

INVESTMENT OUTLOOK

**DIXON, HUBARD, FEINOUR
& BROWN, INC.** *investment
counsel*

- ◆ Stocks finish year on an upswing.
- ◆ Conditions favor further gains in 2011.
- ◆ Critical fiscal and economic issues to be addressed in coming year.

In the final quarter of the year, stocks built on momentum from September and put together a very solid rally. What was looking like a so-so year turned into a good one. But for a several week pause in November, the market rose steadily for the last four months of the year. October did not live up to its reputation as a harbinger of nasty setbacks. A 20% surge from September to December put the popular U.S. market averages ahead by double digits for the full year. Returns abroad were positive as well, but parts of Europe were held back by the debt crisis, and some of the major emerging markets were hampered by concerns over inflation and appreciating currencies.

Commodities, particularly gold, benefitted from both uncertainty about the future of the debt-laden developed economies of Europe, the U.S. and Japan, and burgeoning demand from rapidly growing economies of countries like China and India. That trend does not show signs of changing, and further recovery in the developed world will only strengthen demand. Bonds, on the other hand, suffered from very low yields and a topping out of prices. After three decades of falling interest rates and rising bond prices, there is growing evidence that the trends are reversing. We would not expect a huge move for rates right away, but clearly there is very little room, or reason, for them to move any lower.

Current fundamentals support the notion that 2011 can be another positive year for stocks. Historically, low inflation expectations and low interest rates, as we are experiencing now, have been beneficial to stock prices. Since stock prices largely reflect shareholders' claims to future corporate earnings, the impressive strength of earnings in this recovery is another big plus. Even in a slowly growing economy, efficient corporations can continue to post good profits. Additional stimulus from the recent tax deal that cut the payroll tax and extended the Bush-era income tax rates should also help stocks as the year unfolds.

Lest we seem too complacent, 2011 also promises

Fourth Quarter 2010 Review and Outlook for 2011 by Whitney Brown

to be a critical year when a number of significant issues may come to a head that could roil markets. The Euro zone debt crisis has been fended off only temporarily and will need a firmer resolution before markets will be satisfied. Addressing our own fiscal profligacy in the U.S. has become a defining issue for the new Congress, and solutions will not come easily, if at all. The recovery underway is being supported by



abnormally easy monetary policy and record fiscal stimulus that cannot be sustained indefinitely. Major developing countries such as China, India and Brazil are experiencing rapid growth and inflation that may require restrictive steps to slow those economies to prevent asset bubbles

from developing.

In less than two years time, the stock market has nearly doubled from the lows of March 2009. From the depths of the crisis at that time, few would have thought we could come so far so fast. With the basic investment climate favorable but so many major problems unsolved, 2011 promises to be an interesting year for investors.

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Market Measures	4 th Qtr	YTD
S & P 500 (price)	10.2%	12.8%
Dow Jones Industrial Average	7.3%	11.0%
NASDAQ Composite	12.0%	16.9%
Russell 2000	15.9%	25.3%
MSCI EAFE	6.2%	4.9%
Barclays Capital Inter US Gov't/Credit Bond Index	-1.4%	5.9%
	<u>12/31/10</u>	<u>12/31/09</u>
10-Year Treasury Bond Yield	3.29%	3.84%
Three-month Treasury Bill Yield	0.12%	0.05%



With the vote in Congress in mid-December to extend the “Bush” tax cuts, legislators provided much needed tax certainty, at least for two years. The bill, already signed by the President, locks in the current marginal tax rates for all levels of income. The bill also provides new guidance and levels for estate taxes, extended unemployment benefits, and creates many tax breaks for individuals and businesses. Most of the provisions will expire in 2012 unless they are renewed or modified again.

One of the many provisions that specifically benefits individuals is the increase in the amount of income exempt from the alternative minimum tax. For the tax year 2010, the levels were raised to \$47,450 for individuals and \$72,450 for couples filing jointly. Each of these levels will be increased next year. Another provision important to many of our clients is the revival of the tax break permitting people age 70 1/2 and older to transfer IRA distributions directly to charitable organizations and use such distributions to satisfy required minimums. The amount donated in 2011 from an IRA to a charity is excluded from one’s taxable income in 2011 although claiming a tax deduction for the

donation is not permitted. One is not required to file any special forms to notify the IRS as to the transfer to a charity, as long as there is a statement from the organization showing the donation was made by December 31, 2011.

It is important to realize that donations must be made directly from an IRA to charitable organizations. Depositing a distribution from an IRA into a personal account and then writing a check to a charitable organization does not serve to avoid recognizing the distribution as taxable income. If one receives a distribution directly into a personal account, he or she would owe taxes on it.

Amounts totaling up to \$100,000 per IRA owner qualify for the charitable distribution treatment. Our firm is most willing to help in arranging direct distributions from IRAs to charitable organizations per client instructions.

The new tax bill does not simplify planning strategies for more than two years, but it does provide short-term certainty for capital gains, estate and gift tax rates, alternative minimum tax levels, and making charitable contributions from IRAs to avoid the inclusion of required distributions in one’s personal income.

Bond Strategy Update by Watt Dixon



The long term trend in interest rates has been down. Since 1981 rates have been falling to the levels at which they are now. While we are certainly above the crisis lows of 2008, rates are still at historically low levels. Rates fell for much of 2010 before putting in a bottom in early October. In order to help our struggling economy, the Federal Reserve is committed to keeping rates low for the near term. Low rates are usually good for the stock market because companies can borrow cheaply. Also with low rates, many investors feel stocks are a more attractive investment than bonds.

While yields are indeed low, bonds will continue to play a very important role in most investors’ portfolios. This was very evident in 2008 when just about all common stocks suffered serious losses. During that volatile time, bond holders continued to receive the steady interest income that good quality bonds provided. Being diversified among many stock holdings or many stock mutual funds was not sufficient during 2008. Diversification among different asset classes was vital. Balanced portfolios fared much better. Of course, in 2010, bonds returns have lagged those of most types of stocks.

DHF&B’s bond department operates differently than a traditional retail broker. Through our relationships with different bond dealers across the country, we have access to a tremendous inventory of bonds from multiple sources. When buying or

selling a bond, we gather competing bids or offers from dealers. We are not limited to the inventory of just one firm. This proves to be a very cost effective and efficient method to manage bond portfolios.

For the most part, our clients’ bond holdings consist of portfolios of individual bonds instead of bond mutual funds. Holding individual issues is preferable for several reasons. Individual bond issues have a set maturity date. At maturity the bond holder will have his or her principal returned. Bond funds have no maturity date. In a rising interest rate environment (bond prices fall when rates rise), a bond fund with no maturity date could lose significant value as rates continue to rise. In addition, bond funds can be more costly to own due to fund expenses and commissions. Bond mutual funds can be appropriate in smaller portfolios that need a fixed income component but don’t hold adequate cash funds to diversify with individual issues.

With rates possibly forming a bottom, we have shortened average portfolio maturities. A laddered bond portfolio with maturities extending no more than 7-8 years is what we favor for most clients. Shorter maturity bond prices are less volatile. In addition, if rates do begin to rise, holding shorter maturity bonds allows us to reinvest at new, higher rates upon maturity. Sticking with high quality issues is also important in these shaky economic times.

Dollar Devaluation by Stebbins Hubard



The prospect of a prolonged devaluation of the US dollar is one more challenge in what has been a difficult period for savers and investors. Have we really reached the point where the greenback is in danger of becoming an “also ran” currency? The likelihood that the dollar will suddenly lose most of its value is remote. However,

this does not mean that the dollar is risk-free. There is a strong possibility that the dollar is mired in what could be a prolonged devaluation extending well into 2011.

The credit crisis that triggered the recent recession exposed several flaws in the US economy. The list of shortcomings includes economic growth too dependent on asset bubbles of one form or another, a workforce struggling in the face of greater international competition, and a long-held tradition of relying on deficit financing to keep the party going, thus resulting in an economy and a currency in dire need of a correction.

This correction has already started as millions of unemployed Americans can attest. The Federal Reserve has conceded that unemployment will remain elevated through 2011. When employment does pick up, it is expected to do so at a much slower pace than experienced following recessions of the past.

The Fed’s Open Market Committee can’t adjust

interest rates downward because they’re already zero-bound. This leaves the Fed with only one option; quantitative easing (additional stimulus spending & repurchase of government bonds in the open market) in an attempt to inject more cash into the system. While this excess capital increases liquidity, there is also the side effect of further devaluing the dollar. The chart below illustrates the long-term downtrend in the value of the dollar as well as the past year’s decline.

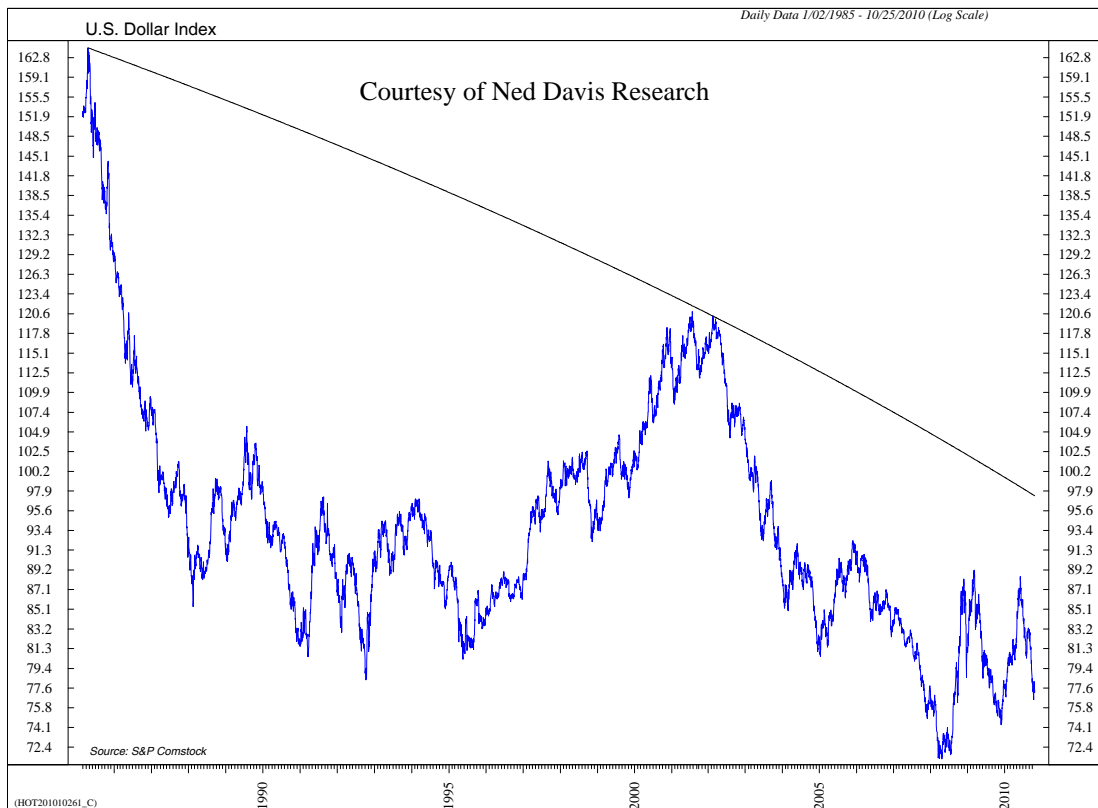
In the State of the Union address, President Obama stressed the need to reduce the trade deficit. The last time the US recorded a trade surplus was 1975 and the president set a target of doubling exports in five years “because the more products we make and sell to other countries, the more jobs we support right here in America.” What was not included in the speech was the fact that the only way in the short term to sell more products to other countries is to actively pursue a low-dollar policy that makes American exports less costly to these markets. A weaker dollar also makes imported goods more costly for American consumers, thereby further reducing the trade deficit. Simply put, in order to meet the administration’s aggressive goal of reducing the trade deficit through a doubling of exports, a weaker US dollar is the new reality.

Naturally, the prospect of a devalued US dollar has China concerned. In 2009, the US Census Bureau placed the yearly value of China’s exports to the United States at \$300

billion or 18 percent of China’s total exports. China is no stranger to currency controversy itself and both sides have routinely accused each other of unfair trade practices. But the rhetoric reached a new level when The Omnibus Trade Act of 2010 was approved by the House of Representatives; however, it failed to pass the Senate. If the bill had been passed into law, US officials would have been free to introduce tariffs on Chinese imports that would have decreased the price advantage enjoyed by Chinese manufacturers.

While the US market remains an important export destination, China is hard at work cultivating new

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Dollar Devaluation (continued)

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customers, and many of these are to be found within her own borders. The increase in demand for consumer products within China is advancing at an unprecedented rate, and the domestic Chinese market – together with other emerging Asian nations – is universally recognized as the largest untapped pool of consumers on the planet. China will not replace the American market overnight; as long as our inflation stays low, there is not much risk of them dumping their US assets. Still, it is clear that a move is on to decouple China's future from the US by reducing its dependence on the American consumer.

So what does this mean for America and more specifically, the US dollar? In the short-term, the Federal Reserve has entered a new round of quantitative easing to inject more cash into the economy. This action alone will devalue the dollar, and the continuation of record-low interest rates will further reduce demand for the buck. This leaves holders of US assets in a bit of a quandary. If the falling dollar appears to be a short-term phenomenon, then it may be feasible to ride out the downturn and hope for a quick turnaround. If however, a weaker US dollar is destined to be with us for awhile, investors and savers may need to look beyond dollar-denominated assets in order to protect investments over the long term.

Regulatory Changes by Jonathon Grace

In the wake of the Madoff scandal, the Securities and Exchange Commission has released a number of new regulatory compliance rules for registered investment advisers such as DHF&B. The new rules are intended to provide additional safeguards to protect clients from fraudulent activities and conflicts of interest.

Form ADV part II, containing information on how DHF&B is organized and operates, is given to prospective and new clients and offered to existing clients on a annual basis. Rule changes now require this document to be written in plain English according to a specific layout and include a table of contents and listing of material changes since the last brochure update.

Changes to the regulations redefine when an adviser has custody of client assets. Even though we do not have physical possession of client assets, we have implied custody when we direct payment of bills and estimated taxes per client instructions, facilitate client gifts, or serve as Trustee or Co-Trustee. As a result, DHF&B is now *deemed* to have custody of certain client assets and must therefore undergo a surprise annual audit. Spencer, Hager and Mosdell, PC, conducted the initial surprise examination in the fourth quarter of 2010. Some clients may have received correspondence from SH&M regarding verification of assets related to this audit.

Finally, we will soon conduct a random sampling of our clients to ensure they are receiving statements directly from the bank or broker that physically holds their assets. Also, beginning with the Portfolio Summary and Appraisal reports for December 31, 2010, we have added a disclaimer urging our clients to compare our statements with those rendered by the custodian.