

The State of the Company ~ Richard D. Gates, President

The challenges presented by the difficult markets over the past two years have helped us focus on the principles that have made this organization successful. A high level of customer service and an investment process that provides competitive returns, while preserving value on the downside, has been the ongoing focus at The Trust Company of Virginia. We remain financially strong, having increased our capital levels in both 2007 and 2008, and are on track to outperform budgeted expectations in 2009. As a nationally chartered financial institution, we also received a strong capital rating from our regulators during their recent examination. Our branches continue to contribute 50% of our top line revenue, led by our largest branch in Roanoke. Our newest office in Lynchburg, having just celebrated its

second anniversary, has exceeded its new business goals and should reach profitability ahead of schedule. We have added an administrator in our Northern Virginia office, Timothy Nolte. Tim joined us as a Vice President and adds even more depth to that office with his extensive experience and background in Personal Trust Administration.

As we move forward, we remain dedicated to our mission of providing the highest quality investment management and fiduciary services to individuals, endowments and foundations through objective advice, competitive results and personal service. ■

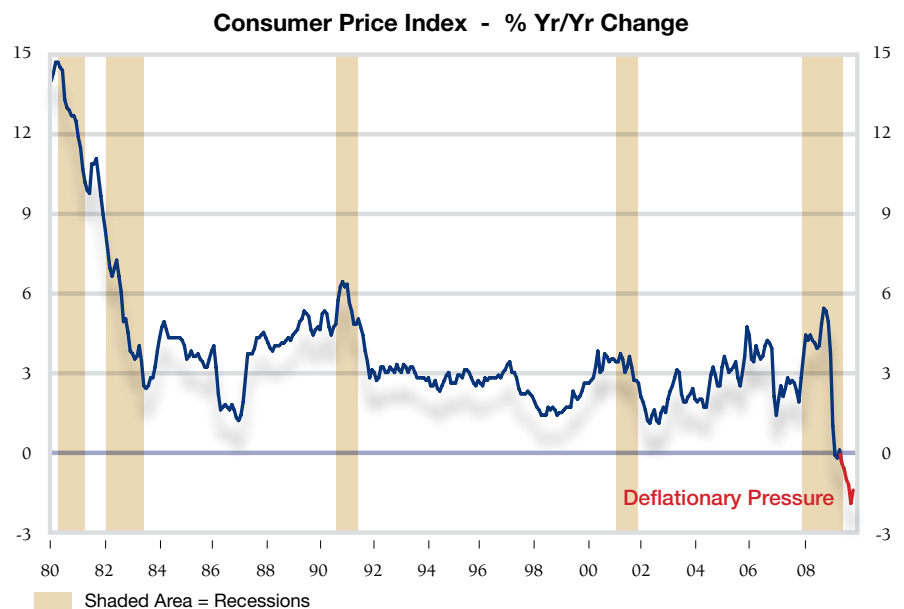
Inflation/Deflation and Your Portfolio ~ P. Barton Peters, CFA, Vice President, Equity Portfolio Manager

Government spending is so high, isn't inflation inevitable?

Peters: While the increase in government spending is unprecedented and could lead to inflation in normal times, these are not normal times.

In order for inflation to be a factor, the economy should have a flood of dollars chasing too few goods. There is little doubt the government is flooding the economy with dollars. It is not clear those dollars are being spent on goods and services. It appears the consumer, for the first time in 25 years, is paying down debt and putting money into savings. Paying down debt is really paying for spending in the past while saving is paying for spending in the future. A lack of spending today is not inflationary but deflationary.

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What if consumer spending bounces back? Would inflation then be more of a problem?

Peters: Yes, it would.

However, consumers are unlikely to resume the spending spree of 2004-2007. Rising home prices and mortgage refinancing fueled a lot of the excess spending. The bursting of the housing bubble dramatically removed a source of “easy money”. Since our homes represent close to 50% of our assets, declining housing prices financially wounded most consumers. It will take some time to let that wound heal.

History suggests inflationary pressures are unlikely to be a factor while the economy suffers with high unemployment and low capacity utilization. When general prices begin to rise, businesses hire more people and put idle capacity back

to work. Unemployment is usually below 5%-6% before inflation creeps into general prices. Unemployment is now nearing 10% and will probably climb higher over the next quarter or two.

Another factor arguing against inflation is capacity utilization. It is now nearing a 60 year low, falling below 70%. Inflation is rarely a problem until over 80% of our nation's productive capacity is working.

It may take several years before consumer confidence, unemployment and capacity utilization move to levels that re-ignite inflation fears.

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Year-end Tax Considerations ~ Richard D. Gates, President

There have been numerous federal tax law changes over the past several years, making year-end tax planning more important than ever in 2009.

Alternative Minimum Tax (AMT) – While this tax originally targeted the wealthy, it has recently affected many more taxpayers. You might consider deferring items that could trigger the AMT, such as large state income tax deductions, exercise of incentive stock options, large capital gains and large amounts of tax-exempt interest from “private activity” municipal bonds.

Postponing Required Minimum Distributions – A tax law passed in late 2008 exempted taxpayers who have reached age 70½ from taking their 2009 “required minimum distribution” from employer sponsored retirement plans or traditional IRAs. If you don't need the income, foregoing this distribution in 2009 could have a positive effect on your taxable income, tax bracket and your ability to claim income restricted deductions and credits

Tax provisions scheduled to expire –

- Additional standard deduction for state and local real property taxes.
- Above the line deduction for tuition and related expenses paid for higher education.
- State and local sales and excise taxes on motor vehicle purchases.
- First-time homebuyer credit. A refundable tax credit of up to \$8,000.
- Income exclusion of up to \$2,400 in unemployment benefits.
- Distributions from IRAs for charitable purposes. Individuals who have reached 70½ can roll over money in IRAs to qualified charities on a tax-free basis through 2009.

As much as \$100,000 may be donated annually. Tax-free rollover amounts are not deductible but may be preferable to taking a taxable IRA distribution and then making a contribution.

Energy Incentives – Tax credits are available for the costs of making certain energy-efficient improvements to your principal residence (such as energy-saving exterior doors, window, insulation and roofs) and for installation of qualified energy property (such as a furnace or water heater).

Capital Gains and Losses – Long-term capital gains and qualified dividends generally are taxed at a maximum rate of 15% (exceptions apply). For 2009 and 2010, a 0% rate applies to long term capital gains and qualified dividends that would otherwise be taxed at a 10% or 15% ordinary rate. The Health Care Bill that is currently under consideration will increase the capital gains tax rate to 24% after 2010. However, there is always the possibility that Congress will accelerate the increase to take effect as of this coming January, rather than January of 2011.

Capital losses are fully deductible against capital gains and unused losses can be carried forward to later tax years.

Estate Taxes – With the repeal of the federal estate tax scheduled for 2010 and its reinstatement scheduled for just one year later, estate planning has become more complicated than ever. We recommend that you contact your attorney or tax advisor to discuss the effect this may have on your estate plan.

As always, we urge you to secure professional tax advice prior to acting on any ideas discussed above. ■

What likely impact will the high government spending have on my portfolio?

Peters: The consumer is paying down debt and the banks are cleaning up their balance sheets. Both of these activities are “de-leveraging” the economy. The government, however, is increasing its debt. This increases leverage in the economy. It is still too soon to tell how leveraged the overall economy will be. What we do know is the government’s spending will produce record deficits.

Assuming government spending isn’t curtailed, there are only two ways to pay down the deficit. Either the economy grows, generating higher tax revenues, or tax rates go up, or both. Generally, raising tax rates slows economic growth.

The White House plans to raise taxes on the very rich. One such tax is to increase the tax rate on the profits on our investments known as “capital gains”. Several times candidate Obama mentioned raising the capital gains tax rate from 15% to about 25% or 28%.

Prudent investors may wish to harvest capital losses today. Unlike realized capital gains, capital losses can stay on your books for years and offset future capital gains. This could be advantageous if future capital gains tax rates climb. ■

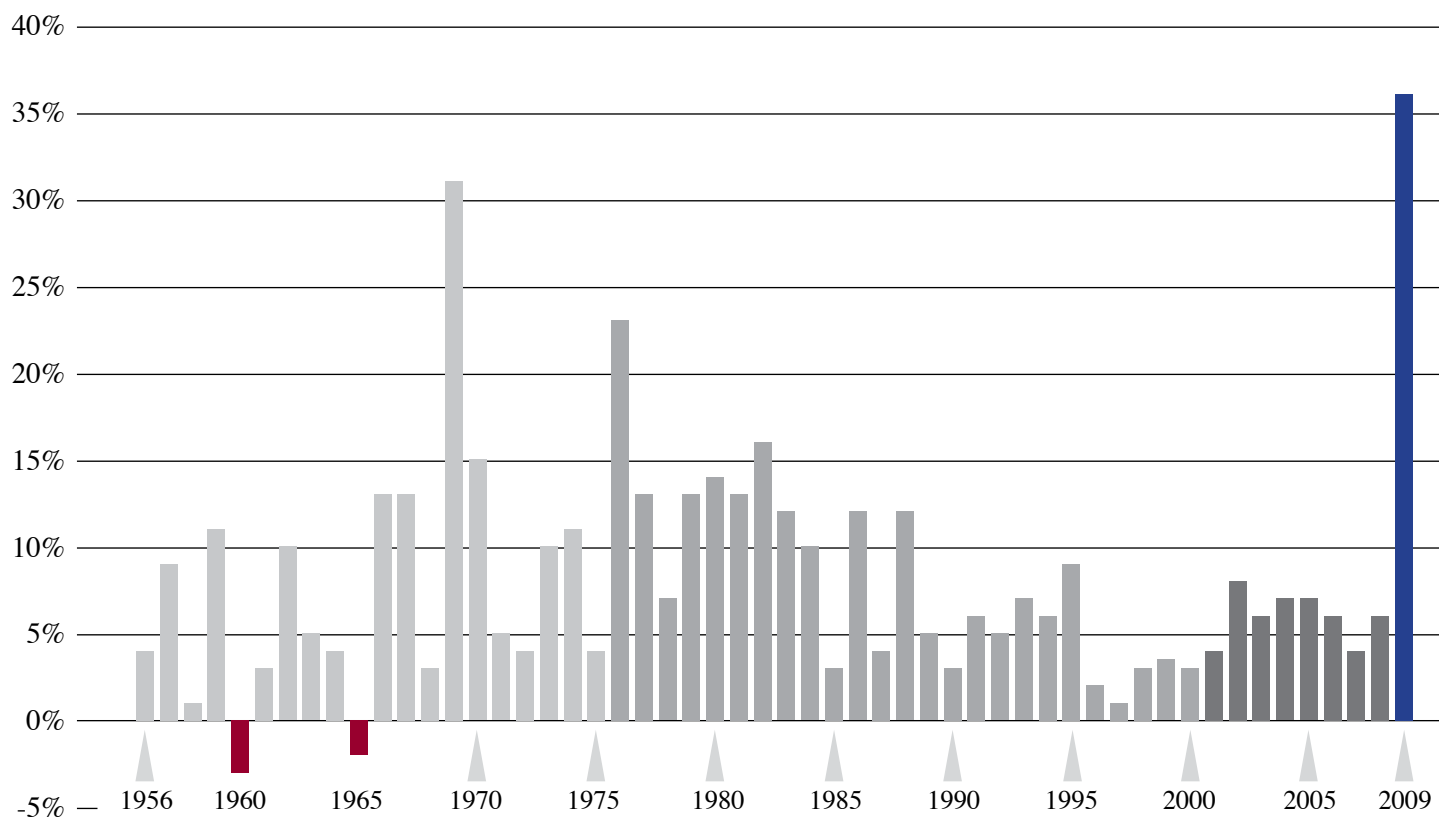
Fixed Income and the Economy ~ Elizabeth Swartz, Senior Vice President, Fixed Income Manager

While most are aware of the size and significance of the equity markets, few understand the magnitude of fixed income markets and their effect on the overall economic landscape. At the end of 2008, global fixed income markets were nearly four times larger than global stock markets. U. S. markets account for half of all outstanding fixed income debt – and that does not include the current amount of government debt being issued in 2009 to fund the stimulus/bailout plans. The chart below illustrates the enormous increase in government spending since 2008. Furthermore, on a 10 year annualized, total return basis,

fixed markets have outperformed equity markets (Barclays US Aggregate Index vs S&P 500). Little attention is given to developed bond markets which possess the ability to influence overall economic efficiency. The process of raising capital in order to fund infrastructure projects, expand companies and create jobs translates into economic prosperity. Commercial borrowers need to be able to access financing through the credit markets, which has positive effects on tax rates, competition, stability and efficiency within the financial system.

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% of Federal Spending (pct change)



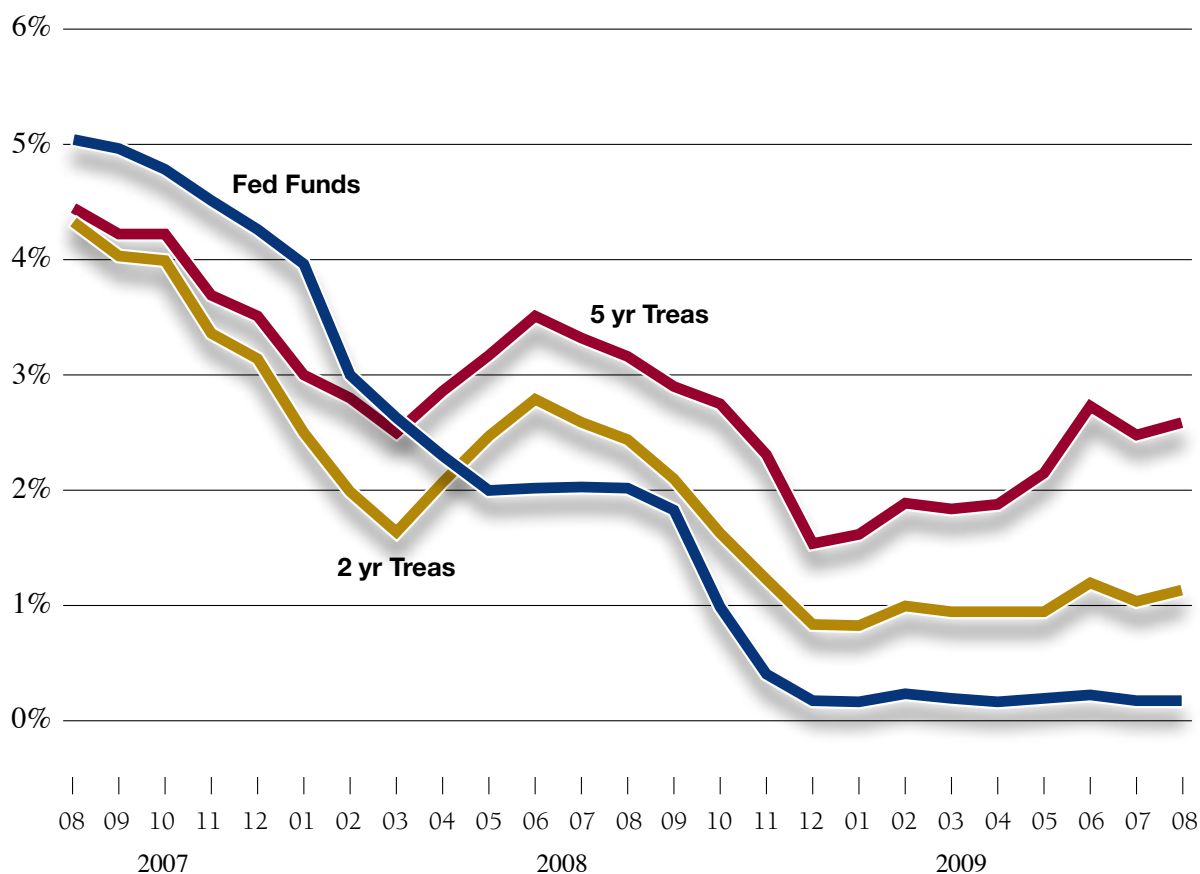
The importance of the bond market was seen last year, when access to credit was frozen and the entire financial system was in jeopardy. Fortunately, it appears the worst may be behind us as debt markets are operating in a more efficient manner and borrowing is gradually increasing. With all the help available from the Federal Government, the landscape of fixed income investing has changed somewhat. As a component of the Temporary Liquidity Guaranty Program, the introduction of FDIC insured bonds gave companies (mostly financial institutions) the ability to raise cash for shorter-term funding needs, at rates that were not accessible through normal means. (Although this program is due to expire in October 2009, there is always the possibility of extension). Under the American Recovery and Reinvestment Act of 2009, municipalities have the ability to issue taxable bonds called "Build America Bonds" to finance infrastructure projects and create jobs. This program allows the issuer to receive a direct subsidy from the Government. The result is lower borrowing costs than if tax-exempt debt was issued. The program has been extremely successful, which in turn has reduced the amount of tax-exempt bonds issued, putting downward pressure on municipal bond yields.

The current yield environment is a result of normal efficiencies within the bond market and policies and

programs recently put into place. During times of financial uncertainty, many investors flock to safety, which translates to investing in U.S. Treasuries. Such high demand will produce lower yields based on supply and demand principals. The chart below illustrates the downward pressure on yields in the past year.

However, the historically low yields in all sectors of the bond market have not occurred solely due to demand, but have been influenced by monetary policy as well. Beginning August 2007, the Federal Open Market Committee has been lowering short-term interest rates, fostering over-borrowing, which in turn helped foster over-inflated housing prices resulting in the real estate bubble that ultimately collapsed. Since the near market collapse in late 2008, the FOMC has attempted to stimulate the economy by using non-traditional measures, which again keep bond yields artificially low. However, the Federal Government will begin reversing these programs and funding options over the next few months, and the timing of this unwinding will be key to an orderly recovery. Other factors, especially unemployment and excess capacity, are keeping the consumer on the sidelines and until there is some relief in these areas, spending will be contained and rates will remain low. Eventually, as consumer confidence improves, economic growth will take hold and rates will begin to increase. ■

Short Term Yields



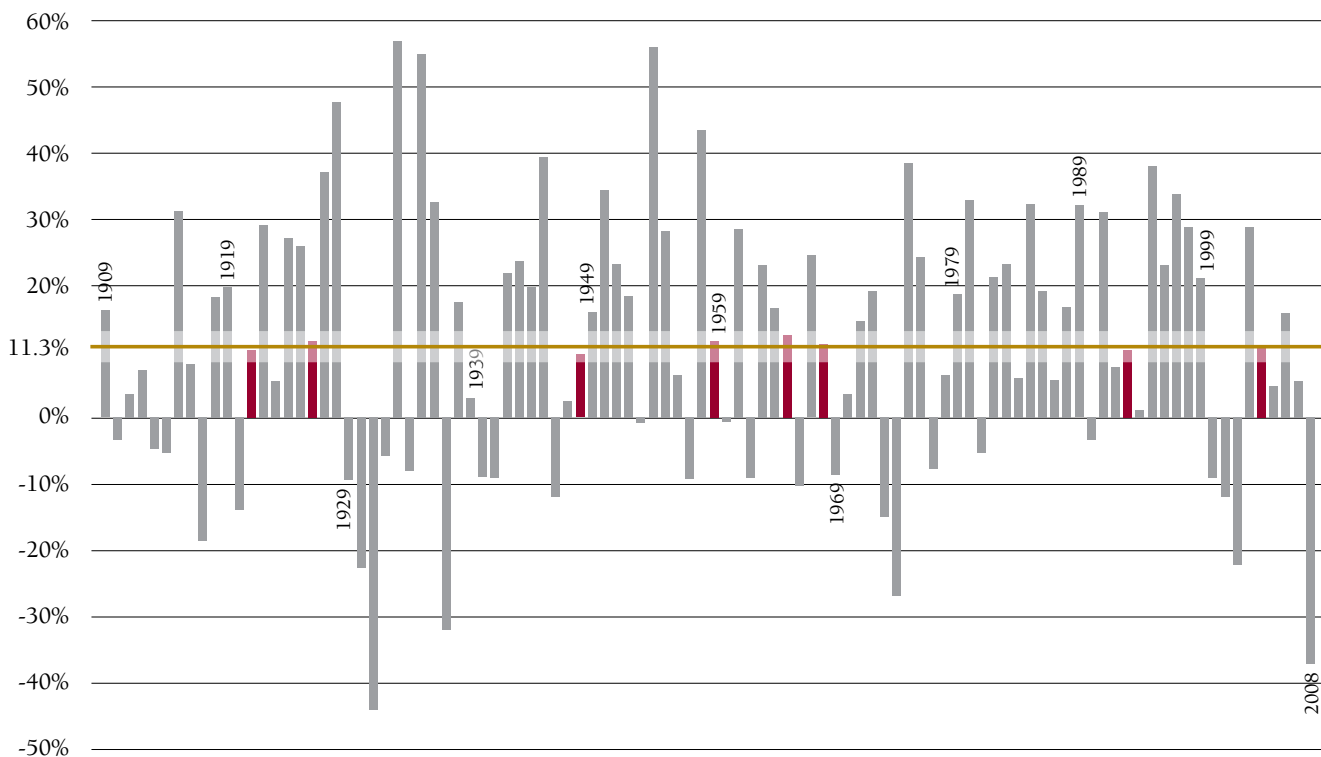
Asset Allocation in Volatile Times ~ Richard L. Ware, CFA, Senior Vice President, Equity Manager

After the performance and volatility of stocks over the last year, many clients have asked if they should change their asset allocation. The answer is, of course, it depends...Most investment advisors consider asset allocation a seven factor decision. Proper asset allocation depends on those seven factors and only period-specific hindsight will verify if the optimal choice was made. The chart below shows 100 years of market ups and downs, during which time the average return was 11.3%. However, returns fell within 2 percentage points of this average return in only 8 years out of this 100 year period.

have reduced a client's net worth and the economy may have impacted his job security, but the other aspects of his background should remain relatively unchanged.

Objectives: A client's return goals, inflation worries, legacy plans and income needs all have a bearing on the proper mix of stocks to bonds. Again, the market decline may slightly affect some of these issues, but for the most part, objectives should not have been changed by the recession.

U. S. Stock Market, 1909 - 2008



The Factors

Although not all-inclusive, the major factors most advisors consider when setting asset allocation are background, objectives, risk tolerance, time horizon, tax consequences, special situations, and liquidity needs. By examining how those factors were affected by last year's financial and economic developments, we can determine whether asset allocation shifts are appropriate.

Background: A person's net worth, investment experience, stage in life, family dynamics, job security, and possibility of inheritance all affect his ability to take risks and recover from downturns. The market's decline may

Risk Tolerance: As the old saying goes, "nothing ventured, nothing gained". Risk and reward go hand in hand. The higher the expected risk, the higher the expected return. Since feeling the sting of last year's decline, many investors have voiced a greater risk aversion. Unfortunately, immediately after a decline is the worst time to reduce equity exposure (as the chart above shows).

Time Horizon: The longer a client's investment horizon, the greater his ability to weather a downturn. As time heals all wounds, a margin of error is needed where portfolios are heavily weighted toward equities. The recession and accompanying market decline should not have affected investors' horizons.

Tax Consequences: The two areas where taxes influence the asset allocation are the choice of fixed income vehicles (taxable vs tax-free) and capital gains on stocks. Since some gains were erased and tax burdens lowered, there may be some appropriate asset shifts caused by the downturn.

Special Situations: Some clients have unusual circumstances which must be considered, such as stock concentrations, restricted securities, pending litigation, or deteriorating health. Once again, the recession should have little effect on these circumstances.

Liquidity Needs: Investment managers need to account for client's cash needs, especially when approaching large lump sum outlays such as college tuition or retirement home admission. The market decline should once again be mute here.

Summary

So, for the most part, the seven factors which determine asset allocation remain unchanged after the market's downturn. It may sound counter-intuitive, but sometimes staying the course, even in troubled waters, is the best plan. At The Trust Company of Virginia, we want you to have the

best asset allocation for your particular situation. And that may mean making adjustments from time to time, but we want you to make those changes for the right reasons – not as an emotional reaction to frightening market news. ■

Company News

May 27 The Richmond office hosted a gala reception at Lewis Ginter Botanical Gardens following a Lincoln Bicentennial lecture by renowned Lincoln scholar, Michael Burlingame.

September 10 Lynchburg clients and friends attended a reception at the Boonsboro Country Club where they heard a presentation by The Trust Company's Equity Portfolio Manager, Barton Peters, on the state of the economy after a year of turmoil.

September 28 The Roanoke office held a reception at the Vinton War Memorial following a conversation between Thomas Jefferson and Henry Rogers, railroad baron and founder of the Virginian Railroad. Well known "re-enactors," Bill Barker played Thomas Jefferson and John Hammant played Henry Rogers.

The Trust Company of Virginia

9030 Stony Point Parkway, Suite 300
Richmond, VA 23235
(804) 272-9044

130 Temple Lake Drive, Suite 3
Colonial Heights, VA 23834
(804) 520-0297

4097 Ironbound Road, Suite B
Williamsburg, VA 23188
(757) 221-0044

204 S. Jefferson Street, Suite 200
Roanoke, VA 24011
(540) 343-1500

8000 Towers Crescent Drive, Suite 1080
Tysons Corner, VA 22182
(703) 462-2530

203 Archway Court, Suite B
Lynchburg, VA 24502
(434) 455-2500

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