

# INVESTMENT OUTLOOK

## Third Quarter 2008 Review and Outlook by Whitney Brown

- ◆ Stocks continue decline.
- ◆ Banks under pressure.
- ◆ Government undertakes financial rescue plan.
- ◆ Economy headed for recession.

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Stocks took a thorough drubbing during the third quarter. What had been a steady decline throughout July and August intensified in September as markets began to panic over the state of the global financial system. All of the major U.S. market averages dropped dramatically and were down approximately 20% for the year through the end of the third quarter.

Areas of strength such as the energy and industrial sectors finally gave in as fears grew that a major recession looms. Foreign stocks, the place to be for the past few years, offered no respite. Both developed and emerging markets stock indexes have fared far worse than the U.S. Ironically, the financial

sector as a whole was one of the better performing sectors for the quarter.

It is fair to say that few had fully anticipated the extent to which the credit crisis would impact global financial markets. Prior to September the problem appeared to be manageable by the private sector with an occasional assist from the Fed or the FDIC.

The unfortunate bankruptcy of the major Wall Street investment bank, Lehman Brothers, sent a shock wave through the financial system. Unintended consequences of the Lehman bankruptcy wreaked havoc in the market for very short-term corporate borrowing known as commercial paper, as well as money market funds owned by countless institutional and individual investors.

For most of September, Treasury and Federal Reserve officials engaged in an almost non-stop series of takeovers, forced mergers and bailouts throughout the financial sector. The torrid pace of extraordinary measures taken in a matter of a few weeks truly boggles the mind. Despite the bold and quick reactions, the pace of events and the seeming lack of consistency in government action may have served to heighten the panic. Officials came to realize that the *ad hoc* approach to the crisis was not working and a comprehensive solution was needed. The rescue bill recently signed into law gives them unprecedented resources and authority.

Perhaps more important than the actual details of the plan is the crucial understanding that the government will not allow the financial

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<u>Market Measures</u>		<u>3<sup>rd</sup> Qtr</u>	<u>YTD</u>
S & P 500		-8.9%	-20.6%
Dow Jones Industrial Average		-4.4%	-18.2%
NASDAQ Composite		-9.2%	-21.5%
Russell 2000		-1.1%	-10.4%
MSCI EAFE		-20.5%	-28.9%
Lehman Bros. Aggregate Bond Index		-0.5%	0.6%
	<u>9/30/08</u>	<u>12/31/07</u>	<u>9/30/07</u>
10-Year Treasury Bond Yield	3.83%	4.04%	4.58%
Three-month Treasury Bill Yield	0.90%	3.23%	3.80%

# It's a Long-term Proposition

by Whitney Brown

With the market in sharp decline and our financial system in need of major government support, it is encouraging to take a few steps back and consider the longer view. Investing in the stock market is clearly not for the faint of heart, nor is it an easy way to make a quick buck. But, for those who are willing to take a patient and disciplined approach, the market offers superior long-term rewards.

The chart below illustrates the long-term total return for the Standard and Poor's 500 Index from 1925 to the present. The total return includes price appreciation and dividends. It is easy to see that over a very long period of time the U.S. stock market has thrived,

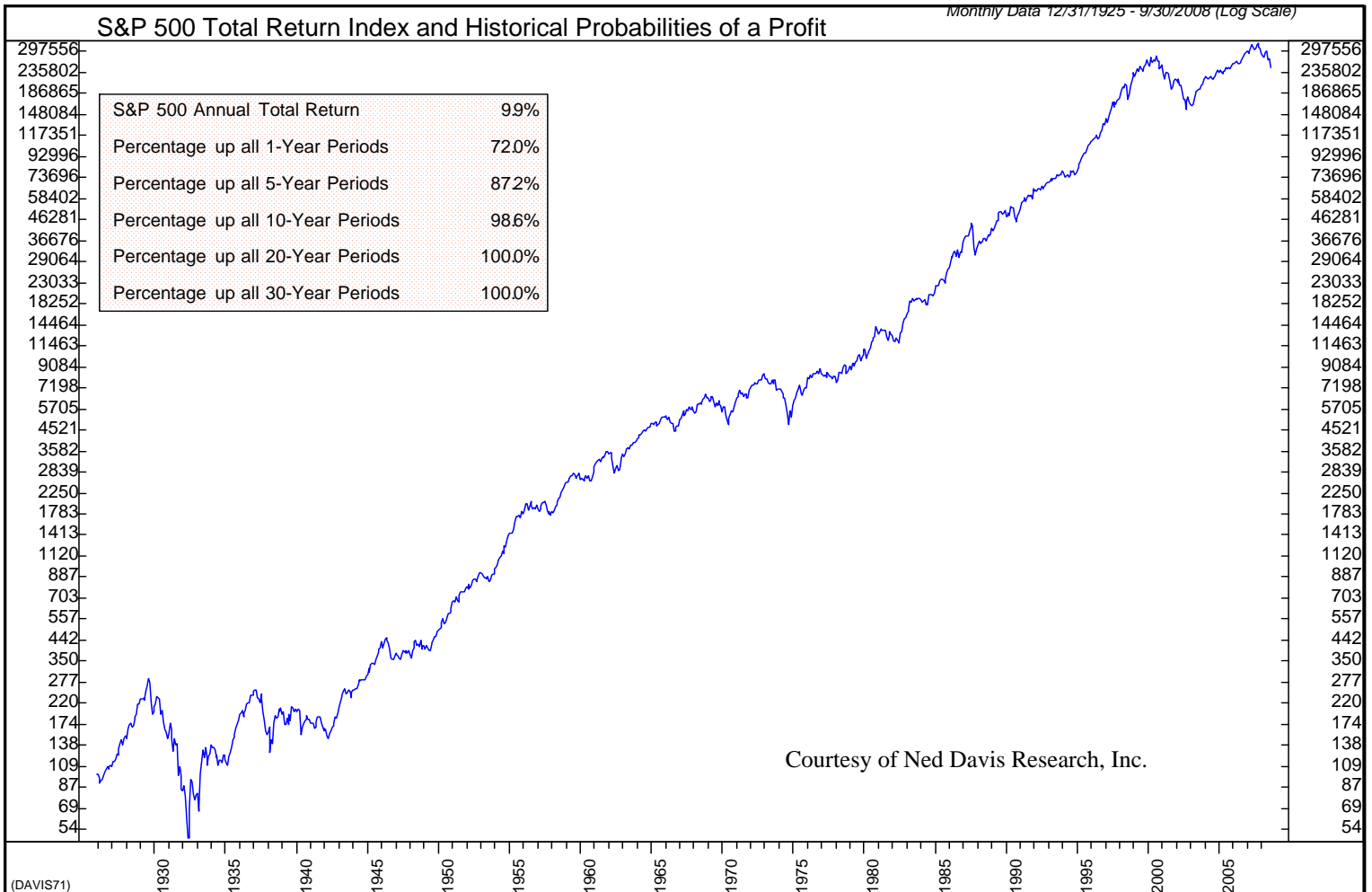
providing an average annual return of 10%. The upward bias of the market is undeniable.

Of course, most of us don't have an 83-year time horizon, but for the less patient the news is still good. The box in the upper left corner of the chart gives the probabilities of a positive stock market return for 1, 5, 10, 20 and 30-year periods. For any single year going back to 1925, there is a 72% probability that it was a profitable year for stock investors. Considering any consecutive five-year period, the odds improve to 87% that it was a profitable time for investors. Stretching the period to ten years makes it a near certainty at 98%, and going to 20 or 30 years makes it a sure

thing at 100%.

What is even more important is that the analysis includes all of the worst economic conditions, financial panics and market shocks of the past 83 years. The crashes in 1929 and 1987, the severe deflation of the Great Depression, the extreme inflation of the 1970's, wars, a presidential assassination, the 9/11 attacks, the S&L crisis, and the bursting of the tech bubble in 2000 are all taken into account.

While today's situation seems dire, history gives us no reason to think that a long-term investment in the companies that comprise our diverse, enormous and remarkably adaptable economy won't be a winner.



# Moody's to Change Its Municipal Bond Ratings System

by Watt Dixon

Moody's Investor Service is introducing a new scale for the rating of municipal bonds. In the past Moody's has rated municipal bonds on the same scale as corporate, agency, and other categories of bonds. However, the default rate of municipal bonds has been greatly different than other bond categories. Between 1970 and 2006, about 1.3% of 'A' rated corporate bonds suffered a default within 10 years of issuance. However, only .03% of 'A' rated municipal bonds suffered defaults over the same time period. Among Moody's 'A' rated general obligation bonds (bonds backed by the full taxing power of a city, county, school district, or state) there was exactly one default from 1970 to 2006, whereas 0.4% of other 'A'-rated municipal bond types defaulted.

Congressman Barney Frank and California Treasurer Bill Lockyer have been pressuring all the rating agencies to rate muni bonds on expected losses only. Their complaint has been that muni bonds are a safer investment than similarly rated corporate bonds, citing the afore mentioned default rates. The lower a bond rating, the higher the rate of interest the issuer must offer. In addition, to make the muni bond more attractive to investors, bond issuers have had to purchase expensive municipal bond insurance, which further increases the cost of the bond.

The chart to the right shows the current Moody's rating scale. Under the new system any direct obligation of a state currently rated 'A1' or higher will now become 'Aaa.' That means that every state, except Louisiana would be 'Aaa.' For other general obligations, including cities and counties, anything rated 'Aa3' or better would be upgraded to 'Aaa.' Even riskier credits like hospitals would enjoy at least a 1-2 notch upgrade. Virginia's general obligations bonds

(G.O.'s) are rated 'Aaa.' If Moody's uses nothing but default expectations it appears every state's G.O. bonds will be rated 'Aaa.' While this has its advantages in the form of lower debt costs to the states and making the bonds more marketable, investors that buy munis in multiple states will lose their ability to differentiate between credits issued by different states. For example, a currently 'A1'-rated California bond will become a 'Aaa'-rated bond. In addition, if a currently 'Aaa'-rated state, such as Virginia, could relax their fiscal standards all the way down to the current 'A1' level of a California bond and still maintain their 'Aaa' rating, they very well may do just that.



There are clearly some advantages to this new rating scale for municipal bonds. However, in a time when lax standards have gotten other sectors of our economy in serious trouble, perhaps we should be sharpening our pencils in rating municipal bonds instead of relaxing our rating standards.

<b>Aaa</b>	<b>Maximum Safety</b>
<b>Aa1</b>	
<b>Aa2</b>	<b>High Grade Quality</b>
<b>Aa3</b>	
<b>A1</b>	
<b>A2</b>	<b>Upper Medium Grade</b>
<b>A3</b>	
<b>Baa1</b>	
<b>Baa2</b>	<b>Lower Medium Grade</b>
<b>Baa3</b>	
<b>Ba1 and below</b>	<b>Non Investment Grade</b>

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POST OFFICE BOX 2768  
ROANOKE, VIRGINIA 24001-2768

TELEPHONE (540) 343-9903

FAX (540) 343-7684

WEBSITE: WWW.DHFB.COM

## Third Quarter 2008 Review and Outlook (continued)

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system to implode. People generally prefer that government stay out of the markets. The reality is that the government makes the rules for the markets, and when markets fail, the government must intervene to get them working again.

The history of past financial crises shows that early and aggressive government action can bring a crisis under control and restore public confidence more quickly and with less damage to the economy than doing nothing. While leaving the free market to its own devices would ultimately bring about a more efficient system in the long run, the process of getting there could be devastating in terms of damage to the economy.

Financial crises and panics are an inevitable part of a democratic capitalist system. Unchecked greed at the height of the business cycle results in excessive risk-taking that ends badly. As the government, with its deep pockets, gets to work shoring up our financial system, the return of confidence and

the smooth flow of credit will get markets going again. Already we are seeing private capital being put to work. Warren Buffett, the famed value investor, has gone on a buying spree, snapping up a whole energy company and taking large positions in the blue-chip companies Goldman Sachs and General Electric. Several major banks have successfully raised billions of new capital in recent days.

Looking ahead, the market will eventually right itself (please see the article on page 2). The recent sell-off has generated cash stockpiles that will not remain idle indefinitely with Treasury bill rates below 1%. Rapidly growing economies of developing countries such as Brazil, China and India are a major long-term source of demand in the global economy and will not be sidelined for long by the dislocations in the financial markets. While we are optimistic about the future of the markets, the current turmoil has made the advantages of maintaining a balanced and diversified portfolio of high quality securities more clear than ever.