

INVESTMENT OUTLOOK

SUMMARY

- 2003 rewards equity investors.
- Three consecutive quarters of stock gains.
- Interest rates in limbo.
- Economy gains ground.

YEAR END 2003 REVIEW AND OUTLOOK FOR 2004

by Whitney Brown

During the fourth quarter, blue chip stocks took a turn in the driver's seat as the Dow Jones Industrials relieved the NASDAQ as the leading index. The broad market worked higher throughout the quarter and finished very strongly in December. The fourth quarter of 2003 marked the third consecutive quarter that stocks delivered positive gains, an experience that investors have not enjoyed in over four years.

The year as a whole proved very rewarding for equity investors. For the first year since 1999, stocks offered positive returns. And, we're not talking about paltry single digits either! Returns of 25% or better on the major market averages take us back to the bubble days of the late 1990's.

Contrary to popular expectations, interest rates failed to follow NASA to Mars. In fact, they spent most of the quarter in a narrow earth bound trading range. Even for the year, despite a dramatic summertime plunge and recovery, ten-year Treasury rates finished only a little higher than where they started. The Fed's ongoing campaign to reflate the economy through ultra-low short-term rates has held down the longer rates as well. Also, economic uncertainty, if not downright skepticism, has helped the Fed keep the lid on.

The present stock market rally sprang from the depths of worry over war in Iraq last March. The SARS epidemic and soaring gasoline prices gave it no pause. A jobless economic



Market Measures	4th Quarter	Year 2003	
S & P 500	11.6%	26.4%	
Dow Jones Industrial Average	12.7%	25.3%	
NASDAQ Composite	12.1%	50.0%	
Morgan Stanley EAFE	16.8%	35.3%	
Lehman Bros. Intermediate T-Bond Index	-0.2%	2.2%	
	<u>12/31/03</u>	<u>9/30/03</u>	<u>12/31/02</u>
10 Year Treasury Bond Yield	4.25%	3.94%	3.82%
90 Day Treasury Bill Yield	0.90%	0.92%	1.17%

recovery and a return to massive Federal budget deficits proved no match. The mushrooming scandal in the mutual fund industry simply has had no impact.

Behold the power of fiscal and monetary stimulus. The \$350 billion Bush tax cut coupled with aggressively easy Federal Reserve policy is strong

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Year End 2003 Review and Outlook for 2004 (continued)

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medicine for what ails the economy and the stock market. As long as interest rates remain unusually low and corporate earnings and dividend payouts continue to improve, stocks are the relatively more appealing investment. When the difference between the yield on bonds and the earnings yield on stocks is small, investors perceive that the risk of owning stocks is worth taking. Absolute measures of value such as the price-to-earnings ratio can be disregarded for the shorter term.

At least for the first part of 2004, we can expect stocks to continue their winning ways. The ongoing market advance continues to have very good breadth. That is to say, across the universe of stocks, participation in the rally is

broad. The usual signs that a market advance may be topping out have not yet emerged.

Additionally, the Fed has all but sworn to keep monetary policy easy until the economy shows signs of entering a self-sustaining expansion. The Fed actually would like to see inflation pick up as a margin of safety against deflation. There are signs emerging such as rising commodity prices that indicate inflation may be taking hold. Gold, perhaps the most well-known inflation hedge, has broken a twenty-plus year down trend in price and continues to hit new multi-year highs. Please see the chart below of gold and other precious metals prices.

It is possible that later this year, if business spending increases as desired, longer term interest

rates could begin to rise in earnest. The extent of Federal borrowing needed to finance the deficit may put businesses, consumers and government in competition for funds, thus bidding rates higher. There are other reasons why we could expect higher interest rates, but we also have to be aware that their direction has a history of defying popular expectations.

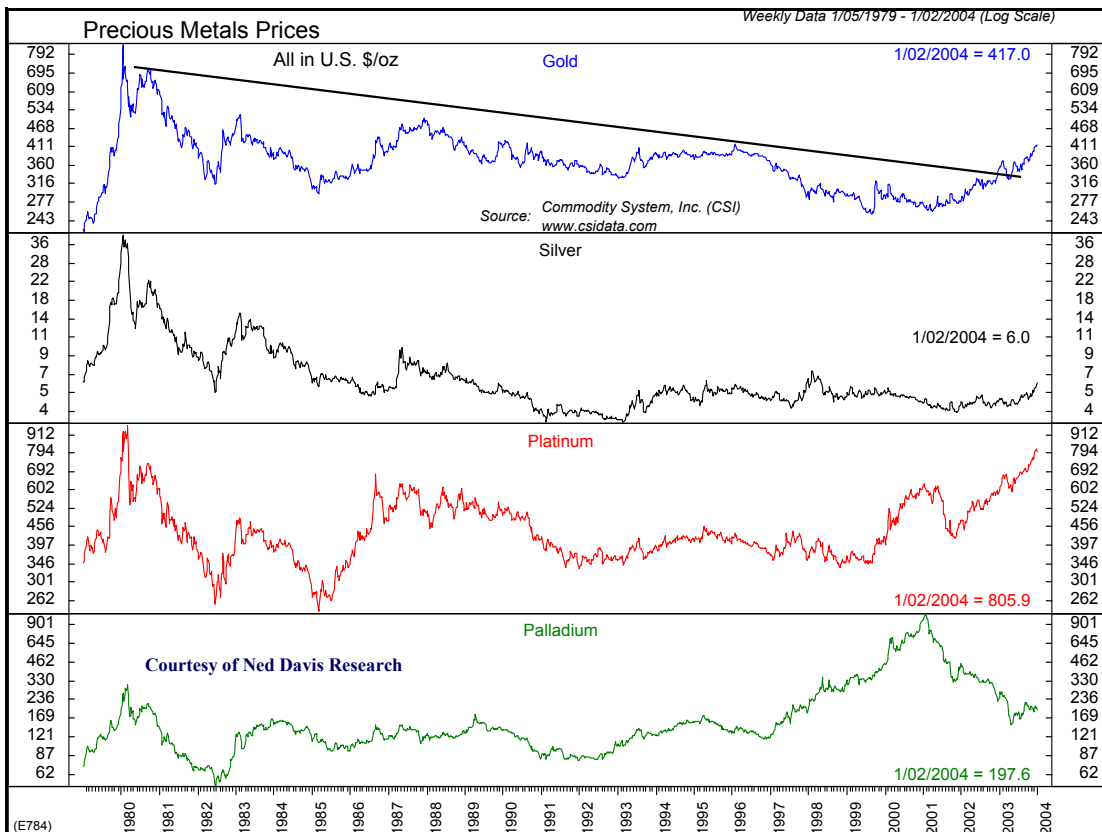
Although the year-end momentum of stocks will likely carry through to 2004, the market is more than due for a correction of some consequence. Since the rally began last March, the S&P 500 has yet to experience a pull back of even 5%.

A flexible approach in the months ahead will allow us to continue to participate in the ongoing bullish cycle while remaining wary of a renewed market decline.

The long-term record strongly suggests that further decline and consolidation of the stock market will be necessary before a long-term bull market can begin anew.

While the consensus view calls for higher interest rates, our view recognizes that rates could operate in a trading range for some time preparatory to further movement either up or down. Higher rates would be a welcome change for income investors.

Best wishes for good health and happiness in 2004.



A HIGH QUALITY INVESTMENT PORTFOLIO

by Walter Dixon



Investment Rule No. 2:
Maintain a high quality investment portfolio.

Last quarter we discussed our first investment rule, which is: Invest *with* the long-term price trends of the securities markets, not *against* them. Long-term we defined as 15+ years; and we discussed where we think we are today in the these equity and fixed income cycles.

Our second rule, of only slightly less importance than the first, is to maintain a high quality portfolio. What exactly do we mean by “high quality”; and why is this important?

High quality to us implies reduced risk: reduced risk of a substantial loss of capital lasting a long time, long enough to be considered permanent.

Investment quality for equity securities is measured by a company’s financial strength and by characteristics of its common stock, relative to other companies.

- **Financial strength** includes various accounting ratios, such as profit margins, cash flow, earnings and sales growth predictability, financial leverage, return on capital and on equity, and interest coverage. It also includes judgments about accounting methods.
- **Common stock characteristics** also are important since, after all, we are buying the *stock*, not the *company*. Factors we consider are the historic stability of the stock price relative to other issues, how a company’s stock price has performed year-by-year compared

to its peers, and its trading liquidity.

- Finally, more **qualitative factors** are considered: company size, geographic diversification, management and its focus, reputation within its industry and the investment community, its competition.

These factors, and others, are included in published ratings by Standard and Poor, a subsidiary of McGraw-Hill, and Value Line, Inc.; and we use these ratings to supplement our own research in determining the quality of equity investments. Investment quality of our clients’ equities is well above average: around the 80th percentile.

In **fixed income portfolios** we utilize extensively the quality ratings of Standard & Poor, Moody, Fitch, and A. M. Best for most corporate and municipal issues. Combined with Treasury issues, we maintain a strong Aa quality average in fixed income portfolios. However, we do not buy issues rated lower than Moody’s Baa (BBB by S&P), which is generally considered to be the lowest investment grade.

Investment quality also relates to **portfolio diversification**, both *between* major asset classes, as well as *within* them. (For example, a portfolio consisting of only two stocks – Proctor & Gamble and Home Depot, for instance -- would hardly be considered a high quality portfolio, even though both companies are very high quality.)

Diversification *between* stocks and bonds, as major asset groups, is determined primarily by financial objectives of the portfolio, the willingness of the portfolio

“owner” to assume specific risks, and finally by the long-term outlook for the stock and bond markets. Statistically, during the 20th century a portfolio invested about two-thirds in equities/one-third in bonds produced the best return for the least amount of risk. It is from this “default” position that we apply the other determinants in arriving at appropriate stock/bond ratios for most portfolios.

Diversification *within* the two major asset groups is appropriate to dampen the effect of unexpected losses of principal related to specific events. Again, using the lessons of the past century, it seems that twelve common stock issues are the least number necessary to get appropriate diversification. Increasing the number of issues beyond twelve continues to lessen risk, but it may not be worth the additional transaction costs. At least, that’s been the theory.

In practice, we have found that a number greater than twelve is useful in mitigating potential portfolio loss in a volatile, quick-reaction environment such as has developed since the mid-1990’s. Also, transaction costs continue to decline, making further diversification not so expensive as before. In recent years we have used a range of 15-30 issues in equity portfolios, which seems very manageable.

Within bond portfolios we usually have not invested more than 5% of the total portfolio in the securities of any one issuer, except for the U. S. Treasury and its affiliates and most states and their affiliates. However, over the years there has been a long-term decline of

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A High Quality Investment Portfolio (Continued)

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general investment quality, producing numerous downgrades in ratings. Despite historically low interest rates, we do not believe it appropriate to “stretch” for yield by buying lower quality bonds, as many investors have done.

And finally, why do we think it important to maintain “high quality” portfolios? After all, so the theory goes, returns are proportionate to the risks assumed: the higher the risk, the greater potential for above average return. Admittedly, our reasons are mostly subjective.

Our experience has been that unexpectedly good things happen more often to high quality companies than to low quality companies. Not only does success seem to breed success, it also makes intuitive sense that a company having good financial resources can more quickly take advantage of new opportunities.

Also, it seems that what few buyers there are at the bottom of a long bear market are looking for high quality, not high risk. For that reason stocks of high quality companies seem to hold better in bear markets and move up first when the market starts to recover. (We also sleep better, knowing that our clients have high quality portfolios.)

Putting investment rules 1 and 2 together: **We go with the long-term flow of the markets, using high quality securities in high quality portfolios.**

Client Corner by Jonathon Grace 2003 Tax Reporting



As you begin the preparation of your 2003 individual income tax returns, please bear in mind that you will receive Form 1099 tax summary information directly from your custodian. (Your custodian is required also to send a copy to the IRS.) These reports, along with your monthly custodian statements, should be forwarded to your accountant.

Because of significant and complex tax law changes enacted last year, especially regarding the treatment of dividend income, it is likely that providers of Form 1099 will be making corrections after the January 31st deadline. While it is important to get your information to your accountant in a timely fashion, there may be filing delays or the need to amend tax returns as a result of corrected Form 1099 information.

As in past years, we gladly will provide additional, or supplemental, info to you or your accountant to assist in the preparation of your returns. We can be especially helpful in furnishing cost basis data and acquisition dates for securities sold during the year. Not all custodian statements reflect cost basis data.

Please ask your accountant to call Jean ReMine, our Tax Reporting Specialist, at 343-9903 for prompt attention and service.