
BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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FINANCIAL MARKET OVERVIEW

U.S. stocks declined over 10% during the second quarter and fell over 16% since late April. Comparable results were evident in nearly all stock categories. The decline in International stocks was larger than U.S. stocks. In general, small and mid-size stocks declined slightly less than large-company stocks. However, all diversified stock asset classes posted negative returns for the second quarter and year-to-date. Positive performance could only be found in a few asset categories such as gold/precious metals, bond funds, real estate investment trusts and the U.S. Dollar. In general, the second quarter erased all of the gains achieved during the first quarter and more.

The chart in the following column displays sample returns of various asset categories during the second quarter and year-to-date through June 30th for 2010:

2010 YTD	2nd Qtr. 2010	Index Return *(includes dividends reinvested)*
- 5.8%	- 9.4%	**Dow Jones Industrial Average**
- 7.4%	- 11.4%	**Standard & Poor's 500 Index**
- 5.5%	- 11.1%	**DJ U.S. Total Stock Market (Broad Market)**
- 8.7%	- 12.3%	**Large-company stock-Growth**
- 7.2%	- 12.2%	**Large-company stock-Value**
- 3.2%	- 9.6%	**Mid-Size Stocks – Growth**
- 2.8%	- 10.2%	**Mid-Size Stocks – Value**
- 2.5%	- 9.6%	**Small-company stock- Growth**
- 1.2%	- 9.8%	**Small-company stock- Value**
- 13.2%	- 13.1%	**International (excludes U.S.)**
- 5.9%	- 9.0%	**Emerging Markets**
+ 5.3%	- 4.0%	**Real Estate Investment Trusts**
		Fixed Income
	+ 1.4%	**Short-term U.S. Treasury *(includes appreciation)***
	+ 3.3%	**Intermediate U.S. Treasury *(includes appreciation)***
		Alternative Investment Category
+ 9.8%	+ 9.2%	**Gold**
	- 13.4%	**Natural Resources**
+ 10.5%	+ 6.1%	**U.S. Dollar**

CURRENT AND NEAR-TERM ECONOMIC OUTLOOK

By the end of the second quarter, the stock market had erased the entire gain from the first quarter, and more. Unemployment remains stubbornly high at nearly 10% (approximately 17% if individuals who have accepted part-time work are included) and is actually higher if individuals who have stopped looking for jobs and filing for unemployment are included.

While corporate earnings are better than reported one year ago due primarily to cost-cutting and reducing the

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number of employees, our Gross Domestic Product (value of all goods and services produced in the U.S.) is still falling and is now below 3% annual growth. Home sales have dried up considerably since the beginning of the year as the government income tax credit for first-time home buyers ended on June 30th (after the end of the quarter, Congress passed an extension for the first-time home buyer credit). Lastly, interest rates dropped again during late June as the worsening economy and the stock market decline suggested additional help to stimulate growth is needed.

Over the short-term, we expect more of the same: both the stock and bond markets will advance in reaction to what appears to be favorable news and we expect sudden reversals based upon new information that falls short of prior expectations. Our short-term outlook is the same as our explanation provided in our previous three newsletters. Our client portfolios are invested conservatively with the proportion of stock holdings below what is normally recommended. At best, managed accounts are solidly invested in the “middle of the road” with more conservative/cautious holdings such as water, energy, gold, foreign government bonds, and high dividend-paying stocks compared to our normal allocation to stocks with higher weightings in growth and international stocks.

Beyond this calendar year and perhaps beginning as early as 2011 or 2012, the economy may begin to recover. The biggest unknown is whether the recovery or improved economic health will be sufficiently strong enough to counter-balance higher income taxes and the two new Medicare taxes discussed later.

FIXING THE ECONOMY WILL TAKE LONGER THAN WE’RE ACCUSTOMED TO

Here’s the bottom line: Aside from the short-lived daily, weekly, and monthly financial market rallies and declines, *sustainable* economic and financial market improvement will not occur for a few years ……. maybe longer. My best guess is two or three years. The path we are on today is unsustainable.

The primary problem and threat to sustainable long-term economic well-being is too much sovereign debt (a debt instrument issued and guaranteed by a government). The U.S. and many other countries around the globe are over-extended in debt. In general terms, the wall of debt has grown exponentially in a very short period of time in the U.S. due to government bailouts, recession, expansive government programs, and unaffordable pension and medical costs for years to come. Comparatively speaking, debt and financial crises *of the past* were almost always driven by events - such as market crashes (Great Depression), wars, recessions etc. and these crises or shocks always ended.

Our current situation (too much debt) has been building for years on an individual level and has begun to reverse course thanks in large part to the real estate bubble bursting. Financial institutions have been caught over-extended with bad loans and the ability of individuals and corporations to borrow on a hand shake has ended.

On the other hand, our government’s deficit spending is on steroids. Here is a realistic analogy of how fast and large our government debt has grown over the past two years : If you had increased your family spending by 500% over the past two years plus your projected spending over the next 5 years on commitments you’ve already made was set to increase another five-fold and finally, if all of that increased spending would come from borrowing or taking on additional debt, you are beginning to understand the course our country is taking. Why did it take so long to get here and why has the debt problem suddenly become unsustainable?

Dr. Woody Brock of Strategic Economic Decisions has written extensive papers on the history of America’s economic growth and the reasons behind our country’s successes and failures. The papers and books are complex and lengthy, but the centuries of history can be simplified as follows.

Many centuries ago, the primary “public good” or service provided by the government or single-ruler nations was military protection. Somewhere along the line, people began to trade, invent, expand and live better lives without going to war and seizing the land next door. As citizens’ standard of living increased, so did our desire for democracy compared to a single-ruler or autocracy. As our country became wealthier, additional “public good” policies were created. Social Security was ushered in by our elected leaders and government to take care of our retired and elderly citizens. Then Medicare was established to provide health care benefits as well. Over the last several

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decades, many additional federal, state, and local "public good" programs were created (welfare, food stamps, unemployment compensation etc.).

In addition, decades ago corporations were confronted by unionized work forces demanding better pay and benefits (badly needed at that time as corporations were heavy-handed). Politicians joined the party and in order to get elected or re-elected, they had to promise more benefits to win the votes. This game started slowly at first, but after years of handing out more and more benefits or entitlements, we now have a 500-pound gorilla in the room. Over time, we created and maintained an astonishing amount of public good entitlements and have mortgaged our future beyond what is sustainable or feasible.

Rather than cutback in times of financial crisis, billions of dollars have been *borrowed* to provide funds for the recent federal bailout of financial institutions, hundreds of millions of dollars for new border security, large pensions provided to federal, state and city employees, bloated government job creation, *trillions* of dollars for a new federal health care package, and numerous borrowings by federal and state agencies to continue favored "public good" programs and collectively the overspending is literally sinking our economy. The risk is real that eventually everyone's standard of living will be lower, as more and more people will be dependent upon and expect government-provided assistance while fewer people will have the desire to provide for themselves. There is a growing realization that we will not be able to afford just the interest payments on our collective government borrowings even before considering reducing or paying off the debt.

The above explanations of where we are on this spending path are facts – not opinions designed to alarm our readers. In effect, our government(s) is continuing to borrow and fund programs (public good or entitlements) beyond our ability to pay for it – a mortgaging of our future. Homeowners and families are cutting back their lifestyles now that easy home equity loans are gone, the number of jobs has been reduced, and the economy is weak. Corporations are cutting back (sharing costs with employees) and pension and medical benefits have been reduced or the cost is now shared with employees. But our federal, state and local government politicians don't have the courage to do what is unpopular (reduce, cut back, tighten the spending belt) for fear of jeopardizing their political future or exposing the truth that their campaign spending promises will, if implemented, severely jeopardize the financial health of this country.

On a positive note, we are in better shape compared to European and other countries. European states have a longer history of providing cradle-to-grave security in the form of health benefits, retirement benefits equal to 85% of salary, more social programs, and full retirement status prior to age 60. Europeans will likely take a much bigger hit to their expectations and future standard of living than Americans will. Americans have already been told that normal Social Security retirement benefits have been extended beyond age 65 and many people are voluntarily working until age 70. In Europe, strikes and factory shutdowns have already begun and these reactions have started before any real pain, cutbacks or other changes have been implemented.

Our leaders need to alter the present course of uncontrolled spending and borrowing. Create good public policy that matches spending with income – the very same decisions that responsible families and corporations ultimately must do. In summary, I don't see any strong indications of a willingness to change current public policy. It takes time, often years to turn this big country around. That is why I am suggesting that clients make adjustments now and alter their expectations or hope of experiencing sustainable economic and financial market growth until a few years pass. The public needs to stand up and speak loud and clear to effect change.

To be brutally honest, most Americans have no idea what's really going on *in the economy*. They are living on spin, lies, political speeches and television programming where the message has been polished by speechwriters, professional marketing and pollsters. Further, Americans are as passionate about their political party as they are about supporting their favorite sport teams regardless of reality. It's all about winning.

For those readers who believe they are reading political undertones in this message, you are mistaken. Personally, I don't care who rises to the top in government at all levels: men, woman, Democrats, Republicans, Independents or Mickey Mouse. Just do what is right, make the difficult decisions and get it done. Either way (current policy or change), there are

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more hard times ahead. The only difference is how long the decline will continue. In this case, if my outlook is misguided and the economy magically finds its way out of this mess, I would be so delighted to be wrong.

MORE DETAILS REGARDING TAX INCREASES

In our previous newsletter, we identified the two new *Medicare tax increases* that will become effective in 2013. The first tax pertains to wages or "**earned income**". A new 0.9% surtax will be applied on wages in excess of $200,000 for single taxpayers or $250,000 for couples filing a joint return. *The employee pays the entire surtax amount.* This surtax ***applies to all wages*** whether hourly, salaried or self-employed. For example, a married couple each earns $150,000 in wages for a total of $300,000. The new 0.90% surtax will apply to the excess ($50,000) wages above $250,000. In this example, the additional tax is 0.90% times $50,000 or $450.

The second Medicare tax is more complicated. Beginning in 2013, ***unearned*** income will be subject to a **3.8%** Medicare tax for single taxpayers with incomes over $200,000 and married taxpayers (joint return) with over $250,000 of income. Unearned income is basically investment income and this new tax applies to ALL taxpayers regardless of age. What is unearned or investment income? The IRS hasn't issued final guidance yet, but preliminary answers to the most important questions are discussed below.

Unearned income includes: interest, dividends, passive rental income, royalties, and capital gains (appreciation) on the sales of all financial instruments such as stocks, bonds, and mutual funds. In addition, the *taxable* portion of insurance annuity payments received on a regular basis is subject to the new tax. For example, if you purchased an annuity contract for $50,000 and the value of the annuity has grown to $100,000 before beginning monthly distributions, one-half or 50% of the payments are taxable ($50,000 gain divided by $100,000 current value equals 50%) at the taxpayers regular income tax rate *plus* an additional 3.8%.

The following category of unearned income is going to upset a lot of folks – gains on the sale of a home. That's right, every taxpayer is allowed to exclude up to $250,000 of gain on the sale of a home for single taxpayers or $500,000 of gain for a married couple. The excess gain is currently subject to capital gains taxes at a 15% flat rate. Beginning in 2013, not only is the excess gain on the sale of a home subject to capital gains tax rate (which by the way, is expected to increase from 15% to 20% beginning in 2011), taxpayers will also pay an additional 3.8% Medicare tax. For example, a married couple purchased a home 20 years ago for $50,000 and the current value is $750,000 resulting in a gain of $700,000. The first $500,000 of gain is excluded. However, the remaining $200,000 is subject to a capital gains tax rate of 15% (expected to increase to 20% in 2011) which amounts to $30,000 **plus** the new Medicare tax rate of 3.8% times the $200,000 gain or $7,600.

Unearned income ***excludes*****:**

- annuity payments received *inside* of a company pension, profit-sharing, 401(k) etc. retirement account
- distributions (withdrawals) from all IRA accounts (Roth, regular or inherited IRAs) and other retirement accounts such as 401(k), profit-sharing, SEP-IRA, etc.
- Social Security payments
- Life insurance proceeds
- Municipal bond interest
- Income from a business that you participate in such as a Subchapter S or partnership – in other words a business that you operate (however, the same income is taxable if you are a passive investor).

The important point to understand is that the tax on *unearned income* can NOT be reduced or eliminated by deductions (mortgage interest, property taxes, medical expenses, charity etc.). For example, even though a taxpayer can reduce his *regular taxable income* by increasing the deductions mentioned above, NOTHING can reduce or offset unearned income. The 3.8% tax is levied on unearned income regardless of deductions that appear elsewhere on a tax return.

To avoid the upcoming 3.8% additional Medicare tax, an investor's first inclination might be to convert all taxable bonds such as Treasuries, corporate bonds, certificates of deposit, etc. to tax-free municipal bond income. This change is certainly an option; however,

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the interest income from municipal bonds with the same maturity and quality rating as the bonds being sold will pay a lower amount of interest because of their tax-free status. Further, trying to avoid the 3.8% new Medicare tax by purchasing municipal bonds will likely result in lower interest income than simply holding the taxable bonds and paying the additional 3.8% tax.

ROTH CONVERSIONS – NOT ADVISABLE FOR MOST TAXPAYERS

Recently, we have received many inquiries from clients regarding whether they should convert their regular IRA accounts to a Roth IRA (referred to as a Roth conversion). In addition, we have read many recent articles and commentaries suggesting Roth conversions are advantageous for most taxpayers. Converting a regular IRA to a Roth IRA is particularly attractive in 2010 mainly because of the elimination of the $100,000 income limit for those wanting to make the switch. Historically, the $100,000 “modified” adjusted gross income limit prevented many taxpayers who earn more than $100,000 from eligibility.

The primary attraction to consider a Roth conversion is future withdrawals from Roth IRAs are *income-tax free*. Withdrawals from traditional IRAs are taxable income. Second, Roth IRAs have *no withdrawal requirements*; traditional IRAs require owners to begin making taxable withdrawals at age 70 ½.

The primary drawback that many taxpayers don’t realize is the immediate income tax implications. Converting a traditional IRA to a Roth IRA creates an immediate income tax liability (taxpayers can elect to pay the income tax due over a two-year period). Basically the entire taxable portion (value) of the IRA account is added to your existing reportable income and is taxed accordingly. Including the value of an IRA account to existing gross income often pushes taxpayers into a higher income tax bracket (25%, 28%, 33% or 35%) PLUS state income tax (up to 9% in California). Essentially income taxes equal to about one-third or more of the IRA account value will be assessed. Who would want to pay that kind of tax earlier than necessary?

The best place to start (because the list is much shorter) the evaluation is to identify what taxpayer circumstances make Roth conversions attractive.

Relatively young taxpayers, individuals in low income tax brackets, and/or individuals who have sufficient assets to retire comfortably and do not want or expect to spend the IRA funds during their lifetime are ideal candidates to consider a Roth conversion. Young taxpayers are generally in a low income tax bracket, the IRA account balances are relatively small, the income tax liability due is usually small, and they have many years to allow the converted IRA account to grow before making tax-free withdrawals. Wealthy taxpayers who do not expect to spend or need the IRA account balance may wish to convert in 2010, pay the income tax now which lowers the value of their estate (paying income taxes now reduces the total value of the estate by the amount of income tax paid and thereby reduces future estate taxes) and allow their heirs to inherit a tax-free Roth IRA account.

For all other taxpayers, the decision to convert a traditional IRA to a Roth is not compelling. It is important to consider all variables that affect this decision – not just one. For example, even if the Roth conversion makes sense, the taxpayer must have the money to pay the income tax and the tax payment should not be paid from the IRA account. Using IRA funds to pay the income tax due defeats the purpose of making the Roth conversion – which is to allow the entire IRA account value to grow tax-free and provide tax-free withdrawals at a later date. In addition, taxpayers under age 59 ½ who use the IRA account to pay the income tax upon conversion are subject to a 10% early withdrawal tax on any amount withdrawn to pay the tax. In summary, a Roth conversion is likely to result in subjecting yourself to 28% to 35% federal income tax, plus up to 9% state tax, plus a 10% penalty tax if the IRA account is tapped to pay the income tax bill by anyone under age 59 ½. The combined income tax liability makes the Roth conversion an unattractive choice for many taxpayers.

Taxpayers must also consider future income tax rates, even though they have no way of predicting how high or low future tax rates will be. If a taxpayer is currently in a very low tax bracket and expects his tax bracket to be higher during retirement, then a conversion may make sense to pay the income tax this year rather than during retirement. However, most taxpayers who are currently

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in a moderate-to-high tax bracket are likely to be in a similar or lower tax bracket at retirement (when salaries, wages or business income no longer apply) and therefore the conversion decision is not compelling.

In summary, taxpayers first need to consider how long they will keep the funds in the Roth IRA before withdrawal because the longer the funds remain untouched and growing in the Roth IRA, the more advantageous the conversion is. Second, can the taxpayer pay the increased income tax upon conversion from other sources and without tapping the IRA to pay the tax? Third, will the taxpayer need the IRA funds during retirement and how long is their life expectancy? Converting the IRA to a Roth and not making any withdrawals can be an attractive asset to leave as an inheritance. Finally, if a taxpayer is likely to be in a lower tax bracket during retirement, choosing to convert the IRA today at a higher tax rates doesn't make financial sense.

The bottom line is each individual situation should be examined independently and multiple "what if" scenarios should be presented (i.e. low/high initial and future income tax rates, long/short life expectancy, low, moderate or high investment return, and the results if income tax owed on conversion is paid from outside accounts verses from the IRA account).

ANNOUNCEMENTS

Please send paper or computer file copies of your 2009 income tax returns to our office upon completion. Our investment decisions and income tax management strategies are greatly improved when we have copies of your income tax returns.

Thank you for your continued trust and confidence and we look forward to hearing from you soon.

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Best regards

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