

INVESTMENT OUTLOOK

SUMMARY

- Stocks pull back.
- Interest rates dip.
- Economy continues to improve.
- Inflationary pressures build.

FIRST QUARTER 2004 REVIEW AND OUTLOOK

by Whitney Brown

The stock market took a needed rest during the first quarter of the year. Momentum from the strong finish last December petered out in January, and stocks spent the balance of the quarter working through the first significant pullback in almost a year. On paper, the major averages finished little changed, but at quarter end appeared to be on the way to resuming their bullish ways.

With stocks on hold, interest rates provided most of the excitement during the quarter. Another bout of economic pessimism, brought on primarily by low job growth and high oil prices, caused rates to dip sharply. The consensus for some time now has been that rates can go only higher, but by early March, revisiting the lows from last June looked like a distinct possibility. That likelihood has passed for now as rates jumped sharply after quarter end on a much better than expected jobs report.

Despite persistent pessimism, the U.S. economy continues to improve. The missing ingredient in the current expansion, job growth, may finally have arrived. The March report was a barn burner and included upward revisions to the January and February figures as well. The lack of job growth has been a considerable flaw in this recovery; and continued improvement would do much to boost business and consumer confidence, thus reinforcing

economic growth.

Corporate profits have been very strong because the economy has been growing while businesses have kept running on lean payrolls and tight cost controls held over from the recession.



Market Measures	1st Quarter		
S & P 500	1.3%		
Dow Jones Industrial Average	-0.9%		
NASDAQ Composite	-0.5%		
Morgan Stanley EAFE	3.7%		
Lehman Bros. Intermediate T-Bond Index	2.9%		
	<u>3/31/04</u>	<u>12/31/03</u>	<u>3/31/03</u>
10 Year Treasury Bond Yield	3.83%	4.25%	3.80%
90 Day Treasury Bill Yield	0.92%	0.90%	1.09%

Businesses have kept inventories low as well. As the economy continues to expand, business will have to loosen the purse strings and spend on payrolls and equipment to keep up with demand. The result will be further reinforcement of the expansion but probably less impressive profit growth.

In general, the economic outlook for the
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First Quarter 2004 Review and Outlook (continued)

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remainder of the year is positive. The Fed is content to keep interest rates low for now and will likely do so until signs of inflation become obvious. The economy suffered a serious deflation scare last year, and the Fed simply will not allow higher interest rates to dampen the strengthening recovery.

Already inflationary pressures are building, especially in commodity prices. Prices for most commodities from soybeans and wheat to gold and oil have been rising for the better part of a year.

The table below illustrates the sharp price increases over the past year for a number of common commodities used in consumer and

industrial goods. Reasons for the price increases vary from supply problems such as poor harvests and capacity constraints to increased demand from a resurgent global, especially Asian, economy. The bottom line is that a lot of things cost much more than they did a year ago. Producers can absorb the higher costs of inputs for only so long before being forced to charge higher prices to consumers.

We have recently commented on rising gold prices. However, oil prices have been particularly worrisome this year, brought to the fore by renewed violence in the hot spots of the Middle East. It is likely that we will need to adjust to a lengthy period of much higher oil prices than we have been accustomed to.

Incremental demand from the booming Chinese economy, along with OPEC quotas and shrinking worldwide reserves, will keep upward pressure on prices.

The stock market should continue to fare well this year. The bull cycle that began in March of 2003 remains intact. Gains will likely not come as easily as last year due to already high valuations and much of the good news already being discounted. Despite the grave geopolitical difficulties in Israel, Iraq and Afghanistan, investors apparently are focused on the improved fundamentals with regard to corporate profits and balance sheets. Considering very low bond yields, an easy money Fed, and near nothing returns on cash reserves, stocks seem to be the more attractive investment for the time being.

Our investment approach since the market peaked four years ago has been marked by both flexibility and caution. We will continue to participate in durable market up trends as they emerge and as long as they endure. But we remain skeptical that all the negative effects of the bitter end to the great bull market from 1982 to 2000 have been fully realized. Just as now is a time to go with the flow and enjoy a rising market, there will come a time when it will be prudent to reduce equity exposure and preserve capital.

Price Increases for Selected Commodities

	Price		Percent Increase
	Current March 31, 2004	One Year Ago March 31, 2003	
Agriculture			
Wheat (U.S. cents/bushel)	417.40	316.40	31.92
Soybeans (U.S. cents/bushel)	983	568	73.06
Corn (U.S. cents/bushel)	302.40	235	28.68
Lumber (U.S. \$/1000 board feet)	376	199	88.94
Pork Bellies (U.S. cents/pound)	107.25	88.73	20.87
Minerals and Metals			
Crude Oil (U.S. \$/barrel)	35.77	31.02	15.31
Unleaded Gas (U.S. cents/gallon)	110.44	90.91	21.48
Gold (U.S. \$/troy ounce)	423.70	334.80	26.55
Platinum (U.S. \$/troy ounce)	903	642	40.65
Silver (U.S. \$/troy ounce)	7.915	4.475	76.87
Aluminum (U.S. cents/pound)	77.30	60.8	27.14
Steel Scrap (U.S. \$/ton)	252.50	107.33	135.26
CRB INDEX	283.77	232.15	22.24

The “Sage of Omaha” Speaks

by Walter Dixon



Warren Buffett’s annual letter to the shareholders of Berkshire Hathaway always is notable for the Chairman’s pithy comments and commentary on current investment opportunities, never more so than now, after a very ho-hum first quarter 2004. Buffett, accountable only to his management team and his shareholders, tells it like it is, for better or worse. Some extracts from this year’s letter written February 27 are worth savoring and digesting (Bold type by us.)

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Common Stock Valuations

“When valuations are similar, we strongly prefer owning businesses to owning stocks. During most of our [thirty-nine] years of operation, however, stocks were much the cheaper choice. We therefore sharply tilted our asset allocation in those years toward equities... In recent years, however, **we’ve found it hard to find significantly undervalued stocks...**

“We are neither enthusiastic nor negative about the portfolio we hold. We own pieces of excellent businesses – all of which had good gains in intrinsic value last year – but their current prices reflect their excellence. The unpleasant corollary to this conclusion is that **I made a big mistake in not selling several of our larger holdings during The Great Bubble.** If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far

higher. So do I.”

Asset Allocation – Stocks, Bonds, Businesses, and Cash Reserves

“We will continue the capital allocation practices we have used in the past. If stocks become significantly cheaper than entire businesses, we will buy them aggressively. If selected bonds become attractive, as they did in 2002, we will again load up on these securities. Under any market or economic conditions, we will be happy to buy businesses that meet our standards....

“In 2002, junk bonds became very cheap, and we purchased about \$8 billion of these. The pendulum swung quickly though, and this sector now looks decidedly unattractive to us. **Yesterday’s weeds are today being priced as flowers.**

“When we can’t find anything exciting in which to invest, our ‘default’ position is U.S. Treasuries... **No matter how low the yields on these instruments go, we never ‘reach’ for a little more income by dropping our credit standards or by extending maturities.** Charlie [Buffett’s long-time partner Charlie Munger] and I detest taking even small risks unless we feel we are being adequately compensated for doing so. About as far as we will go down that path is to occasionally eat cottage cheese a day after the expiration date on the carton.

Our capital is underutilized now, but that will happen periodically. It’s a painful condition to be in – but not as painful as doing something

stupid. (I speak from experience.) ...”

Corporate Governance

“In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren’t encouraging....

“Overreaching by CEOs greatly accelerated in the 1990s as compensation packages gained by the most avaricious– a title for which there was vigorous competition – were promptly replicated elsewhere. The couriers for this epidemic of greed were usually consultants and human relations departments, which had no trouble perceiving who buttered their bread. As one compensation consultant commented: ‘There are two classes of clients you don’t want to offend – actual and potential’.”

Derivatives

[Berkshire Hathaway is unwinding the derivatives positions inherited with the purchase of General Re, a major reinsurer, several years ago.]

“If our derivatives experience – and the Freddie Mac shenanigans of mind-blowing size and audacity that were revealed last year – makes you suspicious of accounting in this arena, consider yourself wised up. No matter how financially sophisticated you are, **you can’t possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions.** Indeed, the more you

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The "Sage of Omaha" Speaks (Continued)

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know about derivatives, the less you will feel you can learn from the disclosures normally proffered you. In Darwin's words, 'Ignorance more frequently begets confidence than does knowledge.'

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Our current thoughts...

Overvaluation of common stock prices, by itself, does not send the market lower. In fact, stocks can remain overvalued or undervalued for years at a time. Our studies of the stock market show few signs that this current bull cycle is tiring; and we expect continued strength, despite overvalued stock prices, into the year-end.

Despite the nearly universal expectation that interest rates are heading higher, and therefore bond prices lower, our examination of bond prices is far from conclusive. The major trend of interest rates is still down, although there has been some backing and filling for the past six months or so. Such consolidations usually are preludes to significant moves, either up or down, but in which direction is unknowable in advance. We will "go with the long-term flow" – which for prices is still up – until the direction changes.

A final question...Who feels comfortable betting *against* the "Sage of Omaha?"

DH&F Welcomes David A. Camper

We are pleased to announce that David A. Camper joined our firm on March 1st as Vice President of Sales.



For the past twenty years, David has specialized in employee benefit sales, investments and 401(k) administration at a variety of local financial institutions, including Dominion Bank, Central Fidelity, and most recently, Thomas Rutherford, Inc.

A graduate of Roanoke College with a degree in Business Administration, David is married to Libby and they have three daughters. Both David and Libby are Roanoke natives.

David is involved in many charitable and civic organizations. He is currently the President of Habitat for Humanity in the Roanoke Valley; and serves as Vice-Chair of both Apple Ridge Farms and CHIP (Child Health Investment Partnership).