INVESTMENT OUTLOOK

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 continue decline.
- Economy and markets in transition.
- Defensive portfolio tactics in order.

THIRD QUARTER 2002 REVIEW AND OUTLOOK

Stock prices declined broadly during the past three months, dropping 17%, on top of the 13% decline already experienced during the first half of this year. Toward the end of July 2002 the averages fell below their previous bear market lows, established after the September 11 terrorist attacks of last year. The market then staged a mild rally into late August, at which time selling pressure again increased; and prices fell throughout September.

Partly offsetting the weakness in common stock prices, bonds rose in value, as interest rates dropped to their lowest levels in about forty years. Treasury issues were especially strong, as investors exiting the stock market sought out the very safest and most liquid investments available.

Year 2002 Stock Market Performance

	Third Quarter	Year to date
S & P 500	-17.6%	-29.0%
Dow Jones Industrial Average	-17.9%	-24.2%
NASDAQ Composite	-19.9%	-39.9%
Morgan Stanley EAFE	-20.1%	-22.3%

The decline in stock prices, which began in earnest just after the end of the second quarter, was very broad in scope. Despite the weakness in the first half of the year, there still had been significant pockets of market strength – small and medium sized moderate growth companies, for example – that held their values well, and even gained in many cases. However, there was virtually no place to hide during the past three

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Third Quarter 2002 Review and Outlook (continued)

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months.

In breaking below the September 2001 lows, a resumption of the long-term bull market that began back in 1982 appears in jeopardy. A strong case can be made that the bull market peaked in March 2000, after a particularly dramatic five-year blow-off run from 1995 to 1999.

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Since autumn of 2000 we have been taking steps to reduce overall risk in portfolios. These measures have included increasing cash reserves moderately by sales of stocks, adding to the bond holdings in balanced accounts, and gradually shifting out of the former leaders of the late '90s into less widely held small and middle sized issues of good financial quality. We have proceeded in small steps spaced out over an expanded time frame, increasingly in the belief that the investment markets, as well as the economy, were going through a significant transition phase. These measures were effective in dampening losses, especially so for portfolios in which capital gains taxes were not a consideration.

The extreme weakness of the last quarter may be setting the stage for a significant rally in stock prices that will recover a portion of the loss. As discussed elsewhere in the Investment Outlook, seasonal influences that historically have been favorable for the market are fast approaching. However, much damage has been done, both to stock prices and especially to investor confidence; and much repair work is needed before we return to the glory days of the 1980s and '90s.

From 1982 to 2000 a simple approach of buying and holding high quality growth stocks was the most effective strategy. Holding on to good stocks and riding out short-term bear markets was the proper position to take. However, if now we are in a long-term bear market, a continuation of buy-and-hold would, no doubt, produce continuing losses. Trying to ride out a long-term bear market may not be an attractive alternative.

We believe that our economy and the stock market still are in a transition period; and while so, preservation of capital should be our primary objective. We are continuing to reduce risk, increase liquidity, and to put portfolios in position to take advantage of better buying opportunities when they develop.

We recognize that our caution ultimately might prove to have been unnecessary. If so, we still will be well positioned to take advantage of new investment opportunities. The future stock market leaders, when they emerge, will almost certainly not be those of the previous bull market. And, it would be most advantageous to have a plentiful supply of cash and short maturity bond reserves available for these new opportunities.

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Throughout the twentieth century, selling America short was a loser's game. We have no doubt that it still is a loser's game. While we are cautious for the next year or so, we fully expect our economy, our financial markets and our democratic system of government to adapt and prosper. —Walter Dixon

Favored Season for Stocks Draws Near

There are currently many negative forces working against stocks. With earnings remaining lackluster, corporate scandals erupting, and war with Iraq a possibility, stocks continue to trend down. While all of these factors are not good for stock prices, the unraveling of the stock market bubble of the late 1990s continues to be the underlying theme of the stock market woes.

Despite the negative forces, two bullish patterns that will soon converge have produced stock market gains in the past. We are approaching the 6 month period of November-April, which has far and away produced better returns for stocks than the May-October period.

According to a recent article in Barron's, since 1950, the average return for the Dow Jones Industrial Average from November through April is 8.2%. Returns are drastically different for the May-October period with the Dow averaging a return of only 0.4%.

An investment of $10,000 made in the S&P 500 Index during the November-April period beginning in 1950 would have grown by $457,103 through April 2002. That is, anyone who got into the market every November and got out every April 30, repeating this strategy year after year, would have seen such returns.

If the reverse strategy were used – with the investor in the market during May-October periods but out of stocks the rest of the year – the same 52-year period would have generated a loss of $77.

There are several theories why the November-April period is often the best time to invest. They include: portfolio adjustments coinciding with mutual funds' October 31 deadline for registering capital gains; stronger retail sales; year-end bonuses and 401K contributions; and a market bounce from a seasonally weak September.

Another bullish pattern occurs with 2003 being a pre-election year in the four-year presidential election cycle. Pre-election years have historically been very good years for stocks. The Dow has gained 18% on average in each of the years preceding a presidential election. Even more impressive is the 51% average gain since 1934 by the S&P 500 from the mid-term election year low to pre-election year high. Even after the crash of 1929, the S&P 500 produced a gain of 23% from the low in the mid-term election year of 1930 to the high in 1931. The only pre-election year in which this did not pan out was 1939, the start of World War II. The logic behind this pattern is that the people in Washington are trying to make things better before the election process begins.

If these patterns hold true this time around, gains could be less than usual, due not only to a possible invasion of Iraq, but to a burst stock market bubble from which we are still recovering. Investors would agree that any gains in 2003 would be a welcome relief from what we have experienced thus far this decade.

—Watt Dixon

Bonds: Laddering for Diversification

When constructing a portfolio of bonds at Dixon, Hubard & Feinour, Inc. we normally implement a diversification strategy, known as laddering. This entails purchasing an equal amount of bonds, maturing each year over a chosen range of maturities. As bonds mature each year we reinvest in new bonds at the then prevailing interest rates.

If interest rates decline, only a small part of the portfolio is subject to the lower rates while the remainder continues to earn the higher rates, which were purchased before the rate decline. Conversely, if interest rates rise, we will reinvest in bonds with a higher yield.

The bond ladder produces a more stable return by averaging interest rates over time thus reducing the portfolio's sensitivity to interest rate risk. If we invest only in short-term bonds, those least sensitive to changing interest rates, the portfolio would have a higher degree of stability, but a lower yield. Investing only in long-term bonds would result in higher yields, but the price of the bonds is more volatile, exposing the portfolio to losses if bonds are sold prior to maturity.

Predicting future interest rates is every bit as inexact as predicting future stock market returns. A laddered bond portfolio allows us to avoid committing all your capital at a single level of interest rates. This strategy produces a steady stream of interest income, but also helps to protect the portfolio from sharp changes in interest rates, which could reduce the portfolio's total return.

—Stebbins Hubard

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