BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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FINANCIAL MARKET OVERVIEW

Investors moved into the New Year frustrated and skeptical about their investment results in 2011. Investment returns during 2011 can be summed up in one sentence: The U.S. stock market ended 2011 about where it started on January 1, 2011 in spite of the hefty 11% gains during the fourth quarter. During the first quarter, stocks were up 6%, relatively flat during the second quarter, down over 12% during the third quarter and up over 11% during the fourth quarter. Including dividends, the Dow Jones Industrial Average (30 of the largest U.S. companies) rose 5.5% and the S&P 500 Index (500 largest companies) rose 2.1% during 2011. The Total Stock Market Index was up .4%. Excluding dividends, only the Dow Jones Average posted a positive gain for the year. The average stock mutual fund dropped 2.9% in during 2011.

Interest rates continued to fall during the fourth quarter and the 10-year maturity U.S. Treasury Bond is paying less than 2% interest. However, as interest rates drop, the price or value of bonds increases. Therefore, the total return (income plus gains/losses) in 2011 ranged between 6% and 15% for long-term bonds with 15 to 30-year maturities.

International (non-U.S.) stocks plummeted by 13% to 17% during 2011 and emerging markets (smaller international countries) dropped 15% to 24% depending upon the country or region. Gold investors were ecstatic through August, only to watch the shining metal drop from $1,888 per ounce at the top to $1,565 by the end of the year. Seems no one can make a buck anywhere these days.

Commodities (metals, grains, etc.) dropped 13% but the price of oil increased 8%. Silver prices dropped 9% during the year. The value of the U.S. dollar ended the year approximately where it started. Even hedge funds, marketed as providing upside potential while limiting losses, averaged a 5% decline during 2011. Both small U.S. stocks and international stocks suffered greater declines compared to large-company stocks.

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

Year 2011	4th Qtr. 2011	Index Return *(includes dividends reinvested)*
+ 5.5%	+ 11.9%	**Dow Jones Industrial Average (^DJI)**
+ 2.1%	+ 11.8%	**Standard & Poor's 500 Index (^GSPC)**
+ 0.4%	+ 7.9%	**DJ U.S. Total Stock Market (VTI)**
- 1.9%	+ 9.1%	**Large-company stock-Growth (IWF)**
- 2.4%	+ 12.1%	**Large-company stock-Value (IWD)**
- 4.4%	+ 10.2%	**Mid-Size Stocks – Growth (IWP)**
- 4.6%	+ 13.1%	**Mid-Size Stocks – Value (IWS)**
- 3.4%	+ 13.2%	**Small-company stock- Growth (IWO)**
- 5.2%	+ 15.5%	**Small-company stock- Value (IWN)**
- 13.6%	+ 4.1%	**International (EFA)**
- 20.3%	+ 4.0%	**Emerging Markets (EEM)**
+ 7.6%	+ 14.6%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 1.9%	+ 0.2%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 14.0%	+ 0.7%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
+ 10.0%	- 3.8%	**Gold (GLD)**
- 5.7%	+ 14.8%	**Natural Resources (Lipper Index)**

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THE ROAD TO RECOVERY - WILL WE TAKE IT?

Without change in **government policy**, there is a very real chance that the decade of 2011-2020 will be characterized by continued *slow growth*, *very high unemployment*, *rising federal debt*, and an *end to U.S. economic leadership* for the first time in a century. For just a moment, put your political support and ideology aside. We need policies that promote growth – business confidence to take risk, expand and hire – we don't have that now. Creating unnecessary government jobs and increasing tax rates on anyone's income bracket are not the answers. Not knowing what tax rates will be for the next four years and what portion of healthcare costs will be shifted to employers will only prolong the stalemate.

The ONLY way to fix this problem is for voters to set aside other moral issues for now, ignore looks, age, and TV ads and vote for economic policy that creates expansion regardless of which party the congressional and presidential candidates are aligned with, their age, gender, and everything else. Increasing *real* economic growth, lower unemployment, smaller government deficits and significant infrastructure investment is the only path to lasting recovery. Controlling and reducing leverage (debt) is a must. Our government needs to trim down just as individuals, families and corporations have had to do when expenses exceed income.

What is the primary impediment to the road of recovery? **Politics**. Do left-wing, right-wing or "independent" politicians really want to disclose the truth about the impact of different tax rates on GDP (gross domestic product) or the impact of providing healthcare for everyone? The truth is all sides cherry-pick historical data and pull out snippets of "facts" that support their ideological positions. These positions were established long ago in their political careers. These prejudices will not go away resulting in stalemates where "winning" their elections and keeping their job title is the primary goal rather than creating and agreeing on policies that benefit the masses. These prejudices have become "normal" everywhere.

For example, a corporate boss wants an analysis and results that support his/her contention that the next line of new cars should be sleek and the color red, or an insurance executive wants to sell more insurance policies to parents to help pay for the cost of college. Both have already selected the results they want – now go crunch the data and present it in a way that supports my theory (prejudices). Our politicians are behaving similarly.

The expansion of **Entitlements** (giving away benefits) is strangling this country (Europe as well). Fortunately, a growing percentage of Americans are finally becoming aware that continuing down the same entitlement path is ruinous. Ask a thirty year-old whether he/she believes in Martians or the likelihood of receiving a Social Security check at age 67. Yes, this country ought to have a safety net for those who cannot provide for themselves. But the reality is, a growing pool of entitlement recipients have become accustomed and comfortable with these programs that are not financially sound. Now, many feel entitled in perpetuity and react quite angrily at the notion of reducing benefits. Current Social Security recipients are not in jeopardy of reducing or losing their benefits – neither political party has suggested or proposed reductions. Yet political advertisements suggest the other side will do just that. And too many people believe it!

Health care costs must be controlled and the actual financial impact of providing more benefits must be seriously addressed before declaring and creating laws that provide this valuable benefit to everyone. Consider how illogical this is: provide increased health benefits to 20-30 million more Americans beginning in a few years while collecting more taxes for this coverage now. This law or declaration will immediately increase the demand for healthcare. What about the supply of doctors who provide the services? The same number of doctors will somehow be able to provide the same level of care for an additional 20-30 million more people and we are asking doctors and healthcare providers to charge less? And the political number-crunchers can't figure out why the cost of health care is rising uncontrollably? Simple. A healthcare policy that increases demand without increasing supply increases costs. Do you know how long it takes someone to become a doctor? My point is simple. If our government has a benevolent idea that will cost substantially more money (entitlement), the policy must be well-conceived, funds must be available and the entitlement must not be jammed through Congress in one week without fully identifying, disclosing and thoughtfully determining how to collect the funds necessary to support the entitlement over the long-term.

The bottom line that Americans must address today for the benefit of everyone (not just themselves) is: What kind of economic system is the "best" and what is the proper policy for "**distributive justice**" – who should receive how much of the total pie (fair shares) and why? Today, over 50% of American taxpayers do not pay any federal or state income tax, yet they benefit from a variety of entitlements, police protection, education, fire protection and much more. Yet, one of the proposed solutions is to tax the top 2% income earners, referred to as the wealthy, and distribute more to the "middle class." If politicians were honest, they would tell Americans that the proposed income tax increase on the "wealthy" would not generate enough additional revenue to pay down one cent of every dollar of debt this country has accumulated. This proposal will not improve economic growth at all. Economic justice and distribution of benefits must relate individual *needs* and their *contribution* into the system that pays for these benefits.

The topics identified above have a profound impact on whether our country will embark on the road to recovery or

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slide deeper into debt similar to European nations. More importantly, the progress or failure to address the above challenges has an impact on our recommended asset allocation and specific investment recommendations for our clients.

FINANCIAL MARKETS – PRESENT POSITION AND OUR APPROACH IN THE YEAR AHEAD

For the most part, the most effective stock investment strategy during 2011 was to focus on large and mature companies that pay generous dividends. We implemented this strategy earlier in the year and expect to continue holding those positions into 2012. As expected, many investment managers and financial commentators are now jumping on the bandwagon. Presently, we are more interested in establishing or increasing positions in growth categories, emerging markets, metals, real estate and several other categories.

Several themes and world events will continue to have a daily impact on market volatility. The European debt crisis, growing tension with Iran, the strength or weakness of the global economy, the inept political leadership in the United States and our November elections will likely have a continued impact on market volatility, investor confusion, and confidence. Second, a shift of economic importance has been underway and is accelerating away from developed economies (U.S., Europe, Canada, etc.) into the developing (emerging markets) economies. Third, our inept political leadership in addressing the ballooning welfare state and deficit spending is the biggest downside risk to our future investment performance over the long run. The good news: periods of confusion and fear often offer better investment opportunities compared to environments where all investors believe the markets are safe and a sure bet.

As discussed one year ago, every BDL investment management client has a "recommended asset allocation" outlined in their investment policy statement and we have included flexibility by creating an asset allocation **range** rather than a specific number. We have ample experience over the past decade that suggests strictly maintaining a static asset allocation strategy without the flexibility to make meaningful adjustments amounts to a "buy-and-hope" strategy. As our confidence and conviction increases or decreases, we can make adjustments to the stock, bond and other portions of the portfolio as well as the specific type of holdings (aggressive, conservative, income-paying, etc.). Lastly, we believe an optimal strategy for the future is to develop not one, but several contingency-dependent future portfolios for our clients.

For example, we have considered what would be an optimal mix of asset classes (stocks, bonds, real estate, natural resources, etc.) if an economic recovery gains momentum or continues to decline, or what would be an optimal mix of asset classes if debt levels increase and conflict escalates around the world. Lastly, we have considered what would be an optimal mix of asset classes (such as gold, natural resources, oil, dividend-paying common stocks, etc.) if inflation and interest rates begin to rise and continue increasing. The point we are making is that we will continue to use our insight and judgment to distinguish between real trends and reversals and select investment holdings accordingly.

ADDITIONAL IRS RULES FOR COST BASIS EFFECTIVE 2012

Cost basis is the amount you paid for an investment. In addition to the original purchase cost, investors must add to their cost basis any dividends or capital gain distributions that have been reinvested into additional shares. Maintaining accurate cost basis records are important because when you sell, any amount of sale proceeds received above your cost basis is your profit or (capital) gain and the gain is taxable (unless the investment is held in a tax-deferred retirement account such as an IRA, 401(k), etc.).

Prior to 2011, brokerage firms and mutual fund companies only had to report the *gross proceeds* from sale to the shareholder and the IRS. It was then up to investors to decide how to calculate any gain and loss (report their cost basis) when they file their income taxes. Obviously, the IRS believes that accurate cost basis reporting is not occurring and tax revenue collections can be increased by requiring brokerage firms and fund companies to report this information.

Beginning in 2011, this rule was enacted for **stocks**. In 2012, this rule will also apply to mutual fund shares and most exchange-traded funds (ETFs). And, this rule will apply to individual bonds and option contracts in 2013.

The message or take-away is; investors should contact their advisor, brokerage firm, or mutual fund company and provide cost basis information (if the broker/advisor doesn't already have this information). For most investors, this new rule will not be an issue because the brokerage firm or mutual fund company already has this information *<u>if you bought the investment through them</u>*. The problem occurs when investors change brokers or advisors by transferring their account(s) and the new firms do not know what your cost basis is (because you didn't buy it through them). The bottom line is: You don't want the IRS to contact you for clarification or audit because your cost basis numbers on your income tax return don't match

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the cost basis numbers provided by your brokerage firm or mutual fund company. Make sure your brokerage firm, advisor or mutual fund company has accurate cost basis information for all investments held in your account.

ANNOUNCEMENTS

We're back! We moved back into our permanent office space at the corner of Del Mar Heights Road and High Bluff Drive (12780 High Bluff Drive, Suite 100) in mid-December. We are very glad to be back in "our house."

On December 27, 2011 Pam's daughter Annie gave birth to her second son! Myles Paul Tippin is 14 months younger than his older brother Wyatt. The Tippin Family is healthy and doing well.

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.

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Best regards

Brian Lowder Clinton Winey Michael Kinnear Remette Martinson Pam Priest