

## DIXON, HUBARD & FEINOUR, INC.

INVESTMENT COUNSEL

601 S. Jefferson Street, Suite 410  
 Post Office Box 2768  
 Roanoke, Virginia 24001-2768  
 Telephone (540) 343-9903  
 Fax (540) 343-7684  
 www.dhfinc.com

### SUMMARY

- Stocks down sharply in second quarter.
- Investors nearing pessimistic extreme.
- Possible cyclical upturn at hand.
- Economic recovery under way; inflation in check.

### SECOND QUARTER 2002 REVIEW AND OUTLOOK

In the second quarter of 2002, stock investors found out that the bear market hadn't finished ripping their portfolios and confidence to shreds. The neutral performance of the first quarter turned out to be the bear just taking a breather before stomping more air out of the great stock bubble of the late nineties. Investors who steered clear of large cap growth and tech stocks fared better, but, really, there were few safe havens among stocks. The performance of the major market averages is summarized in the table above, and it is not good reading.

The egregious behavior of corporate officers at the likes of Enron, Global Crossing, Adelphia, Tyco, and WorldCom has given investors reason to feel like a bunch of patsies. Skepticism is running high. No one knows where the next accounting scandal will come from, only that there will be many more. Good news of growth in the economy and rebounding corporate profits is being ignored or

#### Year 2002 Stock Market Performance

|                              | Second Quarter | Year to date |
|------------------------------|----------------|--------------|
| S & P 500                    | -13.7%         | -13.8%       |
| Dow Jones Industrial Average | -11.2%         | -7.8%        |
| NASDAQ Composite             | -20.7%         | -25.0%       |
| Morgan Stanley EAFE          | -3.3%          | -2.8%        |

getting a negative spin. The dollar is weakening against foreign currencies. The situation in the Middle East remains intractable, and Osama Bin Laden is still unaccounted for. Experts generally agree that there is no positive catalyst on the horizon to get the markets up and going again.

Thank goodness! Extremes in sentiment usually mark turning points in the market. Just as the bear market struck when everyone thought Cisco and

*(Continued on page 2)*

**Second Quarter 2002 Review and Outlook (continued)**

*(Continued from page 1)*

its brethren growth stocks would grow to the sky, a bull market is likely to kick up when least expected. Admittedly, any fledgling bull will favor a new crop of leading stocks, not the old ones. There is much technical evidence indicating that the next bull market cycle will be led by consumer-oriented stocks, not capital goods issues, especially technology.

The typical stock has not performed nearly as poorly as the major averages would indicate. A few large cap stocks that are now mostly out of favor dominate the commonly quoted averages. In fact, many stocks have performed well while the market averages have nose-dived. So far this year, smaller company stocks have

outdone the once dynamic but now doddering stars of the past decade. Investors have placed a premium on the tangible reward of dividends and bid up shares of value stocks accordingly.

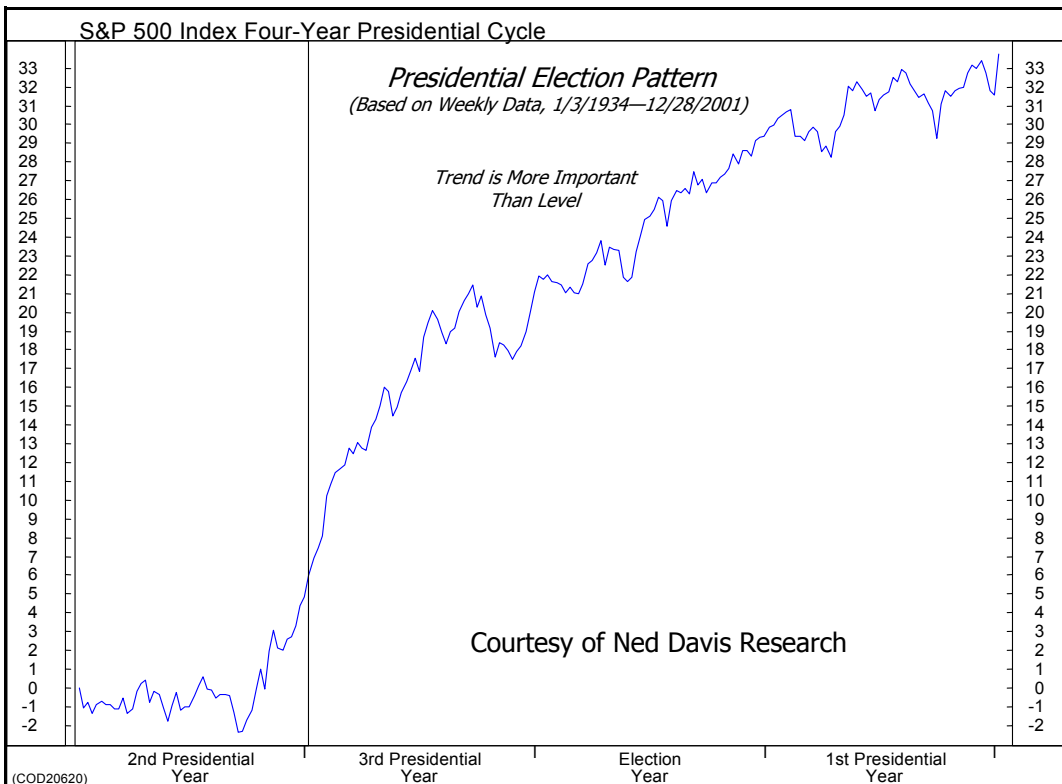
At times like now it is always helpful to step back and try to regain a longer-term perspective. Ned Davis Research has published an analysis of data from 1925 to 2001 comparing the returns on the S&P 500 Index, long-term bonds and T-Bills. The data show that for every consecutive 5-year period the real return on stocks handily beat bonds 75% of the time and T-Bills 81%. For every 15-year period, the odds improved, with the S&P trouncing bonds 92% of the time and T-Bills 90%. For periods of 25 years and longer, stock returns

whipped bonds and T-Bills 100% of the time.

While we recognize that stock investing is a long-term proposition, encouragement for the near-term outlook comes also from Ned Davis Research. Their work has determined that the stock market fluctuates in identifiable cycles of 1, 4 and 10 years. The composite of these cycles indicates that the market should be very close to both a 4-year and a 10-year low. The four-year cycle based on the presidential election year is presented in the chart below. The cycle anticipates a significant low point in the second half of this year followed by a very strong move to the upside.

The stock market is never without risk, and now is no exception. But, the conditions are ripe for a significant cyclical rally. Interest rates are likely to remain low. There is abundant liquidity in the financial system. The U.S. economy is growing at a healthy pace again. The U.S. dollar has eased against foreign currencies, making U.S. goods and services more competitive abroad. Investor sentiment, a contrarian indicator, is approaching a pessimistic extreme. We remain on guard but look forward to a respite from the bear.

—Whitney Brown



## TRUST and Corporate Responsibility

Trust is a word that helps define those qualities such as confidence, honesty, integrity, and reliability that underlie our most basic relationships. Trust is usually subconscious, taken for granted. Deep, abiding trust can't be bought with money.

*Trust is the soul of capitalism, even while self-interest is its heart.*

Attained only with time and experience, it comes free.

The dollar bills in our wallets and purses have no intrinsic value of their own. Their value comes from our trust, based on the promise of the United States government, that they will be readily accepted in exchange for goods and services, which do have intrinsic value.

And only a step or two removed is trust that our monthly bank statement reflects information that also can be easily converted into goods and services – or, of course, into dollar bills, if we wish. We also put the same kind of trust into the plastic card we carry in our wallet.

Trust is the soul of capitalism, even while self-interest is its heart.

Our trust in corporate

America has been badly shaken by a series of revelations beginning last fall with the Enron debacle. Global Crossing, Tyco, Adelphia, WorldCom... details vary, but the story is the same: corporate officers have deceived their shareholders and mismanaged their companies, but gained huge personal fortunes in the process. Not only have billions in shareholder wealth been lost, but also employees by the tens of thousands are losing their jobs – 17,000 most recently laid off at WorldCom, for instance.

Wall Street also has contributed to the decline in trust of corporate America. Investor confidence was dealt a blow by the revelation that Merrill Lynch engaged in deliberately deceptive practices for their own self-interest, promoting stocks to their customers that they privately knew to be poor investments. For this they were fined \$100 million.

The exposure of crooks and rotten apples is only the rankest and most public manifestation of the problem; but our system can deal with this. More pernicious, but less obvious, has been the growing use and acceptance of deceptive accounting practices that corporations have used to

overstate their companies' financial health, often to the great personal benefit of top management. Boards of directors and external auditors have been complacent at best and complicit at worst. The consequences are proving dire

*More pernicious has been the growing acceptance of deceptive accounting practices...*

and may yet become more serious.

Regaining the trust of corporate shareholders now is vital. Extended studies and Congressional inquiries about how the problem developed, who's responsible, and who in leadership positions may or may not have lily-white hands are secondary. Most important now, we need courageous leadership at the very top levels of government and business, to do whatever it takes to reestablish honesty and trust between corporate managers and their shareholders.

We hope the public and our government do not underestimate the seriousness of the issue. Honesty is still the best policy.

—Walter Dixon

## INVESTMENT OUTLOOK

### Bonds for a Smoother Ride

To many investors, bonds lack the pizzazz of stocks. It is usually stocks that get most of the attention in newspapers and on television. Although no one knows with any degree of certainty what the markets will do in the short term, historically over time, stocks have appreciated. Most of the time stocks trend higher, but with more volatile swings in value than bonds.

Accelerating growth and falling inflation are ideal conditions for stocks, while slowing growth and falling inflation are not. Bond prices, however, will perform well in periods of falling inflation and poorly in periods of rising inflation. As a result of these major asset classes responding differently to economic events, stocks and bonds generate different patterns of return. With a combination of stocks and bonds the volatility of a portfolio can be reduced significantly.

Numerous investment studies have shown an investment mix of roughly two-thirds equities to one-third bonds produced the best returns with the least amount of risk. Equity exposure above two-thirds increased potential return. However, risk increased at a much greater rate than the potential return increased. The inverse is true as well. Reducing equity exposure much below two-thirds reduced

risk but potential return was reduced at a much greater rate. Of course, tax considerations often have to be taken into account and can warrant this ratio differing from the optimum.

During bull market cycles, investors often feel as if they can stand volatile swings in a portfolio. After several down years in the stock market, investors will often change their minds as to how much volatility they can actually stomach. This often leads to stock sales at the most inopportune times.

Stock market corrections are normal and healthy for prices in the long haul. A portfolio with the right mix of quality bonds can smooth out the ride by producing a steady stream of income with less risk to principal. At Dixon, Hubard & Feinour, Inc. we begin with the two-thirds/one-third ratio and adjust it depending on each client's individual goals and needs. At times, market conditions may call for some temporary reallocation in favor of stocks, bonds, or cash. This two-thirds/one-third ratio is by no means a set allocation rule, but rather a starting point in determining an appropriate strategy for each investor.

—Watt Dixon

## DIXON, HUBARD & FEINOUR, INC. INVESTMENT COUNSEL

PROVIDING INVESTMENT MANAGEMENT SERVICES FOR ...

INDIVIDUALS & FAMILIES  
TRUSTS & ESTATES  
RETIREMENT PLANS  
ENDOWMENTS & FOUNDATIONS  
BUSINESSES

WALTER M. DIXON, JR., CFA  
W. STEBBINS HUBARD, JR.  
EDWIN R. FEINOUR  
C. WHITNEY BROWN, JR., CFA  
WALTER M. DIXON, III  
JOHN E. GRACE

601 S. JEFFERSON STREET, SUITE 410  
POST OFFICE BOX 2768  
ROANOKE, VIRGINIA 24001-2768  
TELEPHONE (540) 343-9903  
FAX (540) 343-7684  
E-mail: *last name@dhfinc.com*