64th anniversary of D-Day and the World War II in Miniature exhibits celebrating Father's Day. Family Day returns Saturday, July 19 and the summer season comes to a close on Saturday, August 23 with another evening concert featuring the Smith Mountain Lake Harmeneers.

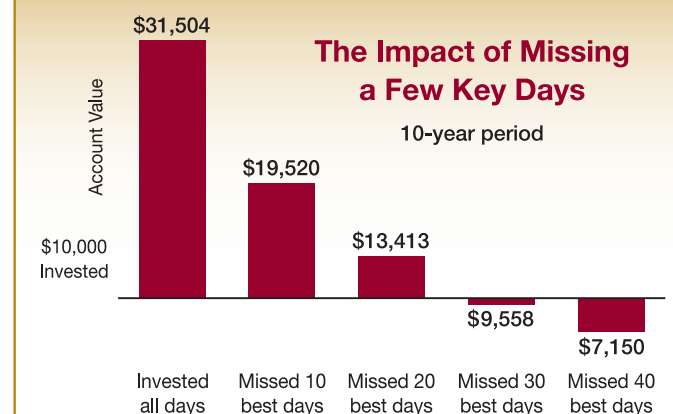
For updates on events and news at the Memorial, please visit www.dday.org or call 540.586.3329. ■

Editor's Note: From time to time, we feature articles about clients of our Charitable, Foundation & Endowment Group and thought it especially appropriate to highlight the National D-Day Memorial on the eve of the 64th anniversary of D-Day

While recent moves are encouraging, world equity markets still have some hurdles to face of course – not the least of which will be earnings comparisons over the next few quarters. Analysts have pared estimates over the past few months, reflecting a gathering consensus that the U.S. economy is headed for some period of flat to perhaps negative growth. The impact on earnings is that consensus earnings estimates for 2008 are now about 5-6% ahead of final results for 2007. Over the next few weeks, companies will begin to report earnings for Q1, and these results will indicate just how far weakness in housing and financials has spread to other sectors of the economy.

Recession rhetoric, specifically the history and experience of the U.S. economy in recessionary periods, has been around for a number of months. Just to refresh – using the last 10 recessions (back to 1949), U.S. stocks have on average peaked 4 months before the onset of recession and troughed 8 months after the start of recession. On average, the market has fallen by 23% from its pre-recession peak to its recessionary bottom, while it has taken 13 months for earnings to trough once recession has started. During these periods, markets have rallied, on average, by 33% in the first year of recovery. The problem with this sort of analysis is that we never know just how severe an economic contraction might be, and therefore

The Difficulty of Market Timing



This chart attempts to show the difficulty of timing markets successfully. The problem is that investors may, from time-to-time, be able to make the first decision successfully (selling), but suffer when attempting to return to longer term positions (buying). The difficulty is that investors miss the most statistically significant trading days – that is, the moves in

Turmoil in the Municipal Bond Market

The turmoil experienced by the credit and debt markets over the past several quarters has spread to areas previously believed to be immune. **The municipal bond market, which appeared removed from the problems surrounding the mortgage crisis, is working through the most complex and volatile period this sector has ever seen.** Sub-prime trickle down has put pressure on the capital requirements and balance sheets of the monoline bond insurers and constrained liquidity in the short term markets resulting in a rapid steepening of the yield curve.

Up until about 7 years ago, monoline bond insurers were satisfied with providing guarantees on interest and principal payments in the event of default to cities and counties issuing debt. In an attempt to further boost revenues, the insurers expanded their scope by guaranteeing collateralized debt obligations, which as we now know, were at least partially backed with sub prime mortgages. As the value of these mortgages tumbled, potential losses to the insurers skyrocketed and the amount of capital needed to maintain their AAA rating was in jeopardy. With the possibility of municipal bonds backed by these insurers effectively being downgraded, upward pressure on longer term yields materialized. In addition, tax-exempt hedge funds experienced margin calls and were selling large positions of muni bonds, flooding

the market with supply, and driving longer term yields higher by as much as 80 basis points in some cases.

On the short end of the yield curve, the Federal Reserve continued on their mission of providing liquidity and trying to avoid a substantial downturn in economic activity by lowering borrowing costs and pushed yields lower. Liquidity constraints migrated to an area of the muni market which had been running smoothly for over 25 years. The short term funding market (Auction Rate Securities) suddenly fell apart, for many reasons. This was largely due to the losses experienced by the investment banks and capital that was once

dedicated to this market was needed elsewhere. Liquidity, which had previously been provided in times of supply/demand imbalances, was withdrawn. With tax-exempt money market funds finding less and less eligible short term debt to invest in, the short end of the market became even more expensive.

The steepening of the yield curves and the relationship between Treasuries and municipal bonds has given rise to unprecedented opportunities. Due to the overall high credit quality of the municipal bond market, examining the differential between tax-free yields and Treasury yields is one factor in determining



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Credit quality should always be the primary consideration whether investing in the taxable or tax-exempt arena and varying individual time horizons should be considered carefully.

relative value. Typically, a 10yr muni bond's yield would be about 70-80% of a comparable 10 yr Treasury bond's yield. With all that has taken place in terms of absolute yields, that relationship is currently 140-150%. The higher percentage yield of a municipal versus a Treasury, the more value the municipal possesses, in a relative sense, after taxability is taken into consideration. With the shifts in level and slope of both curves, this relationship is attractive not only to the traditional buyer, but more importantly to the taxable bond buyer.

High quality, tax-exempt bonds purchased at yields that surpass Treasuries represent an

appealing investment. The complexities which led to this disconnect between the two markets may only last for several more months; the pressure on the long end of the yield curve is expected to subside. Regardless of the relationship between treasuries and municipals, and the opportunities that currently can be gained, we continue to stress adherence to individual objectives. **Credit quality should always be the**

primary consideration whether investing in the taxable or tax-exempt arena and varying individual time horizons should be considered carefully. ■

- Elizabeth Swartz, Senior Vice President, Fixed Income Manager

Sub Prime Leadership

The cycle of excess continues: from the savings-and-loan industry collapse in the 80's to the 2000-01 bursting of the tech-stock bubble to the current mortgage debacle.

Described as the extreme version of credit risk transfer or, the "originate and distribute" business model, mortgage bankers originated aggressive loans then



Wall Street sold the questionable securities to investors resulting in this remarkable financial mess. Billions in market losses, ousted CEOs of UBS, Merrill Lynch and Citigroup are just some of the fallout. Ben Stein, columnist and economist states 'the vicious, cruel truth is that some very greedy, selfish and, yes, stupid people made fortunes on deals that were economically and/or ethically wrong. (why else hide them off balance sheet)... and we stockholders and taxpayers foot the bill, of course.' In spite of this, more laws from Henry Waxman and Barney Frank are not the remedy for corporate wrongdoing. Nor will shuffling the regulatory agencies preclude future malfeasance.

What is missing is leadership and accountability. Russell Roberts, a professor of economics at George Mason University states, "...we're in uncharted territory, a world where the Fed and the Treasury are making up the rules as they go along, where accountability is being ignored and a world where the government bails out Bear Stearns and its creditors rather than letting those who have been reckless learn a lesson for the next time." This too shall pass... and this too shall occur again... so when it comes to the gimmicks of Wall Street, buyer beware.

We can't fix the national economy or bring accountability to the investment banking world, but we can keep our own values at the forefront of everything we do. The sole focus of our company remains the best interest of our clients. We will continue to provide long-term, tried-and-true solutions for clients.

Integrity and accountability are the standards that guide our unbiased advice and Richard Gates and I always want to hear first hand if you have a "sub prime" experience at The Trust Company of Virginia. ■

- Douglas A. Nunn, President