// BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

The second quarter of 2013 began with continued strong stock market performance during April and May, but one-half of those gains were given up during the month of June. The second quarter ended with U.S. stocks posting a moderate return of approximately 2.5%.

The Total Market Index, the broadest measure of the overall U.S. stock market, was up 2.6% during the second quarter. Large, mid-size and small-company stock indexes all posted positive returns ranging from 1.5% to 3.5% during the second quarter, however, large-company stocks are trailing the performance of small and mid-size company stocks and growth stocks are trailing value stocks for the first half of 2013.

A notable difference in stock market performance is international stocks compared to U.S. equities. International stock performance was slightly negative during the second quarter and up only 3% year-to-date compared to the double-digit U.S. stock returns during the first 6 months of 2013. The disparity in performance is larger for emerging market (international) stocks which are trailing domestic stocks by a significant margin. This disparity is unusual, as emerging market stocks usually rise faster than U.S. stocks during up cycles and declines are typically larger during periods of negative stock price performance. This is the second consecutive quarter where U.S. stock prices significantly outperformed international and emerging stocks with the latter two actually declining as U.S. stocks advanced.

The most significant factor affecting market prices during the second quarter was rising interest rates. One year ago, the interest earned on a 10-year U.S. Treasury Note was 1.4%. The yield was 1.7% at the *beginning* of the second quarter of 2013, and currently the yield on a 10-year U.S. Treasury is 2.7%. Yes, interest rates are still near historic lows, but the rate of increase (change) is significant – almost double the rate one year ago. When interest rates increase, the value or price of bonds decline. The net result was a 5% to 10% decline in bond prices.

The total return (income less price decline) of intermediate and long-term bonds (regardless of quality) was *negative* 5% to 9% during the second quarter. In essence, the most conservative asset class (bonds/fixed income) performed poorly during the second quarter and once conservative investors realize rising interest rates will continue to deliver negative returns, the rotation out of bonds will accelerate.

Gold prices suffered the largest decline. Gold was down 22% during the second quarter. The sudden reversal in gold prices will be discussed later in this newsletter. Real estate (REIT's) posted a 1.6% negative return during the second quarter (due to rising interest rates), but earned a 6.3% return year-to-date.

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The following chart displays sample returns of various asset categories during the second quarter of 2013:

Yr-to-Date 2013	2nd Qtr. 2013	Index Return (*includes dividends reinvested*)
+ 13.8%	+ 2.3%	**Dow Jones Industrial Average (^DJI)**
+ 13.7%	+ 2.9%	**Standard & Poor's 500 Index (^GSPC)**
+ 13.8%	+ 2.6%	**DJ U.S. Total Stock Market (VTI)**
+ 11.4%	+ 1.9%	**Large-company stock-Growth (IWF)**
+ 15.6%	+ 3.2%	**Large-company stock-Value (IWD)**
+ 14.5%	+ 2.7%	**Mid-Size Stocks-Growth (IWP)**
+ 17.2%	+ 3.6%	**Small-company stock-Growth (IWO)**
+ 14.2%	+ 2.5%	**Small-company stock-Value (IWN)**
+ 2.8%	- 0.9%	**International (EFA)**
- 12 0%	- 8.8%	**Emerging Markets (EEM)**
+ 6.3%	- 1.6%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
- 0.1%	- 0.2%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
- 4.0%	- 4.1%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
- 26.4%	-22.8%	**Gold (GLD)**

ECONOMIC AND FINANCIAL MARKET OUTLOOK

Although the stock market finished the second quarter with a sudden decline in June, the performance over the first half was the best in several years. The U.S. stock market finished the first half of the year up approximately 13% and about 2.5% during the second quarter. Stock market performance has been surprisingly strong – up over 40% since October 2011. Some of the explanation is tied to economic improvement, but most of the gain can be attributed to other factors that change constantly.

Eighteen months ago, there was much uncertainty. Economic activity was weak and declining, the unemployment rate was holding steady near 8%, U.S. stocks were down 8% for the year, European stocks were down over 12% and the Asian markets were down twice that amount, presidential election campaigning with polarized views was underway, politicians did not agree to a new debt ceiling and our country lost its triple A bond rating for the first time.

Today, the stock market is up nearly 40% over the past 18 months, Gross Domestic Product (GDP) is still weak but stronger than it was 18 months ago, the presidential campaign is over, the European debt crisis is no longer dominating newspaper headlines, and the U.S. unemployment rate is slowly improving.

The economic outlook has improved. U.S. Gross Domestic Product (GDP) was up less than 1% during 2012 but, during the first quarter 2013, GDP was up 2.4% (later revised down to 1.8%). We expect GDP growth to remain in the 2% range over the near term. The desired or stable GDP growth rate is in the 3% range.

The government or "official" U.S. unemployment rate has improved marginally over the past two years and is holding steady at 7.6%. Approximately 195,000 new jobs were created last month and the 2013 monthly average of new jobs is about 200,000. Though these figures are positive and seemingly large, at this rate of increase, it will take a decade to replace the jobs lost in 2008-2009. Further, most of the jobs added were service ones – such as store clerks and restaurant employees. It is an improvement.

Unfortunately, the broadest measure of unemployment includes the "official" rate quoted above *plus* people who are neither working nor looking for a job after giving up in defeat plus people who want full-time work but settled for part-time positions because that's all they could find. This broader measure of unemployment *rose* last month from 13.8% to 14.3%. We are improving, but at a very slow pace.

Overall, corporate profits have improved. In addition, the uncertainty over income tax rates is no longer a mystery. Effective this year, income tax rates have increased for top income tax bracket taxpayers. Without debating whether this increase is fair or positive, at least the uncertainty is gone.

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Real estate prices have stopped declining and many homeowners are experiencing significant sales price increases over the past six months. It appears the real estate price decline has reached or found its bottom, but no one should expect the sudden bump up in prices will continue at the same pace or rate in the future. Further, banks are in better financial shape than they were 2 years ago. In addition, some states (California is one of them) are starting to see unexpected but very small budget surpluses as opposed to deficits.

Economically, we are better off than we were 18 months ago – still very weak, but positive economic improvement especially compared to Europe and other emerging market nations. On the other hand, we still have significant longer-term challenges in America and worldwide. Perhaps the biggest challenge that is hard to gauge over the short term, but definitely could restrain economic improvement is enormous federal deficits from past overspending as well as current deficit spending. Our country owes significantly more debt than any other time in its history. And, more debt is surely to come as our nation begins to implement an incredibly expensive national healthcare system. Even if national healthcare implementation proceeds perfectly as planned, our country will be deficit spending for the next 10 years before breaking even. Scary thought, as politics and uncertainty seem to destroy any chance of meeting stated implementation goals.

In addition, the Federal Reserve's "quantitative easing" is scheduled to terminate by the end of this year. Many have heard of this phrase – quantitative easing – but do not know what it really means. We do not wish to describe it fully here, but suffice to say this program essentially gives the Federal Reserve the power to increase our country's (taxpayers) debt and use the borrowed funds to purchase Treasury Bonds that were issued years ago. The net effect is greater debt, but lower interest rates for most borrowers. The thought is lower interest rates will allow our country to financially recover more quickly than without them.

The recent announcement that this program will end sometime soon caused both the stock and bond markets to drop suddenly in June. Taking away the patient's (US economy) medicine (low interest rates) before a full recovery is the second biggest threat to economic recovery. Announcing the end of the quantitative easing program resulted in an immediate rise in interest rates – nearly a one percent increase in the 10-year U.S. Treasury Note over the past 30 days. Rising interest rates permeate throughout our financial system quickly by affecting new mortgage rates to credit rates.

Bond rates shot up causing fixed income (bond) investors to lose 3% to 9% on the value of their low-interest bonds. The longer the maturity, the greater the price decline. Over just one month, bond investors now have a negative 12-month return on their individual and bond mutual fund portfolio. What's next? Certainly after reaching a 70-year low in interest rates over the past 15 years, this recent rate increase isn't the last one.

Anemic economic growth, rising interest rates and high unemployment verses a slowly rebounding economy. Which way will the markets go in the future? Since the stock market has already advanced by nearly 40% over the past 18 months in expectation of economic improvement, will the economy follow through over the next 12 to 60 months? Very hard to say, except that after a 40% increase in stocks, there is little room for disappointment. Continued economic improvement is ALREADY embedded (expected) based on the current prices of most U.S. stocks – but not all stocks. That is the key.

Investors must focus on the new reality – interest rates will slowly increase over time and at the same relative pace as the growth in the U.S. and global economy. Over time, yields or interest rates should track economic expansion. Conservative or fixed income investors can no longer rely on 10% or more annual returns from bonds. In the past, even though bond interest rates were dropping and income was shrinking, falling interest rates *increased the value* of the bonds. The total or combined annual return including income

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and price appreciation was attractive. Bond investors were enjoying a combined return of 6% to 12% annually. Now, that interest rates are rising, bond values are falling much faster than the increase in income from higher interest rates.

Bond or fixed income investors should shorten the maturity of their individual bonds or bond mutual funds. This adjustment will reduce losses, but not eliminate them. Alternatively, they could buy individual bonds with short maturities. The income will be extremely low (0.5% to 2%), but investors will receive the full value of the bond at maturity. Not so with bond mutual funds. The price decline will continue as interest rates rise because there is no maturity date for a bond mutual fund. Alternatively, bond investors can purchase or hold bonds of all countries – as interest rates are different among the many nations. Foreign interest rates may be higher or lower than others.

The best approach is focus on total return, not just income. Income and price appreciation varies among individual stocks, real estate (REITs), oil and gas, utilities, large-dividend paying companies, etc. There are many stocks that are fully valued. The total stock market is selling for about 15 times net earnings (an analogy is the average home is selling for about $200 to $300 per square foot). But many established, dividend-paying and big-name companies are selling for 10 times earnings or less. The point is – a blended return can be achieved with relatively low volatility compared to an all bond or all stock portfolio. Further, discipline is necessary when adding new investment holdings. Buying should be done at low-risk entry points not after the markets hit temporary new highs.

Certainly, some adjustments should be made at this point. However, investors who attempt to make strategic changes every time interest rates move or when the stock market advances/declines and do so frequently will surely be frustrated. And their portfolio performance will suffer. Expect a great deal of volatility over the next 12 months as our economy works through this change from artificial accommodation, low interest rates and easy money to a policy of slow growth and "you (economy)are on your own now".

Gold has suffered a huge decline in 2013. Why? Prior to 2013, our easy money and deficit spending policy suggested to traders that eventually inflation would grab hold and would be very hard to stop once set in motion. Gold prices and inflation love each other (gold also moves according to calamity, terrorism attacks, debt crises, uncertainty, etc.). Well, traders always send metal prices up and down faster than what would normally occur, but in addition, the first defense to combat excessive growth and inflation is raising interest rates. Now, with interest rates suddenly moving up, it is not likely that inflation will spurt ahead. Therefore, the immediate outlook (new purchases) for gold is not attractive.

Lastly, it will be interesting to see how long fixed income investors will suffer negative investment performance due to rising interest rates. Generally, conservative investors choose bonds and fixed income investments that earn a lower return because they enjoy the income and would rather receive a lower and more predictable (less volatile) rate of return rather than the higher but more volatile return from stocks and real estate. As bond returns decline in line with rising interest rates and losses grow over time, fixed income investors may be coaxed into buying stocks given the abnormally high return stocks have earned over the past 18 months and the fact that CDs pay less than 1%. If that happens, the stock market could continue advancing and stock prices could move well beyond rationale expectations (similar to real estate prices during 2003-2006).

International and emerging stock markets have underperformed the U.S. market by a significant margin this year. As a whole, the European economy is stagnant. While the cumulative U.S. budget deficits (spending exceeding revenue) over the past 6 years have resulted in a 16 trillion dollar

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debt level, the European economy and deficit spending is horrifying. If a stagnant or slow growth global economy continues, we can expect more of the same relative poor performance.

Emerging markets have also overspent, have fiscal problems and the slow global economy has impacted their stock markets as well. Consequently, their equity market performance year-to-date is negative. Emerging market stocks typically advance faster during positive economic periods and suffer greater declines during stagnant or declining economic cycles. However, an economic global recovery will translate into much higher stock returns compared to the U.S. if or when the opportunity for growth and a financial rebound unfolds.

In conclusion, the U.S. and global financial markets have a long way to go to achieve an economic recovery. However, the (stock) gains are realized on the path to recovery, not after a recovery has occurred. Some risks and uncertainties have been removed over the past two years, but many hurdles remain. Easy returns from bond funds are over as interest rates begin to rise along with economic activity. It is going to be a volatile ride – expect it. If volatility is something you can't live with, stay out of stocks. We plan to make strategic adjustments to increase equities over time during low-risk entry points.

LONG-TERM CARE INSURANCE

We are receiving an increasing number of questions and concerns from clients asking about long-term care policies. Long-term care insurance or protection is something everyone would like to have – you don't have to sell individuals on the idea. The issue is: do you need up to $250 per day insurance coverage based on your current investment net worth and/or can you afford coverage over the rest of your life (or until a claim is made)?

Conservatively, a 1 to 1.5 million investment net worth would generate a sufficient investment return to provide the same daily benefit ($200-250 per day) as a long-term care policy without having to pay the $2,000 to $7,000 annual premium for coverage. Unfortunately, a majority of Americans do not have that size of an investment net worth. But most Americans cannot afford the annual insurance cost either.

Medicare does provide very basic coverage *only after* nearly all assets are depleted, and the benefit is not sufficient to pay for the type of care facility elegantly presented in magazines or advertisements.

The most common situation is an individual or couple that has already purchased a long-term care policy - some have owned the policy for years. But now, the annual premium is increasing 10% to 50% each year. True, your individual policy premium cannot be increased, however, premiums can and do increase for an entire "class" – such as all policy holders between the ages of 60 and 65. Policyholders don't want to give up the protection and certainly would feel awful about paying for a policy for many years and then having to cancel it without ever receiving a single dollar of benefit. Further, a common concern is not to become a financial burden to your adult children.

Consider these perspectives: One, the equity in your home could be considered to be an alternate or substitute for insurance coverage if the annual cost to insure yourself is a financial burden. For couples, that includes the willingness of the "healthy" partner to rent rather than own a home. There is much more detail to discuss, but home equity is an option. Alternatively, have one or more of your adult children (if financially able) purchase your home and allow you to rent it. Parents can receive cash for the equity value in their home while still living in it.

Two, many policyholders will reduce their long-term care coverage to help reduce the cost. Accepting lower benefits and/or electing protection over a shorter period of time reduce the annual insurance cost.

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Three, as uncomfortable as it is, have a frank and humble discussion with your adult children. Sharing the annual cost of insurance coverage is far less of a financial burden than paying for long-term care directly ranging from $45,000 to $85,000 annually. Encourage a discussion. Silently over time ending up cash poor and insurance rich is not a good choice.

ANNOUNCEMENTS

Brian's son Andrew will begin attending college this fall at Santa Barbara Community College. Clint's daughter Amanda will begin college this fall as well and will be attending University of Michigan's School of Nursing. Clint's oldest daughter Alexandra will be returning to Marquette University for her junior year where she continues to play on the women's lacrosse team.

COPIES OF 2012 TAX RETURNS

Please send paper or electronic (email) copies of your 2012 income tax returns to our office at your earliest convenience. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

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