BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

Investors keep hoping for a turnaround or at least a bottom to declining stock prices, but their hopes keep getting dashed. The dismal stock price performance over the past three months has tested the strength and convictions of even the strongest investors. At the end of the third quarter, the Dow Jones Industrial Average reached its lowest level since August 1998. The third quarter drop of 17.9% was the worst quarterly decline since the final three months of 1987. The overall stock market is now at levels that defy rational decision-making. But, just as we experienced irrational investor behavior with stock prices going up in late 1999, the mirror opposite on the downside is still before us. Trying to predict the market top was a futile exercise in March 2000, and suggesting when we can expect an end to the current decline is also counterproductive. Before discussing how to proceed under the current market environment, below are sample returns of stocks and specific sectors of the financial markets for the **third quarter**:

The bottom line is that decisions for the future must be made from a reference point that begins today. The economic losses and declines to portfolio values since March 2000 are real. However, historical performance and investment losses are historical facts and are not relevant to your decisions today. For those investors who have concluded that the losses and volatility they have suffered in the stock portion of their portfolio were larger than they are able to tolerate, then they should permanently reduce the allocation to stocks in the future. The series of events that occurred since September 11th 2001 and the direction of the stock market over short periods of time are not predictable. The cost of reducing volatility in your portfolios is a lower and more predictable long-term rate of return in the future.

Investors who remain committed to earning a higher target rate of return compared to safe fixed income investments (earning 4% or less today) should focus on making decisions based on today's prices and future outlook. Referencing the figures above, would you consider investing a portion of your portfolio in growth assets (stocks) that have declined 35% to 77% over the past 2 ½ years, but have also provided an 8% to 12% compound annual return over the past 70 years? Do you find yourself asking why you didn't buy more real estate in 1997? Have you ever asked why you didn't buy stocks immediately after the infamous Monday, October 19, 1987 market crash? The answer is probably the same. Either you responded I couldn't afford to take that kind of risk regardless of how much

	3RD Qtr.	**Year-to-Date**	**Decline Since Record Close in March 2000**
Dow Jones Industrial Av.	-17.9%	-24%	-35%
S & P 500 Index	-17.6%	-29%	-47%
NASDAQ	-16.4%	-40%	-77%
Large U.S. stocks	-17.1%		
Mid U.S. stocks	-18.5%		
Small U.S. stocks	-21.3%		

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money I could have made. Or, I was too scared and psychologically unable to make that decision.

Uncertainty and fear are normal emotions during times like today. We don't expect investors to develop a shield for their emotions. However, the decisions investors make during euphoric market conditions and during tough and uncertain times has an enormous impact on investment performance and attaining long-term retirement goals. The issues I am addressing here are risk tolerance and long-term perspective.

Investors do not earn 8% - 12% compound annual returns over a ten-year time horizon by investing in growth assets at a time when the market has been trending up for years and the risk is perceived as low. Rather, investors stay invested over a period of time that includes good times (late 1990's), bad times (2000-2002) and when prices are below rational levels that create opportunities (presently). Darting in and out of the market has limited short-term potential and near-certain probability for long-term failure. Selling growth assets today after enduring a 2 ½ year decline is likely an emotional decision. On the other hand, the decision to buy a growth asset (i.e. residential real estate) after it has doubled over a six-year period is probably based on immediate *past performance* and not on an objective and fundamental evaluation of expected performance in the future.

OUR PERSPECTIVE

Many clients have requested that we communicate our perspective during these emotionally difficult times and to support the recommendations with our views on the economy and the financial markets. To begin with, there is conflicting data and valid reasons to support opposing views. While confusion and conflicting data presents a challenge, it also creates opportunities. When investors and advisers agree and everyone is sitting in the same bandwagon, trouble is near. To begin our discussion, below is a list of opposing reasons that impact investor decisions, the overall economy and the direction of the financial markets:

Pessimistic Factors:

1) Still suffering the emotional shock and reality of a significant stock market decline. Investor confidence is low and uncertainty is widespread.
2) Suspicion of more corporate malfeasance announcements.
3) Economic recovery hasn't arrived as expected. Collectively, corporate earnings are still trending down.
4) Recent announcements of layoffs are on the rise again.
5) The perceived adverse economic impact of an Iraqi / U.S. war.
6) WILDCARD – Terrorism risk. While the likelihood of additional terrorist acts or war with Iraq is a legitimate concern and creates a cloud over the financial markets, the *real question* is whether the likelihood of a terrorist act or war will have a *material effect* on our economy.
7) Growing debt levels of American consumers.
8) Concern that consumer spending will weaken. Consumers have enjoyed a healthy influx from rising real estate values and repeated refinancing at lower interest rates. How long will this last?
9) Business confidence and willingness to incur additional expenses and capital commitments is low.

In particular, numbers one, five and six are having the greatest short-term impact in pushing stock prices back to the levels reached in 1998.

Optimistic Factors:

1) Very low interest rates. Regardless of where we are in the economic cycle, low interest rates are beneficial to businesses and consumers. We don't need *lower* interest rates. Some investors make the argument that lowering interest rates below today's current level will not have any effect on the economy. We agree. We don't need *lower* interest rates to jump-start the economy. We need low interest rates in place when the recovery begins.

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2) Real incomes (adjusted for inflation) are still rising in spite of the stock market decline.
3) There is an enormous amount of cash (money market funds, bank certificates of deposits, etc.) on the sidelines as a result of investors selling into the decline.
4) Stock valuations are at attractive levels. Investors have a tough time with this statement. Just as the public (investors) did not have a fundamental basis or understanding of stock valuations as they purchased tech stocks at ridiculous price levels in 1999, they also do not realize how “fair” stock prices are today. Except this time, instead of being worried about being left behind and not making tons of money, investors want *out* and can’t see any reason to stay invested in stocks.
5) Corporate insiders are buying again.
6) The American economy is not as bad as investors believe and economic cycles always change over time.

There is a perception of greater downside risk today in the stock market than two years ago. While downside risk is always there, the level of uncertainty and pessimism is high. The stock market correction, recent corporate malfeasance and threats of war and terrorism are fresh in the minds of most investors. But we have already experienced most if not all of the downside risk. We believe the optimistic factors carry much more weight from this day forward. Investors must think hard about their short-term time horizon and comfort with short-term risk. The temporary risk to the equity market should be weighed against the potential returns *when* we experience a cyclical upturn over the next year. Below are our near-term (5-year) expectations for various asset categories:

Gold

After 22 years, gold is still down over 50% from its high reached in 1980. Gold has produced a positive return in only three of the past 12 years. However, in two of those years, the gain was less than 1%. Yet, gold is often mentioned as the place to be in the current environment. Why? One, gold prices move in the same direction and magnitude as investor fear, uncertainty and rising inflation rates. The 2.5-year stock market decline, terrorist attacks and increasing tension between the U.S. and Iraq have created uncertainty and fear. Two, upward momentum in the price of gold catches the attention of investors. Many investors are still chasing whatever investment category is on the rise – often referred to as momentum investing.

Aside from investor uncertainty and global tension, is there any tangible or fundamental reason to invest in gold? It certainly can’t be because of increased demand for jewelry or industrial uses for the metal itself. High inflation rates also cause gold prices to rise, but inflation is dead – less than 2% annually. The bottom line is that gold is not a long-term investment holding. If gold is purchased today, investors must be prepared sell it. Gold does not provide positive mid-term or long-term investment performance – it is an asset that requires trading. The price of gold is up because of uncertainty and the threat of war. Once war has been averted or begins, the uncertainty is gone and the price of gold will likely fall – unless you believe America will not prevail.

Real Estate

Our confidence in assessing the near-term prospects of this asset class is much higher today than any other asset class at this time. To begin, I've heard nothing but real estate today on CNBC! This past weekend, I was “channel surfing” on my television and often found one or more cable stations with programs on how to increase cash flow, buying real estate with nothing down and interviews showing people making more than their annual salary in real estate (sound familiar?). In addition, they interviewed “experts” offering new theories and paradigms having to do with demographics and immigration that are supposed to push prices ever higher. Interesting. New theories on why things are different this time – where have I heard this before?

Locally in San Diego and in general the whole state of California, residential real estate prices have more than doubled since the Spring of 1997. How could this occur? One, we had a six-year decline in real estate values from 1991 through Spring 1997. Over time, home prices fell to bargain levels. Two, interest rates have declined to the lowest levels we have experienced since 1960. Lower interest rates enable homeowners to pay a lower financing cost on their existing homes or to buy larger homes without an increase in their mortgage costs. Three, unemployment rates are low (6% currently). After enduring a six-year decline in real

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estate prices followed by lower interest rates and high employment rates, the result has been a very favorable real estate market over the past 6 years.

Now, speculators are trying to earn a positive investment return on the only asset class (other than gold) that has produced positive returns since the stock market correction began in March 2000. The bandwagon is full. Real estate investment clubs are sprouting up all over and regular folks are investing in everything from commercial real estate to land. Two weeks ago, the L.A. Times published a feature article about 100 women in Los Angles banding together to purchase real estate. If real estate investors believe that: a) the stock market is heading lower, b) corporate earnings will continue to fall, c) the consumer is in too much debt, d) unemployment will rise, e) we are headed for war and (f) inflation is approaching zero, just what, exactly, is going to cause real estate prices to rise much less hold their values? Their answer: "Well, real estate prices keep going up". Where have I heard this logic before?

Observation: The recent appreciation rate and current prices for residential and commercial real estate are not sustainable. The timing of the pending adjustment is the only unpredictable variable. We agree that many cities like San Diego have a limited inventory of open space to build additional homes. But, that fact alone is not enough to support real estate prices. There are many other cities that have higher housing density than San Diego (San Francisco, L.A., New York, etc.) and real estate values in those areas were not immune to corrections. Likewise, real estate prices in San Diego did not escape the 1991-1997 correction either. Recent performance and unrealistic investor expectations suggest avoiding future speculation in this asset class.

Bonds / Fixed Income

Bonds have been a safe haven over the past 3 years and remain attractive for those investors who wish to avoid stocks and real estate. In our view, the expected return for this asset class over the next 5 years is also much lower than the recent past. Interest rates have declined to levels we haven't experienced since the 1960's. The yield or income return on new short-term high-quality bonds is less than 4%. It takes nearly 20 years to double your money at these low rates. Investors who seek principal preservation as their primary investment objective will still find this category attractive, but the long-term investment return for this category is limited. Keep your bond maturities short. If you elect to purchase bonds with longer maturities and slightly higher interest rates, be prepared to trade (sell) them within a few years. Rising interest rates will be your cue to sell.

Stocks

Opportunity or long-term disappointment? Our country and financial markets have been through much worse than what we are facing today. Taking a "wait-and-see" approach to future commitments to the stock market is understandable and appropriate in many circumstances. It takes time to remove the excesses of the late 1990's. But, the opportunity is also present.

Positive changes and more accountability will result from the exposure of corporate malfeasance. Corporations are undertaking the painful process of downsizing and focusing on improving earnings in a competitive environment. Low interest, inflation and unemployment rates are in place to allow a recovery to begin. Our country will move forward whether conflict is avoided or addressed directly. The timing of when these changes will occur and when investor confidence begins to impact the financial markets is uncertain. This uncertainty is the core reason why stocks and real estate deliver higher but more volatile long-term rates of return.

IMPACT OF TECHNOLOGY ON INVESTOR BEHAVIOR

Enhanced technology and the rapid delivery and dissemination of information are unduly influencing investor expectations. We are receiving an overload of data and information on television, radio, print, email, internet and cell phone access to the internet to the point where investors expect decisions, delivery, and results - now! We want more information and have it delivered faster. We expect to accomplish many more tasks and make many more decisions in a shorter time period than anytime in history. (For a great book about our new fast-paced world and the impact on corporations,

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individuals and families see *Seeking The Calm In The Storm – Managing Chaos In Your Business Life* by Dr. Judith Bardwick, PhD, Financial Times Prentice Hall, 2002).

We want our food served rapidly, our car serviced or repaired in hours, and we want our expected investment returns *now*. If the stock market or individual investments haven't performed as expected in our fast-paced environment, then we quickly search for alternatives. Forget about the big picture, reflection, perspective, thoughtful analysis and making the right choices for the best results in three to five years. There's no time. If stocks are moving up, buy more. If stock prices are moving down, sell now. Advancements in technology have certainly improved the rapid dissemination of information and accelerated our reaction times. But, quick access to data and information and quick decision-making is not equivalent to knowledge.

Investment success with growth assets (real estate and stocks) still requires thoughtful analysis and a long-term perspective. Investors will continue to experience frustration, confusion and disillusionment with the investment process until they are able to separate the rapid flow of information and heightened expectations with thoughtful analysis and long-term perspective. Unfortunately, I do not see much evidence of change at this time. Consequently, expect continued mood swings from investors and a continued volatility in the financial markets.

YEAR-END TAX PLANNING

Our previous four newsletters discussed the tax law changes in much detail. Please refer to our website www.bdlowder.com under "Newsletters" for a review. Two important issues are worth mentioning here: Tax-loss selling and increased retirement plan contributions. Tax-loss selling is simply a strategy of selling investment holdings today at a loss, immediately buying back a substitute (or the same security) in 31 days, and deducting the tax loss on your tax return. When the tax loss selling process is complete and the substitute investments are purchased, the investment portfolio looks the same as it was before the process began. The big difference between doing nothing and tax loss selling is the current and future reduction in income taxes. If an investor has more losses than gains, the loss can be carried forward to future years (until death). Investors might as well take a bad situation and proactively create a current and future benefit of reduced income taxes.

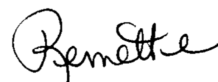
Again, the maximum retirement contribution to 401(k) plans, IRA accounts and most qualified retirement plans has been increased for everyone and an additional increase is permitted for those taxpayers attaining age 50 in 2002. Please refer to our earlier newsletters or call our office for a discussion.

Best regards

Brian Lowder

Clinton Winey

Michael Kinnear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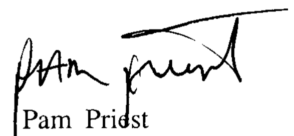
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