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Post War Economic Expectations

The conflict in Iraq is going to end – guessing which day of what month isn't productive. Attempting to perfectly time the financial market's reaction to the inevitable conclusion of the war while protecting your principal in the interim will not be successful, nor will it help families attain their financial objectives.

This month, we will *begin* a fourth year since the stock market began to tumble in March 2000. In all previous declines of two years or longer, there were always economic reasons or factors that led to the decline. For the past three years, interest rates have been falling and are now hovering at a 40-year low, unemployment is only 6%, inflation is less than 2% and real estate prices have doubled over the past six years. Nothing seems to make sense.

In retrospect, the primary cause of the bear market is easily understood. Euphoria and unrealistic expectations during the late 1990's created a mania in the stock market and eventually, the pin found the bubble. We were overdue for an adjustment. Then, a series of unpredictable and exogenous events began to occur. The September 11th attack on the World Trade Center, terrorism around the world, exposure of corporate officers playing recklessly with company finances, high profile bankruptcies, accounting and auditing firms implicated in wrongdoing, and the war in Iraq have all created an atmosphere of confusion, reduced confidence and diminished expectations about everything in life.

Simply stated, we have not been experiencing normal cyclical events in our economy over the past 8 years. A prolonged period of irrational upside expectations from 1996 through March 2000 (the new millennium) resulted in investment returns significantly above a normal range. Immediately thereafter, stocks have declined precipitously over the past three years to a level that does not reflect economic reality. Neither the advance nor decline was based on economic fundamentals.

Expectations are important in the long-term planning process. For planning purposes, we have always advocated using "normal or conservative" assumptions and expectations. We suggest that clients and families adopt a more conservative perspective for future planning purposes. For the long-term, expect average to slightly below-average investment returns over the next 5 or more years. Over the short-run, anything can happen. It is likely that the stock market will bounce up from current levels following the conclusion to the war in Iraq. Thereafter, we expect a return to a normal and slower growth pattern for two simple reasons.

One, we have just experienced two extreme periods of irrational market behavior. A five-year period from 1996-2000 was characterized by overly optimistic expectations and above average investment returns followed by three years (March 2000-March 2003) of pessimism and significantly negative returns. While corporate malfeasance and terrorism may never be eliminated, significant steps to address these problems have been implemented. It simply seems likely that a return to normal or slightly conservative returns is probable.

Two, the future direction of economic indicators or variables are not likely to move significantly in either direction. A burst of economic activity is unlikely and

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would signal expectations of rising interest and inflation rates. Alternatively, further reductions in interest rates below current levels are unlikely and would not have much stimulative effect. Today, interest rates are near a 40-year low, inflation is less than 2% and economic growth has slowed considerably due to the collapse in spending for technology, communications and internet services and the uncertainty in our world. Therefore, we do not expect significant growth or decline in any of these economic variables. The likely result is a reversion to a normal range of investment returns.

Financial Market Overview

The first quarter of 2003 featured more of the same volatility as the previous year. The financial markets continue to be dominated by emotion and daily reports of the war in Iraq. One week, the stock market is up over 10% and the next week the gains are erased. In general, the overall stock market was down 3.5% to 4.5% during the first quarter with growth stocks outperforming value stocks and mid-size companies outperforming both large and small companies. As of April 2nd, the market averages were back to the same level as year-end 2002. Below are sample returns of stocks and other asset classes during the 1st quarter of 2003:

1st^h Quarter	*Year 2003*
- 4.2%	*Dow Jones Industrial Average*
- 3.6%	*Standard & Poor's 500 Index*
+ 4.2%	*NASDAQ*
- 1.4%	*Large-company stock-Growth*
- 5.4%	*Large-company stock-Value*
+ 0.8%	*Mid-Size Stocks – Growth*
- 3.8%	*Mid-Size Stocks – Value*
- 4.0%	*Small-company stock- Growth*
- 4.9%	*Small-company stock- Value*
- 8.8%	*International (excludes U.S.)*
+ 0.50%	*Short-term U.S. Treasury (includes appreciation)*
+ 1.03%	*Intermediate U.S. Treasury (includes appreciation)*

New Proposal For Retirement Plans

On January 31, 2003, President Bush announced the most significant *proposed* changes to retirement plans since the creation of Individual Retirement Accounts (IRA's) almost 30 years ago. Congress will ultimately decide whether all or parts of the proposed changes to retirement plans will become law. It is important to begin understanding the new retirement plan options. If passed, many financial plans will need to be restructured and critical decisions will have to made almost immediately since the changes are slated to begin in 2003. Although our country is already dealing with budget deficits, war with Iraq and an earlier proposal to eliminate income taxation on dividends, there is a good chance at least some aspects of these proposed changes to retirement plans will become law. At this time, the main objective is to understand what the new proposal contains and how these changes will alter your current financial and estate plans.

Under the proposal, *no more IRA or Roth IRA contributions will be allowed after 2003.* In addition, the new proposed retirement plans will *replace 401(k)s, 403(b)s, governmental 457s and SIMPLE-IRA accounts.* Only defined benefit pension plans and defined contribution plans (such as SEP-IRAs) will not be affected since these types of retirement plans are funded solely by employers and do not allow employee deferrals (contributions).

The main idea is to encourage individuals to move taxable funds into tax-free retirement accounts. Individuals who have made *tax deductible* IRA contributions in the past must decide whether to convert to the new tax-free plans and pay income taxes now or be subject to existing rules over their remaining lives. Let's begin with the basics.

The President's plan will create three new types of retirement accounts. The first two plans below will be funded and maintained by individuals. The third one will be created by businesses:

1) **Lifetime Savings Account (LSA)**
2) **Retirement Savings Account (RSA)**
3) **Employer Retirement Savings Account (ERSA)**

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All IRAs and any retirement plan that allows employee contributions will be eliminated. Existing IRA's and employee funded retirement plans may be "frozen" or converted to the new plans above. Below are brief descriptions:

- **Lifetime Savings Accounts**
  Anyone can contribute up to $7,500 each year to an **LSA** regardless of income, age or whether you are employed, retired or a minor. The contributions are *nondeductible*. Investment income and gains are never taxable and withdrawals can be made *anytime* for any reason without penalty. Required minimum distributions beginning at age 70 ½ will no longer be required.

  If you have Medical Savings Accounts, Coverdell Education Savings Accounts (formerly Education IRAs) or 529 Qualified State Tuition Plans, they can be converted to **LSA**s but only until the end of 2003. Coverdell and 529 Plan conversions would be tax-free.

- **Retirement Savings Accounts**
  These accounts can be used for *retirement* only. **RSA**s will replace IRAs and Roth IRAs as of Jan. 1, 2004. After 2003, no contributions can be made to traditional IRAs and Roth IRAs. You can elect to keep your traditional IRA "as is" if you do not want to pay the income tax to convert it to a **RSA**. You can still roll over your 401(k) or other retirement plan balances to a traditional IRA and keep it there "frozen" until you decide to convert. Conversion is not a requirement. If you decide to convert to an **RSA** *before Jan. 1, 2004,* you can spread the conversion (income) tax over four years (similar to the option to convert regular IRAs to Roth IRAs six years ago). Anyone can convert regardless of age or income.

  Contributions are not deductible and there are conditions to make tax-free withdrawals. To withdraw tax-free, you must be at least 58 (not 59 ½) or disabled. The maximum annual contribution is $7,500 per person *in addition to* the $7,500 **LSA** described above. Effectively, the total allowable contribution for both plans is $15,000 per individual or $30,000 per couple. You must have compensation to make an **RSA** contribution. If one spouse has at least $15,000 of earned income, then each spouse can contribute the $7,500 maximum. Further, *anyone* can contribute to your RSA as long as *you* have earned income. For example, grandparents can contribute to children and/or grandchildren's **RSA** if the accountholder has employment income. Tax-free withdrawals may begin at age 58 and there are no required minimum distributions at age 70 ½ (however, required minimum distributions at age 70 ½ remain in effect for those taxpayers who elect NOT to convert their regular IRA, 401(k) etc. to the new **RSA**).

- **Employer Retirement Savings Accounts**
  This new retirement plan account is created and maintained by employers and will replace 401(k)s, 403(b)s, government 457s, SARSEPs and SIMPLE IRAs (all retirement accounts created by employers that allow employee contributions). The typical plan participant will not detect any changes other than the name. Employees would be allowed to contribute up to $12,000 of their compensation (just like current 401(k) plans) or up to $14,000 if the employee were age 50 or older (born before 1954). What will change is the compliance rules employers are required to follow to avoid being classified as "top-heavy" and or failing to meet "discrimination testing". The rules for contributions to **ERSA's** will be simplified and uniform.

In summary, the objective of the proposed plans is to provide simplification and allow much more money to be contributed towards retirement than under current retirement plans. In addition, the three new plans above are designed to change the current system that actually penalizes savers by imposing estate and income taxes on already taxed money. First, taxpayers earn their money through wages and it becomes subject to income tax. Then you save it and pay income tax on the earnings, or if invested in a retirement plan, the tax is deferred but ultimately assessed when withdrawn during retirement. Finally, if your estate is large enough, it is again subject to an estate or death tax.

One primary drawback is eliminating the deduction for IRA contributions. For many taxpayers, this income tax deduction has been a strong incentive to save for retirement. Another drawback is the timing of the

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proposal. Many states have budget deficits. Allowing more funds to escape income taxation couldn't come at a worse time. The federal government would likely see an increase in tax revenue over the first four years as many taxpayers will decide to convert their existing IRAs and pay the income tax now (equal payments over four years) in exchange for tax-free withdrawals during retirement. But, tax revenues will decrease later on when tax-free withdrawals begin during retirement.

In the final analysis, the new proposed retirement plans and Bush's proposal not to tax dividend income are both designed to rectify the unfairness of double taxation and to increase taxpayers ability to save for their own retirement. Unfortunately, the timing couldn't be worse. Presently, we are involved in an expensive confrontation in Iraq, the federal and state budget surpluses from the late 1990's have turned into budget deficits, and corporate officers and individuals are holding back on spending. The end result is a lack of confidence and a drag on the economy. We will keep you informed on this issue as the details become available.

At this time, it is important to understand what is being proposed, when decisions must be made and how the proposed retirement plans might affect your personal financial plan.

Year 2002 Income Tax Returns

Please send us copies of your 2002 Federal and State income tax returns as soon as they are available. Our investment advice and long-term financial planning recommendations are most effective when we have current income tax information in our files. Your tax preparer will only send us this personal information upon your request. Please contact your accountant or send us copies at your earliest convenience.

Best regards

Brian Lowder   Clinton Winey   Michael Kinnear   Remette Martinson   Pam Priest