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Investment Strategy cont. from pg. 1

skilled professionals. He was the first to suggest success depends on understanding the shift from a “winner’s game” to a “loser’s game”.

‘The best way to achieve long-term success is not in stock-picking and not in market timing and not even in changing portfolio strategy. Sure, these approaches all have their current heroes and ‘war stories’, but few hero investors last for long and not all war stories are entirely true. The great pathway to long-term success comes via sound, sustained investment policy: setting the right asset mix and holding onto it.’

[Charles D. Ellis, “Lessons from the Warwick and Chateau Chambord.” *The Future of Investment Management*, AIMR, 1998, p. 25].

Zach Johnson finished at 1-over 289, matching a Masters record last set in 1956 for highest winning score. This high score indicates the difficulty of the playing conditions. How did Zach do it? He kept the ball in play and made fewer mistakes. Johnson did not take heroic risks and will not have a lot of footage on the highlight reel. He played a very solid, quiet game and won the Master’s coveted Green Jacket. He would make a very successful investor. ■

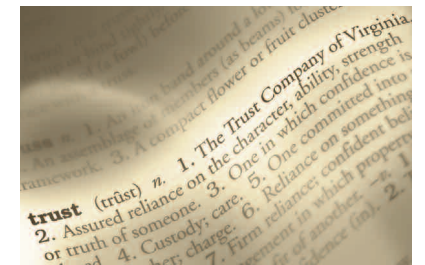
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CREATING VALUE THROUGH TRUST

Quarterly Review

First Quarter 2007



Investment Strategy from the Masters - Barton Peters

The Masters is usually the most exciting golf tournament of the season, but this year was different. We saw plenty of great shots, but not as many as in past years. The cold wind made greens slick and dry but these treacherous conditions did not translate well to the audience watching the game unfold at home. Halfway through the final day, there were 5 different players in sole possession of the lead. Competition was fierce.

When frontrunner Zach Johnson laid up his second shot on 15, the last par 5, the TV commentator seemed disappointed that he did not go for the green. Tiger Woods, the best golfer in the world, was playing a few holes back and could certainly birdie or even eagle the 15th. The second commentator remarked that, unlike the big hitters, Zach did not try to reach

any of the par 5s greens in two all week, yet he had done better than anyone else with 11 birdies and no bogeys. He went on to par the hole.

That was when it became obvious Zach Johnson was using the classic “Loser’s Game” strategy. “The Loser’s Game” is Charles D. Ellis’s seminal work, and required reading for anyone sitting for the Charter Financial Analyst exam in the last 30 years.

Mr. Ellis builds the case that highly competitive professional “games” require a professional strategy for success. Most amateurs think in terms of a “winner’s game” strategy in which the winner’s skill, talents and luck control the game’s outcome. A “loser’s game” strategy requires all of that plus discipline and patience. A “loser’s game” strategy is one in which the outcome is dictated by the mistakes of the loser. Using professional sports to illustrate his ideas he concluded:

“... the strategy for winning is to avoid mistakes. The way to avoid mistakes is to be conservative and keep the ball in play, letting the other fellow have plenty of room in which to blunder his way to defeat.”

Of course, Mr. Ellis was referring to professional investing. The “Loser’s Game” clearly saw that investing was increasingly dominated by equally

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EQUITY MARKETS - Allan Keyes

Equity markets in the quarter experienced periods of increased volatility, and were characterized by investor jitters both in domestic and in international markets. In spite of considerable weakness in late February, these markets ended the quarter with small gains – the S&P 500 eked out a total return of 0.65 percent, and the Morgan Stanley Capital Index EAFE finishing the quarter ahead 3.0 percent.

The weakness in late February began in markets in Shanghai – a reaction to talk in China’s government circles about slowing the boom that had occurred in those markets over many months. Higher reserve requirements for banks, tighter interest rates, stricter implementation of a capital gains land tax, and also some form of capital controls were then in the rumor mill. The decline in Chinese equity markets spilled into Europe and then to markets in North American, trimming about 3% from market values in the process. These events caught U.S. markets at a vulnerable moment – concern over the fall-out in the sub-prime lending arena, ongoing weakness in housing, and the direction of interest rates had already contributed to nervousness among investors. By quarter end, these losses were largely recovered, leaving most of the indexes flat to moderately higher.

In the end, investors always will look to the health and continuation of an expansion because an expanding economy drives earnings and earnings are the ultimate driver of stock prices. While the current expansion is still intact, earnings growth is certainly under pressure. After increasing at double-digit rates for several years, earnings for companies in the S&P 500 are expected to grow by only 5% in the first quarter, and by 7% for the

full year. While this rate might seem unacceptable by some, it represents growth at about the historical rate for S&P 500, and is somewhat more sustainable than the rates of a few years ago.

Further, while economic activity is slowing, having the expected impact on corporate earnings and earnings growth rates, the underpinnings for the U.S. economy remain good. The unemployment rate fell to a five-year low of 4.4 percent as job growth picked up to 180,000 last month. The March increase in jobs reported by the Labor Department reflected a revival of hiring among construction companies, department stores and retailers as well as continued robust growth of health care jobs. The March jobs results brings the average monthly gain to 152,000 – down from last year’s level slightly, but consistent with the slower growth in output levels.

Many economists and strategists expect markets to experience continued volatility in the months ahead as the economy slows and markets continue to adjust to lower levels of output. In an economy as large as the U.S., forecasting is not the most exact science, and therefore, investors are facing some months ahead when data will be conflicting. In such an environment, we can only turn to items that are easier to quantify – earnings and earnings expectations, relative valuation levels, and perhaps interest rates. In this regard, earnings, while slowing, should grow at close to historical rates, and markets are not valuing those earnings at excessive levels. In the case of domestic markets, the S&P 500 is trading at 16 times the 2007 consensus estimates – not a level that can be characterized as over valued. If inflationary pressures remain contained, allowing some flexibility for the Fed to ease rates over the next few quarters, we remain optimistic about equity markets, and expect returns in domestic markets to approach 10 percent for the next 12 months. ■



The Fed - will they or won't they? - Beth Swartz

The debate over potential monetary policy changes by the Federal Reserve continues to take center stage. Analysts seemed evenly divided as to which way the Fed will move: will they lower or will they raise short term interest rates. The arguments on both sides are very plausible.

As the housing sector continues to show signs of slowing and with the most recent concern over sub-prime lending and its effect on the housing market, the question remains whether the impact on the economy will be significant enough to cause the FOMC to lower short term interest rates. Due to the complex relationship between the housing sector and the rest of the economy (employment, consumer spending, durable goods, etc.), dramatic reductions in sales and construction could cause changes in levels of economic growth. This in turn could cause the Federal Reserve Board to cut interest rates, should a slowdown become substantial. Over the course of the first quarter, the bond market was anticipating anywhere from a 20% - 90% chance of a rate cut, depending upon the current economic data and the latest to suffer due to sub-prime defaults. The probability of a rate cut has decreased, but has not been eliminated. Although it would not be seen as a change in monetary policy, many economists feel a rate cut could be the Fed’s next move.

On the other side of the debate, as the quarter progressed, prices at both the producer and consumer levels were somewhat higher than what the Fed considers its “comfort zone.” Although moderate growth remains, more recent data suggests inflation has not moderated as expected and may be a cause

for more concern than in the past several quarters. At the last FOMC meeting, the Fed made it clear that they are more concerned over rising inflation levels than stunting economic growth, even though the language that came out of that meeting was altered. Consumer spending has tapered off slightly from last year’s levels, but not by much. Retail sales have eased, but again, the underlying basics remain strong, giving the Fed an optimistic outlook in this area. Could the firming of monetary policy be the next move, should the data strengthen?

The real answer will lie within further data and the reactions of the bond market. Fixed income markets are one of the best in interpreting and predicting the direction of economic growth. Even though the yield curve is still slightly inverted out to 5 year maturities, it has steepened over the quarter, with the changes taking place primarily on the short end. This would typically indicate the market is anticipating an ease of Fed policy. Fed funds futures data predicts where short rates will be in the near term. According to this indicator, monetary policy will be on hold for most of the year and has priced in a rate cut in the second half of the year. However, the longer end of the curve is beginning to tell investors that maybe the Fed is not seeing inflation moderating into acceptable ranges and may become more of a concern down the road. Yields on Treasuries have remained in a somewhat tight trading range, with very little reason to break out. Only further economic data will tell, but for the near term, there does not appear to be a compelling reason for the Fed to move in either direction. ■

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