KALORAMA Wealth Strategies

A Beautiful View To Your Financial Future℠

Second Quarter Market Review ~ A Picture is Worth More…

July 2006 - After humming along at a nice upside clip for the first four months of 2006, stock markets turned sharply lower in May and June, resulting in nearly across-the-board losses for the second quarter. The trifecta of higher inflation, rising interest rates, and increasing concerns about a slowing economy weighed heavily on equity markets. Stocks rebounded in the latter part of the quarter, leaving most asset classes in positive territory for the first half of the year. After shedding 1.1% for the quarter, Real Estate Stocks maintained their position at the top of the list with a year-to-date rise of 14.5%. The big losers for the second quarter were Domestic Small Cap sectors, sinking 2.7% to 7.3%, and International Emerging Markets, dipping 4.3%. International Developed Markets eked out a gain 0.9%.

The shift out of International Emerging Markets to less-risky assets was mirrored in the bond market, with International Emerging Markets Bonds falling 2.1% and Global Aggregate Bonds jumping 2.4%. Despite worries regarding the economy, U.S. Corporate High Yield Bonds improved 0.3%. The Federal Reserve again increased the Fed Funds rate twice during the period by quarter-point increments to 5.25%. At quarter end, the yield on the 10-year Treasury Note was 5.14%, up 29 and 75 basis points for the quarter and year-to-date, respectively (the yield as of July 20th was 5.03%).

Below are rates of return for selected market indices for the second quarter of 2006, year-to-date 2006, and the three-, five-, and 10-year averages as of December 31, 2005.

	2Q:2006	YTD-2006	3-Yr. Avg.	5-Yr. Avg.	10-Yr. Avg.
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	-3.90%	-0.81%	13.23%	-3.58%	6.73%
Russell 1000 - Value	0.59%	6.56%	17.49%	5.28%	10.94%
Russell 1000 - Blend	-1.66%	2.76%	15.42%	1.07%	9.29%
Domestic Small Cap					
Russell 2000 - Growth	-7.25%	6.07%	20.93%	2.28%	4.69%
Russell 2000 - Value	-2.70%	10.44%	23.18%	13.55%	13.08%
Russell 2000 - Blend	-5.02%	8.21%	22.13%	8.22%	9.26%
Real Estate (Dow Jones Wilshire REIT)	-1.12%	14.48%	27.32%	19.16%	15.36%
International Developed Mkts (MSCI EAFE)	0.94%	10.50%	24.18%	4.94%	6.18%
International Emerging Mkts (MSCI EM)	-4.27%	7.34%	38.52%	19.44%	6.98%
Fixed-Income (Bond) Indices					
Lehman Brothers					
Global Aggregate	2.39%	2.29%	5.76%	6.81%	5.35%
U.S. Aggregate	-0.07%	-0.72%	3.62%	5.87%	6.17%
U.S. Corporate High Yield	0.25%	3.14%	14.28%	9.34%	6.92%
Municipal	0.03%	0.28%	4.44%	5.58%	5.71%
International Emerging Markets	-2.13%	-0.51%	17.03%	12.96%	13.15%

A Picture is Worth More…

than a thousand words, but if the beauty you are beholding is the Internal Revenue Code, a 2004 White House press release maintains that the current word count is more than a million. According to tax publisher CCH, based on its *Standard Federal Tax Reporter*, the number of pages including the tax code, regulations, and IRS rulings more than doubled from 26,300 in 1984 to 54,846 by 2003, and morphed to 61,224 in 2005. Further, as the complexity of income tax compliance has increased, the number of IRS tax forms jumped from 402 in 1990 to 526 by 2002.

To add to this quagmire, on May 17, 2006, new federal tax provisions were signed into law with the auspicious description "Tax Increase Prevention and Reconciliation Act of 2005". Below is an overview of the more significant new provisions applicable to taxpayers and investors. Although it doesn't reduce any taxes, the good news is that it extends lower tax rates that were scheduled to expire, eventually eliminates income limits for Roth IRA conversions, and temporarily stops the Alternative Minimum Tax (AMT) from affecting more taxpayers. The bad news is that it pushes part of the cost onto children by increasing the "kiddie tax" to a higher age.

Taxes on Capital Gains & Dividends

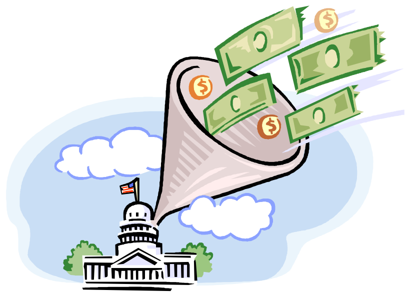
If you have money in taxable investments, you may benefit from an extension of favorable tax rate rules. Tax rates on long-term capital gains and qualified dividends were already set lower than ordinary income tax rates through 2008. For investors in the two lowest income tax brackets (10% and 15%), the highest tax rate on capital gains and dividends is 5% through 2007 and drops to 0% in 2008. For investors in the higher income brackets, the tax rate for capital gains and dividends is capped at 15%. The new law extends the 0% and 15% tax rates on long-term capital gains and qualified dividends for two years through 2010.

Traditional to Roth IRA Conversions

Currently, an investor with a modified adjusted gross income (MAGI) greater than $100,000 is not eligible to convert a Traditional IRA to a Roth IRA. The new law eliminates this income restriction for tax years after December 31, 2009, by allowing all investors to convert Traditional IRAs to Roth IRAs. Based on current law, conversion amounts are typically taxed as ordinary income in the year of conversion. However, investors who convert in 2010 can choose to include half of the conversion amount as income in 2011 and the balance in 2012, thus partially deferring the payment of taxes on the conversion.

This new rule effectively eliminates the income restrictions for making Roth IRA contributions beginning in 2010. Unless Congress changes this unintended loophole before its inception, taxpayers with a MAGI greater than $160,000 filing jointly or $110,000 filing singly could contribute to a Traditional IRA and immediately convert the Traditional IRA to a Roth IRA.

An Alternative with No Choice



The Alternative Minimum Tax (AMT) is a parallel tax system originally created in 1969 after Congress was stunned to learn that 155 wealthy individuals were not paying tax because they used too many of the deductions Congress enacted. Although it was designed to ensure that a small number of high-income people who paid no federal income tax would have to pay at least some tax, the AMT exemptions were not indexed for inflation and have been capturing a rapidly increasing portion of taxpayers.

The law provides temporary relief by raising the exemption associated with the AMT **only** for 2006 to $62,550 for joint filers and to $42,500 for singles, from $58,000 and $40,500 in 2005, respectively. Without the change, these amounts were slated to drop to $45,000 and $33,750, respectively, ensnaring an estimated 22 million taxpayers in 2006, with the figure growing to 36 million by 2010. Stay tuned.

"Kiddie-Tax" Age Raised to 18 from 14

The "kiddie tax" applies to a child under the applicable age who receives "unearned" income such as dividends, interest, and capital gains. The first $850 is tax free and the next $850 typically is taxed at the child's rate. Previously, unearned income over $1,700 for children 14 to 17 had been taxed at the child's income tax rate. Now, any unearned income over $1,700 for a child under 18 is taxed at the parents' top rate.

Assets in a 529 college savings plan and Coverdell Education Savings Account are not affected. Earnings continue to accumulate tax-free and withdrawals are tax-free through 2010 as long as they are used for qualified education expenses.

Uncertainty Increases Need to Plan

Although the new tax law provides some important tax benefits, it also extends an element of uncertainty that has besieged investors since the "sunset" measures were introduced in 2001 and 2003. This makes planning essential. Kalorama Wealth Strategies can help you create a plan to invest your assets in a manner providing professional management, diversification, marketability, and liquidity. For more information, please see our web site at www.kaloramawealth.com.

Thank you for your business, trust, and referrals. Please feel free to provide a copy of this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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Fee-Only Investment Advisory And Financial Planning

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