# BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 10, Issue 3 October 2007


## INSIDE THIS ISSUE


- ▼ **Financial Market Overview**
- ▼ **Future Economic Outlook**
- ▼ **Avoiding Mistakes**
- ▼ **Inflation, Longevity and Consistency**
- ▼ **Year-End Planning**


## FINANCIAL MARKET OVERVIEW

Once again, the stock market resembled a roller coaster ride during the third quarter. Between mid-July and mid-August, daily reports of worsening credit woes and loan default problems sent the Dow Jones plunging over 9% or 1,500 points to close below 12,500. At the same time, oil prices reached over $80 per barrel for the first time and the U.S dollar hit a record low against the euro.

Do you recall what caused a reversal in stock prices just forty-five days later when the Dow Jones closed above the 14,000 level on October 1st? In a word ….Bernacke. The Federal Reserve Chairman lowered interest rates by ½% from 5.25% to 4.75% on September 18th. Investors reacted to the larger-than-expected rate cut by driving stock prices up by the biggest one-day percentage gain since 2003. As investors have been conditioned to do, interest rate declines result in an immediate stock buying binge. The stock market rallies sometimes for days and at other times for longer periods, assuming additional rate cuts follow.

It was a rocky ride over the third quarter with large stocks outperforming all other categories. In a slower-growth economy, large companies presumably benefit from economies of scale, more secure or predictable sales and access to global markets compared to smaller companies. Oddly, the *average* U.S. diversified stock mutual fund averaged just under a 1% gain over the third quarter. Yet, the Dow Jones (30-stock average) was up 4.2%, the S & P 500 (500-stock average) was up 2.0% and the broad stock market average – the Wilshire 5000 (over 5,500-stock average) was up 1.4%. Small and mid-size stock indexes posted negative returns during the quarter. The following chart displays sample returns of various asset categories during the third quarter 2007:

| 3rd Quarter | Year-To-Date 2007 | *(includes dividends reinvested)* |
|---|---|---|
| **+ 4.2%** | **+ 11.5%** | **Dow Jones Industrial Average** |
| **+ 2.0%** | **+ 9.1%** | **Standard & Poor's 500 Index** |
| **+ 1.4%** | **+ 9.1%** | **DJ Wilshire 5000 (Broad Market)** |
| **+ 6.2%** | **+ 14.3%** | **Large-company stock-Growth** |
| **+ 0.1%** | **+ 7.2%** | **Large-company stock-Value** |
| **+ 4.1%** | **+ 17.6%** | **Mid-Size Stocks – Growth** |
| **( 3.3%)** | **+ 7.3%** | **Mid-Size Stocks – Value** |
| **+ 1.3%** | **+ 12.5%** | **Small-company stock- Growth** |
| **( 6.2%)** | **+ 1.2%** | **Small-company stock- Value** |
| **+ 3.2%** | **+ 14.1%** | **International (excludes U.S.)** |
| **+11.7%** | **+ 31.0%** | **Emerging Markets** |
| **+ 1.3%** | **+ 3.0%** | **Real Estate Investment Trusts** |
| **+ 2.1%** | **+ 3.7 %** | **Short-term U.S. Treasury** ***(includes appreciation)*** |
| **+ 3.6%** | **+ 4.1%** | **Intermediate U.S. Treasury** ***(includes appreciation)*** |

## FUTURE ECONOMIC OUTLOOK

Do you recall what the troubling news was that sent stock prices reeling during the mid-summer months? Today, neither does Wall Street nor individual investors. Likewise, the recent rally inspired entirely by the Federal Reserve Chairman's decision to reduce interest rates will also fade away soon. The point is new information is disseminated and acted upon so rapidly that this behavior is becoming obsessive and fashionable. Investors and traders quickly attempt to determine whether new data is crucial stimulus for market rallies or unexpected data suggesting a pending

*Continued on page 2*

*Continued from page 1*

financial market decline. Within a very short period of time, this "new information" is old and less important more rapidly than ever before. The only lasting memory is that stock prices have become more volatile.

Price volatility and obsessive behavior to act quickly is not limited to overall stock prices. Technology, communications and internet stocks displayed the same volatility and sudden adjustment in 2000. Residential real estate prices soared over a seven-year period and the current downward adjustment seemed unthinkable just a short time ago. Recently gold and oil prices have both reached historic highs, the U.S. dollar is posting daily all-time lows and the U.S stock market has recently hit an all-time record closing price. The daily and weekly changes to home mortgage interest rates are now advertised constantly, urging consumers to make knee-jerk changes from fixed to variable, adjustable to five-year fixed, etc.

There seems to be a disconnect here, because the economic outlook sure doesn't seem to be bright enough to justify record prices in several asset classes. This observation is the quandary we must face each day and determine how we can best serve our clients by both preserving and growing their accumulated assets. Below is our assessment.

The positive indicators are a good place to start. The *unemployment* rate is holding steady near 5%. Obviously, maintaining a high percentage of working American citizens improves the chances of continued economic growth.

While a falling *U.S. dollar* has both positive and negative implications, the good news is a cheap dollar gives U.S. companies economic and competitive pricing strength overseas. Exports represent over 10% of our country's Gross Domestic Product (the total market value of all goods and services produced in a year). The weak dollar helps U.S. companies that generate the bulk of their sales overseas increase sales and earnings by translating those foreign sales into more dollars at home. Likewise, improved global sales strength could keep U.S. companies from trimming their work forces.

*Low interest rates* and the hope for further rate cuts provide a powerful short-term boost to the stock market. Investors believe lower interest rates will effectively lower the cost of borrowing and stimulate economic growth. The stock market tends to rally on the news of rate cuts with the expectation that economic improvement will follow.

The consensus of Wall Street analysts is that *corporate profits* will improve substantially from the 3%-4% range expected in the third quarter of this year to an 11% to 12% growth rate during the next two quarters. But is all of this bullishness realistic?

The list of negative indicators is longer but our assessment is based on the probability of a negative or positive outcome, not the number of indicators on either side. First, the *real estate* market is clearly in the midst of a correction. Sales of new and existing homes are down significantly and price reductions are underway. Ed Laeamer, who heads the forecasting center at UCLA's School of Management, correctly points out that weakness in residential investment occurred before eight of the past ten recessions. In addition, the *credit markets* (loans, mortgages) are clearly in disarray with potentially more bad news on the horizon.

The most *recent monthly reports* on jobs, retail sales, industrial production, manufacturing activity, and consumer confidence have all been weaker than expected.

The *U.S. dollar* has been sinking to new lows for over two years now and *gold* has been making new highs weekly with the current price at its highest level in over 25 years. The growth of our economy (*GDP*) has slowed considerably. The price of *oil* has reached new highs at over $80 per barrel.

The bottom line is our economy is in transition, moving from slow expansion to what investors hope will be a more robust economic growth aided by further interest-rate cuts from the Federal Reserve. However, we could also move from slow expansion to even slower growth or shrinkage. When former Federal Reserve Chairman Alan Greenspan publicly comments that the probability of a recession "is in the neighborhood of 50/50," it's time to sit up and pay attention.

The decision we've made is very practical. The potential risks are higher than the expected rewards in the overall stock and real estate markets. The

***Continued on page 3***

*Continued from page 2*

probability of above-average gains over the near-term horizon don't justify the risks of maintaining an over weighted position in stocks. Opportunities will come later.

Therefore, we have maintained our average to below-average exposure to stocks and real estate at this time. New accounts with higher-than-normal money market balances will be invested when we believe the opportunity for appreciation is sustainable.

Our economy and lifestyles seem to be moving more toward obsession and focus on short-term gratification and results. We need to pause on occasion and re-focus on two basic issues we shouldn't overlook: First, the cost of making mistakes is more significant than the reward of earning an above-average investment return over any one year. Likewise, the potential reward of correctly choosing an individual stock that performs well does not adequately compensate for the losses incurred on all other individual stock selections that were not successful.

Second, our accumulated wealth has to last longer than any generation before ours. Longevity is probably the single most important issue faced by investors. We are living much longer than previous generations and the prospect of living a frugal lifestyle is a humbling prospect after decades of hard work. Avoiding mistakes and planning for longer life expectancies are key inputs to successful investment management.

## AVOIDING MISTAKES

It is relatively easy for a reluctant investor or an avid one to earn a reasonable rate of return during periods of rising economic success. Over most rolling ten year-periods, about half of the time, the "market or average" rate of return will be reasonable and all one has to do is be invested. Maintaining a well-balanced investment portfolio and having exposure to different asset classes will likely result in achieving the market or average rates of return.

During a few years of most decades, market returns or the performance in specific sectors of the economy will deliver above-average returns for a variety of reasons. The overall economy may be performing well, certain technological advances or events require updating (i.e. most computer operating systems were not developed to recognize a change from using 1900 dates to the year 2000), or more often, investor confidence and expectations become disconnected with rational valuations. Investors repeatedly fall for this latter mistake by increasing their investments in stocks or sectors that have recently performed well. Examples include technology/internet stocks during the late 1990s, real estate, emerging markets, etc. When the adjustment period inevitably arrives, investors are overexposed, the market reaction is swift, and investors are reluctant to make changes until after the damage is done.

Lastly, investment returns during a few years in each decade will be below normal and will occasionally result in losses. It is normal to expect and experience downward adjustments in the financial markets. A predisposition of worry and fear toward the possibility of a market decline leads to underexposure to important asset classes that are necessary to keep ahead of inflation over your life expectancy. This overly cautious approach leads to below-average investment results.

A better approach is to limit the amount of exposure to any asset class or individual security to a specific range that allows reasonable overweighting, normal or underweighting depending upon the market conditions. Establishing a normal asset allocation provides a disciplined method of targeting a specific rate of return that coincides with a client's ability to tolerate risk. The flexibility to alter the range of investment exposure to any asset class (within defined limits) allows the portfolio manager to increase (decrease) investment performance and risk as the economic environment changes. At the same time, the normal or target asset allocation provides the discipline to remain invested under most market conditions and to minimize mistakes.

Mistakes and overexposure to higher risk holdings are more damaging than the potential reward of superior performance. More importantly, longevity favors consistency in results. Significant losses in any one or two years greatly reduce the 10-year average annual returns on your total investment net worth.

## INFLATION LONGEVITY AND CONSISTENCY

Understanding the long-term impact of inflation and minimizing mistakes in the portfolio management process

*Continued on Page 4*

*Continued from page 3*

are key determinants of maintaining your desired standard of living over a longer life expectancy. The long-term impact of inflation requires a continual growth in assets and income sources just to maintain a given standard of living. A $100,000 total annual spending target today will not purchase the same amount of goods and services five, ten or fifteen years from now. The true annual increase in the cost of living is much higher than the government's official rate of inflation.

Since the mid-1980's, the average annual inflation rate has averaged about 3% according to the official government–provided inflation statistics (CPI or Consumer Price Index). However, the true cost of living is much higher. Health insurance is up over 75% since 2002, but this expense is not included in the government's CPI calculations. Residential home prices have doubled over the past 7 years, but this increasing cost is also not included in the calculations. If you add the cost of education, gasoline prices and several other common expenditures, the actual annual increase in spending necessary just to maintain your standard of living is much higher than expected.

The bottom line is we are living longer, expenses (inflation) are rising much faster than we are led to believe and therefore consistent investment performance and minimizing mistakes are far more important than trying to discover the next Apple Computer stock or shoveling money into this year's best-performing mutual fund.

## YEAR-END PLANNING

The end to another year is rapidly approaching. Please take this opportunity to review your investment objectives, retirement (financial independence) planning progress and any other changes to your personal financial circumstances. With the holiday season almost here, now is the best time to call for a telephone discussion or arrange an appointment at your earliest convenience.

## Contact Us

***Brian D. Lowder, Inc.***

Brian D. Lowder, CFP®, CFA®
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

Brian D. Lowder, Inc., a California Corporation, is a fee-only wealth advisory firm specializing in comprehensive financial planning and investment management. Brian D. Lowder, Inc. is registered with the Securities and Exchange Commission and licensed by the State of California Department of Corporations as an Investment Advisor.

Best regards

Brian Lowder    Clinton Winey    Michael Kinnear    Remette Martinson    Pam Priest