

INVESTMENT OUTLOOK

Third Quarter 2010 Review and Outlook by Whitney Brown

- ◆ Stocks up in the third quarter.
- ◆ Economic recovery slowing.
- ◆ Low bond yields support stocks and commodities.
- ◆ Stocks may benefit from seasonal and election year influences in the 4th quarter.

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Stocks put together a very convincing rally in September. The market finally broke out of a limited trading range lasting nearly five months. Economic news since the first quarter has varied from awful to merely disappointing, but the market has managed to hold on. Weak, but stabilizing, readings for most economic indicators have quieted much of the summertime chatter about a double-dip recession, and with its recent breakout, the stock market appears to be anticipating a sustainable period of slow growth.

For the quarter, most major market averages advanced on the order of 7-10% with most of the gains coming in September. Certain narrower indexes such as midcap stocks, emerging markets and commodities fared even better. Gold actually hit an all-time high above \$1,300/oz., it too breaking loose from the summer doldrums. For the year as well, all of the popular market indexes are positive again after giving up a lot of ground in the spring.

There is little doubt that prices of riskier assets like stocks and commodities have benefitted from low bond yields. The Federal Reserve has kept the federal funds target rate near zero for almost two years now and does not anticipate raising it any time soon. The Fed has recently driven longer dated Treasury bond yields back down to historic lows by disclosing the intent to buy those securities in large numbers, a process referred to as quantitative easing. With such meager returns available from Treasury securities, investors are forced to seek return from riskier assets.

Economic recovery in the developed world still seems tentative while growth in developing countries is more encouraging. Financial markets have been nervous, reacting weekly to the latest economic data offering either glimmers of hope or more disappointment. Bonds offer little value relative to stocks, and commodities have the wind at their back as the dollar resumes its long-term decline.



October has a well-deserved reputation for delivering some nasty stock market setbacks, and we can't rule out another round of selling after the sharp rally in September. At the same time, the equity market shows signs of firming and never really behaved as poorly over the middle part of the year as the financial headlines would have suggested. Favorable seasonal influences, an election year boost, and six months of correction behind us support the bullish case that 2010 can end on an upswing.

<u>Market Measures</u>	<u>3rd Qtr</u>	<u>YTD</u>	
S & P 500 (price)	10.7%	2.3%	
Dow Jones Industrial Average	10.4%	3.5%	
NASDAQ Composite	12.3%	4.4%	
Russell 2000	10.9%	8.1%	
MSCI EAFE	15.8%	-1.3%	
Barclays Capital Inter US Gov't/Credit Bond Index	2.8%	7.4%	
	<u>9/30/10</u>	<u>12/31/09</u>	<u>9/30/09</u>
10-Year Treasury Bond Yield	2.52%	3.84%	3.32%
Three-month Treasury Bill Yield	0.16%	0.05%	0.12%

Cost Basis Reporting

by Jonathon Grace



The Emergency Economic Stabilization Act was signed into law in October 2008. One provision of the law will affect how clients compute gains or losses on the sale of stocks and other securities. The cost basis reporting requirement is a provision of the so called “bailout bill.” It came about due to IRS studies that showed that billions of dollars in potential tax revenue were going uncollected due to incorrect reporting of investment income and losses. In particular, the study identified the underreporting of gains due to inflated cost basis.

The new law requires custodians (banks and brokers) to include adjusted cost basis on annual 1099 reports to taxpayers and to the IRS. Previously, 1099s have only reflected proceeds for the sale of securities, leaving it up to the taxpayers and their accountants to determine the cost basis and report gains or losses on their 1040 income tax returns. Please note that the law does nothing to change how cost basis is calculated—only that it must be reported.

Even though banks and brokers have known about the law for two years, preparedness is coming right down to

the wire. Cost basis reporting will be required for all stocks purchased starting January 1, 2011. One year later the law will expand to include mutual funds and dividend reinvestment plans. The year after that, all other covered securities, including fixed income, will require cost basis reporting on 1099 reports.

While the brunt of the law will be borne by banks and brokers—those who actually issue the 1099s—it will also impact investment advisory firms such as DHF&B. We have historically provided cost basis information to our clients or their accountants upon request. However, this data may not have always agreed exactly with the cost basis maintained by the custodian. Differences can arise if corporate actions are handled differently and if the closing method (e.g. highest tax cost, lowest tax cost, First In First Out [FIFO]) is not the same. In the future, however, the cost basis maintained on DHF&B’s portfolio accounting system will need to be reconciled with custodians’ records or questions will ensue at tax time. We will also be responsible for communicating, by settlement date of any sale, the lot closing method. The days of waiting until tax time to choose an advantageous closing method are coming to a close.

Build America Bonds

by Watt Dixon



In an attempt to help stimulate economic growth, Congress has created Build America Bonds (BAB’s). First issued in 2009, BAB’s are municipal bonds issued by state and local governments. Unlike traditional tax-free municipal bonds, the interest on these BAB’s is taxable. In a portfolio where current taxes are a consideration, these BAB’s may not be attractive because of the tax owed on the interest. However, in portfolios where taxes are deferred, such as an IRA, these bonds become viable investments.

BAB’s were created to help cities issue new bonds. The Federal government is picking up 35 % of the interest. If the interest on a BAB is 7%, the cost to the issuer is only 4.55%. Of course, the investor receives the full 7%. Over \$120 billion of these bonds have been issued. By law, the money raised must be used to fund construction projects, thus fulfilling the goal of stimulating the economy by creating jobs.

While the U.S. government has a role in subsidizing these bonds, payment of interest or principal is not backed by the government like that of a US Treasury Bond. Many BAB’s carry ratings by Moody’s and S&P just like the traditional munis do.

BAB’s are not without their critics. Some fear that the government could suspend or do away with the 35% subsidy. Also, some people feel that cities and states should not be borrowing in tough economic times. They feel that these government subsidized muni bonds encourage more debt when a more cautious approach should be taken.

For investors that do not need tax-free income, BAB’s offer a great way to diversify bond holdings and reduce overall risk. Presently there are AAA rated BAB’s that yield more than some BBB rated corporate debt. Unless Congress acts soon to extend the program, the issuance of any more BAB’s will cease after the end of this year.

High Quality, High Dividend Stocks for Income and Low Risk

by Stebbins Hubbard



With the market possibly resuming its upward motion, now might be a good time to consider adding high quality, high dividend stocks to your portfolio. With bond yields flirting with record lows, dividend yields are more competitive than ever. These high quality stocks

were left very much behind last year in the biggest and most speculative rally since 1932. So far this year, they have held their own. Buying these stocks at relatively low prices not only locks in higher dividend yields, but also offers a higher probability of price appreciation. Government bonds, on the other hand, have enjoyed a bull market that has left them with extremely low yields and little room for upside price movement. Also, equity dividends are likely to grow and keep pace with inflation over time in contrast to low bond payouts whose coupons are fixed.

Grant's Interest Rate Observer determines a stock is high quality and high dividend when it meets the following criteria: 1) market capitalization of at least \$5 billion; 2) return on equity of 15% or more; 3) a dividend yield greater than 2%; 4) a debt-to-asset

percentage of less than 35%; and 5) a price-to-earnings ratio of less than 15.

Following is a list of 8 stocks that meets Grant's high quality criteria:

Ticker	Company	P/E	Yield%
MO	Altria	14.4	6.4
KFT	Kraft	11.3	3.7
DD	DuPont	13.0	3.7
JNJ	Johnson & Johnson	12.7	3.5
RTN	Raytheon	10.6	3.4
MAT	Mattel	13.6	3.2
ABT	Abbott Labs	14.9	3.3
CPB	Campbell Soup	14.9	3.0

All have dividend yields of at least 3% with Grant's considering them so low risk they could be alternatives to Treasury notes (10-year note currently yielding 2.5%). Also, dividends are currently taxed at the low capital gains rate of 15% instead of the individual's marginal tax rate at which bond interest is taxed. This, however, is subject to change next year depending on Congressional action (see article below).

Tax Issues Still Unsettled

by Ted Feinour



Individuals face many tax issues in today's uncertain environment. Not since the Great Depression has Congress had so much tax work to do, yet they recently postponed making those decisions until after the midterm elections in November. From the income tax to the estate tax, from the alternative minimum tax to

possible increased taxes on capital gains and dividends, nearly every area of individual taxation is uncertain. Economists have raised concerns about the potential risks of allowing these tax issues to go unresolved, as well as the pitfalls of raising taxes during a difficult economic time.

If all the current tax cuts expire, the 10% lower bracket would disappear and the top marginal rate – the one many small business owners pay – would rise from 35% to 39.6%. Top rates on capital gains and dividends, now both at 15% would rise to 20% for capital gains and 39.6% for dividends. This would pose a real challenge for saving and investment planning. Changes to the estate tax could possibly cause the top estate tax rate to increase from 0% this

year to 55% in 2011.

In addition, a number of retirement proposals were also left undecided by Congress prior to their break. One of the biggest decisions not made was the allowance for people at least 70½ years old to donate as much as \$100,000 a year directly from their individual retirement accounts to charity, count it toward their required IRA minimum distribution, and not pay taxes on the amount. This "qualified charitable distribution" provision expired at the end of 2009. It was hoped that this provision would be extended through this year, but attempts to add this item to bills have been thwarted by concerns about collecting enough tax revenue from the required minimum distributions.

Congress has a great many decisions to make when it comes back into session after the elections. If it becomes a "lame duck" session, however, these items may not be addressed, causing all current tax cuts to expire in the interest of deficit reduction. November and December will be very important months for further discussions on tax and retirement planning issues.

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Structural Unemployment by Whitney Brown

In the mature developed economies of the U.S. and Europe, high unemployment, deleveraging and a retrenching consumer market will define the investment climate for the next few years. Low inflation, low interest rates and high productivity will do much to offset these negatives. It's hard to argue against the prudence of debt reduction and the new frugality of tapped out consumers, but high unemployment is a troubling issue that will not be easily resolved.

In the U.S. the unemployment rate peaked above 10% a year ago and has contracted very little since then. By comparison, the pre-recession level of unemployment was below 5%. Unemployment has not been this high since the 1981-1982 recession. Even in the best of times, a certain level of unemployment is acceptable due to the dynamism and inefficiency of the economy. Over the past several years, a number of factors have come into play that may force us to live with a higher normal level of unemployment.

Several of the more critical factors include uncertainty among small businesses, reduced mobility of the labor force, changing demographics, and a mismatch of skills to job openings. The lack of job creation among small businesses is due not just to slack demand for their products and services but also difficulty in obtaining credit and great uncertainty with regard to pending changes in tax laws and

increased regulations such as mandatory health care.

The moribund housing market has severely limited the ability of job seekers to relocate from one part of the country to another to take advantage of job opportunities. The aging of the workforce also plays a role by reducing the willingness of older workers to relocate. Largely for financial reasons, older workers are remaining in the workforce longer than before, keeping the ratio of workers to available jobs higher.

Perhaps the most frustrating issue for employers is the lack of workers with the right skills to fill available job openings. Even before the recession, certain specialized areas in healthcare, information technology and engineering suffered a shortage of qualified applicants to fill job openings. As the ranks of the unemployed have grown, many of these jobs have remained unfilled due to the length of time it takes for laid off workers from other industries to obtain the necessary education and training.

There are a number of other elements to this complex issue, but no quick fixes. Policy makers will have a difficult challenge to promote job creation and workforce re-training while balancing the needs for fiscal restraint and inflation fighting.