
BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

The second quarter ended with another one-quarter percent increase in the federal funds rate – the ninth increase over the past 12 months. Although most stock indexes and mutual fund categories ended the second quarter with modest gains, all major stock indexes were down slightly during the first half of 2005. In retrospect, the stock market didn't perform badly given some powerful headwinds – runaway oil prices reached \$60 per barrel, the trade deficit worsened, General Motor's credit rating was downgraded, growth in corporate earnings is slowing and the number of new jobs created during the first half was lower than expected. Below are sample returns of various asset classes during the second quarter and year-to-date.

<u>2nd Quarter</u>	<u>Year-To-Date 2005</u>	(includes dividends reinvested)
(1.6%)	(4.7%)	Dow Jones Industrial Average
+ 1.4%	(1.7%)	Standard & Poor's 500 Index
+ 2.4%	(0.8%)	DJ Wilshire 5000(Broad Market)
+ 2.9%	(1.8%)	Large-company stock-Growth
+ 2.5%	+ 2.8%	Large-company stock-Value
+ 1.3%	+ 2.8%	Mid-Size Stocks – Growth
+ 2.8%	+ 2.3%	Mid-Size Stocks – Value
+ 3.8%	(1.7%)	Small-company stock- Growth
+ 2.9%	+ 0.8%	Small-company stock- Value
(0.7%)	+ 2.1%	International (excludes U.S.)
+ 3.9%	+ 5.2%	Emerging Markets
+ 13.0%	+ 5.1%	Real Estate
+ 1.2%	+ 1.3%	Short-term U.S. Treasury (includes appreciation)
+ 2.3%	+ 2.6%	Intermediate U.S. Treasury (includes appreciation)

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The outlook for the investment markets and the overall economic environment seems confusing. The stock market rises in one month only to lose the gains in the following month. Alan Greenspan continues to raise short-term interest rates (federal funds rate), yet long-term interest rates are still at the same level as they were twelve months ago. One month investors are optimistic and the following month disappointment reappears. It's just a matter of time before rising interest rates and the price of oil slow the growth rate of the economy. As stated in recent newsletters, expected investment returns are likely to stay in a narrow range and the probability of a dramatic increase or decrease appears unlikely.

Real Estate

Over a year ago, we expressed our concern that the overall real estate appreciation rate was unsustainable. Most investors and homeowners remain euphoric as they continue to experience unprecedented annual appreciation rates while simultaneously paying the lowest borrowing costs during their lifetimes.

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Several factors have attributed to this unprecedented real estate appreciation cycle that began in 1997. Prior to 1997, homeowners endured a six-year period of depressed real estate values. Beginning in 1990, real estate values began to decline and the demand for housing and investment real estate was nearly non-existent by 1996. Families simply deferred their plans to upgrade their homes and the idea of purchasing investment real estate was simply unattractive. Beginning in 1997, a significant increase in family wealth was born fueled by the overall growth in the economy, a bull market in internet and technology stock prices in the late 1990's and finally, interest rates continued to decline until reaching their lowest levels in forty years. After experiencing six years of declining real estate prices and simultaneously experiencing an increase in employment income and speculative stock market valuations, the pent-up demand for real estate suddenly exploded.

In addition, statistically the highest *volume* of real estate transactions begins at age 26, peaks at age 37 and begins to slow at age 42. The peak baby-boomers born in 1961 would have hit the primary peak in home buying in 1998 and the secondary peak of age 42 in 2003. Historically, the largest segment of our population - the baby boomers - had just entered into their peak spending years just as the pent-up demand for real estate was about to explode, the technology/internet bubble was creating enormous wealth and lastly, interest rates had fallen to their lowest levels in forty years. In retrospect, the combination of the above events led to an explosive jump in real estate prices.

Is the party over? We firmly believe it is. Frankly, it is not terribly important to us whether the changes we see on the horizon will occur in six months, twelve months or longer. Trying to predict the exact timing of anticipated changes is a difficult task. Our objective is to identify problems or opportunities and provide our clients with adequate time to make appropriate decisions. Changes can be made proactively based on

rational analysis rather than emotional reaction. Below is a sample of the excesses and false assumptions we find in the real estate market today:

Mortgage Bankers are desperate to lend. The old game of continually refinancing your home mortgage to a lower-rate loan has ended. Consequently, refinancing volume has tumbled and the profitability of mortgage lenders has declined. Just as auto companies sought to maintain sales volume after the terrorists attacks in New York by offering low-rate and zero interest rate auto loans, mortgage lenders are offering increasingly sweet deals in a scramble for market share. Douglas Duncan, the chief economist of the Mortgage Bankers Association, reports that profits have fallen 70% from 2003 to 2004 among the top seventy lenders. Lenders are increasingly offering cheaper products (loans) to keep business moving while simultaneously lowering their lending standards. As long as real estate prices keep moving up, the day of reckoning is prolonged.

Creative financing schemes are encouraging buyers to accept higher prices in exchange for cheaper financing. Lenders are creating and promoting a growing array of financing schemes and lower qualification standards in an effort to maintain lending activity. No-money down loans, interest only loans, allowing borrowers to defer (skip) loan payments and add the payments to the loan balance, low initial teaser rates that adjust later on, low initial fixed rates that switch to a variable rate in three to five years, and 40-year loans that ease qualifying standards and lower monthly payments are all part of the growing menu of choices for borrowers that were either not available or considered poor choices prior to this recent surge in real estate prices.

Adjustable-rate and interest-only loans accounted for nearly two-thirds of all new loan originations in the second half of 2004. These loans are less

expensive initially and enable buyers to purchase more expensive homes. In California, interest only mortgages accounted for 61% of all new mortgages in the first two months of this year, up from less than 2% in 2002. Shockingly, during the month of May 2005, 82% of all the new home-purchase loans in San Diego had adjustable rate features. A rational analysis of this trend would indicate that 82% of home buyers expect interest rates to stay flat or decline over the next fifteen to thirty years, or they do not expect to stay in their home beyond a relatively short period of time. Alternatively, an irrational but very likely reason for such a high demand for adjustable rate loans is that borrowers can't afford the payments on a standard fixed-rate 30-year loan or they don't realize they are making a long-term purchase decision using short-term financing.

Even in the unlikely scenario that interest rates *never* increase, the payments on an interest-only \$350,000 mortgage will increase over 40% after five years when the principal portion of the mortgage payment must begin to be included in the monthly calculations. If interest rates jump by 2%, from today's 5% level to a still reasonable 7% level, the mortgage payment on an interest-only loan will increase more than 70% after five years. The explanations and rationalizations that lenders and homebuyers are counting on to justify these lofty real estate prices are reminiscent of the explanations cited for paying ridiculous prices for internet/technology stocks in the late 1990's. Homebuyers are simply not considering the economics of the real estate transaction. The fear of being left behind (similar to investor fears during the late 1990's regarding technology and internet stocks) is the driving force rather than what they are going to pay over the long-term and the implications or risks they are assuming with regard to the future direction of interest rates.

Banks and other lenders learned this lesson the hard way back in the 1980's. For many years, banks used to accept or shoulder the burden of interest-rate risk by offering primarily fixed-rate loans and allowing new homebuyers to assume

(take over) the payments on existing home loans as properties were sold. As interest rates began to rise, lenders found themselves locked into low interest rate home loans while trying to remain competitive by offering higher rates of return on certificates of deposits and other investment accounts. Their revenue sources (home loans) were locked in at low fixed rates, yet banks were forced to pay higher rates of return on customer deposits as interest rates increased.

Over time, banks began to favor variable rate loans that allow the home mortgage rate to change according to the level and direction of interest rates. Basically, banks shifted the burden of interest rate risk to consumers. Today, the same scenario is occurring in reverse. Borrowers are accepting variable rate or interest only short-term financing while interest rates are currently at a forty-year low instead of locking in a fixed rate that matches the expected holding period of their homes. In the near future, consumers will find themselves in a difficult situation when interest rates rise. Sometime in the future, it will be their responsibility to refinance their home loans at future interest rates when they could have locked into today's low fixed rates.

Why are consumers choosing variable-rate and interest only financing rather than fixed-rate financing today? Variable-rate financing is popular primarily because home prices have increased dramatically and the only way consumers can qualify for a larger loan or reduce the costs of maintaining a home is to choose variable or interest-only financing. Essentially, homebuyers are making a long-term purchase decision with short-term financing.

The population growth exceeds available housing. False. The construction of new homes is outstripping the natural growth of the population in San Diego County. Further, only 18% of residents can afford to buy a home in San Diego and most of the influx of new residents in our county earns less than \$100,000

annually. Lastly, many corporations that provide higher-paying jobs are leaving San Diego and California. Over the past two months, Intel announced it is relocating 200 to 300 workers from San Diego to Oregon. Astutely, Intel may decide to sell its 30 acre parcel of land along Interstate 15 at an enormous profit and move the campus elsewhere.

Hewlett Packard has also announced job relocations by moving employees away from San Diego. The old kelp-harvesting firm, Kelco, (now a division of International Specialty Products) is completely closing its plant in San Diego. The truth is - population growth is not the primary reason supporting San Diego's escalating real estate prices and population growth won't support real estate prices as interest rates rise. The lack of large undeveloped parcels of land in San Diego is also not a relevant explanation for escalating real estate prices. Real estate prices in areas that have plenty of vacant land available for development have also risen sharply.

In summary, consumers have experienced a wonderful increase in home equity values. In the future, be rational rather than hopeful. Aside from the discussions above, historically no asset class has experienced an indefinite period of extreme abnormal returns. The longer the period of extreme abnormal returns, the greater the adjustment will be. Accept the reasons that allowed such a marvelous return and be wise about protecting that appreciation in the future. Knowing when to protect your gain is every bit as important as having the guts and confidence to make the initial purchase.

If your expected holding period for existing real estate is five years or less, it is not relevant whether you have fixed-rate or variable rate financing. If your family expects to maintain the existing home for more than five years, or if your investment property is generating sufficient income to cover expenses and the holding period

is long-term, we recommend locking in fixed-rate financing immediately. Lastly, don't be fooled by the persuasive suggestions that variable-rate financing is the best choice for the future based on the previous 15 years. With hindsight, variable-rate financing was a good choice! Since the early 1980's, home mortgage interest rates have declined from over 15% to less than 5%.

Where are interest rates headed in the future? No one knows the answer with absolute certainty. However, we do know where interest rates have been in the past and the economic environment during these periods that resulted in rising and falling interest rate levels. Rather than guessing where interest rates might be headed over the next fifteen years or more, now is the best opportunity in many years to lock in very low mortgage-rate financing that corresponds to your expected holding period of your home and investment real estate. In other words, families can remove interest rate risk by locking in to very low fixed costs today. If interest rates do decline further, then refinancing is always an option. However, in our opinion the probability of experiencing higher mortgage rates in the future is *much greater* than the probability of experiencing flat or even lower interest rates.

The Wisdom of Asset Allocation and the Impact of Economic Changes on the Investment Process

Asset allocation is the foundation of a sensible long-term wealth-building plan. To be a successful investor over a long period of time, you *must* have a basis or starting point in the portfolio management process. For many investors, the starting point is deciding which individual stock, mutual fund or other investments to purchase. However, the *specific* investment selection is the *last step* in our investment management process. In the discussion to follow, we will review our

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investment management process and the reasons behind the shifts we have made in our client portfolios.

Asset allocation is simply the process of apportioning your total investment funds among categories of assets. Examples of common asset categories are: *cash equivalents, stocks, fixed income or bonds, real estate, etc.* Asset allocation affects both the risk and return of your total portfolio. For example, the larger the allocation of funds to stocks, the greater the risk and potential investment return.

Using an asset allocation model for your portfolio has the following benefits. The model serves as a blueprint for building an investment portfolio that matches your investment return objective without exceeding your risk tolerance. Simply stated, asset allocation creates boundaries, helps us maintain the desired exposure to different asset categories and is an effective tool in controlling risk. More importantly, using the asset allocation model as a starting point or framework for making investment decisions provides a disciplined process of focusing on three important characteristics identified below.

One, allocating your funds to various asset categories first, before considering individual security selections, places the emphasis on the total portfolio return, not the prospective performance of one or more individual investment selections. Two, spreading your funds over a variety of asset categories provides diversification. Diversification is the best defense against experiencing large losses during periods of economic uncertainty and unexpected events. Three, while the asset allocation model allows flexibility to overweight certain asset classes that are expected to perform well, it also provides the discipline to maintain a minimum exposure in each asset category. This approach reduces the frequency and magnitude of changes to your portfolio. Additionally, infrequent trading reduces

commissions or transaction fees, reduces the number of potential mistakes and minimizes the income tax consequences of selling investments within a twelve-month holding period.

Once the overall asset allocation decision has been made and the entire portfolio is divided into specific asset categories, the next step is deciding which *subcategories* to use within each broad asset class. For example, if we have jointly determined that 65% percent of your total portfolio should be invested in stocks, which types of stocks should be included? It is important to note that we haven't yet arrived at the point in the process where individual stock or mutual funds are evaluated. The economic environment, world affairs, interest and inflation rates, and many other variables should be considered when determining how much of the 65% allocation to stocks should be invested in *growth or value stocks, large companies, midsize or small companies, international, global or U.S. stocks.*

Some investors and portfolio managers do not include this step in their portfolio management process. Their reasoning is that it doesn't matter whether the company is considered a growth stock or value stock or whether the company is large or small. If the company financials are strong and the product line or services are in high demand, then further classification is not necessary. This approach is referred to as "bottom-up", where the evaluation and selection process begins at the company level without considering the overall economy, industry or the "big picture."

When portfolio managers begin the evaluation process with an assessment of the overall economy and then determine what type of industries should perform well in that specific economic environment, the last step is identifying and evaluating which specific stocks, companies or mutual funds have the best competitive advantage within that industry. This latter method or process is referred to as a "top-down" approach.

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While both methods are acceptable and widely used in the investment selection process, we prefer using the “top-down” approach before evaluating specific securities to purchase or sell.

While an evaluation of the overall economy is certainly a difficult and uncertain endeavor, we find the exercise is worth the effort. Certain subcategories perform better than others depending upon the economic environment. For example, during the late 1990’s, *large-company growth stocks* (especially technology and internet-related companies) were very popular. The economy was strong and all companies realized the necessity of updating their computer hardware and information technology applications in preparation for the year 2000 (new millennium). The combination of a growing economy and very high demand sent stock prices of *large-company growth stocks* into the stratosphere.

The strategy of moving your funds into the “hot” stocks or into the best performing equity categories at the moment is referred to as an *active trading or momentum strategy*. Stock selections are based primarily on which stocks have the upward price momentum at the moment. This approach is very appealing and irresistible to most investors. It is also the strategy that allowed many investors and professionals to overweight the technology and internet sector in the late 1990’s. While using an asset allocation model would not have prevented losses in the *large-company stock* category during the year 2000, it did prevent investors from over-exposing their portfolio to greater losses in this single asset subcategory. Chasing the “hot stocks”, individual securities or mutual funds within the best-performing subcategory and ignoring the importance and discipline of an asset allocation strategy is a losing proposition over a long-term time horizon. During one year, large-company growth stocks may be the best performing asset category followed by small-company value stocks in the subsequent year. In

support of this statement and assessment, we offer the enclosed charts.

The first chart simply ranks the performance of six different stock subcategories and one bond category from best to worst over the previous 21 years. The columns indicate the calendar years from 1984 to 2004 and the rows indicate performance with the best performing category in the top row and the worst performing category in the bottom row. For example, in the first year 1984, the *Bond* category performed best followed by *Large Value* stocks and so on. The worst-performing category was *Small Growth* stocks.

Several observations can be made. As the chart clearly illustrates, a strategy of trying to predict the best performing investment category for any year will have little success because top performing categories do not always repeat. Furthermore, the top performing category in one year often ranks among the bottom performers in subsequent years. Since no one can predict next year’s top performing category with certainty, it makes sound investment sense to diversify your money into more than one investment category. This is exactly what asset allocation models do.

The first chart also illustrates which asset categories are the most volatile and unpredictable. The *International* stock category is the most volatile. Very rarely does this category fall into the middle section of relative performance. During most of the twenty-one period, *International* stocks either perform very well or very poorly. During the twenty-one period, the *International* stock category performed best in five of those years and second best during three years. On the other hand, the *International* stock category also ranked last seven times during this period.

The second chart highlights only the *International* and *Large Growth* stock categories over the past

twenty-one years to illustrate their erratic relative performance. While both categories exhibit volatile historical performance, both categories also offer above-average return opportunities. The *Large Growth* stock category is the best example of recent volatile performance. During the late 1990's, large growth stocks became the "darlings" of Wall Street over a six-year period. Over the ensuing five-year period from 2000 through 2004, large-company stocks were the second-worst performing category.

From 1984 through 1993, growth stock performance was very volatile – fifty percent of the time landing in the top 50% of relative performance and an equal number of times in the bottom half of performance.

The third and final chart illustrates the two asset categories that we favor over both long and short-term time horizons. *Large-Company Value* stocks and *Mid-Cap* stocks have a consistent record of above-average and relatively predictable performance records. While neither category has had the absolute best performance in any one-year period over the past 21 years, they also have not recorded the worst performance either. The most important point to remember is that the average return in these two stock categories is still a very acceptable return for long-term wealth accumulation.

In summary, the asset allocation strategy gives you a starting point for assessing risk and return, provides a blueprint for selecting asset categories, creates boundaries, promotes diversification, infrequent trading and best of all, is one of the best long-term investment management strategies. We use asset allocation models for all of our clients because it provides a disciplined basis or framework for creating and maintaining a diversified portfolio.

You may have noticed that we have systematically reduced your exposure to *large-company growth*

stocks and *small-company* stocks over the past eighteen months and maintained your exposure to *mid-size company* stocks. Conversely, we have increased your exposure to *international* stocks and *large-company value* stocks. International stocks are appealing because the U.S. dollar has been declining in value relative to other foreign currencies and the U.S. has both a trade imbalance and deficit spending problems to correct. In addition, many jobs and business opportunities will continue to gravitate toward other countries where wages, taxes, regulations and other impediments to business growth are more favorable compared to the United States. Large-company value stocks are also attractive because the U.S. economy is likely to grow at a modest pace throughout the remainder of this decade. With corporate profits growing at a slower rate, the adverse impact of higher oil prices on corporate earnings and the likelihood of continued interest rate hikes by the Federal Reserve, we view established companies that pay attractive dividends as a more secure and predictable place to be for our investors.

At this point in time, we expect to continue favoring these categories. We hope this discussion is helpful in understanding the purpose and benefits of using asset allocation as a starting point in the investment management process and the areas we find most appealing over the next five years.

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Best regards



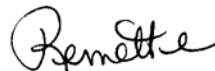
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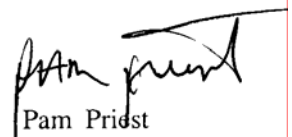
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