

INVESTMENT OUTLOOK

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- Energy, materials, utilities, telecommunications sectors fare well.
- Fed bumps interest rates three times during quarter.

A TRUE STORY

By Walter Dixon



“Just don’t ever buy a common stock!” my grandfather said, as he stacked the contents of his lock box onto the little cubicle table between us.

There were tax-free bonds, a pile of AAA-rated corporate bonds (mostly AT&T and General Motors), and several first mortgage bonds on properties he had owned and sold – but nary a common stock.

“Why no stocks?” I asked. The curt rejoinder: “Because they’re no damn good. That’s why.” Period. End of conversation.

The year was 1971; and my well-to-do grandfather George Rhodes, at age 81, was having some health problems. He had asked me, his oldest grandchild, to take care of my grandmother Sadie Rhodes’s finances after his death.

He died two years later; and I managed a trust for Sadie’s benefit until her own death in 1980. But true to my promise to George, I never bought a common stock.

Last year I set out to retrace George’s footsteps – from his 1890 Louisiana birthplace, to West Virginia, and finally to Virginia – to document his life and, in the process, to learn why an obviously successful man, intelligent and astute, would not own a single, solitary common stock...and why he thought stocks were “no damn good.”

Despite humble beginnings, George’s father had prospered as a Louisiana sugar cane farmer and was able to provide his son with a good education. After getting an accounting degree at a small local college, George ultimately ended up in Charleston, West Virginia, with Sadie and their children, as comptroller for a large wholesale grocer.

With business booming due to the war in Europe, profits of American companies were heading higher; and increased earnings were reflected in rising common stock prices. George saw money being made, and he went into the stock brokerage business with a small regional firm in Charleston. In 1919 the

company moved him to Huntington to manage their branch office.

In 1924 George and a retired physician Dr. James I. Miller formed a stock brokerage partnership, Rhodes & Miller, and opened for business in a swank downtown location. Dr. Miller put up most of the money, and George managed the business.

And business was good! Soon George had moved his family out of their small row house in downtown Huntington into a fine new home across the river on ritzy Whitaker Hill overlooking the city. He put the Whitaker Hill home in Sadie’s name alone, just in case problems ever developed with his business.

According to the Huntington newspaper, George and Sadie were high-steppin’ in high society, as well as spending some of the winter months in Florida! Sadie’s mother, in a letter to her sister, worried about their grand lifestyle; but she knew George was doing well in “his business with the stock market,” and Sadie was enjoying all the “coming and going.”

Despite some early warning signs, the stock market crash that began on October 24, 1929, rocked the country; and Rhodes & Miller felt the effects. However, American business seemed sound; and as recently as October 15th of that year one of the foremost economists in America, Professor Irving Fisher from Yale, had announced that: “Stock prices have reached what looks like a permanently high plateau.”

In mid-November the stock market, down about 50% from the early September high, at last found a bottom; and from that point through the year-end, prices drifted modestly upward. Meanwhile, economic conditions had turned inexplicably sour.

The Dow Jones Industrials rallied strongly during January, February, and March of 1930; and it seemed that the worst had passed. However, the respite proved temporary, and in April the market began to lose momentum. In June there was another

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Third Quarter 2004 Review

By Whitney Brown



Stocks

In the third quarter, stocks drifted lower. The major market averages continued this year's progression of lower peaks and lower troughs. Nothing in the extreme, but the quarter saw the S&P 500, Dow and NASDAQ all lose ground. As could be expected during the summer, trading volume was relatively low.

Several traditionally defensive market sectors fared very well for the quarter with energy up 10%, telecommunications and utilities up 5% each, and materials up 3%. Because of the way the market averages are computed, those good returns were hidden by the poor returns in other high profile sectors such as information technology down 10%, and healthcare and consumer staples down 6% each.

A few very large market capitalization stocks dominate the major averages that are commonly reported in the popular media. For instance, of the 500 stocks in the S&P 500, the 25 largest ones account for 37% of the total return of the index. Yet, all the stocks in the outperforming sectors mentioned above, energy, telecommunications, utilities and materials combined, account for only 17% of the index. When stocks like Intel, Pfizer, Microsoft, IBM, and Cisco aren't doing well, neither are the market averages.

A number of other market indicators point to a healthier market than what the major averages imply. On the New York Stock Exchange the number of issues advancing exceeds that declining. The majority of stocks are trading above their average price for both the short term (10 weeks) and the intermediate term (30 weeks). And, the number of issues making new 52-week highs exceeds that making new lows.

Interest Rates

The Federal Reserve bumped short-term interest

Market Measures		3rd Quarter	YTD 2004
S & P 500		-2.3%	0.2%
Dow Jones Industrial Average		-3.4%	-3.6%
NASDAQ Composite		-7.4%	-5.3%
Morgan Stanley EAFE		-0.7%	2.3%
Lehman Bros. Intermediate T-Bond Index		2.3%	2.8%
		<u>9/30/04</u>	<u>12/31/03</u>
		<u>9/30/03</u>	
10 Year Treasury Bond Yield	4.12%	4.25%	3.94%
90 Day Treasury Bill Yield	1.67%	0.90%	0.92%

rates three times during the third quarter. All the increases were fully expected and thoroughly discounted by the markets. The Fed has made clear that they intend to bring short rates up to a more normal level.

The Fed also has made clear that they believe the U.S. economy has entered a period of self-sustaining recovery in spite of a so-called soft patch this summer. The bond markets may not fully agree.

Despite the determined upping of short-term rates during the third quarter, longer-term rates such as the 10-year Treasury note have retreated sharply. The 10-year Treasury rate has retraced most of the abrupt move made last April from 3.7% to 4.9% and is now back in the neighborhood of 4%. Longer-term bond rates usually carry a message about the market's expectations for inflation and economic growth. Falling rates would imply low expectations for both.

Outlook

Contrary to the overwhelmingly negative tone of the news from around the world, conditions remain favorable for the stock market to finish the year strongly. The positive effects of concluding the presidential election and the seasonal flow of money into the market should bode well. Best wishes for a splendid fall.

BLACK GOLD RISING

By Watt Dixon



For decades, oil has been at the center of many of the world's tensions. With Americans consuming twenty-five percent of the world's oil production, and surging oil demand from developing countries such as China and India, oil reserves are currently at dangerously low levels. The year 2004 has seen the fastest demand growth for oil in twenty-four years. The tiny amount of spare capacity leaves us more vulnerable to supply disruptions.

The majority of the world's oil production comes from a region that is a hot-bed of political and religious uprisings. This lack of supply combined with world tensions has some investors thinking that oil at \$50 per barrel is not over-priced, despite a jump in crude prices this year of over fifty percent. The chart below illustrates the surge in oil prices over the last few years.

During this time of extreme world-wide unrest and already low oil reserves it could be tough for the oil market to absorb a geopolitical crisis without pushing oil prices even higher. Conversely, if tensions settle down in Iraq and in other oil rich areas, the "terror/war" premium could be removed from oil prices, sending them lower.

On an inflation-adjusted basis, oil prices are well below the crunch time of the late '70s and early '80s. Still, higher oil prices drain income that could be spent on other things such as cars,

clothing, and electronics. This is critical to our economy in which consumer spending plays a large role. To make matters worse, winter is approaching, and home heating oil prices have been moving up, which could further cut into discretionary income.

On the corporate front, profits have yet to be hurt too badly by rising oil prices. However, if prices stay at these levels or move higher, companies will feel the pinch. Corporations will have to pass the cost on to consumers or become less profitable, both potential negatives for stock prices and the economy.

While oil prices have surged, interest rates have fallen, pushing bond prices higher. If this relationship between oil prices and interest rates continues, the Federal Reserve may slow their tightening process. Interest rates

may remain low for a while.

World currencies are affected differently in an environment with rising oil prices. Countries that are dependent on oil imports, such as the United States and Japan, are the most affected by spikes in oil prices. Thus far, the Japanese yen has felt the biggest effect of rising oil prices. Being an industry-intensive country, Japan uses a lot of oil. Also, Japan has very little in the way of domestic sources of energy. Their need to import vast amounts of crude oil, natural gas and other energy sources makes them very sensitive to rising oil prices.

The fact is, higher oil prices have an impact for people everywhere. With a world so dependent on oil, rising prices are felt at many levels, not just at the gas pump.



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A TRUE STORY (Continued)

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sharp loss; and prices for the next two years worked their way sickeningly, but inevitably, lower. In the scramble for liquidity, the banks went after Dr. Miller to repay the partnership's loans, and Dr. Miller went after George for his share.

In early 1932 Sadie pledged as collateral their Whitaker Hill home to secure a new loan, but to no avail. It was good money after bad. When the money ran out, the bank took the home; and Rhodes & Miller went into receivership. The Whitaker Hill home, for which they had paid \$18,700 in 1926, sold at auction on the courthouse steps for less than \$7,000.

My grandfather rented a small apartment in downtown Huntington for his family, and my mother dropped out of college. He moved to Lynchburg to live temporarily with his sister-in-law Amy and her husband Will, where Will thought the job opportunities might be a little better.

The story has a happy ending. After working odd jobs as a carpenter, George found steady work in a jewelry store; and from there several years later he bought his own jewelry store in Staunton from a local bank that was settling an estate. He even talked the bank into loaning him the money!

The business was quickly a success, and within a few years George was able to resume spending some time during the winter months in Florida. Again recognizing opportunity, he successfully bought, fixed up, and sold his Florida and Virginia homes every few years, each time stashing away some profits in gilt-edged bonds. The rest is history, as they say.

George Rhodes was a wonderful grandfather, and I loved him very much. He especially enjoyed Sunday nights, sitting on the floor, playing Chinese checkers and other games with his family. However, George always was a competitor; he never "let" us win. At least, I don't *think* he did. And he treated us grandchildren like we had some sense, which somehow seemed to bring out the best in us. We didn't want to disappoint.

I learned a lot from him, although I don't think he was always right. Certainly in investing George made some mistakes; but, even so, I hope I've learned something from his mistakes:

1. When times are good, it seems the sky's the limit. When times are tough, though, it's often hard to see light at the end of the tunnel. Our attitudes are shaped by our experiences; and after a long run of success, we should resist feeling comfortable and complacent. Conversely, after a long bear

market, we shouldn't let our fears dominate our reason and good sense. Neither good times nor bad times last forever. While I'm sure my grandfather *knew* this, I think he found it difficult to *act* on it.

2. Random events...things we don't expect happen, both bad and good. We must be prepared to deal with the unexpected. George was in the right place at the right time in 1917, when the stock market started its long run to 1929; but after 1929, he was in the wrong place at the wrong time. It's hard to fault him for sticking with it, considering the circumstances; but sometimes you have to just cut your losses and move on.

3. The most important of all investment decisions is to be in sync with long-term trends. After he got back on his feet in the jewelry business and started making some money trading up in real estate, George invested his excess cash directly *contrary* to the major trends. Starting in the mid-1940s, bond prices declined for the next 35 years, while stocks began a 20-year bull market. Later on, he probably realized this, but he still would have told you, "Common stocks are no damn good!"

All in all, I think George enjoyed the days and slept well at night. And maybe that's as good as a portfolio of growth stocks. Maybe even *better*.