BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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FINANCIAL MARKET OVERVIEW

The first quarter of 2013 ended with U.S. stock market averages at record highs. U.S. stocks rose over 10% during the first quarter. The U.S. stock market continues to surprise investors by simply ignoring every crisis planted in its path.

The New Year started off with Congress unable to act and agree upon a budget by year-end. Over the fiscal cliff we plunged – for one day. Congress came up with a unique solution – a sixty day delay. Further, if the federal budget could not be balanced by March 1st, then our President would implement ***sequestration***. Most Americans have little idea what this term means let alone understand the implications. Simply stated, if Congress did not approve a budget by March 1st, **every** government program would be subject to an automatic percentage cut in funding. Thus far, only tours of the White House have been affected.

The Total Market Index, the broadest measure of the overall U.S. stock market, was up nearly 11% during the first quarter. Large, mid-size and small-company stock indexes all posted double-digit advances ranging from 10% to 14%. The average stock mutual fund jumped 11% during the first quarter of 2013. To fully appreciate how significant first quarter stock performance was, if the stock averages continue at the same pace for the remainder of the year, stocks will post over a 40% annualized gain.

Interest rates increased slightly and the interest paid on 10-year U.S Treasury Notes increased fractionally. As interest rates increase, the value or price of bonds decline. The net result was a slightly negative total return (income plus gains/losses) on bonds during the first quarter.

International (non-U.S.) stocks only advanced 3.75% and emerging market (smaller international countries) stocks actually posted a negative 3.5% return during the first quarter. Gold also declined by nearly 5% and real estate investment trusts (REITs) advanced approximately 8%.

While the first quarter U.S. stock market performance was well-above expectations, it is a troublesome sign when international stocks only advanced by 3% and emerging markets actually declined by more than 3%. The following chart displays sample returns of various asset categories during the first quarter of 2013:

1st Qtr. 2013	**Index Return** ***(includes dividends reinvested)***
+ 11.8%	**Dow Jones Industrial Average (^DJI)**
+ 10.6%	**Standard & Poor's 500 Index (^GSPC)**
+ 11.0%	**DJ U.S. Total Stock Market (VTI)**
+ 9.3%	**Large-company stock-Growth (IWF)**
+ 12.0%	**Large-company stock-Value (IWD)**
+ 11.5%	**Mid-Size Stocks – Growth (IWP)**
+ 13.8%	**Mid-Size Stocks – Value (IWS)**
+ 13.2%	**Small-company stock- Growth (IWO)**
+ 11.4%	**Small-company stock- Value (IWN)**
+ 3.7%	**International (EFA)**
- 3.6%	**Emerging Markets (EEM)**
+ 8.0%	**Real Estate Investment Trusts (VNQ)**
	Fixed Income
+ 0.1%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 0.1%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
	Alternative Investment Category
- 4.7%	**Gold (GLD)**
+ 4.2%	**Natural Resources (Lipper Index)**

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Economic and Financial Market Outlook

Momentum has shifted. After a 35% increase in the overall U.S. stock market since October 11, 2011 (the date stocks began to advance), nearly everyone believes stocks are now attractive. What happened to all of the concerns about the 2012 Presidential election (regardless of who won), tension with Iran, rising income tax brackets, fiscal cliff, our budget crisis and sequestration, slow economic growth, dysfunctional Congress, fiscal crisis in Europe, terrorism and all of the many other headlines suggesting gloom and doom was eminent?

Apparently, it doesn't matter. The current theme, hot topic, or "buzz of the day" is U.S. stocks have been on a roll. Neither corporate profitability nor very slow economic growth can explain or support the 35% advance in overall stock prices.

The problem is that no one seems to have a clue as to what really is happening on Main Street—either here in the US or in Europe. For example, the housing statistics are very promising one week and then lackluster two weeks later. On March 26th, we learned that U.S. housing starts fell by over 4% just when housing was reportedly poised for a boom.

Confusion about the labor market is much greater still. We learned in February's headline news that the unemployment rate had fallen to 7.7% from 7.9%. On the surface, this seems to be somewhat good news. However, few observers focused on the fine print in which we learned that the share of the workforce employed — correctly measured —had declined to the lowest level in decades. While "discouraged workers" (those who have given up and are no longer looking for work) are <u>omitted</u> from the headline unemployment numbers, they are included in the far more relevant U-6 unemployment measure which still exceeds 15% of the workforce.

More somewhat good news can be found in recent headlines touting the ongoing rise of the U.S. Gross Domestic Product. We are told the recovery is working. Or is it? Often overlooked is the fact that the *rate of growth* of the economy has been *decelerating* at the very moment it should be accelerating. After 2.4% GDP growth in 2010 and 2011 - growth much lower than in past recoveries - growth slowed to 1.5% in 2012. More importantly, cumulative growth for the past 12 quarters (four years combined!) was merely 6.3%. That is the lowest in all eleven recessions since World War II.

Back in October 2011, we wrote in our newsletter ….."without change in **<u>government policy</u>**, there is a very real chance that the decade of 2011-2020 will be characterized by continued *slow growth*, *very high unemployment*, *rising federal debt*, and an *end to U.S. economic leadership* for the first time in a century". We also wrote ….. "what is the primary impediment to the road of recovery? **<u>Politics (lack of sound economic and tax policies)</u>**". And lastly, we wrote …… *"the good news: periods of confusion and fear often offer better investment opportunities compared to environments where all investors believe the markets are safe and a sure bet."*

So, 17 months later and after a 35% increase in U.S. stock values, where are we now? Have the domestic and foreign economies improved sufficiently to justify the 35% increase in stock valuations, is meaningful economic improvement just around the corner and the stock market has correctly anticipated the change, or is something else responsible for the sudden increase?

It appears to us the overwhelming fear back in October 2011 was overblown and is now nearly extinct. That attitude alone is disconcerting. More importantly, a new acronym has been born - we have a **TINA** market. This stands for **<u>T</u>**here **<u>I</u>**s **<u>N</u>**o **<u>A</u>**lternative to U.S. stocks as a place to store your money. Bank certificates of deposit and safe money market accounts pay 0.5% to 1% annual

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Quarterly Portfolio Statements Have a New Look!

Your quarterly *Portfolio Statement* has a new look. Four columns have been removed and three new columns have been inserted. *Cash Invested, Unit Cost, Dollar Gain and Percentage Dollar Gain* have been replaced with three new columns; 1) *Unrealized Gain(Loss)*, 2) *Percentage Gain(Loss)Appreciation* and 3) *Annualized Return Including Dividends.*

The prior "Cash Invested" column was useful information in that clients could compare the current value of any investment with their original cash invested to determine how much total gain had occurred since the purchase date. The "Dollar Gain" (or loss) was presented as "% Dollar Gain". The benefit of including these three columns of data on your quarterly reports was **simplicity**. How much money did I originally invest in each security (*cash invested*), what is it worth today, what is my *dollar gain* and finally, what is the *percentage dollar gain*?

The problem or weakness with this data is dividends and capital gain distributions are ignored and excluded - only price appreciation (gain) or loss is included. The most accurate TOTAL return measure should include both income and appreciation. For example, if a particular stock rose in value by 10% over two years, this performance would be equally as good as a stock that did not rise in price, but paid 10% in dividend income over the two-year period. Under the old columns, the stock that rose 10% in value showed a 10% dollar gain, but the other stock that did not rise in price, but paid 10% in dividend income would show a zero percent gain. Yet both provided the same 10% *total return* over the two year period.

The three new columns improve the accuracy of calculating "total return" and provide a running total of the "unrealized gain/loss". A sample of the updated portfolio statement is provided on the reverse side.

Column #1 as indicated is titled *"Unrealized Gain/(Loss)*" and is a measure of what the **taxable** gain or loss would be if the security were sold today. Please note, for IRA accounts and retirement plans, "unrealized Gain/loss and cost basis are irrelevant – income taxes are never assessed on sales of securities or income received inside of a retirement account. Rather income taxes are assessed on the value of withdrawals.

The next column #2, is titled "*Percentage Gain/(Loss) Appreciation"* which is the **taxable** profit or loss divided by the cost basis. If a particular investment *does not pay dividends or if dividends are paid in cash but not reinvested into more shares*, then the gain is simply the difference between the current value and the original purchase cost.

When *dividends are paid and immediately reinvested into more shares* of the same security, the "cost basis" or total investment in the security increases. If dividends are reinvested, this would be the same as purchasing more shares with additional dollars.

The last column on the right #3, is titled "*Annualized Return Including Dividends"*, is a measure of ***total return*** (income plus price appreciation) for each security and the return is "converted" into an annualized figure – not simply a gross return that ignores dividends.

							1	2	3
Weight	Description	Quantity	Trade Date	Cost Basis	Current Value	Current Price	Unrealized Gain(Loss) (Current Value - Cost Basis)	Percent Gain(Loss) Appreciation	Annual Return Includes Dividends
EQUITY									
	Large Companies								
3.7%	ABC CORPORATION	1,000	03/31/2010	10,100.00	14,000.00	14.00	3,900.00	38.6%	12.43%
3.6%	INTERNATIONAL PAPER CO	795	06/23/2011	22,813.21	37,031.10	46.58	14,217.89	62.3%	35.3%
1.7%	ISHARES RUSSELL 1000 VALUE	213.4389	01/01/1980	16,141.53	17,324.84	81.17	1,183.31	7.3%	16.9%
	Accrued Income				82.81				

For example, if ABC Corporation (highlighted yellow) was originally purchased for $10,000, paid $100 in dividends, and increased in value to $14,000 after three years, the "old" column - *<u>% Dollar Gain</u>* would show a 40% return ($14,000 current value minus $10,000 original investment equals a $4,000 gain. A $4,000 gain dividend by the original $10,000 investment equals a 40% gain). Dividend income would **not** be included. The 40% gain is impressive over 3 a three-year period, but what does a 40% gain over three years equal on an "annualized basis" including dividends?

The **average return** is **13.33%** (40% divided by 3 years), but the **<u>annualized return</u>** (excluding dividends) is **11.87%.** Here is the computation: $10,000 earning 11.87% after the first year would be worth $11,187; the ending value of $11,187 earning 11.87% again would be worth $12,515 at the end of the second year. The ending second-year value of $12,515 earning 11.87% after the third year would be worth $14,000. <u>Annualized return converts multi-year performance into annual periods</u>. Logically, this example would be the same as investing $10,000 into a bank CD, receiving and adding the interest earned after one year to the original $10,000 balance and investing the combined total at the end of each year at same rate for 3 years in a row.

The new column, *<u>Annualized Return Including Dividends</u>*, **includes dividends** as well as **price appreciation**, and also converts the performance into an <u>annualized figure</u>. Using the same example above, the stock increased in value by $4,000 and paid $100 in dividends. Under this new measure, the **annualized return** is **12.43%,** which includes price appreciation and dividends paid on an annualized basis. ***Annualized return is the best measurement.***

Note, any security held less than one year will NOT have an entry under the far-right hand column – annualized return requires at least a one-year holding period.

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income. International and emerging market stocks are trailing the U.S. stock market by a very wide margin. Bonds? The interest income is currently at the lowest level in 65 years. A 10-year maturity U.S. government bond pays a whopping 1.9% annual interest rate.

Some individuals and pension funds remain underinvested (less in stocks compared to “normal” times). Quietly, this group of investors – the ones still unable to forget the stock- market wreckage in the rear-view mirror, are considering re-allocating a larger portion of their portfolios to the new front-runner investment category (stocks).

The bottom line is stocks have recently become the darling investment choice based primarily on momentum and recent past performance. The financial markets can and do move in one direction for short periods of time based on factors not used in core investment analysis and valuation techniques. The reasons could be world events (terrorism, European debt crisis, elections, etc.), investor confidence or fear, comments made by world leaders, portfolio managers, corporate executives, market pundits or more commonly newspaper articles. Momentum doesn’t have to be explained, it often just happens.

Real estate price appreciation seemed to defy logic during 2003-2006. A significant correction soon followed. Gold prices more than doubled from October 2009 through October 2012, but over the past year, the price of gold is down 6% while U.S. stock values are up 12%.

The point is short-term momentum shifts occur regularly. No one can predict when these short-term shifts will begin or when they will end. The question many investors are asking is whether or not they should jump into the game once the momentum theme has been identified. The stock market surge could continue for a while longer, especially if portfolio managers and individuals who lightened up on stocks during 2012 become more confident and begin reinvesting into stocks.

Another undeniable factor that could actually extend the stock market advance is rising interest rates. Relatively safe bonds and bond mutual funds will post negative returns when interest rates rise. Interest rates may be starting a permanent move upward now (We’ve been expecting this for …. two years!). While U.S. stocks were up over 10% during the first quarter, high-quality bond funds earned a negative 0.1% to positive 0.1% return. This “safe” money could leave bond funds and continue to flow into stocks. More demand or interest in stocks could continue to fuel this rally.

Our position is to stay the course: underweight bonds and maintain balance with a slight overweighting to large, mature and dividend-paying stocks. For relatively new accounts, those established within the past 12 months or so, we will continue to allocate funds periodically until the desired allocation is reached.

If we had to choose one side (optimistic) or the other (pessimistic), our best advice is to expect near-term declines in both stocks and bonds. We simply cannot rationalize a 35% increase in stocks over the past 17 months. This upward movement may be just one of many saw-tooth moves that repeat over and over. The general long-term trend should be a reasonable advance or better once the economy is truly picking up steam, however – a 35% gain over the past 17 months cannot be supported by the current weakness in the economy and the lack of government economic/tax policies. Expectations seem to be way ahead of reality. It appears that the best explanation for the significant stock market advance is short-term momentum and that is a weak reason to purchase more stocks at this time.

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COPIES OF INCOME TAX RETURNS

Please send paper or computer file copies of your 2012 income tax returns to our office upon completion. Your tax preparer must receive written or verbal approval/permission to send copies of your personal income tax returns to our office. Our investment decisions and income tax management strategies are greatly improved when we have copies of your income tax returns.

Contact Us

Brian D. Lowder, Inc.

Brian D. Lowder, CFP®, CFA
Michael Kinnear, MBA, MSFS, CFP®
Clinton Winey, MBA, CFP®, CFA
Remette Martinson
Pamela Priest

Address
12780 High Bluff Drive Suite 100
San Diego, CA 92130

Telephone
(858) 794-6800

Fax
(858) 794-6906

Website
www.bdlowder.com

Email
brian@bdlowder.com
mike@bdlowder.com
clint@bdlowder.com
rm@bdlowder.com
pam@bdlowder.com

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Best regards

Brian Lowder | Clinton Winey | Michael Kinnear | Remette Martinson | Pam Priest