BRIAN D. LOWDER, INC.

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INSIDE THIS ISSUE

- **Financial Market Overview**
- **Real Estate**
- **Slower Economic Expansion Ahead**
- **Strategic Implications for Investors**
- **How the New Tax Act Affects You**

FINANCIAL MARKET OVERVIEW

Once again, what the first quarter gave, the second quarter took away. Investment returns through April 2006 were nearly equivalent to the annual returns achieved during the entire 2005 calendar year. During May and June, most of the higher-risk and best-performing asset classes had dropped considerably. By the end of the second quarter, large-company growth stocks, small-company growth stocks and emerging market stocks were all down 5% or more.

The second quarter ended with another one-quarter percent increase in the federal funds rate – the 17th increase since mid-2004. The federal funds rate has increased from 1% to 5.25% since the Federal Reserve began increasing rates two years ago. Most consumer and business lending rates follow the changes to the federal funds rate. For example, fixed-rate home mortgages and the prime lending rate have increased from 4.75% to 6.5% and 4% to 8.25% respectively over the previous two years. In spite of rising interest and inflation rates and a dramatic increase in oil prices, the U.S. and international stock markets have performed reasonably well.

In general, we expect more of the same from the financial markets over the next two years. Investment returns are likely to stay within a narrow range equivalent to or slightly less than the historical averages. We have already made the most important adjustments to our managed accounts over the past year. Aggressive or growth-oriented stock positions have been replaced with more conservative or "value-oriented" stocks, small-company stock positions were reduced over one year ago and emerging markets were eliminated in May 2006. Below are sample returns of various asset categories during the second quarter and for the year-to-date ending June 30, 2006:

2nd Quarter	Year-To-Date 2006	(includes dividends reinvested)
+ 0.94%	+ 5.2%	Dow Jones Industrial Average
(1.44%)	+ 2.8%	Standard & Poor's 500 Index
(1.91%)	+ 3.5%	DJ Wilshire 5000 (Broad Market)
(5.01%)	(2.4%)	Large-company stock-Growth
(0.04%)	+ 4.5%	Large-company stock-Value
(5.80%)	+ 3.0%	Mid-Size Stocks – Growth
(2.00%)	+ 4.7%	Mid-Size Stocks – Value
(7.36%)	+ 4.8%	Small-company stock- Growth
(3.36%)	+ 7.2%	Small-company stock- Value
(0.73%)	+ 9.4%	International (excludes U.S.)
(4.96%)	+ 6.9%	Emerging Markets
(1.14%)	+ 12.7%	Real Estate Investment Trusts
+ 0.39%	+ 0.6%	Short-term U.S. Treasury *(includes appreciation)*
+ 0.14%	(0.4%)	Intermediate U.S. Treasury *(includes appreciation)*

REAL ESTATE

Offices, apartments, industrial and other commercial real estate investments continue to perform well as demand for office space and monthly rents have stayed firm. However, residential real estate has clearly entered an adjustment period and we are expecting prices to continue to weaken for several years.

Continued on page 2

Continued from page 1

Several other real estate experts have recently changed their forecasts as well. The UCLA Anderson Forecast (*May 4, 2006 Union Tribune*) predicts residential real estate prices in San Diego County will remain flat through 2011. Residential *sales* in San Diego County have fallen 30% since hitting a peak in April, 2004.

Portfolio manager G. Kenneth Heebner, who manages the top-performing real-estate-focused mutual fund over the past 10 years, confirms that a huge buildup of inventory of homes is underway and expects a significant retrenchment in inflated markets such as California, Arizona, Florida and the East Coast.

Assuming the economic and business environment doesn't decline in San Diego, a crash in real estate prices is very unlikely. Historically, we generally experience significant declines in home prices during recessions and when large numbers of workers lose their jobs. Presently economic growth continues at a moderate pace, the 5% unemployment rate is reasonable and has steadily improved; and corporate profits are reasonably strong. These indicators have been helpful in evaluating the strength of the residential real estate market in the past.

However, we should also consider what circumstances are different today. Certainly, the spending power of the baby boom generation has had a positive impact on both real estate prices and economic growth over the past ten years. It is also true that the first year of the oldest baby boomers just began retirement in 2006. Their spending priorities have changed and each successive year will bring another graduating class into retirement. Financing homes and automobiles will no longer be a priority.

The cost of financing a home has dropped dramatically over the past 25 years, but is currently moving in the opposite direction. Home mortgage interest rates dropped from 15% in 1981 to just below 5% in 2004. The current rate has risen to about 6.5% and is most likely to remain at this level or higher. At the same time, other costs are rising much faster than inflation and wages. Not only has the cost of financing a home increased, so has the cost of fuel, education and healthcare expenses, yet the growth in family income has been relatively flat. The combined cost of financing expensive real estate at higher interest rates and other costs identified above will adversely impact future real estate prices and overall economic growth.

Perhaps one of the most significant and relatively hidden risk factor affecting future real estate appreciation is the continued upward adjustment in monthly mortgage payments over the next three years. In San Diego County alone, over 75% of all new mortgage applications in 2005 and 2006 were adjustable-rate, interest only for three to five years or zero down payment loans.

Lenders have created and promoted a growing array of financing schemes and lower qualification standards in an effort to maintain lending activity. No-money down loans, interest only loans, allowing borrowers to defer (skip) loan payments and add the payments to the loan balance, low initial teaser rates that adjust later on, low initial fixed rates that switch to a variable rate in three to five years, and 40-year loans that ease qualifying standards and lower monthly payments are all part of the growing menu of choices for borrowers that were either not available or considered poor choices prior to this recent surge in real estate prices.

As interest rates continue to rise, homeowners with adjustable rate loans will be faced with the reality that an increasing portion of family income will be necessary to maintain mortgage payments. If they elect to refinance their adjustable rate loans, the monthly cost of the new mortgage will still be greater that the previous loan payments. Likewise lenders have been offering, and

Continued on Page 3

Continued from page 2

consumers have eagerly accepted, loans that have low initial interest rates for a three-to-five year period, but then adjust to current market rates. These loans will expire in 2006 through 2008 and the monthly cost of the new mortgage will be significantly greater that the previous loan payments because interest rates will be higher and the new mortgage will include principal as well as interest.

In both cases described above, some proportion of homeowners will recognize that their home mortgage payments and property taxes are consuming too large a portion of family income. In the past, the rapid increase in home values seemingly justified the decision to use home equity lines of credit or refinancing to a larger loan amount to pay for automobiles, vacations, education and a host of other expenditures. Now that real estate values have begun to decline and home mortgage payments are rising, we will see more homes available for sale and fewer buyers. The stage has already been set for a reversal in bargaining power. Buyers will continue to have more available listings to choose from and increased bargaining power to demand price concessions.

DataQuick reported in The San Diego Union Tribune *(June 14, 2006)* that San Diego County's median sales price is up less than ½% over the previous twelve months (May 2005 through May 2006) and down 5% since November 2005. The volume of sales transactions is down for the 23rd straight month. At the current rate of closing sale transactions, it would take over seven months to sell all homes available for sale – assuming no further listings are added to the total.

One year ago, the consensus opinion regarding real estate values in San Diego was a moderate increase in prices for the foreseeable future. Now, the only debate is how far real estate prices will fall and how long the adjustment will continue. We believe the current downward trend in real estate values will continue throughout the remainder of this decade. Therefore, we emphasize our earlier recommendation to control spending (and debt) and lower investment return expectations in order to achieve your saving, giving and spending objectives throughout this decade.

SLOWER ECONOMIC EXPANSION AHEAD

Consumers' willingness to use their home equity as a source of funds and increase their debt to finance consumption is coming to an end. As discussed above, consumers' willingness to spend has been a significant driver of continued economic growth in our country. Aggregate consumption now accounts for 70% of the United States' gross domestic product (GDP) and the *annual growth* in consumption accounts for an astonishing 71% of the growth in our economy in 2005. The prospects for growth in our economy are now more dependent than ever on the consumer. Readers may be willing to debate how large the impact has been and what proportion of our country's growth in the GDP will be impacted by a reduction in overall consumer spending, but the direction of change is clearly lower.

Falling real estate equity values, high consumer debt levels, rising interest rates, higher energy prices and a negative U.S savings rate is simply too much to ignore. Combine this new environment with the realization that baby boomers are now slowly phasing out of their peak spending years and into their retirement years also supports a gradual slowdown in overall spending. This expected slowdown is supported by another important and detailed assessment of our country's growth in net worth (wealth).

Several months ago, *Business Week* magazine presented an article that supported a popular (or more accurately, hopeful) view that the growth in ***aggregate wealth*** during the past two years would enable U.S. households to be able to continue spending above and beyond their income through 2007. Interestingly, this viewpoint is not

Continued on Page 4

Continued from page 3

supported by the data presented from a recent Federal Reserve study (*Survey of Consumer Finances*) that reveals *most* families are experiencing a sharp slowdown in wealth growth. How can two unrelated parties view the same data and arrive at opposite conclusions? A closer look at the details reveals the correct answer.

The gains in total wealth largely accrue to the top 15% of families. Simply stated, the top-tier families account for 85% of national wealth, but only account for 23% of total consumption. The growth of our overall economy and the fate of Main Street America are dependent upon the fortunes of *average* people.

Since the year 2000, most families are experiencing a slowdown in *wealth growth*. "Wealth" is measured as the market values of all household assets (stocks, bonds, bank accounts & real estate) minus all liabilities (including home mortgages). During most of the 1990's, all household asset categories were up. Bonds increased in value as interest rates fell, stocks performed exceedingly well from 1994 through 2000 and real estate prices began to rise significantly in 1997. Since the year 2000, a reversal of fortune is underway.

Currently, stocks are still below their highs of early 2000, household debt has soared, and the savings rate is negative. Only housing or real estate has performed well and this category has clearly flattened and could easily decline for the next several years. While a strong housing market boosted the typical American family's net worth during 2001-2004, stagnating stock prices, rising debt and a falling savings rate offset the good news from housing.

STRATEGIC IMPLICATIONS FOR INVESTORS

If the future economic environment does unfold as described above, does this suggest investors should liquidate their stocks and real estate and prepare for the worst? No, but investors should lower their investment return expectations and spending habits. Second, the scenario of lower economic growth applies to market indices or the overall performance of specific asset classes. To the extent investors can select individual stocks, businesses, real estate etc. or delegate selection to investment managers that will perform well during a slower economic growth environment, opportunities to achieve moderate returns will continue to be available.

Third, the dynamics of wealth and economic growth in the U.S. need not mirror what will occur elsewhere. Global investing and diversification offer astute investors opportunities to avoid being dragged down by slow wealth growth in the U.S. if this occurs.

Fourth, while changes in the economic environment usually occur over a longer time period, changes in *consensus beliefs* about future returns can be sudden or continue for a long period of time. Recent examples include the extended stock rally in technology/internet stocks during the late 1990s. Stock prices for most companies in this category were lifted to insane valuation levels, yet consensus beliefs suggested the valuation levels would continue to soar in this new information era. In September 2001, a seemingly unrelated or exogenous event (terrorist attacks) quickly turned consensus beliefs in the other direction. The downward adjustment gained momentum through 2002 until once again, consensus beliefs caused an "overshoot" on the downside. The same storyline has been underway for several years, but in a different asset class – real estate. Opportunities to capture or avoid market inefficiencies will continue to present themselves in the future.

Finally, the discussion presented here regarding economic and wealth growth is a mid-to-long-term scenario. Both positive and negative events can occur over the short-term which may necessitate altering the course or simply standing

Continued on Page 5

Continued from page 4

firm through the storm. In addition, several short-term events will likely cause continued optimism and further delay an adjustment or reversion to mean (normal) valuations.

For example, the Federal Reserve Board has raised short-term interest rates by one-quarter percent over 17 consecutive quarters since June 2004. Rising interest rates are rarely viewed as positive news for businesses, real estate or the overall stock market. Within the next six to twelve months, it is very likely that the Federal Reserve Board will pause or actually stop raising interest rates at the end of each quarter. When this event occurs, the investment markets will likely advance in response to such great news – at least over a short-term time horizon. However, the underlying growth rate in stock prices and the rate of growth in wealth accumulation will likely be more closely aligned with the slower projected growth rate in gross domestic product (total market value of all the goods and services produced by a nation during a specified time period).

The primary purpose for this discussion is to convey our advice to lower your investment return expectations and focus your efforts on variables you can control – spending and saving. As investment advisors, we have already made the first phase of changes away from high-growth companies and emerging markets in favor of stable firms in established industries. Interest and dividend income will clearly play a more important role in the economic environment ahead. For those families who are working towards their financial independence, the most important variables affecting your ability to maintain your saving, giving and spending objectives are exercising informed and firm control over spending and making clear distinctions between your wants and needs.

How the New Tax Act Affects You

In mid-May, President Bush signed the *Tax Increase Prevention and Reconciliation Act of 2005.* The tax act has a long name but only a few practical changes that are relevant to most families.

Education Savings: Custodial Accounts (UTMA): The most common college savings account before the introduction of State Sponsored 529 Plans and Coverdell Education Savings Accounts (Education IRAs) is the Uniform Transfer to Minor Accounts (UTMA). These accounts allow individuals to contribute (gift) funds to a minor child with an adult serving as the custodian. Until now, investment income of children under the age of 14 that exceeds a specific inflation-adjusted limit ($1,700 in 2006) was taxed at the parents' highest marginal tax rate. In the past, we were able to avoid any tax liability by purchasing tax-free bonds, using a buy-and-hold strategy at least until the child reached age 14 to avoid capital gains and by purchasing growth stocks with little or no dividend income. Once the child reached age 14, any capital gains (profits) and income would then be taxed at the child's tax rate (rather than the parents' higher rate).

Now, starting with the 2006 tax year, the investment income of children up to ***age 18*** is taxed at their parents' rate. Parents who had planned to sell a child's stock portfolio once the child reached age 14 and invest the funds more conservatively before the child entered college, must either delay selling until the child reaches age 18 (earliest age for lower tax rates) or sell now and pay tax based on the parents' tax bracket.

The attractive feature of UTMA accounts is the funds can be used for any expenses (education, car, clothes, rent, etc.) once the child reaches age 18 compared to the Coverdell Account

Continued on Page 6

Continued from page 5

which can *only* be used (tax-free) for kindergarten through college education expenses and state-sponsored 529 Plans which can *only* be used (tax-free) for college education expenses. Withdrawals from Coverdell and 529 plan accounts for non-education expenses are subject to income and penalty taxes.

While UTMA custodial accounts are still attractive for families who are just starting a college savings program with relatively small sums of money, this change (to age 18) certainly makes Coverdell accounts and state-sponsored 529 Plans more attractive for those families who already have or plan to save larger sums of money for college expenses.

Other Changes: Beginning in 2010, converting regular IRA account balances to a Roth IRA will be allowed for everyone. Presently, only taxpayers with less than $100,000 adjusted gross income are eligible for a Roth conversion.

The Tax Act extends the current maximum income tax treatment on dividends (15%) and capital gains (15%) for an additional two years through 2010.

Small businesses may continue expensing (writing-off) up to $108,000 of qualified business property each year through 2009.

The new tax act takes a small step towards "freezing" the number of taxpayers subject to alternative minimum tax.

Please call us if you have any questions, would like additional information, or a detailed discussion of how the tax law changes may affect your personal circumstances.

Contact Us

Brian D. Lowder, Inc.

Brian D. Lowder, CFA, CFP®
Michael Kinnear, MBA, MSFS, CFP®
Clinton Winey, MBA, CFP®
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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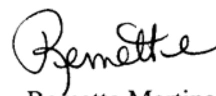
Best regards

Brian Lowder

Clinton Winey

Michael Kinnear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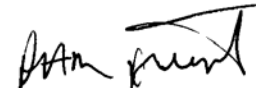
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