// BRIAN D. LOWDER, INC.
QUARTERLY NEWSLETTER
Volume 14, Issue 3 October 2011

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INSIDE THIS ISSUE

FINANCIAL MARKET OVERVIEW

The third quarter of 2011 began on a rather cautious but upbeat note. Soon, investors were quickly hit by a barrage of volatility and worrisome news and events. Over the first sixty days, the stock market fell by more than 1% on 29 days and there were 15 days with moves exceeding 2%. Furthermore, investors simply couldn't understand how the stock market could be down over 2% in the morning and close up by nearly 2% by early afternoon. By the end of September, most investors had seriously considered moving funds into safe and guaranteed investments (certificates of deposit, money market funds) in spite of the miserable 1% or less return.

Economic data in early July revealed the hoped for U.S. recovery was slowing. Simultaneously, our policymakers in Washington continued their fight along party lines and took our country to the brink of default in early August by not reaching a meaningful agreement over the debt ceiling and a solution toward containing our deficit spending. Then, Standard & Poor's rating service delivered a historic blow to our country by downgrading our triple A rating on U.S. government bonds – a first in our country's history. The final blow was Europe's deepening debt troubles and disagreement on how to bail out Greece. Traders quickly dumped stocks and were so eager to find a safe haven that large inflows of cash were invested in 10-year U.S. Treasuries paying as low as 1.25%.

By the end of the third quarter, stocks were down five months in a row with the worst performance occurring in September. During the first quarter, stocks were up 6%, relatively flat during the second quarter, and down over 12% during the third quarter. By September 30th, the year-to-date performance for U.S. stocks was down over 5% for the thirty large-company stocks in the Dow Jones Industrial Average and over 8% for the broader stock market.

The damage was much worse in Europe and other international countries. The French and German markets were down more than 25% during the third quarter. Asian and Hong Kong markets were down 12% to 20%. Even gold, the preferred investment during uncertain times, reached a record high in August only to fall along with the rest of the market. During one week in September, gold lost 12% of its value. And the final shock: short-term U.S. Treasury Bills (3 and 6-month maturities) were actually yielding 0% during the worst week in September.

Small and mid-size U.S. stocks suffered greater declines compared to large-company stocks and international stocks suffered larger declines compared to U.S. stocks. Gold and U.S. Treasuries were the only major asset classes that posted positive returns for the year and during the third quarter (however, gold has declined 15% over the past 4 weeks). Lastly, in spite of all the turmoil, the U.S. dollar actually rose against most other major currencies – once again illustrating the U.S. Dollar is still perceived as the strongest currency in the world during uncertain times.

The chart on the following page displays sample returns of various asset categories during the third quarter and the entire 2011 calendar year:

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Year 2011	3rd Qtr. 2011	Index Return (*includes dividends reinvested*)
- 5.7%	**- 12.1%**	**Dow Jones Industrial Average (^DJI)**
- 10.0%	**- 14.3%**	**S&P 500 Index (^GSPC)**
- 9.9%	**- 15.2%**	**Total Stock Market (VTI)**
- 7.3%	**- 13.1%**	**Large-company stock-Growth (IWF)**
- 11.4%	**- 16.2%**	**Large-company stock-Value (IWD)**
- 11.8%	**- 19.4%**	**Mid-Size Stocks – Growth (IWP)**
- 13.1%	**- 18.4%**	**Mid-Size Stocks – Value (IWS)**
- 15.6%	**- 22.3%**	**Small-company stock- Growth (IWO)**
- 18.7%	**- 21.5%**	**Small-company stock- Value (IWN)**
- 16.3%	**- 20.6%**	**International (EFA)**
- 25.6%	**- 26.3%**	**Emerging Markets (EEM)**
- 5.6%	**- 14.5%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 1.3%	**+ 0.5%**	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 14.2%	**+ 10.4%**	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
+ 13.9%	**+ 8.3%**	**Gold (GLD)**

**All returns calculated using adjusted historical quotes from finance.yahoo.com*

INVESTMENT OUTLOOK AND UNCERTAIN FINANCIAL MARKETS

We are not going lie, urge you not to worry, suggest maintaining a buy-and-hope investment strategy or provide stale platitudes. This market is downright scary. U.S. stocks dropped noticeably in August followed by a 10% decline just during the month of September and international stocks dropped nearly twice that amount. A normal day is a 500 point swing in prices as measured by the Dow Jones Industrial Average – we start the day with a 200 point advance and by the time we return from lunch, the market is down 250 points.

One year after this firm was established, we experienced the biggest one-day percentage stock market loss in decades – October 19, 1987 the stock market fell **22.6% in one day!** October 13, 1989, stocks dropped 7% in one day. In 1991, the United States' military operation, Desert Storm was announced and stocks dropped substantially. Following the late 1990s' technology/internet craze where stocks were up substantially for three straight years, stocks dropped 12% in 2000, dropped another 12% in 2001 following the terrorist attack and dropped another 24% in 2002. The most recent and largest one-year decline in stock prices occurred in 2008, when the overall U.S. stock market dropped nearly 40%.

In each instance above, investors were shocked, disgusted and were convinced that the stock market was irrational and the financial markets wouldn't recover for years. In contrast, we could not convince our clients to refrain from the urge to invest in more technology start-ups and to resist day-trading in 1999. In the late 1990s, stock prices were rising nearly every day and the only rationale was: prices keep going higher. The urge to buy more stocks overshadowed good judgment.

Shortly thereafter, stock prices crumbled. Most investors were so distraught after the three-year decline in stock prices in 2000-2002, they completely missed the 30% advance in 2003. The same observation can be made in 2009 after stocks dropped nearly 40% during 2008. The following year, stocks advanced 30% and most investors refused to consider stocks and missed the recovery. In each instance (abnormal advances and declines), unrestrained optimism and overwhelming fear replaced good judgment.

My point is; abnormal stock market returns do occur in about 3 to 4 years of each decade – in either direction. Each investor and their advisor had better be comfortable with the current portfolio composition and holdings at all times, because irrational or sudden price changes can occur at any moment. The worst feeling is to be over or under-exposed to market risk during sudden market declines or advances.

When investment portfolios are properly created, adjusted and maintained with appropriate risk exposure, those investors can confidently avoid making sudden or desperate changes during market turmoil. More importantly, while the feelings of fear and concern will always be present during market volatility, an investor can remain composed and avoid making rash investment decisions when panic sets in. Our portfolio changes and adjustments are implemented before (usually too early) significant market volatility. This is the reason we do not make significant changes or sometimes make no changes at all during sudden market declines. The point we are making is that we intend to use our insight and judgment to distinguish between real trends verses emotional and reactive trading.

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Our final comment – which we have suggested on only two or three occasions over the past 20 years: The next financial market surprise is more likely to be on the upside over the next 12 months.

SELECTED INCOME, ESTATE & HEALTH CARE TAX PROPOSALS

Most of the proposed income tax changes apply to individuals and married couples with incomes exceeding $200,000 and $250,000 respectively. Beginning in 2013, two additional or higher income tax rates are proposed. Currently, the highest federal income tax bracket is 35% for single and married filers for that portion of their taxable income(s) that exceed $379,500. The new proposal beginning in 2013 is to add two additional income tax brackets of 36% and 39.6% and apply those rates when taxable incomes exceed $200,000 for individuals and $250,000 for married couples. Basically, if this proposal passes, taxpayers will have the balance of this year and 2012 to consider tax planning opportunities to accelerate income (bonus, stock options, etc.) before 2013. All other taxpayers in the 10%, 15%, 25% and 28% federal tax brackets are unaffected by these proposals.

Recently, a new income tax proposal is being floated around the Senate as a replacement or substitute for the above proposal: Implement a new 5% tax on all taxpayer income exceeding 1 million dollars.

Second, limiting the value or amount of some itemized deductions (home mortgage interest, charitable deductions, etc.) is also contained the President's proposal. When deductions are capped or reduced, the result would be higher reportable taxable income. The net effect is more income subjected to higher tax rates. There is not much taxpayers can or should do until the final rules are passed and 2013 draws near. Paying down mortgage debt or making relatively large charitable contributions now rather than later (2013) are worth considering.

A new 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% real estate 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 limits mentioned above on the sale of a primary residence AND their income for the year must exceed the 200K or $250K limit before the tax applies.

Planning opportunity: If clients plan on selling their primary residence in the next few years, have a large gain after owning the home for decades, and expect to report taxable income exceeding the 200K or 250K limit during the year of sale, then they should consider selling before 2013.

A new 3.8% Medicare Tax on investment income is also buried deep in the Health Care Bill **beginning in 2013**. This tax will catch a larger number of taxpayers than the real estate sales tax discussed above. This 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. The current Medicare tax rate is 1.45% of ***wages*** paid by employers and another 1.45% is paid (deducted from your payroll checks) by employees. Beginning in 2013, taxpayers will also pay a new 3.8% tax on interest income, dividends, capital gains, annuities, rents, etc. but only for individual taxpayers with income above $200,000 ($250,000 for married couples filing jointly).

We will be watching the developments and proposals for increasing income taxes, new real estate sales taxes, capital gain tax adjustment and new Medicare tax increases. At this time, just be aware of these proposals and be alert to income shifting strategies before 2013.

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ANNOUNCEMENTS

We expect the reconstruction and repairs to our permanent office space (12780 High Bluff Drive, Suite 100) to be completed sometime between December and January. We are anxious to move back into our permanent office space and will keep you informed of the exact timing once the completion date is determined.

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Best regards

Brian Lowder   Clinton Winey   Michael Kinnear   Remette Martinson   Pam Priest