BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 10, Issue 2 July 2007

INSIDE THIS ISSUE

- ▼ Financial Market Overview
- ▼ Future Economic Outlook
- ▼ Two-Tiered Real Estate Market
- ▼ Net Unrealized Appreciation
- ▼ Copies of 2006 Income Tax Returns

FINANCIAL MARKET OVERVIEW

As expected, volatility in the financial markets was the central theme during the second quarter. After posting modest advances during the first quarter, both the Dow Jones Industrial Average and the Standard & Poor's 500 Index reached new highs in May by finally topping their peak levels made back in March 2000 amid the Internet-stock mania. These advances came even as the U.S. economy slowed considerably. During the month of June, the mood changed amid fears that losses from the sagging housing market and rising loan defaults may last longer than many optimists had hoped for. On many occasions, the stock market would advance significantly during the morning only to reverse course suddenly before the day ended. This uncomfortable pattern of early rallies and steep declines was particularly evident during the month of June.

Over the entire second quarter, stocks were up significantly and the gains were across the board. International stocks, domestic large, mid and small-company stocks and most sectors were up nicely, except for real estate. The average stock mutual fund was up better than 6% during the second quarter. Generally, growth stocks performed best during the second quarter of 2007 and the broadest measure of stock performance – the Wilshire 5000, was up 6% during the second quarter. Both real estate funds and taxable bonds were the only notable exceptions. Both categories posted negative returns during the quarter. In the following column are sample returns of various asset categories during the second quarter of 2007:

2nd Quarter 2007	**(includes dividends reinvested)**
+ 9.1%	**Dow Jones Industrial Average**
+ 6.3%	**Standard & Poor's 500 Index**
+ 6.0%	**DJ Wilshire 5000 (Broad Market)**
+ 6.6%	**Large-company stock-Growth**
+ 6.2%	**Large-company stock-Value**
+ 8.1%	**Mid-Size Stocks – Growth**
+ 6.1%	**Mid-Size Stocks – Value**
+ 7.5%	**Small-company stock- Growth**
+ 4.9%	**Small-company stock- Value**
+ 7.1%	**International (excludes U.S.)**
+14.3%	**Emerging Markets**
(8.0%)	**Real Estate Investment Trusts**
+ 0.2%	**Short-term U.S. Treasury** *(includes appreciation)*
(0.8%)	**Intermediate U.S. Treasury** *(includes appreciation)*

FUTURE ECONOMIC OUTLOOK

Our previous newsletter summarized and explained how the various positive and negative economic variables are impacting our financial markets. Our conclusion was an economic stalemate. One side doesn't offer a compelling advantage or significantly higher probability of occurrence over the other.

The positive influences are: a strong job market in the U.S., stronger economic growth worldwide, increased government spending, a growing service economy, benign inflation, and relatively low inflation and interest rates. While the growth rate in corporate profits has slowed from over 15% annually to less than 10%, the current level appears sustainable.

The negative variables are: the conflict in Iraq is dragging on, political uncertainty, the growth of our economy (Gross Domestic Product) is below a 3% annualized rate, interest rates are trending upward rather than declining, oil prices have spiked above $70 per barrel again, real estate prices are still sagging, loan defaults are on the rise and Americans are continuing to post a negative savings rate.

Continued on page 2

Continued from page 1

In summary, the U.S. economy will grow by about 2% to 2.5% this year, inflation will stay subdued, and corporate profits will increase by only a 6% to 9% range in 2007. Is the glass half-empty or half-full? What is holding up the stock market and why have stocks increased so much recently? Several theories are floating around. The oldest and simplest explanation is momentum. Why try and figure out the reasoning – if the market has been going up recently, get on board. We have not and will not subscribe to this reasoning.

Another reason is simply the supply of cash or credit available for borrowing by consumers and corporations is enormous. The "supply" is simply the availability of credit or loans. Lenders are continuing to allow corporations and individuals to borrow - mainly because lenders have the funds available and if they don't lend, profits decline.

Large and privately managed funds are also raising money from investors and then using this cash as security to borrow money to buy entire corporations. These professionally managed funds are proliferating. Basically, the goal is to search for and identify well-managed companies with modest debt and then buy them using loans that only cost 5% to 7%. The managers are betting the corporate cash flow will be sufficient to pay the interest and still deliver a reasonable excess cash flow. The managers of these funds are paid quarterly regardless of the outcome – it's the investors who are shouldering the risk.

Another recent phenomenon is *sovereign funds*. Basically, several wealthy countries have been accumulating excess profits (or technically foreign-exchange reserves). In the past, most of these excess reserves (sovereign funds) were invested conservatively into U.S. Treasuries and euro-denominated bonds. With interest rates so low, these countries are now "diversifying" into real estate, corporate buyouts and individual stocks in search of higher returns. Who are these countries ? China, Dubai, Russia and several others. Again, when the supply of cash is readily available for lending or investing, Wall Street will find a place to invest the funds.

In the big picture, the stock markets around the world still have a continuous stream of large sums of money in search of investment returns exceeding a safe 5% return. As long as the supply of cash is available, investors are willing to borrow, and the short-term positive results continue, the trend can stay in motion. When attempting to make sense out of all of the above observations and then commit our clients' funds (who must have their capital for continued financial independence) beyond where we have them invested now, we simply cannot follow the trend with confidence and conviction. We will stay the course at your normal to slightly-below normal allocation to stocks. New deposits or excess funds will be invested at the appropriate time and we will continue to resist the trend to follow the market until the decision can be supported by sound reasons.

The false good news is that there is such widespread concern and search for the first signs of bad news coming soon (from either Iraq, real estate prices, mortgage defaults etc.), that many have the false impression that their awareness will provide sufficient time to react.

TWO-TIERED REAL ESTATE MARKET

What is the status of your local residential real estate market? The answer depends upon who you ask and where that person is living. In most large cities such as California and Florida, homeowners are finally walking across the bridge of denial. Real estate prices have fallen 10% to 15% and the slide is not over. However, in other areas of the country that missed the prior housing boom, the residential real estate market is strong. Portland, Salt Lake, Boise, Houston, Austin, Charlotte, Raleigh and others appear to be a bargain compared to other cities where prices have more than doubled since 2000.

The current real estate market in California is showing definite signs of splitting home buyers/owners into two distinct categories or a two-tiered market: In one category are those families who have owned homes (in San Diego) during the eight-year housing boom ending in 2005 *verses* the second category characterized by those families moving to San Diego who a) can't afford to purchase a home, b) families who already own a home in San Diego but are burdened by mortgage debt and/or c) current residents who are trying to buy a home for the first time.

Local housing prices doubled between 2000 and 2005 compared to single-digit wage growth during the same period. The problem is job expansion in San Diego is concentrated in the middle-to-lower-paying service sector yet the area has many $1 million plus homes. Those families who already own a home with substantial equity can certainly afford to trade or move-up in value.

At the upper-end of the wealth category, record purchase prices have recently been announced and multi-million dollar sales activity continues to occur albeit at a slower pace. In addition, sale prices in several popular areas with home values ranging from $750,000 to $2,000,000 have flattened recently after declining 10% to 15% over the past 2 years. While current sales volume in San Diego is down 25% compared to last year (down 30% to 45% in Los Angeles, Orange and Riverside counties), the recent

Continued on page 3

Continued from page 2

moderate sales activity in some popular areas suggest to some hopeful observers that significant future price declines may not occur.

At the other end of the spectrum, over 40% of current homeowners in San Diego are considered to have *housing cost burdens* – defined as spending more than 30% of gross income on all housing costs (*U.S. Census Bureau, 2005).* Homes in the median-to-lower price range are likely to experience continued downward pressure. In this latter category, are families who have purchased homes within the last three years, chose variable rate financing, minimal or no down payment and/or were subject to "sub-prime" lending standards. Many of these homeowners will not be able to afford the higher mortgage payments nor will they be financially able to increase their debt. Downward pressure on home values will likely continue for several years.

Building permits (new home construction) are down substantially and builders are discounting and offering incentives to blow out excess inventory. The transition is underway and it is real.

As expected, those observers affiliated with the real estate industry have a positive outlook. Their forecast anticipates an end to the recent two-year decline in home prices with stable prices just around the corner. Most economists do not believe the housing market has hit bottom and is certainly not poised for a meaningful or sustainable rise in prices. Their consensus expectations are flat to falling prices at least through 2009.

Our view has not changed. Although the wealthiest 5% of the population will continue to buy whatever real estate they desire and the news media will marvel at the record selling prices, too many negative factors have and will continue to impact the overall housing market. None of the preceding factors are significant by themselves, but collectively, the future impact on housing prices is negative. Over the past five years, housing prices have advanced far beyond the growth in wages – *affordability* remains an important issue.

Lending standards have finally tightened and the ridiculous (lack of) qualifying standards for home loans have changed. The net result is *tighter lending standards* causing fewer families to qualify for loans in the short-term but a necessary development before a real estate recovery can occur in the long-term. A growing number of *foreclosures* and problems with sub-prime (lower-quality borrowers) loans are a real problem.

Further, recent data provided by Fannie Mae indicates that at today's prices, over one-fifth of homeowners who have adjustable rate mortgages are *already* underwater – meaning most homebuyers who made purchases over the past 2 years opted to use adjustable rate mortgages with low initial payments at the peak of the real estate market and now have no equity in their homes. Their estimate is if (when) prices decline an additional 5% in value, about one-third of homeowners will have negative equity. How long do you suppose these families will continue to justify making payments on a loan that exceeds the value of the property?

Collectively, the future direction of home values will continue trending downward because of prior years of excess speculation in home values, reduced affordability, excess supply of new homes available for sale, increased foreclosures and the simmering problem with sub prime and variable rate mortgages. This scenario doesn't even consider the impact if interest rates rise above 7%. Presently, most observers and homeowners are choosing to believe the lowest probability outcome – the modest decline is over and a recovery is imminent. This attitude is similar to a tree falling alone in the middle of the forest and homeowners choosing to ignore the sound. How far down and how long the adjustment process will continue is speculative at best. We suggest focusing on acceptance of where we are in this cycle and the near-term direction of housing prices rather than the magnitude and duration of change.

NET UNREALIZED APPRECIATION

An often overlooked tax strategy but one of the most powerful ways to make retirement less taxing is to take a distribution of company stock from your retirement plan rather than selling and rolling over the proceeds to an IRA account. This tax strategy is called *net unrealized appreciation* (NUA). It allows investors who leave a company to receive an in-kind distribution of their company's stock and pay income tax only on the average cost basis (value of the stock when placed or contributed into their retirement plan), rather than on the current market value.

A typical example of how or when net unrealized appreciation works is when an employee is about to retire and qualifies for a lump sum distribution from a qualified retirement plan. Typically, most investors roll the entire retirement plan balance (including the proceeds from selling company stock) into an IRA account. As the money is withdrawn from the IRA, the investor pays income tax on the entire withdrawal amount at tax rates typically ranging from 15% to 35%.

By using the NUA strategy, the investor elects to receive the company stock directly from the company (does not roll it over to an IRA) and only pays income tax on the average cost basis (value of the stock when contributed to the retirement plan). This allows the investor to continue to defer tax on any appreciation on the stock until it is finally sold. At that time,

Continued on Page 4

Continued from page 3

the investor is taxed on the appreciated value at the current long-term capital gains rate, which is currently only 15%.

There are several specific rules and procedures to follow to be eligible for this tax saving technique such as the distribution must be made in a lump sum (not a series of payments) and the employee must take the distribution within one year of leaving employment. The main point here is to recognize the opportunity when you leave employment or retire and talk to a qualified advisor/accountant before completing your distribution paperwork.

COPIES OF 2006 INCOME TAX RETURNS

Reminder: if you filed an extension or haven't yet sent us duplicates, please forward copies of your 2006 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. Our advice is greatly improved when we have current income tax bracket information and capital loss carryforward figures. In addition, we may find opportunities to improve investment performance, implement new financial planning strategies and minimize income taxes. 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.

Contact Us

Brian D. Lowder, Inc.

Brian D. Lowder, CFP®, CFA
Michael Kinnear, MBA, MSFS, CFP®
Clinton Winey, MBA, CFP®
Remette Martinson
Pamela Priest

Address
12780 High Bluff Drive Suite 100
San Diego, CA 92130

Telephone
(858) 794-6800

Fax
(858) 794-6906

Website
www.bdlowder.com

Email
brian@bdlowder.com
mike@bdlowder.com
clint@bdlowder.com
rm@bdlowder.com
pam@bdlowder.com

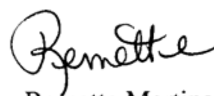
Brian D. Lowder, Inc., a California Corporation, is a fee-only wealth advisory firm specializing in comprehensive financial planning and investment management. Brian D. Lowder, Inc. is registered with the Securities and Exchange Commission and licensed by the State of California Department of Corporations as an Investment Advisor.

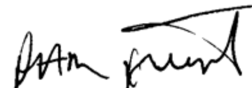
Best regards

Brian Lowder

Clinton Winey

Michael Kinnear


Remette Martinson


Pam Priest