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SUMMARY

- Mild recession ends.
- Federal Reserve puts rate cuts on hold.
- Corporate accounting practices under scrutiny.
- Higher oil prices may dampen recovery.

FIRST QUARTER 2002 REVIEW AND OUTLOOK

The first quarter of 2002 turned out to be a mixed bag that left both bulls and bears disappointed. Economic news went from gloomy to hopeful as the very mild recession was declared over. The world outside the U.S. wouldn't go away as the desperate situation in the Middle East grew ever more grim and overshadowed the war on terrorism. Cheap gasoline once again became a memory, and the Federal Reserve decided interest rates were low enough.

The market slumped in January after the strong rally off the September lows, rebounded in February and faded again in March. The end result did not amount to much. The Dow Jones Industrial Average gained a few percent; the NASDAQ Composite lost a few. The S&P 500 and the EAFE international index each made a round trip that left them basically unchanged. Fortunately, the

Year 2001 Stock Market Performance

	First Quarter	Year 2002
S & P 500	-0.1%	-0.1%
Dow Jones Industrial Average	3.8%	3.8%
NASDAQ Composite	-5.4%	-5.4%
Morgan Stanley EAFE	0.1%	0.1%

major averages held above their pre-September 11th levels and did not revisit the crisis lows of September.

The stock market is being buffeted by a number of conflicting issues on the minds of investors. Foremost among them is the end of interest rate cuts. Certainly a two-edged sword, the Fed's ending of the easing cycle indicates economic recovery but also raises the specter of inflation and higher costs of borrowing for consumers

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First Quarter 2002 Review and Outlook (continued)

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and businesses. An environment of flat or rising interest rates, while good for income-oriented investors, also does not bode well for bond prices.

Investors are anxious about corporate profits because recent results have been dismal. The recession has been mild in terms of overall economic contraction; however, it has been one of the most severe in the post-World War II era for corporate profits. Global competition and excess capacity have created an environment where companies have limited ability to raise prices.

A recovery in demand should have an impressive impact on corporate profits, but the reluctance to rehire and increase capital spending may slow the economic recovery.

The fall off in demand forced companies to cut jobs and slash capital spending in order to remain profitable or minimize losses. Many companies are now reluctant to add those costs back in order to avoid future earnings disappointments. A recovery in demand should have an impressive impact on corporate profits, but the reluctance to rehire and increase capital spending may slow the economic recovery.

Hopes for economic recovery seem to be well founded,

but the nature of the recovery remains unclear. Some analysts are calling for a muted rebound due to the lack of pent up consumer demand and weak capital spending plans by businesses. Others believe the robustness of the recovery is being underestimated based on strength in certain indicators such as housing demand.

A real concern for the health of the fledgling expansion is higher oil prices. The escalating conflict in the Middle East, further complicated by tension among Arab nations and the U.S. regarding our intentions toward the "axis of evil," has caused oil prices to spike up. Higher gas prices will dampen consumer demand for other goods and services and may curtail travel and related spending just as summer approaches. Higher crude oil prices will mean higher costs for industries that use petroleum in their finished products.

The gravest and least accessible issue of the day is that of dubious corporate accounting practices exposed in the wake of several high profile bankruptcies, notably Enron and Global Crossing. As the super bull market raged, passive boards and biased analysts condoned or failed to notice questionable practices and lack of disclosure. In more than a few situations, it seems that reportedly robust earnings growth has been the result of slick

accounting rather than solid operating results. The investing public's trust has been betrayed, and many highly regarded corporations find themselves under intense scrutiny. Rattled by the recent calamities on the heels of a two-year bear market, investors are demanding that corporations confess their accounting sins, shore up their balance sheets, and present results more clearly. Corporate America and Wall Street have the daunting task ahead of restoring investor confidence.

The outlook for the remainder of 2002 includes

Limits on the stock market's upside potential include higher interest rates, already high valuations and higher oil prices.

economic recovery and modest gains for the stock market. The end of declining interest rates will be a welcome relief for income investors but will take a toll on bond prices. Corporate bonds should fare better than government issues as the budding recovery makes the corporate issues more attractive relative to the ultra-safe governments. Limits on the stock market's upside potential include higher interest rates, already high

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529 College Savings Plans

Since the early 1980s, college costs have increased faster than the rate of inflation and over the past five years have risen at an annual rate of 5%. If these expenses grow at the same rate over the next eighteen years, by 2020 the total cost for four years of college could range from \$95,000 for a public college to \$249,000 for a private university.

Even so, college is worth it. The 1997 U. S. Census Bureau shows that the average annual earnings of a bachelor's degree recipient are 60% higher than for a high school graduate.

Traditional methods of saving for college like EE Bonds and custodial accounts have given way to much more appealing and tax efficient plans. Specifically, in 1997 the Section 529 Plan was created.

529 plans are administered by individual states, and the benefits are many. Individuals in any tax bracket may contribute to a 529 plan. Contributions may be made to any state plan, whether the donor lives in that state or not.

While contributions are permissible to any state plan, some states allow income tax deductions if you contribute to your own state's plan. Furthermore, the beneficiary does not have to attend school

in the state where the plan is administered. For example, the beneficiary of a plan set up in Virginia may use the plan to pay college expenses in any state.

Prior to the Tax Payer Relief Act of 2001, earnings on a 529 plan grew on a tax-deferred basis and were taxed upon withdrawal. Now, qualified withdrawals from a 529 plan are tax-free. Many plans also allow funds to be used not only for tuition, but also for room and board, books, and other qualified expenses. The plans may be used to pay for post-graduate education and vocational schools as well.

Under current law, an individual may make a tax-free gift up to \$11,000 each year to another individual. Section 529 plans regulations allow a donor to use up five years of this annual exclusion by making a \$55,000 contribution in one year and up to \$250,000 over the life of the plan. By being able to make large contributions, a donor may be able to reduce his taxable estate and provide a tax-wise method for helping fund college expenses.

While contributing to a 529 plan is an excellent way to reduce your taxable estate, the donor does not give up control of the funds. Beneficiaries may be changed at any time, for any

reason. If the beneficiary of a plan decides not to attend college, the donor may simply change the beneficiary. In fact, a plan may be established for the benefit of any individual, not just a relative, including the donor himself.

The outstanding tax advantages of the 529 plans seem to far outweigh the limitations. If funds are withdrawn from a plan but not used for qualified educational expenses, you will pay taxes on the earnings and also be hit with a 10% penalty on those earnings. Investments are presently limited to mutual funds, and selections may be changed only once per year.

529 college saving plans are a great way to help fund a college education, while getting some very significant tax and estate benefits in the process. These plans are truly a win-win situation for the donor and especially the college bound beneficiary. The 529 plans are a relatively new savings vehicle and seem to be gaining popularity.

If you would be interested in learning more about these plans and their benefits, please let us know.

—Watt Dixon

INVESTMENT OUTLOOK

Review and Outlook Continued

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valuations and higher oil prices. We are likely to see an extended period in which the market follows a cycle of rally and decline without great progress in the major indices. Careful stock selection and willingness to take profits will become more important than ever.

It is unlikely that technology stocks will fare well without a dramatic turnaround in demand and profitability. Technology stocks as represented by the NASDAQ Composite continue to struggle. Every modest advance is met with sharp selling. Demand for many companies' products and services remains weak, and the unwinding of the speculative bubble has yet to run its course. It may be a number of years before many of the former high-flying tech stars return to investor favor.

-Whitney Brown

WHITNEY BROWN NEW PARTNER

C. Whitney Brown, Jr. has become a principal of Dixon, Hubard & Feinour, Inc. Whitney came to DH&F in 1998 and was promoted to vice president in 2001. His primary responsibilities are in equity analysis and portfolio management.

Whitney recently earned the Chartered Financial Analyst designation. The CFA is widely recognized as the premier professional achievement in the investment management industry. He earned his undergraduate degree at the University of Virginia and his MBA at the University of Chicago.

In keeping with the tradition of Dixon, Hubard & Feinour, he is active in community affairs. Originally from Memphis, he is married to the former Ellen Hagan of Roanoke, and they have two children.

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