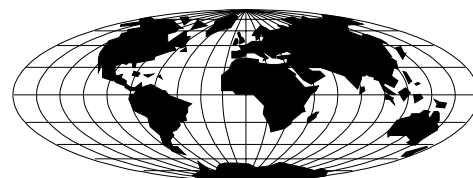


LOWE, BROCKENBROUGH & COMPANY, INC.

INVESTMENT COUNSEL



INVESTMENT REVIEW

April, 2004

LOWE, BROCKENBROUGH INVESTMENT REVIEW

March 2004 Quarter End Highlights

The Financial Markets

- ◆ Improving corporate earnings continued to reflect a strengthening economy as the stock markets paused to digest the gains of the last twelve months. Sluggish employment growth, higher energy prices and volatile international incidents combined to contain investor confidence. The S&P 500 Index rose 1.7% while the Dow Jones Industrial Average and the NASDAQ declined 0.4% during the quarter.
- ◆ Economically sensitive sectors drove the market higher during its January advance. February and March brought a reversal and a rotation into more defensive sectors. For the entire quarter consumer staples, energy, utilities and telecommunications services did well while information technology, materials and industrials lagged.
- ◆ Despite nearly unanimous expectations that interest rates had to move higher from the historically low levels that prevailed at the end of 2003, the bond market defied consensus and yields declined in the first quarter. The yield on the 10-year Treasury Note ended the period at 3.84%, down from 4.25% at the end of December. The string of disappointing employment reports and renewed fears of terrorism supported the rally in Treasury bond prices. For the quarter the Lehman Aggregate Index rose 2.7% and the Lehman 5-year Municipal Index rose 1.3%.
- ◆ Continued intervention in the foreign exchange markets by the Bank of Japan also boosted demand for Treasuries. During the first three months of 2004 the BOJ sold a staggering 15.2 trillion yen,

the equivalent of \$143 billion, in an effort to slow the rise in value of the yen in order to protect Japanese exporters. The dollars accumulated in these interventions are typically invested in short maturity U.S. Treasury securities, pushing yields lower.

- ◆ Corporate bond spreads were largely unchanged during the quarter after narrowing dramatically in 2003. Yield spreads remain near their tightest level in over five years.

The Economy

- ◆ First quarter GDP growth is forecast to be close to the healthy 4.1% achieved in the fourth quarter of 2003. Monetary and fiscal stimulus did their job “kick starting” the economy and taking it to a level of growth that should be sustainable for the immediate future if not longer.
- ◆ Consumer spending was strong in the first quarter buoyed by growth in incomes, increased home refinancings and bigger tax refunds. The largest tax refunds should accrue to the higher income taxpayers who normally file later in the cycle. This will prolong the refund effect and its impact on discretionary consumption. Tax refunds issued are running \$12 billion ahead of last year, a smaller increase than forecast by the Treasury.
- ◆ Domestic corporations are generating record amounts of cash flow. The growth in corporate liquidity over the last two years has been double that normally generated during the first part of an economic expansion. This liquidity has been primarily used to pay down large amounts of debt

March 2004 Quarter End Highlights *(continued)*

and will likely be used in the future for capital spending, higher dividends, stock buy-backs and acquisitions.

- ◆ Commodity prices increased to the highest levels in decades thanks to robust demand from China and tight global supplies. At the end of March the CRB Index reached its highest level in 20 years. A spike in commodity prices is often a leading indicator of growing inflationary pressures. Higher energy prices continue to take spending dollars out of the consumer and business pocketbook.

Future Prospects

- ◆ The momentum of economic growth should expand and carry through 2004. The recent strong employment report now gives credence to the sustainability of growth in our economy. Fiscal stimulus and higher incomes continue to fuel consumer spending as well as business investment.
- ◆ Stock prices should continue to benefit from rising expectations for earnings. Earnings for S&P 500 companies are now forecast to increase 12% in 2004. If current reasonable valuations on stocks relative to interest rates are preserved, stock prices should advance in line with earnings growth. A rapid or significant rise in interest rates may threaten these valuations.
- ◆ As earnings growth slows from the peak rates at the beginning of the recovery, larger capitalization, higher quality stocks should begin to outperform the stocks of lower quality, smaller companies. These more volatile stocks advanced quickly off of low valuations at the end of the bear market. Positions

in growth and economically sensitive areas such as industrials and technology continue to benefit from the strong economy. More defensive holdings should become attractive later in the cycle.

- ◆ The Federal Reserve will continue its accommodative monetary policy, as the inflation rate remains low. Federal Reserve policy makers are focused on the monthly employment reports, and will not begin to remove their easy money stance until the labor market experiences sustained improvement in job growth. The federal funds rate is expected to remain at 1.00% at least into the second half of 2004.
- ◆ With the yield on the 10-year Treasury at 3.84% at the end of the quarter, fixed income valuations are now more unattractive than at the start of 2004. Yields should gradually climb as the economic expansion unfolds. Investors are already beginning to anticipate when the Federal Reserve will determine that the U.S. economy no longer needs stimulative monetary policy. Accordingly, we have maintained a defensive stance in our taxable and non-taxable fixed income portfolios with average maturities and duration short of the benchmark.

Small or Large Capitalization Stocks?

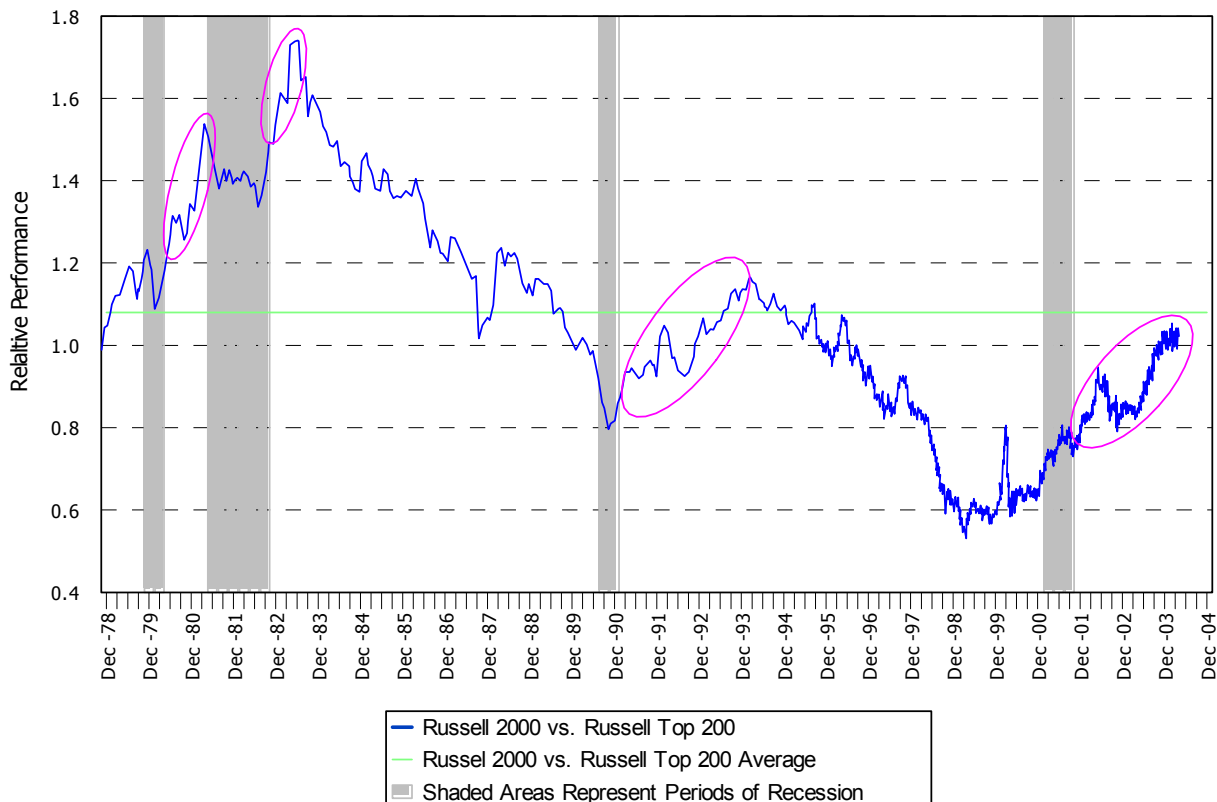
Investing history is littered with examples illustrating the perils of chasing hot performing investment styles. One only has to look back to the late-1998 to early-2000 bubble in technology and telecom stocks to find a recent painful example. Could there be another similar event looming in the not too distant future? The outstanding performance of the small-cap sector of the market over the past several years raises this question.

The annualized return for the small-cap sector over the 1999 to 2003 period (as measured by the Russell 2000 Index) surpassed that of the large-cap sector of the market (as measured by the S&P 500) by 7.65%. The five consecutive years of outperformance is unprecedented over the past 20 years, and has been surpassed in duration only once in the last 50 years, following the 73-74 recession. The performance

differential for 2003 was the widest seen during the entire five-year period (+18.5%). Are small-cap stocks likely to continue to outperform their large-cap peers, or is there trouble on the way? Before this issue can be addressed, it is important to first understand why small-caps have done so well recently.

Over time, these two sectors of the market have experienced distinct performance cycles. As previously noted, the past five years have been extraordinarily positive for small-cap stocks, but in the five years prior to that, small-caps underperformed large-caps by an average of nearly 12% annually. The reason for these performance cycles relates to the economy and interest rates. Small-cap stocks typically outperform in the early stages of economic recoveries, with large-cap stocks then gaining momentum as the expansion matures. This is

Russell 2000 vs. Russell Top 200 Past 25 Years
Small-Cap Relative to Large-Cap Performance



Source: Frank Russell Co. and Smith Barney

Small or Large Capitalization Stocks?

(continued)

because small-cap stocks generally have a higher sensitivity to changes in economic growth. In addition, the lower interest rate environment typically in place after a recession allows small companies to finance their growth at attractive rates. As the expansion matures and earnings growth decelerates, stocks with better earnings visibility (typically larger-cap stocks) tend to outperform. The higher interest rates that usually accompany a maturing expansion are also likely to have a more negative impact on smaller companies, which tend to have a higher relative cost of capital.

The environment of the past year, marked by a recovering economy and low interest rates, has clearly been conducive to the outperformance of small-cap stocks. But, with the economy continuing to expand, the time may be growing near for a change in leadership.

Does this mean that small-cap stocks will experience a collapse reminiscent of technology stocks in 2000? We believe not. While valuations of small-cap stocks relative to large-caps have increased significantly from the lows reached in 1999, they are not at exorbitant levels. A rapid and steep rise in interest rates is not anticipated. Therefore, we expect an orderly shift in leadership back to larger-cap stocks as the year progresses.

For investors willing to accept the higher volatility typically associated with small-cap stocks, they can have a place in investment portfolios. However, the current economic environment and historical precedent would argue against a substantial move into small-cap stocks at this time. As history has shown, chasing the hottest performing investment style rarely leads to good results.