

INVESTMENT OUTLOOK

First Quarter 2006 Review

By Whitney Brown

- Stocks advance.
- Interest rates up.
- Oil prices remain high.
- Bull cycle aging.



Stocks made good progress in the first quarter of the year. Markets moved steadily higher both in the U.S. and abroad. Several productive investment themes of the past year or two are still delivering good returns.

Oil, industrial, materials and foreign stocks continue to push higher.

As stocks quietly grind ahead, investor attention seems more focused on oil prices and interest rates. Addressing the latter topic first, longer term interest rates such as the yield on the ten-year Treasury bond moved up sharply throughout the quarter and now are at levels last seen two years ago. One catalyst for higher rates seems to be a tightening in the labor markets. Recent data point toward lower levels of unemployment and upward pressure on wages. So far inflation, outside of energy costs, is still under control. But, rising labor costs are usually a harbinger of more inflation and therefore cause for concern.

The Federal Reserve has given little indication that an end to short-term rate hikes is at hand. That's a vote of confidence for the strength of the economy, but begs the question of how high

<u>Market Measures</u>	<u>1st Quarter 2006</u>		
S & P 500			3.7%
Dow Jones Industrial Average			3.7%
NASDAQ Composite			6.1%
Morgan Stanley EAFE			9.2%
Lehman Bros. Intermediate Gov't Bond Index			-0.3%
	<u>3/31/06</u>	<u>12/31/05</u>	<u>3/31/05</u>
10-Year Treasury Bond Yield	4.86%	4.39%	4.50%
Three-month Treasury Bill Yield	4.63%	4.08%	2.79%

rates can get before they really start to drag the economy down. Many worry that the Fed will overdo the increases and push the economy into recession. We are already seeing a softening in the housing markets; and with so much spending financed by debt, consumers may soon begin feeling pinched. We can hope that the recent rise in longer rates will have a moderating effect on the economy and keep the Fed from putting too much pressure on short-term rates.

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May All Your Mistakes Be Small

By Whitney Brown

Ned Davis, founder and Chief Investment Strategist of the preeminent independent investment research firm bearing his name, recently wrote, “All investors make mistakes, and the difference between the winners and losers is that losers make big mistakes while winners make small mistakes.” That bears repeating: the difference between winning and losing at investing is not whether you make mistakes or not but rather how small your mistakes are. It’s very humbling but true.

A look back at the past ten years of stock market returns from 1996 to 2005 gives us a perfect opportunity to put Ned’s wisdom to the test. Let’s consider large cap growth stocks which were the “must own” stocks of the late nineties. They will be represented by the S&P 500/Barra 500 Growth Index. Now let’s consider small cap value stocks, the polar opposite of large cap growth. They’ll be represented by the Russell 2000 Value Index. The table below gives the year by year returns for each type of stock as well as the cumulative and average returns for the ten year period.

Year	Return (%)		
	Large Growth	Small Value	
1996	24.0	21.4	
1997	36.5	31.7	
1998	42.2	-6.5	
1999	28.3	-1.5	
2000	-22.1	22.8	
2001	-12.7	14.1	
2002	-23.6	-11.4	
2003	25.7	46.0	
2004	6.1	22.3	
2005	3.5	4.7	
Cumulative Return (%)	121.3	241.7	353.9*
Average Return (%)	8.3	13.1	16.3

*The ‘small mistake’ investor switched from large cap growth (yellow) to small cap value (green) in 2001. Making the change boosted the cumulative return to 354%.

Large cap growth stocks delivered phenomenal returns from 1996 to 1999; however, those same stocks were sold heavily from 2000 through 2002 and have yet to lead the market again. During the same ten years small cap value stocks started out lagging the market and actually lost money in 1998 and 1999. By 2000 the tables had turned and those same stocks led the market for 5 out of the 6 years from 2000 to 2005.

A ‘big mistake’ investor who bought large cap growth stocks in 1996, as many did (some got in even later as the market continued to surge through the late nineties), and held them throughout the ten-year period would have around a 120% cumulative return for the ten years or 8% annual average. That doesn’t sound too bad until you consider the ‘small mistake’ investor. That investor bought the large cap growth stocks in 1996 but realized it would be a mistake to keep holding after the first big down year of 2000 and switched to small cap value for the rest of the ten-year period. That investor would have a cumulative return of over 350% or 16% annual average.

Our example is basic, not taking into account the expense of switching such as capital gains or transaction costs. But, the difference between 350% and 120% would cover those costs many times over. In addition we recommend diversifying among several different types of stocks and other asset classes, although many investors fail to do so.

We would not advise switching at minor trend changes on a weekly or monthly basis, but only at major trend reversals that occur every several years. The significance of a reversal of a multi-year trend cannot be overstated. The ensuing counter-trend process of correction and consolidation frequently lasts as long as the prior trend itself and can result in substantial loss. The same characteristics apply to individual securities as well as broad market averages.

This simple analysis drives home the point that a buy-and-hold strategy works as long as what you’re holding is going up. When it starts moving the other way, you can easily let a small mistake turn into a big one. Be flexible, and may all your mistakes be small.

Coming Up Short by David Camper



This month, The Employee Benefit Research Institute (EBRI) released findings from the 16th annual Retirement Confidence Survey (RCS) reminding many of us that

American workers may not be adequately saving for retirement. Curiously enough, the report indicates that American workers continue to express a fair degree of confidence concerning their financial prospects in retirement.

The overall report findings indicate that many are not ready to undertake the task of financial planning for their own retirement and as a result, face the prospect of having to work far longer than they expect. As retirement will make up a significant proportion of most people's lives, why are people

neglecting to prepare for it?

Workers may be overestimating their prospects for a financially secure retirement. Of workers surveyed indicating they were very confident they will have enough money for a comfortable retirement, consider the following: 1) 22% are not currently saving for retirement; 2) 39% have less than \$50,000 in savings; and 3) 37% have not done a retirement needs calculation

Additionally, workers may fail to understand how much money is needed to have a comfortable retirement. Many of the respondents would like to maintain or better their lifestyle in retirement years, yet half of the survey participants think they can live comfortably with 70% of their pre-retirement income or less. However, a study conducted by Aon Consulting in conjunction with Georgia State University illustrates workers will need between 75-89% of their pre-retirement

income (varies with income level).

Employer sponsored retirement savings plans, such as 401(k)'s play a critical role in encouraging retirement savings. Employers must promote retirement savings now more than ever. Employees need access to education materials that are easy to understand and a plan design that promotes diversification among asset classes without overwhelming individuals. Employers need accessible retirement plan specialists capable of providing investment advice to their workforce.

Dixon, Hubard & Feinour, Inc.'s new Retirement Plan Services area assists employers with the development of wealth accumulation programs tailored to meet the needs of their workforce. Building on our investment expertise and commitment to client service, we are now able to offer our services to employers throughout the Roanoke Valley and Virginia.

REITs by Ted Feinour



During the latter half of 2005 and for the first quarter of 2006, real estate stocks have continued to rally. Real Estate Investment Trusts (REITs) have continued to outperform the stock market. REITs are investment companies that specialize in commercial real estate and whose shares trade on major stock exchanges. For this year, the Dow Jones Equity REIT Index is up nearly 13% compared with a gain of 4% for the Standard & Poor's 500 Index.

The increase in REIT prices, although surprising, is driven by mutual funds and other big investors who are interested in the recent improvements in the outlook for almost every sector, especially hotels, self storage, and office properties. This phenomenon is not limited to the

United States since the increased capital flows have truly occurred worldwide. U.S. companies are investing in global real estate and non-U.S. companies are investing in U.S real estate markets.

Rising interest rates are certainly a concern for real estate investors and mean increasing borrowing costs for real estate companies. Interest rates, however, are still historically low, and at present levels are more of a concern for residential buyers than in the commercial property area. A rising rate environment usually indicates an improving economy, which helps REITs in the form of lower building vacancies, higher rents, and other revenue increases.

2006 should continue to be a favorable environment for REITs with solid but slower economic growth, improving corporate real estate fundamentals and fair valuation levels. We feel REITs will continue to deliver strong results in well diversified portfolios.

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First Quarter 2006 Review (continued)

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Oil prices pose another potential threat to what is a more or less benign economic and investment climate. To date, the high for crude oil of \$70 per barrel came in the immediate aftermath of Katrina and has not been topped since. Sharp rallies in January and March fell successively short of the mark. While supplies seem plentiful, the current prices carry a premium for geopolitical instability. Recent news from the Middle East, Venezuela and Nigeria, all major oil-producing regions, does not give much hope that oil prices could move substantially lower any time soon. The economy is coping well with the higher crude prices, but a serious supply disruption could spell trouble.

Looking ahead toward summer and beyond, there are some signs of fatigue in the current bull market for stocks. The cyclical uptrend we are experiencing began well over three years ago and is

long in the tooth by historical standards. While the major averages are making multi-year highs, fewer stocks have been participating in each successive rally. The well-established four-year market cycle also anticipates significant market weakness sometime during the mid-to-late part of this year followed by strength through year's end and into next year. Unfortunately, we can't know with any useful precision the timing or extent of any market correction.

Still, the burden of proof lies with the bears. It's a bull market until proven otherwise, and what is anticipated need not come to pass, at least not yet. The bond market should remain fairly dull with shorter maturities offering the better tradeoff between risk and reward. We will continue to explore areas of strength in the market and stay away from the weak spots.