// BRIAN D. LOWDER, INC.
QUARTERLY NEWSLETTER
Volume 7, Issue 2 July 2004

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Financial Market Overview

The suspense and drama are over. On the last day of the second quarter, the Federal Reserve Board raised interest rates for the first time in four years from a 45-year low of 1% to 1.25%. Since everyone anticipated the rate increase, the financial markets reacted with a long-anticipated yawn. The overall stock market rose less than ½%.

The consensus forecast for interest rates is a gradual increase in the federal funds rate from the current 1.25% to somewhere above 3% and less than 5% over the next few years. Since the direction and magnitude of future interest rate changes are expected and confirmed by Alan Greenspan, no one should be surprised about future rate increases. Consequently, investors should not be overly concerned about the potential for a severe market correction due to rising interest rates.

An upward trend is expected to continue for many important economic indicators. The growth in new jobs and higher wages has provided a boost to consumer confidence. Corporate profits and our country's total output of goods and services are growing at a steady and sustainable pace.

As expected, economic improvement will have a direct impact on consumer prices. The rate of inflation, while still low, has increased from a 2.5% annual rate to 3.5% over the past twelve months. Rising interest rates will increase the cost of maintaining debt. Fixed-rate home mortgages have recently increased from 5% to over 6% and are likely headed toward 7% by the end of next year.

The financial markets will adjust as new information becomes available, but the overall economic outlook is favorable. Investment performance is likely to remain positive though much closer to historic averages. Investment returns on various asset classes were uninspiring during the second quarter. The average stock mutual fund was up less than 1% during the second quarter and the year-to-date performance is just below 4%. The major stock indexes were up slightly more than 1% during the second quarter and up about 3.5% through June 30th. Large-company stocks outperformed mid-size and small company stocks by a narrow margin. In general, value-oriented stocks outperformed growth stocks. Bond funds declined as expected due to rising interest rates and real-estate funds, last quarter's top performer, fell more than 5.5% in the second quarter. Gold funds had the worst performance during the second quarter falling more than 18%.

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Below are sample returns of various asset classes during the second quarter of 2004:

12 Months	2nd Qtr.	
18.6%	+1.2%	Dow Jones Industrial Average
19.1%	+1.7%	S&P 500 Index
20.4%	+1.3%	Wilshire 5000 (broad market)
15.6%	+1.2%	Large Cap Growth
19.2%	+1.0%	Large Cap Value
22.6%	+0.5%	Mid Cap Growth
30.1%	+2.0%	Mid Cap Value
27.0%	- 0.6%	Small Cap Growth
34.1%	+1.9%	Small Cap Value
28.6%	- 0.8%	International Stocks
26.7%	- 5.6%	Real Estate
25.7%	-18.5%	Gold
0.2%	- 2.4%	Intermediate Bond

Our Perspective: Short Verses Long-term Expectations

For the remainder of 2004, the financial markets will likely be uninspiring. The presidential election will not have a material impact on the stock and bond markets. Americans are equally split between the two candidates and the two political parties in Congress are nearly equally represented. In this neutral environment, it will be challenging for either political party to forge significant changes to our tax laws, economic policies, or social programs. Significant changes to our current income and estate tax laws are not likely and the renewed interest in a flat national sales tax doesn't have enough support in Congress to become a reality anytime soon.

Rising inflation rates have traditionally benefited real estate prices. Oddly, real estate prices have increased dramatically over the past seven years while inflation rates were falling. While the inventory of open space for large residential development is scarce in metropolitan areas, the primary reason homes have dramatically increased in value over the past seven years is because of the significant decline in interest rates at a time when residential real estate prices had just completed a seven-year decline. Simply stated, that phenomenon is over. Likewise, the repeated refinancing of mortgage debt and simultaneous withdrawal of equity value for increased consumer spending is finished. Only homeowners with variable-rate financing will be refinancing over the short-term. The long-term outlook for residential real estate prices will likely be flat to modest declines over the next five years. Commercial and investment real estate prices will perform better than homes, but rising interest rates will keep a lid on future price appreciation. Our best guess is rental income will be offset by a modest decline in property valuations.

Similar to real estate values, the prices of both gold and oil usually increase in value due to rising inflation rates. Since inflation rates were falling over the past five years, the jump in oil and gold prices can be directly linked to terrorism. Terrorism, along with the war in Iraq and Afghanistan, has created fear, uncertainties, shortages and disruptions in normal supply and demand relationships. While religious and political conflict originating in the Middle East will not likely be completely resolved and acts of terrorism may occur in the generations ahead, the heightened concerns and fears are subsiding. Expect volatility in oil and gold prices over the short-term, but the longer-term outlook for gold and oil prices is not attractive.

The high probability of continued interest and inflation rate increases renders intermediate and long-term bonds unattractive. The loss in value will likely offset the interest income. Therefore we recommend limiting your bond investments to short maturities and growth investors should consider selling (short) long-term bonds. U.S. common stocks should perform near or slightly below their long-term average returns.

The most attractive opportunities beyond the immediate or short-term horizon are international

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stocks, emerging markets and to a lesser extent large U.S. company stocks. The growth opportunities in the Pacific Rim, India, China, Russia and others are higher than in the United States. The U.S. will always have the edge in providing services, intelligence, technology and other areas, but the real growth in manufacturing, supplies, etc. are overseas.

In summary, the asset classes that performed best over the previous 3 years are not likely to be the best choices for the next five years. Important changes discussed earlier are underway. Investment returns will likely trend toward the mid or lower-end of their historical averages. Retirees and others who derive most of their spending income from their investment portfolio need to plan ahead with the assumption of modest investment returns. In our opinion, the probability of earning above-average investment returns equivalent to the returns earned in 2003 or the late 1990's is very small. Likewise, we view the probability of experiencing three consecutive years of negative stock returns similar to 2000-2002 as very unlikely. Clients need to focus their attention on total expenditures as they have much more control of their annual spending than they have control over future investment returns.

We continue to do our part by paying close attention to reducing costs. Active stock trading or choosing mutual funds with high expenses and/or turnover ratios (active trading within the mutual fund) increases costs to investors and reduces investment returns. In addition, we pay particular attention toward reducing the income tax consequences of active trading and carefully matching investment gains against investment losses.

Advisors should employ both passive (indexing) and tactical (proactive changes) investment strategies when the opportunity arises. Passive investment management reduces costs and routinely outperforms active investment managers 70% of the time over periods of 5 years or longer. Tactical investment moves are the exception to a passive management strategy, but are clearly worthwhile when the economic environment is changing (as we believe is the case today).

Our clients should have noticed a reduction in their small-company stock holdings, an increase in large-company value stocks, international stocks, emerging markets, and the purchase of other alternative investments. Our relatively conservative clients should have noticed a meaningful reduction in growth stocks, an increase in value-oriented stocks and short-term bonds. Attention to these details is critical during a period of anticipated moderate to below-average investment returns.

We Made It!

The move to our new office location in Del Mar Heights is complete! The entire staff planned everything to the smallest detail and we are pleased to announce everything went very smoothly. We look forward to meeting with you in our new location in Del Mar Heights.

Year 2003 Income Tax Returns

We would like to thank our many clients who sent us copies of their 2003 income tax returns. Our investment advice and long-term financial planning recommendations are most effective when we have current income tax information available in your file. For those clients who extended their deadline to file, please send us copies at your earliest convenience.

Best regards

Brian Lowder | Clinton Winey | Michael Kinnear | Remette Martinson | Pam Priest