

Second-Quarter 2007 Market Review ~ Commencing Countdown, Engines On!

July 2007 - Building on first-quarter gains, bullish sentiment and continued mergers & acquisitions activity led stock indices higher in April and May. Despite a choppy June, broad stock measures posted across-the-board advances in the second quarter of 2007. Leading the way was International Emerging Markets, leaping 15.1%. The runner up was Domestic Large Cap Growth, rallying 6.9%. Reversing a long-term trend, Domestic Large Caps outpaced Domestic Small Caps, while Growth bested Value. On the downside, after multi-year advances, real estate stocks hit the skids, retreating 9.7%.

Bond yields moved up in the quarter, leaving most bond indices in the red. International Emerging

Markets dipped 1.1%, Global Aggregate lost 0.9%, Municipal shed 0.7%, and U.S. Aggregate slipped 0.5%. The only winner for the period was U.S. Corporate High Yield, eking out 0.2%. Although the Federal Reserve maintained the Fed Funds rate at 5.25%, the yield on the 10-year Treasury Note added 39 basis points for the quarter to 5.03% (the yield as of July 11th was also 5.03%). Inflation concerns saw the yield on the 10-year Note rise upwards of 5.25% during the quarter.

Below are rates of return for selected market indices for the second quarter of 2007, year-to-date 2007, and the three, five, and 10-year averages as of December 31, 2006.

	<u>2Q:2007</u>	<u>YTD-2007</u>	<u>3-Yr. Avg.</u>	<u>5-Yr. Avg.</u>	<u>10-Yr. Avg.</u>
<u>Equity (Stock) Indices</u>					
Domestic Large Cap					
Russell 1000 - Growth	6.86%	8.13%	6.87%	2.69%	5.44%
Russell 1000 - Value	4.92%	6.23%	15.09%	10.86%	11.00%
Russell 1000 - Blend	5.90%	7.18%	10.98%	6.82%	8.64%
Domestic Small Cap					
Russell 2000 - Growth	6.69%	9.33%	10.51%	6.93%	4.88%
Russell 2000 - Value	2.30%	3.80%	16.48%	15.37%	13.27%
Russell 2000 - Blend	4.42%	6.45%	13.56%	11.39%	9.44%
Real Estate (Dow Jones Wilshire REIT)	-9.36%	-5.97%	27.26%	23.79%	15.27%
International Developed Large (MSCI EAFE)	6.67%	11.09%	20.52%	17.02%	9.96%
International Developed Small (MSCI EAFE)	4.37%	11.88%	25.86%	26.46%	NA
International Emerging Markets (MSCI EM)	15.05%	17.75%	31.03%	28.67%	13.99%
<u>Fixed-Income (Bond) Indices</u>					
Lehman Brothers					
Global Aggregate	-0.89%	0.39%	3.81%	8.09%	5.75%
U.S. Aggregate	-0.51%	0.98%	3.70%	5.09%	6.31%
U.S. Corporate High Yield	0.22%	2.87%	8.57%	10.66%	6.97%
Municipal	-0.66%	0.14%	4.28%	5.55%	5.82%
International Emerging Markets	-1.14%	1.00%	11.37%	14.66%	11.31%

Source: www.russell.com, www.wilshire.com, www.mscibarra.com, www.lehman.com

Commencing Countdown, Engines On!

Does Your Financial Advisor Follow an Investment Management Process?

Ground Control to Major Tom, commencing countdown, engines on! From David Bowie's fictional Major Tom to NASA's space-shuttle astronauts, aviation engineers follow a process to achieve their goal of executing a successful mission. Do you or your financial advisor follow a process to reach financial goals?

Although probably not quite as complicated as rocket science, whether your countdown is to retirement, education, or another important goal, using a process should enhance your chances for success.



In April, we wrote about Portfolio Spring-Cleaning (See *Portfolio Spring-Cleaning Revisited* at www.kaloramawealth.com/news.html) to provide a framework for "what" should be done to organize and optimize the performance of your portfolio to achieve your goals. This article discusses the "how" of Portfolio Spring-Cleaning by providing the steps in the Investment Management Process.

There is much more to investing than simply buying the next great idea. What a disciplined investment process lacks in excitement, it more than makes up in long-term profits. Whether your portfolio is large or small, you or your advisor should follow a disciplined process which begins with a thorough understanding of your long- and short-term financial goals, tolerance for risk, and tax situation. Only after these items are known, can an appropriate asset allocation strategy be developed which is consistent with your unique situation. The portfolio is then constructed with specific investments to fill the proposed allocations. The process becomes continuous with ongoing monitoring, periodic rebalancing, and performance reporting.

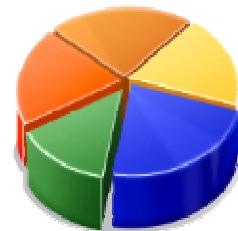
This process, which is the same approach used by large institutional investors such as pension funds and endowments, should also be used by individual investors. The seven steps include:

One: Define Investment Objectives and Constraints

Each investor has a unique combination of goals, time horizons, liquidity needs, tax circumstances, risk tolerances, and attitudes towards investing. These investment objectives and constraints are defined to determine investment strategy and which types of investments are appropriate for the construction of the portfolio. A questionnaire and interview are typically used to assess your objectives and constraints.

Two: Develop Target Asset Allocation Strategy

Once your objectives and constraints are known, a target asset allocation strategy is developed to reflect risk tolerance and desired rate of return. Asset allocation is the distribution of investment dollars among various asset classes, such as stocks, bonds, and cash, and the diversification of investments within each of those asset classes.



The asset allocation strategy should be formulated through a disciplined methodology. The first and most important step is to determine the broad portfolio balance between equity (stock) and fixed-income (bond) investments. This decision concurrently determines the portfolio's long-term expected rate of return and the level of volatility around the rate of return. The next step is to diversify the portfolio within the broad stock and bond asset classes with a strategic mix.

Three: Evaluate Current Portfolio Asset Allocation

Your current asset allocation and investment positions are evaluated to determine which asset classes are over- or under-weighted compared with the proposed target allocation.

Four: Develop Investment Policy Statement

An Investment Policy Statement (IPS) is prepared which describes your: goals, objectives and constraints, and risk tolerance; asset allocation strategy; performance measurement criteria; as well as any special considerations in the management of your portfolio. An IPS provides a description of how the portfolio will be constructed and managed and helps to keep you committed as markets rise and fall. It also helps to ensure that your portfolio remains within your stated risk tolerance.

Five: Portfolio Construction and Asset Location

Portfolio construction is the selection of specific investment vehicles to fill the proposed allocations. Investments available include individual securities (stocks and bonds), mutual funds, or exchange-traded funds (ETFs). Your IPS should state which investment vehicles will be used to construct the portfolio.

Portfolio construction also includes asset location, which involves the strategic placement of your investments in taxable, tax-deferred, or tax-free accounts to achieve the highest level of tax efficiency.

Six: Portfolio Monitoring and Rebalancing

You or your advisor should monitor your investments and portfolio to ensure that assets are invested in a manner which is consistent with the original investment strategy and risk tolerance. This includes a periodic review of the strategic asset allocation to rebalance the portfolio by restoring it to the original target allocation, or to determine whether the allocation should be adjusted and the portfolio rebalanced to agree with the new allocation. A new allocation may be required for significant life changes which would cause an investor to reconsider financial objectives and constraints. You should also assess the impact of taxes and transaction costs as a result of portfolio changes.



Seven: Performance Reporting

On a periodic basis (at least annually), you or your advisor should review the performance of your portfolio. This review will allow you to determine whether you are on track to reach your goals. Reviewing portfolio and investment performance relative to a benchmark will also provide insight into how your portfolio and its holdings stack up against other similar or alternative investments.

So now we know the “what” and “how” of Portfolio Spring-Cleaning. In our next newsletter we will cover the “why” (Does Your Financial Advisor Have an Investment Philosophy?) of organizing and optimizing the performance of your portfolio to achieve your goals.

Whether your countdown is to retirement, education, or another important goal, 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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