BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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FINANCIAL MARKET OVERVIEW

The second quarter of 2012 began on the heels of a fabulous first quarter. Stocks were up over 10% from January through March. As you might have guessed, the second quarter ended with stocks posting negative returns ranging from negative 2.5% to 5% depending on which stock index is used for comparison. International and emerging market stocks were down 9%, or twice the decline of U.S stocks. Nearly every asset class was down during the second quarter except bonds and a few other fixed income securities. Interest rates reversed course and dropped from 2.2% (10-yr U.S Treasury) to 1.66% - an incredibly low level by historical comparison. The interest rate decline resulted in positive performance for fixed income securities because bond *prices* or *values* increase as interest rates decrease.

Once again, U.S. economic data released during the second quarter and during the first week of July revealed the hoped for U.S. recovery was still slowing. Additionally, the European nations' debt problems continued to slide in and out of the press with yet more financial maneuvering and bailouts announced. Even China is now experiencing slower growth.

For the first six months of the calendar year, U.S. and international stocks still posted a reasonable rate of return ranging from 5% to 9% and fixed income returns ranged from 2% to 4%. Depending upon the percentage of total assets held in stocks, most investors have earned a blended rate of return of 4% to 8% during the first six months of this year.

During the second quarter, small company stocks suffered slightly greater declines compared to large and mid-size company stocks and international stocks suffered larger declines compared to all U.S. stocks. Real estate investment trusts and U.S. Treasuries were the only major asset classes that posted positive returns during the second quarter.

The following chart displays sample returns of various asset categories during the second quarter and the Year-to-Date 2012 through June 30, 2012:

Yr to Date 2012	2nd Qtr. 2012	Index Return (*includes dividends reinvested*)
+ 5.4%	- 2.5%	**Dow Jones Industrial Average (^DJI)**
+ 8.3%	- 3.3%	**Standard & Poor's 500 Index (^GSPC)**
+ 8.4%	- 3.5%	**DJ U.S. Total Stock Market (VTI)**
+ 9.4%	- 4.3%	**Large-company stock-Growth (IWF)**
+ 7.5%	- 2.6%	**Large-company stock-Value (IWD)**
+ 7.5%	- 5.8%	**Mid-Size Stocks – Growth (IWP)**
+ 6.7%	- 3.8%	**Mid-Size Stocks – Value (IWS)**
+ 8.6%	- 4.1%	**Small-company stock- Growth (IWO)**
+ 7.2%	- 3.5%	**Small-company stock- Value (IWN)**
+ 0.8%	- 9.0%	**International (EFA)**
+ 3.1%	- 8.9%	**Emerging Markets (EEM)**
+12.8%	+ 2.8%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
- 0.2%	+ 0.1%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 2.2%	+ 4.5%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
+ 2.1%	- 4.3%	**Gold (GLD)**

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INVESTMENT OUTLOOK – GLOBAL UNCERTAINTY

The lack of clarity and continued uncertainty with our economic outlook, confusion surrounding future income tax rates and a divisive political atmosphere has perpetuated an atmosphere characterized by below average and volatile investment performance. And this trend will continue.

The U.S. and world economies are weak and most are contracting. Europe will continue to slow as their debt problems will not be solved any time soon. China's growth, while positive, is slowing for the first time in many years. In the United States, our banks and corporations have worked their way through the financial crisis that began in 2008, leaving individuals and our government to reign in their spending. Europe is in the beginning stages of their "financial crisis" so expect continued uncertainty with their financial markets.

The only realistic and long-lasting solution for economic recovery is to "grow our way out of this" – period. And by that measure, the U.S. is barely moving along. Our unemployment rate has indeed declined from over 10% in 2009 to the current 8.2%, but if the recent year-to-date rate of job growth (at 80,000 per month) continues, it will take 4.5 years to get back to the level of employment we had in 2008 (which wasn't a banner year if you recall).

The press and political pundits on one side have correctly informed us that the country has added 4.4 million ***new*** jobs since January 1, 2009. But, what they "accidentally" forgot to disclose is that this country has lost over 9 million jobs during the same time period. And, if we rightfully include Americans who have stopped looking for a job and those who took part-time work, the true unemployment rate is ***14.9%***. The long-term average unemployment rate in this country, including good times and recessions, is ***5.8%***. Economic growth and more jobs is the only solution and increasing this country's debt (borrowing) every day while our political "leaders" refuse to do their job (but at the same time continuing to provide benefits we can't pay for), only makes the problem more difficult.

So, down the uncertain pathway we continue to travel. This current path also means the uncertainty will make investment management more difficult and the financial markets more volatile. One quarter, we are up, and the next quarter we are down. The indicators we used to use and rely upon to help determine whether economic conditions and the financial markets are heading one way or another are useless.

Economic indicators such as inflation and interest rates, growth rate of corporate earnings, international competition, job growth, and improved productivity (new technology and processes that allow us to produce more at a lower cost) have all been replaced by … political announcements. The financial markets react daily to what one political party says about the other and how we are doomed if we believe one side or the other. Frankly, this behavior is getting old.

Tell us what the personal and corporate income taxes will be for 2013 and beyond, will Obama Care be implemented or not, what are the estate tax rates, what deductions will be eliminated or reduced and then, don't change them for at least 4 years! Give us the rules and some level of certainty, and Americans and businesses will plan accordingly.

Until job growth improves and the tax laws/policies are hammered out, we will continue to manage our clients' accounts more conservatively. Large, mature, and dividend-paying common stocks are preferable to assertive and high growth companies both domestic and abroad.

2013 INCOME, ESTATE & HEALTH CARE TAX CHANGES

On Thursday June 28, 2012, The Supreme Court decided that both new tax increases to pay for Obama Care and the requirement for all taxpayers to purchase health insurance included in President Obama's Affordable Care Act, were constitutional. Two new taxes will now be effective in 2013:

New 0.9% Medicare Tax on Employment Income: Currently, the *Medicare* tax on salary, wages, and self-employment income is **2.9%**. If you are an employee, you pay 1.45% through payroll withholding and the other 1.45% is paid by your employer (self-employed taxpayers pay the entire 2.9%). Starting in **2013**, an extra **0.9%** *Medicare* tax will be charged on salary or

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self-employment income above $200,000 for an unmarried taxpayer or $250,000 for married couples filing jointly. Again, this new tax will only affect those taxpayers with higher incomes and it only applies to wages, salary and self-employment income.

New 3.8% Medicare Surtax on Investment Income:
Also starting in 2013, all or part of "net investment income" (which includes capital gains, dividends, interest, annuity income, rental income such as net profits from real estate rental property, royalties and gain on the sale of your personal residence) will be taxed at **3.8%**. The **3.8%** Medicare Surtax only applies to taxpayers with adjusted gross incomes that exceed $200,000 for unmarried taxpayers, $250,000 for married joint-filers, $125,000 if you're married and file separate returns and $12,000 for Trusts (doesn't apply to Family, Living or Revocable Trusts because income flows through the trust and is reported on your personal income tax return).

The new 3.8% Medicare Surtax provision will be the first time in our country's history that the federal Medicare tax will be applied to income beyond wages and self-employment income. We have never been subject to Medicare tax on investment income.

The two new Medicare taxes above only apply to higher-income taxpayers. But several other tax rates discussed below may also increase beginning in 2013 if Congress doesn't pass new Tax Laws as the already-extended Bush tax cuts will expire again on December 31, 2012.

Old 20% Long-term Capital Gain tax rate to Replace Current 15% Rate:
Presently, the *maximum* federal tax on long-term capital gains (gain on the sale of investments held for longer than 1 year) and dividends is only **15%**. Starting in **2013**, the maximum rate on long-term capital gains is scheduled to go up to **20%**. Add the new **3.8%** Medicare Tax, and the new combined tax rate is **23.8%**. The 5% increase in the capital gains ***tax rate*** is equal to a 33% increase in ***tax dollars*** (5% increase divided by the 15% current rate equals 33%). Even worse, all dividends will no longer be taxed at the 15% current maximum tax rate. Instead, beginning in 2013, dividends will be taxed at your "ordinary" tax bracket just like wages and salary (the top tax rates are scheduled to increase to 28%, 31%, 36% and a new 39.6% rate). This change will affect ***all taxpayers*** in the 28% or higher income tax bracket.

Highest Income Tax Bracket Scheduled to Increase to 39.6% in 2013:
If the so-called Bush Tax cuts expire as scheduled at the end of 2012, ordinary income tax rates will increase for most individual taxpayers effective January 1, 2013. The 10% bracket will be eliminated, the 25% bracket will increase to 28%, the 28% bracket will increase to 31%, the 33% bracket will increase to 36% and the top bracket will increase from 35% to 39.6%. Because ALL dividends will be taxed as ordinary income (all dividends will be considered non-qualified dividends), the maximum tax rate on dividends and employment income is scheduled to increase to **39.6%.** Currently the highest federal income tax bracket applies to that portion of taxable income(s) that exceed $388,350 for married filers.

Planning Consideration: Although distributions from an IRA account and other retirement plans are **exempt** from the Medicare Surtax directly, having to include the distributions as taxable income can push a taxpayer over the $200,000 (unmarried) and $250,000 adjusted gross income threshold levels and all income above the threshold is subject to the 3.8% tax.

Planning opportunity: If a taxpayer is considering converting all or a portion of their regular IRA into a Roth IRA and pay the income tax on conversion, it would be better to do so before the end of the year. Higher tax brackets and the Medicare Surtaxes kick in on January 1, 2013.

A 3.8% Real Estate Sales Tax is buried deep within the President's Health Care Bill. Many emails have been circulating stating that the 3.8% sales tax will apply to all home sales **beginning in 2013**. Not true. There is indeed a 3.8% sales tax that applies on "net gain … attributable to the disposition of property". This provision ***does*** include gain on the sale of a home, but the tax applies only on the portion of any gain that is "taken into account in computing taxable income" under the existing tax code. Simply stated, the tax code allows for individuals to exclude the first $250,000 of gain on the sale of a primary residence or $500,000 of gain for a married couple. So, a taxpayer must have a gain on the sale of a home that exceeds the above limits. Second, the 3.8% tax applies only to individuals with incomes over $200,000 a year ($250,000 for married couples filing jointly). In summary, taxpayers must have a gain larger than the

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limits mentioned above on the sale of a primary residence AND their income for the year must exceed the $200,000 or $250,000 limit before the tax applies.

Planning opportunity: If clients have already decided to sell a primary residence within the next year or so, have a large gain after owning the home for decades, and expect to report taxable income exceeding the $200,000 (unmarried) or $250,000 (married) limits during the year of sale, then they should consider selling before 2013.

Planning Discussion: Is it time to make changes, what changes should be considered and what is the likelihood of challenges to the above tax rate changes? First, the **0.9%** and **3.8%** Medicare Surtaxes WILL go into effect on January 1, 2013. There will certainly be further challenges to ObamaCare or outright repeal efforts if the country votes for a new President in November. However, any challenges or repeal efforts will not be successfully completed before year-end. These two taxes will go into effect in six months.

The automatic increase in the 15% capital gains tax rate to 20% and the automatic increase in tax rates applied to dividend and all other investment income from a maximum 15% rate to a maximum 39.6% rate *can only be stopped if Congress miraculously gets together after the November presidential election and before year end and EXTENDS the current lower tax rates another year to allow sufficient time for comprehensive and bi-partisan agreement on a new Tax Law package.* Sorry, I can't even begin to offer any odds of Congress successfully extending the current lower income tax rates before year-end, as our Congress is solidly dysfunctional.

Investment Portfolio Adjustments

Given the fact that income tax rates will be higher in 2013, the obvious adjustments (without considering investment merit – only income tax minimization) are:

1) Replace taxable bonds (corporate and Treasury) with tax-free bonds (municipal). If implemented, interest income would be less as tax-free bonds pay lower interest than taxable bonds of equal quality, but the interest income would not be subject to Medicare Surtax or Income tax and
2) Replace dividend-paying common and preferred stocks where dividends may be taxed at a maximum 39.6% rate in 2013 compared to 15% in 2012, with non-dividend paying growth stocks (note, the higher Income and Medicare tax rates apply only to taxpayers with adjusted gross income exceeding $200,000 for unmarried and $250,000 for married filing jointly.)
3) Sell investments that have large gains in 2012 while the current capital gains tax rate is 15% compared to 20% beginning in 2013 and the capital gains could be subject to the new 0.9% and 3.8% Medicare Surtaxes in 2013.

From an income and Medicare **tax angle only**, the above suggestions would reduce a taxpayer's income tax liability in 2013 compared to 2012. However, any analysis that considers only one variable (income taxes) is incomplete.

Most conservative and moderate-risk investors are advised and usually prefer to purchase and hold large dividend-paying common stocks of mature companies and higher quality corporate or treasury bonds for the higher interest income and greater degree of safety that comes with quality. Switching to non-dividend-paying common stocks means investors are increasing risk and will be banking on only one potential source of return – price appreciation. With dividend-paying stocks, investors have two sources of return; dividends and price appreciation.

Further, municipal or tax-free bonds are backed by the taxing power of a state or a specific project (utility, toll road, etc.), whereas taxable Treasury and corporate bonds are backed by the full faith and credit of the Federal Reserve or the specific company (corporation). The credit quality of municipal verses Treasury bonds is not the same. But more importantly, if investors sell appreciated bonds that were purchased years ago when interest rates were higher, and now use the sale proceeds to purchase Municipal bonds that will pay a much lower interest rate – income will decrease substantially, and even worse, these investors would be purchasing new long-term bonds at a time when interest rates are presently at a 60-year low. It is simply a matter of when not if; interest rates will rise in the future. Under today's low interest rate environment, purchasing new long-term bonds today may very well be extremely poor timing.

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<u>Conclusion / Recommendation</u> We recommend clients DO NOT make any of the portfolio changes discussed above (switching from high dividend-paying mature company stocks to non-dividend paying growth stocks and selling taxable corporate and Treasury bonds for tax-free municipal bonds) for three reasons. One, growth stocks and municipal bonds require a higher risk tolerance. Two, the changes would result in lower income and Medicare ***taxes,*** but also significantly lower portfolio ***income***. Lastly, after carefully adding high dividend-paying stocks to client portfolios at opportune times over the past two years, we are reluctant to sell them before year-end. It is possible that the Bush tax cuts or lower tax rates could be extended for another year.

ESTATE PLANNING REMINDER

Back in late 2010 and last quarter, our newsletter discussed important estate planning changes and opportunities. Since these changes will expire at the end of 2012, we will briefly discuss these opportunities again. **The estate and gift tax rate** was reduced from 45% to 35% and the lower 35% rate is only guaranteed through the 2012. More importantly, the **estate tax exemption** amount (the total value of your estate that is excluded from the 35% estate and gift taxes) was $3.5 million and was recently increased to $5 million (increased to 5.12 million for inflation). Simply stated, no estate tax is due on estates valued at $5 million or less at death.

The most important estate planning benefit – the **gift tax exemption** amount was increased from $1 million during your lifetime (or at death) to $5 million. Simply stated, ***each*** taxpayer may gift up to $5 million *during their lifetimes* and pay no gift taxes. Taxpayers still have the flexibility to give away up to $5 million during their lifetimes, gift a partial amount or preserve the entire $5 million exemption at death – but only through the remainder of the 2012 calendar year. Parents or grandparents may wish to take advantage of the increased lifetime gift amount by making gifts of appreciated securities, real estate or business interests to children or grandchildren this year before the favorable tax rates and exemption amounts expire.

COPIES OF INCOME TAX RETURNS

Please send paper or computer file copies of your 2011 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. This is especially true with the pending tax rate changes that we have discussed in this newsletter.

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Best regards

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