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Inside This Issue

- **Financial Market Overview**
- **What is Needed and Are We on Track**
- **Current and Near-Term Economic Outlook**
- **Income/Estate Taxes and Deductions for 2011 and 2012**
- **Lessons Learned**
- **Announcements**

Financial Market Overview

Once again, the final quarter of the calendar year produced most of the gain for the entire year. Similar to 2004-2006, the final quarter of 2010 was exceptional and again, no one predicted such a large upward advance in stock prices. Stock price performance was negative during the first eight months of the year. Beginning in September, the financial markets correctly assessed that the November elections would bring the beginning of change away from the present course of massive deficit spending. Overall, the markets were buoyed by great *expectations* for economic recovery, which in case you haven't noticed, have yet to be realized. But at least the threat of a double dip decline has diminished considerably and the current course of one-sided economic policies has been neutralized.

Small-company and mid-size company stocks significantly outperformed large-company stocks during the 2010 calendar year. While a few foreign countries had significantly greater stock price performance compared to the United States, overall, international stocks trailed the performance of the U.S. stock market. The price of gold finished the year up 30% (although precious metals are down significantly in the first few trading days of 2011), silver was up 80% and copper up 33%. Even agricultural commodities such as corn, wheat and soybean prices were up 30% to 70% during 2010. The price of oil was up over 15% during 2010. Ironically, our government's measure of inflation was reported below 2%.

Lastly, the U.S. Dollar declined and ended the year weak compared to most foreign currencies. By the end of the year, all major U.S. and international stock indexes turned positive ranging from the low teens to mid-twenties. The average U.S. stock mutual fund was up over 15% for the entire calendar year. The only negative performance was the safest category – long-term bonds of all kinds and quality. More on this topic later.

The following chart displays sample returns of various asset categories during the fourth quarter and the entire 2010 calendar year:

Year 2010	4th Qtr. 2010	Index Return (*includes dividends reinvested*)
+ 14.1%	**+ 8.0%**	**Dow Jones Industrial Average**
+ 15.1%	**+ 10.8%**	**Standard & Poor's 500 Index**
+ 17.5%	**+ 11.7%**	**DJ U.S. Total Stock Market (Broad Market)**
+ 14.8%	**+ 11.4%**	**Large-company stock-Growth**
+ 13.0%	**+ 10.6%**	**Large-company stock-Value**
+ 25.9%	**+ 14.2%**	**Mid-Size Stocks – Growth**
+ 22.4%	**+ 12.8%**	**Mid-Size Stocks – Value**
+ 27.6%	**+ 16.6%**	**Small-company stock- Growth**
+ 26.0%	**+ 15.9%**	**Small-company stock- Value**
+ 10.7%	**+ 7.4%**	**International (excludes U.S.)**
+ 19.5%	**+ 7.0%**	**Emerging Markets**
+ 27.6%	**+ 7.0%**	**Real Estate Investment Trusts**
		Fixed Income
+ 3.0%	**- 0.3%**	**Short-term U.S. Treasury** ***(includes appreciation)***
+ 5.6%	**- 1.0%**	**Intermediate U.S. Treasury** ***(includes appreciation)***
		Alternative Investment Category
+ 27.2%	**+ 7.8%**	**Gold**
+ 21.3%	**+ 21.2%**	**Natural Resources**

What is Needed and Are We on Track

The short-term problem is unemployment. "Entitlements" (free money) are the long-term problem. The solutions necessary to overcome both are being held hostage by a broken political system characterized by a win-at-all-cost objective and obstruction when the minority cannot attain their goals. To make matters worse, voters are asking

Continued on page 2

Continued from page 1

politicians for promises to deliver more benefits without anymore taxes to pay for them.

The government's measure of the unemployment rate (those individuals *actively* seeking employment) is stuck at 9.7%. However, when individuals who have quit searching for jobs, have taken part-time positions or have accepted positions beneath their skill level are included, the unemployment rate stands at 17%. Our economy cannot recover with this many people searching for jobs or remaining underemployed.

Our government's two-pronged strategy has been to borrow money (issue debt) and use the funds for "stimulus" spending and thereby "create" or "save" jobs. After sufficient time has elapsed, we can observe that neither the economy nor the employment rate have improved to justify the expenditure. The quality and composition (what the funds are used for) of government spending is what really matters.

If government spending is used for engineering, new technologies and capital investments (projects) that will be self-funding down the road (toll ways, high-speed trains, ports, and ship or airline terminals), once the asset is built and comes into service, then the revenue generated will eventually cover or exceed the investment. The expenditure will be repaid, the deficit does not grow indefinitely and there is a return on investment. More importantly, permanent jobs are created that are needed and necessary.

Unfortunately, stimulus funds were given away to corporations to shore up their balance sheets, purchase auto companies, pay for "research", and hire government workers for jobs that were not necessary. The results were a zero return on investment, the jobs created were temporary and the deficit (debt) has grown larger along with increased interest obligations. The inevitable consequences of continued wasteful spending and entitlement give-aways are going to be devastating (if continued) primarily because of this country's demographics.

The largest jump in population over the past 75 years came from the baby boomer generation and they are beginning to retire effective in 2011. All baby boomers will eventually leave the workforce at a growing rate over the next 20 years. The cost of promised entitlements (Social Security, Medicare, etc.) will soar while simultaneously our country has added *3 trillion dollars* of new debt to its balance sheet. Just paying the interest on this new debt will be a burden. Unless the current wasteful spending at all levels of government is halted and converted to capital investment, then continuing down the same path **will have** a terrible impact on our future standard of living.

What's needed is wise capital spending and investment - not by our federal government but rather by the largest and best employer in the country; small business owners – they account for 70% of all jobs. Second, the income tax rules and business regulations need to be defined and left unchanged for a sufficient period of time to encourage businesses to stop hoarding cash, take risks and expand (increases jobs and tax revenues to the government). Finally, politicians need to act in the best interest of the country and not in the best interest of their own political party or careers.

Are we headed in the right direction? I think the seeds of change have been sown. A growing number of Americans correctly sense that the present course has not and will not improve the economy and the national employment rate.

CURRENT AND NEAR-TERM ECONOMIC OUTLOOK

In general and in its simplest form, I believe the 4th quarter 2010 rally was simply a sigh of relief. The relief is the growing belief that the macroeconomic decline and one-sided policies have been halted. Remember, the initial moves in the stock market are based primarily on expectations. Whether the rally (or decline) continues will be based upon whether results follow the expectations. The next phase will be the true test. Will economic activity and employment improve? I think so.

While the near future will not be clear sailing and without disappointment, we believe the time has come to re-allocate client investment accounts back to their "normal" allocation (or higher) to growth categories – primarily domestic, international and emerging market stocks and real estate.

The biggest potential surprise and disappointment in 2011 is likely to come from the safest investment category – bonds. Fixed income or bond investments have performed well-above average over the past few years. However, the performance was not due to moderate or high income. Most clients are very aware of how low interest rates have dropped along with their interest income. The superior performance came as a result of bond ***prices*** or values going up by more than 8% per year.

Recent bond price appreciation did not come about as a result of improving quality or ratings. Bond prices of all kinds (Treasury, corporate, municipal, international, etc.) rose primarily and in most cases, solely because of the drop in the general level of interest rates. Bonds issued years ago at a time when interest rates were higher and the interest income was better are now more valuable compared to similar bonds that were issued in 2010 when interest rates were much lower. When interest rates drop, bond *values/prices* increase. On the other hand, when interest rates rise, bond *values/prices* decline. The latter scenario cannot be avoided when economic activity picks up. Interest

Continued on page 3

Continued from page 2

rates were artificially lowered to help stimulate growth (increased borrowing and capital investment). As the economy recovers, interest rates will inevitably increase.

The overwhelming probability of an improving economy (no matter how strong or weak) justifies the expectation that interest rates will increase and that the value of the U.S. dollar will strengthen. Although rising interest rates do adversely impact bond prices, stocks can still appreciate as long as the increase is modest, commensurate with increased economic activity, and the future series of interest rate increases do not exceed or occur faster than investor expectations.

Trying to find and purchase *stable* fixed income (bond) investments during a rising interest rate environment for the "safe" portion of client portfolios is nearly impossible. Therefore, we will proceed with a three-pronged recommendation. One, reduce the maturity of all fixed income (bonds) to 5 years or less. The longer the bond maturity, the greater the price change (rise and fall). Two, continue investing in global (non-U.S.) bonds in those countries with strong currencies. Three, add large, mature, multinational, diversified and dividend-paying common stocks to the portfolio in lieu of bonds. We believe these kinds of companies will prove more secure than the solvency risk of municipal and corporate bonds in the decades to come.

The 10-year U.S. Treasury Bond is currently paying 3.5% interest. Top-quality corporate bonds are paying slightly more than 3.5%. There are several large U.S. and multinational companies that pay 3% to 5% dividends. Frankly, I prefer the risk of owning large global stocks that pay a 3% to 5% dividend compared to owning a 10-year (maturity) bond paying 3.5% interest that is sure to drop in value as interest rates increase.

In addition, we intend to move back into real estate investment trusts (REITs) that also pay 3% to 5% dividends as well as international and emerging market stocks. Natural resource and energy stocks are also attractive during an economic recovery. As economic activity picks up so does the increased use of natural resources to make the products. Increased economic activity also increases energy use. Water stocks that pay 3% dividends and distribute an irreplaceable product continue to be attractive.

INCOME/ESTATE TAXES AND DEDUCTIONS FOR 2011 AND 2012

Very late in December, Congress finally passed new legislation for estate tax laws that expired over one year ago and income tax regulations which expired last week. After all of the posturing and meetings, the 2009 income tax brackets will remain the same: Five tax brackets ranging from 10% to 35%. The tax bracket for long-term capital gains and qualified dividend income remains at 15%. The maximum estate tax rate is 35% and the tax is assessed on estate valuations exceeding 5 million dollars. Charitable donations of up to $100,000 directly from an IRA to charities have been extended and retirement plan contribution limits remain the same as last year. For 2011 only, employees will pay 2% less of their earnings (4.2% instead of 6.2%) into the Social Security System – a potential savings of up to about $2,000.

LESSONS LEARNED

Last year, several of our clients passed away. In the process of closing one particular estate, we encountered a problem and would like to share the solution to help our clients avoid the same predicament. We advise all of our clients to hold important original documents (wills, trusts, durable powers, deeds, ownership documents, life insurance policies etc.) in a safe or bank safe deposit box. The problem is accessing the safe deposit box after a death occurs.

First, more than one person should be listed in order to access the safe deposit box and those access persons should be local. Second, if all access persons are deceased, the executor will have to provide multiple documents (will, trust, Letter of Testamentary from the courts, original death certificate, notarized Small Estate Declaration etc.) even though many of the requested documents are not legally necessary. Every bank has their preferred procedures and unfortunately, many of the bank personnel are not well-informed of the process.

Finally, if a safe deposit box owner has a Living Trust, we recommend that the box be owned or listed *in the name of the Trust*. In this manner, the successor Trustee will have the authority to enter the box after producing the original trust and certified copy of the death certificate even when he/she is not listed as an access person. Unfortunately, even though I was listed as executor and successor trustee for an unmarried client with no children, the client did not list another access person for the box, and the safe deposit box was not owned in the name of the Trust. The process of gaining entry, misinformation and the delays were intolerable. If the box was listed in the name of the trust, I would have been allowed access as the successor trustee.

If you have a safe deposit box and do not have a Living Trust, list at least one other local access person and better yet, if you do have a Living Trust, hold title or ownership of the box in the name of the Trust. In this manner, the successor trustee can access the box even though he/she is not listed as an access person. Lessons learned.

Continued on Page 4

Continued from page 3

ANNOUNCEMENTS

Our property management company has asked us to temporarily move out of our office space for a three-to-fourth month period. The roof and brick siding around the entire building must be replaced due to water damage. While this temporary move will be an enormous inconvenience, the repairs must be completed. There are five buildings in our office complex and our building is the last one on the work schedule to undergo the same re-construction. We will be moving to one of the adjacent buildings and we expect the mailing address and phone numbers to remain the same. The expected move date is June 2011. We will provide more details as the temporary move date approaches.

We have received several referrals from our clients and their professionals during 2010 and we would like to thank you and acknowledge your referrals as the highest form of compliment we can receive. Thank you for your continued trust and confidence and we look forward to an improving economic and investment climate in 2011.

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Best regards

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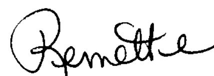
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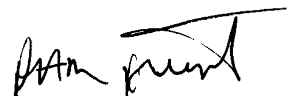
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