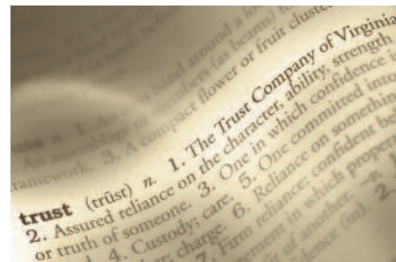
The Trust Company of Virginia

CREATING VALUE THROUGH TRUST

Quarterly Review

Fourth Quarter 2007



Equity Markets in 2007

Equity markets in 2007 were an adventure to say the least. From the highs at mid-year and in October, to the lows late in the year, these markets weathered a lot of adversity – the housing slump, and the sub-prime lending crisis and credit crunch, while managing to finish the year with positive returns. The S&P 500 advanced 5.42% (total return) and the Dow returned 8.82%, while international markets advanced 9.89% as measured by the Morgan Stanley EAFE index. These returns mark the fifth year that world equity markets have experienced positive results, bringing annualized returns for the S&P 500 over that five year period to 12.83%, and for the EAFE, 18.79%.

But of course that is all in the mirror, and what is in front of investors has become slightly more murky as we head into 2008. There is no question that the housing and credit problems in the U.S. are taking a bite out of GDP growth – the housing slump is currently reducing output in the U.S. by about 1.5% and the ripple effect from this weakness is no doubt greater. Growth in the U.S. has been sustained by strong demand in exports, government spending, relatively strong capital spending, and yes, consumer spending has also remained strong. Nevertheless, there are increasing signs that the strength in the economy in the first three quarters of 2007 is about to change. The overriding question is whether or not falling home prices, still-high energy prices and a credit crunch will crimp consumer spending so much that the U.S. slides into recession.

We suspect that the almost daily debate about recession from the media, securities analysts, strategists, economists and on and on is probably a bit overdone. By the way, Martin Feldstein reminds us that the designation of recession, at least in the U.S., is done by the business-cycle dating committee of his organization, the National Bureau of Economic Research (NBER). The bureau defines a recession as a significant decline in economic activity spread across the economy and lasting more than a few months. In judging whether the economy is in recession, the committee looks at monthly data on real income, employment, industrial production, and wholesale and retail sales. Note that he does not necessarily define recession as two consecutive quarters of negative growth. The fact remains that economists cannot reliably forecasts recessions, nor can they detect for certain when a recession is in progress. Again, we will know this in a few months, because the NBER will tell us – after the fact and with start and ultimately, ending dates.

With this in mind, suffice it to say that even though we know that economic activity is slowing, there is still very little evidence that a significant and protracted contraction is underway. For almost two years in the U.S., economists have been saying that housing weakness would impact consumer spending, and it just has not happened yet – it very well may, but not yet. Brian Wesbury of First Trust Advisors points out that all the rhetoric makes serious economic problems less likely. If a recession occurs here, it would be the one of the most anticipated ever – that alone makes it improbable. Again, slowing job growth and rising unemployment last month, and the ISM manufacturing index drop, all signal slowing in the economy. But recession – we and all investors will just have to wait a few months to be able to apply that label.

Jason Trennert and his associates at Strategas Research Partners also made a very interesting observation a month or so ago, pointing out that the extremes of expansions and contractions since the mid 80s have moderated. Recessions since that time are fewer, and of more modest duration. They titled the chart "The Great Moderation", – we could take from the data that investors, above all else, should remain committed to their long term investment objectives, and not become too worried about the expanding and sometimes, contracting economy.

cont. on pg. 4

Fixed Income Markets in 2007

2007 return estimates for the fixed income markets were extremely moderate, but actual returns ended up being anything but. Aside from a few rough patches, the first half of the year was fairly calm leaving investors to believe they were headed towards another uneventful year for bonds. But midway through, things began to change dramatically.

The second half of the year was much more tumultuous. The earlier rise in interest rates and the Federal Reserve's concern with inflation risk, lost credibility, and an overall economic slowdown due to the magnitude of the housing market's problems became a more compelling scenario. With the financial sector's disclosure of massive subprime mortgage write offs and liquidity constraints in the credit markets, and with plenty of cash to put to work, investors became apprehensive as to where to invest cash. As is always the case, in a time of uncertainty, investors sought the security of the Treasury market, pushing interest rates back down to historic lows. The slope of the yield curve became steeper, with most of the movement into shorter maturities. The Fed made an attempt to calm financial markets by lowering not only the Fed Funds rate, but the Discount Rate, where liquidity is provided to institutions without their issuing debt in the marketplace. This had the temporary effect of settling liquidity and credit concerns.

Staying the course with high levels of credit quality, not taking unnecessary risk and seeking stability of principal remain even more important principles of our investment strategy during times of uncertainty.

The bond market and the shape and slope of the yield curve have always been thought to be a fairly accurate indicator of economic growth. And this time, it appears the market was right again. The fact that the flatness of the yield curve typically indicates the slowing of economic growth, proved true. The difference between Treasury yields and non-Treasury yields (corporate and agency bonds) widened out, as investor began to require more yield to compensate for the risk taken. Some would argue that other than the housing market, the U.S. economy remains relatively healthy, but as yields moved substantially lower, interest rate cuts and the volatility in the equity markets, all things indicate slower growth potential ahead.

With all the volatility in the credit markets, it is not surprising that the financial names were the worst performers in the fixed income arena. On the whole for 2007, the U.S. bond market enjoyed higher than average time weighted rates of returns; 7.39% as measured by the Lehman Intermediate Government/Credit Index. Long term Treasuries enjoyed double digit returns and government agencies were not far behind. Moving into 2008, it appears that economic slowing will continue and the market anticipates the Fed will continue to lower short term interest rates. This will make it more challenging for those seeking higher levels of income, but they will see attractive rates of return.

Accounts managed by The Trust Company of Virginia remained relatively insulated from the fixed income market volatility and downturn in bond values. The lack of transparency of mortgage backed and asset backed securities as a whole, breeds skepticism and prevents a prudent investor from participating in this sector. Staying the course with high levels of credit quality, not taking unnecessary risk and seeking stability of principal remain even more important principles of our investment strategy during times of uncertainty. ■

- Elizabeth Swartz, Senior Vice President,
Fixed Income Manager

Charitable Accountability in a Changing World

If you are like most Americans, you gave to at least one charity this year. According to *Giving USA*, taxpayers gave more than $295 billion to charity in 2006 and will likely give more when the final 2007 dollars are counted. At the same time, a study by New York University shows 71% of Americans believe charities waste money.[1] This is up from 66% the year before, which is an increase from prior years.

In a seeming paradox, Americans continue to give more to charities each year while simultaneously believing their donations are not being used efficiently. No one can explain this other than by acknowledging the unrelenting generosity of Americans. Although it is impossible to logically reconcile these two statistics, that does not mean people have not noticed.

Congress, in particular, has focused on charities in the last few years with a stated intent of encouraging charitable accountability. A recent article in the Wall Street Journal suggests charities need to act now to regulate themselves or Congress will do it for them.[2] Congress has already tightened restrictions on certain property donations and has even required stricter documentation on cash gifts. The IRS, too, is revising its FORM 990 which charities use to report basic financial information.

Whether coming from Congress, donors or even the IRS, there is a growing movement for charities to be more open and transparent with their finances. Most vocal in the quest for more information is Republican Senator Charles Grassley of Iowa. In 2004 he said, “Donors should have confidence that their money is handled responsibly.” Grassley was responding to well-publicized events of recent years where he said charitable assets were being used for “private jets and European vacations.” He, along with many charitable watchdogs, say the key is getting charities to be more forthcoming with information.

No matter what regulations are considered or mandated, the best regulation will come from charities themselves. Critics and supporters alike say charities can avoid most scrutiny. They only need to do a better job of reporting what they are already doing.

Donors, too, can and should play a larger role in helping charities become more transparent. Ask questions before you give. Charities should never mind a donor wanting to know more about the organization and how it is fulfilling its mission. There are other sources, too. Independent websites such as www.guidestar.org and www.charitynavigator.org are good starts for learning basic information about your favorite causes. However, nothing can replace the personal experience of getting to know your charity.

Giving to a non-profit is always rewarding, but it is even more gratifying when you have the satisfaction of knowing exactly where your money is going to go. ■

- Wayne Olson, Vice President,
Charitable, Foundation & Endowment Group

[1] http://wagner.nyu.edu/performance/confidence/Confidence_in_Charities_2006.pdf.

[2] Beatty, Sally; “How Charities Can Make Themselves More Open,” The Wall Street Journal Online, December 10, 2007.

Portfolio Online

In December, we replaced TrustWeb with Portfolio Online, a greatly enhanced web access to client accounts. With duel authentication and security protection, Portfolio Online offers our clients the ability to safely view their account information online. In addition to the standard transaction and asset holding information, this service provides:

- Scrolling ticker/quick quotes
- Client customized watch list
- Performance returns
- Gain/loss summary
- Tax lot information
- Financial calculators

This value-added service is available to all clients. Please contact your account administrator to request internet access or for more information.

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Equity Markets in 2007 *cont. from pg. 1*

Recession or not, slowing GDP growth means slowing earnings growth of course, and that suggests some continuing pressure for equity markets and continuing volatility. Yet at this writing, consensus estimates for S&P 500 earnings growth for this year compared to a final level of 2007 are still in the neighborhood of 7%. Even if that number proves to be optimistic, valuation levels for domestic markets are certainly not excessive. The steepest year-end slump in global stocks since 2000 left equities with the lowest valuations in almost 30 years – the S&P 500 trades now at less than 15 times those 2008 estimates. Relative to bonds, stocks at year-end were trading at the lowest values since the early 1970s – bear markets rarely begin with the earnings yield (the inverse of the P/E ratio) from stocks hovering well above the benchmark 10-year Treasury yields, as is the case today. Also, market tops are almost always characterized by speculative excesses, and rising valuations – again, hardly the case today.

While we, like all investors, may be cautious with regard to near-term slowing in the U.S. economy, we expect to remain fully invested in all equity accounts and in equity portions of balanced accounts, and consider equity values to be very attractive for our long-term investment objectives. ■

- Allan Keyes, Chief Investment Officer

Controller / Blue Star Mom

Paige Bartholomew joined The Trust Company in December as our Controller and Accounting Manager. A graduate of VCU, Paige has worked in accounting for all her professional career. Most recently she ran her own business providing financial management for elderly clients.

Paige and her husband, John, have two sons. Rust is a senior at JMU and Scott, a VMI graduate, is serving in the regular army in Iraq. Always active in the community, especially in her sons' schools, Paige helped form the Richmond chapter of Blue Star Mothers of America last year. This national non-profit organization (www.bluestarmothers.org) was started in World War II, when families would hang a blue star in the window to signify a family member was at war. Today this organization serves as a support group for military families.

We are delighted to have Paige on board. ■