BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 15, Issue 3 October 2012

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FINANCIAL MARKET OVERVIEW

The 2012 year-to-date quarterly performance of the financial markets continues with the same theme – feast or famine. The first quarter ended remarkably above expectations with the overall stock market up over 10% only to be followed by a dismal and negative 4% decline during the second quarter. The third quarter of 2012 ended with a solid 5%-6% overall market return. In spite of much uncertainty, the overall stock market is up a solid 13% -16% through September 30, 2012.

The year-to-date gains are positive for nearly all asset categories. International and emerging market stocks reversed course after posting negative performances during the first half of the year and are now posting positive gains for 2012 ranging from 7% to 8% or about one-half the performance of the U.S. stock market. The overall U.S. stock market was up a solid 5%-6% during the third quarter, up approximately 16% from January through September of 2012, and remarkably up about 25% since October 2011 (one year). One year ago, no one (individual or professional) predicted the overall stock market would advance 25% over the ensuing 12 months.

The stock market advance was also broad-based. Large, middle and small company stocks all posted 5% returns during the third quarter and both growth and value stocks performed equally well.

While interest rates do fluctuate daily, rates were slightly lower at the end of the quarter compared to the beginning of the quarter. As a result, long-term bond fund values increased by 1%-2% and short-term bond funds increased by .3% during the third quarter.

Depending upon the percentage of total assets held in stocks, most investors have earned an 8% to 15% blended rate of return during the first nine months of this year.

Gold and precious metals staged an impressive 10% quarterly return, while real estate investment trusts posted a slightly positive return during the third quarter.

The following chart displays sample returns of various asset categories during the third quarter and the Year-to-Date 2012 through September 30, 2012:

Yr to Date 2012	**3rd Qtr. 2012**	**Index Return** ***(includes dividends reinvested)***
+10.0%	**+ 4.3%**	**Dow Jones Industrial Average (^DJI)**
+14.6%	**+ 5.8%**	**Standard & Poor's 500 Index (^GSPC)**
+16.2%	**+ 6.2%**	**DJ U.S. Total Stock Market (VTI)**
+16.6%	**+ 5.9%**	**Large-company stock-Growth (IWF)**
+15.6%	**+ 6.4%**	**Large-company stock-Value (IWD)**
+13.7%	**+ 5.3%**	**Mid-Size Stocks – Growth (IWP)**
+13.9%	**+ 5.6%**	**Mid-Size Stocks – Value (IWS)**
+14.3%	**+ 4.8%**	**Small-company stock- Growth (IWO)**
+14.4%	**+ 5.6%**	**Small-company stock- Value (IWN)**
+ 9.5%	**+ 6.1%**	**International (EFA)**
+ 10.2%	**+ 5.6%**	**Emerging Markets (EEM)**
+14.8%	**+ 0.1%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 0.3%	**+ 0.3%**	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 4.2%	**+ 1.1%**	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
+13.1%	**+ 10.8%**	**Gold (GLD)**

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Investment Outlook: Fear of Decline vs. Continued Market Success?

Despite stock prices achieving a new 4-year high and this year's surprising double-digit positive performance, many investors are acting as if they believe there is imminent danger of a severe market correction similar to the 40% decline in 2008. This scenario seems logical and justified given recent history of stock price behavior and the current poor economic environment. Stocks earned a zero percent total gain from 2000-2009 and in 4 of those years, the annual return of the overall U.S. stock market ranged from negative 11% to negative 38%.

Every day there seems to be a new or continuing crisis: the debt crisis across Europe, slower growth in China, U.S. budget deficits continue growing at the rate of a trillion dollars per year, dysfunctional politicians, stubborn unemployment, less than 2% economic growth, and a seemingly imminent conflict with Iran over nuclear weapons. Real estate prices appear to have stabilized, but where's the growth? Stocks are downright scary, and bonds are paying the lowest interest income in over 60 years. Bank savings accounts or certificates of deposit appear to be safe, but earn less than a 1% annual return.

In general, many investors have lost confidence in the stock market to deliver gains that will last longer than a year and no longer trust Wall Street. Their main concern is avoiding a loss rather than earning a reasonable rate of return. Most investors have a perception that there seems to be no stability in the world on anything. Further, they have a skewed and inaccurate view of recent U.S. stock market performance. In a recent study by Franklin Resources conducted in 2010, again in 2011 and 2012, at least 48% of respondents *each year* said the stock market had been down or flat in the preceding year. In fact, the overall U.S. stock market was up 17%, 1% and 25% in 2010, 2011 and 2012 through September 30th.

In addition to the problems above, which Presidential candidate will be elected next month and what impact, if any, will the results have on our financial markets? Also, if Congress doesn't get its act together before year-end and agree upon a new schedule of tax rates, the current tax rates will expire and automatic increases discussed below will begin on January 1, 2013.

Capital gains tax rates will automatically increase from 15% to 20% (a 33% increase). The 15% maximum tax rate on dividend income will expire at year-end and the new tax rate will be equivalent to whatever the taxpayer's "ordinary" tax bracket is ranging from 15% to 39.6%. Finally, all taxpayers who earn more than $200,000 (unmarried) or $250,000 (married) in 2013 will pay an extra 0.9% new Medicare tax on *employment* income and a new 3.8% Medicare Surtax on *investment income (capital gains, dividends, interest, rental income, etc.)*

<u>Our Strategy: Stay The Course – Be Prepared To Act</u>

Beyond 2013, there are good reasons for stocks to lead a sustainable advance compared to real estate and bonds. Even the smallest improvement in economic growth and the unemployment rate will quickly translate to higher stock prices. Real estate prices will improve as well, but not nearly as quickly as stocks. Most bonds (fixed income) will be the biggest disappointment for investors. Increased business activity, economic growth and more jobs will ultimately result in higher interest rates. It doesn't matter that interest rates will continue to be relatively low for several more years. It is the direction of change (up) that will cause bond <u>prices</u> to fall. There will be no exceptions to the mathematical rule: as interest rates rise, bond prices or values will fall.

In addition, a growing number of investors are relying upon past performance of bond funds and their historical high returns (due primarily to falling interest rates which result in higher bond values – not higher interest income) as a safe place to invest. Even worse, most closed-end bond funds appear to be paying 6%-10% income returns but many investors do not realize what these bond fund managers are doing to achieve such high

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income returns. A growing number of bond fund managers are using leverage (borrowing money at 2% or less and buying more bonds that earn 3% to 5%), options and short-selling to increase the yield. Yet investors assume the "income" return is coming from interest on the bond holdings when most of the return comes from borrowing, options, repurchase agreements and short-selling. These "bets" can lose money just as easily.

Our biggest concern is market risk or disappointment between now and 2013. The stock market is already fairly valued at this level given the current state of our economy and with so much uncertainty ahead of us. This country still has a fiscal crisis (too much debt) and our decision-makers (Congress and the President) couldn't be more divided and slow to act. The longer it takes to implement government spending reductions and/or increase revenues, the longer the period of uncertainty and the greater the likelihood of future unpleasant reactions in our financial markets.

I think the majority of Americans are trying to "hope our way out of this." Somehow our problems will just fix themselves. But the reality is, regardless of who wins the upcoming election, our leaders must reduce federal spending just as any family or corporation has to cut back when expenses exceed income. It has to be done and it is not a pleasant experience to cut back on anything we have become accustomed to. And the fact is, the financial markets will not initially view cutbacks as positive over the immediate term because cutbacks reduce Gross Domestic Product (the value of all goods and services produced.) Even worse, the financial markets will punish prices if no changes or reforms are made. It is no different from families experiencing the initial discomfort of reducing debt and debt payments until their outflows match their inflows.

The positive side is once the reforms or changes are agreed upon and implemented, it doesn't take long for investors to begin looking beyond the first year and begin valuing stocks at what they will soon be worth. The stock market has always, still does, and will continue to value stocks at prices they think companies will be worth in the near future – always forward looking. The only real uncertainty is whether the overall economic conditions assumed in that forecast are too optimistic, about right or understated. When reality unfolds and it doesn't match the expectations assumed, that's when the financial markets react quickly and sometimes violently.

This inevitable mismatch between optimistic assumptions about the future and the reality that change will come about slower than expected is why we will continue with our current portfolio management strategy. We will remain invested with stronger, dominant, more mature and dividend-paying companies rather than non-dividend paying stocks of companies whose future performance is based primarily upon above-average expectations of growth in the overall economy or their particular industry. We are just not at the point where optimistic assumptions about immediate economic growth are a fair, highly probable or expected outcome especially following at 20% plus return on stocks over the past 12 months.

Additionally, long-term bonds of weak companies or countries (junk bonds, emerging markets and countries whose debt is currently a large percentage of their GDP) will not be added to our client portfolios.

For downside protection, our advisory staff has already reviewed all client portfolios and identified which stocks will be sold if a decision is made to quickly reduce stock holdings by 25% to 35%. This downside protection and equity (stock) reduction plan has already been identified; trades have been summarized into block trade files and are ready to be executed in the event we decide to implement the protection plan.

ESTATE PLANNING REMINDER

Back in late 2010 and last quarter, our newsletter discussed important estate planning changes and

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opportunities. Since these changes will expire at the end of 2012, we will briefly discuss these opportunities again. **The estate and gift tax rate** was reduced from 45% to 35% and the lower 35% rate is only guaranteed through the 2012. More importantly, the **estate tax exemption** amount (the total value of your estate that is excluded from the 35% estate and gift taxes) was $3.5 million and was recently increased to $5 million (increased to 5.12 million for inflation). Simply stated, no estate tax is due on estates valued at $5 million or less at death.

The most important estate planning benefit – the **gift tax exemption** amount was increased from $1 million during your lifetime (or at death) to $5 million. Simply stated, ***each*** taxpayer may gift up to $5 million *during their lifetimes* and pay no gift taxes. Taxpayers still have the flexibility to give away up to $5 million during their lifetimes, gift a partial amount or preserve the entire $5 million exemption at death – but only through the remainder of the 2012 calendar year. Parents or grandparents may wish to take advantage of the increased lifetime gift amount by making gifts of appreciated securities, real estate or business interests to children or grandchildren this year before the favorable tax rates and exemption amounts expire.

COPIES OF INCOME TAX RETURNS

If you have not already done so, please send paper or computer file copies of your 2011 income tax returns to our office upon completion. Our investment decisions and income tax management strategies are greatly improved when we have copies of your income tax returns. This is especially true with the pending tax rate changes that we have discussed in this newsletter.

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Best regards

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