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FINANCIAL MARKET OVERVIEW

For the third time in a row, the final months of the year delivered most of the investment gains for the entire year. The second half of 2006 began under ominous signs of potential problems ahead. We had just finished a disappointing second quarter of negative investment returns when conflict in the Middle East erupted, the price of crude oil skyrocketed to over seventy dollars per barrel and residential home prices were definitely entering a period of flat to declining values. Further, the Federal Reserve Board had raised interest rates by one-quarter percent over the previous seventeen consecutive quarters. Collectively, the above concerns appeared to suggest an increase in the risk of slower economic growth, higher inflation and higher interest rates.

Most investors and advisors concluded that the probability of a declining investment environment or a potential correction had increased. Therefore, was it prudent to "stay the course" and remain over weighted in stocks, real estate and other growth assets or reduce your exposure commensurately? Simply stated, we could not justify to ourselves or to our clients to maintain an over-exposure to growth assets. Consequently, we reduced our clients' higher-risk equity positions by 10 to 30%.

By the end of the third quarter, the Israeli/Hezbollah conflict subsided, the Federal Reserve Board stopped raising interest rates and oil prices had dropped below $60 per barrel. Over the past 6 months, none of the above concerns materialized and a stock market rally ensued with earnest and finished the year with double-digit gains over the past six months.

The Dow Jones Industrial Average, the Wilshire 5000 and the Standard & Poor's 500 indexes rose 7% during the fourth quarter. Once again, the larger, dividend-paying and more conservative companies (value stocks) performed significantly better than large growth-oriented stocks, mid-size companies and small-company stocks. Commercial real estate, international companies and emerging company stocks continued their surge posting the best returns of most stock categories during the fourth quarter and entire calendar year.

Below are sample returns of various asset categories during the fourth quarter and for the year-to-date ending December 31, 2006:

4th Quarter	2006	(includes dividends reinvested)
+ 7.4%	**+ 18.3%**	**Dow Jones Industrial Average**
+ 6.7%	**+ 15.8%**	**Standard & Poor's 500 Index**
+ 7.3%	**+ 15.8%**	**DJ Wilshire 5000 (Broad Market)**
+ 5.4%	**+ 5.6%**	**Large-company stock-Growth**
+ 7.0%	**+ 17.9%**	**Large-company stock-Value**
+ 6.3%	**+ 8.2%**	**Mid-Size Stocks – Growth**
+ 8.2%	**+ 15.9%**	**Mid-Size Stocks – Value**
+ 8.2%	**+ 10.3%**	**Small-company stock- Growth**
+ 8.4%	**+ 16.6%**	**Small-company stock- Value**
+ 10.5%	**+ 24.9%**	**International (excludes U.S.)**
+ 17.6%	**+ 32.1%**	**Emerging Markets**
+ 10.2%	**+ 34.3%**	**Real Estate Investment Trusts**
+ 0.9%	**+ 3.7 %**	**Short-term U.S. Treasury *(includes appreciation)***
(0.4%)	**+ 1.4%**	**Intermediate U.S. Treasury *(includes appreciation)***

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FUTURE ECONOMIC OUTLOOK

We expect more of the same volatility in both directions from the financial markets over the next 12 to 24 months. Presently, hopes are high and optimism reigns immediately following stock market rallies. Six months have passed without additional interest rate increases by the Federal Reserve Board, the conflict in the Middle East has subsided, oil prices have suddenly reversed direction, concerns about higher inflation have decreased, and the year-end stock market rally has renewed investor confidence. It seems that most people and a majority of economists are prepared, or are expecting, only a favorable outcome at this point.

Despite lingering uncertainty that recent stock market advances have been based on expectations of a near-perfect world characterized by steady economic growth, low inflation and interest rates, and without any serious world instability, more investors are following recent performance and re-establishing a larger exposure to equities (stocks).

In the months ahead, be prepared for what may seem to be reverse psychology or in simple terms: good news will be followed by stock market declines and bad news will be followed by stock market rallies. What appears to be good news to some parties will be perceived as bad news by others.

For example, some economists expect the overall economy to weaken and thus prompt the Federal Reserve Board to lower interest rates. While a majority of economists expect average investment performance in 2007, some are concerned about the prospect of a slowing economy and recession. Lower interest rates would help stimulate the economy. In addition, investors typically react to expectations of lower interest rates by increasing their stock and real estate holdings. On the other hand, the Federal Reserve Board is concerned about the potential of rising inflation due to higher energy costs, increases to the minimum wage rates and increased consumer spending due to lower interest rates. Even though indications of economic weakness and slower growth appear to be "bad news", the stock market (driven by professional money managers) will rally in anticipation of pressure on the Federal Reserve Board to lower interest rates and stimulate the economy. Alternatively, last week the government reported a substantial increase in the number of new jobs created during the month of December – a seemingly positive announcement. Immediately, the stock market dropped in reaction to higher job creation as the decline may be a sign of strength and the Federal Reserve will not likely lower interest rates anytime soon if more people are working and the economy is strengthening.

Presently, we have a mixed bag of positive and negative economic indicators - some are long-term and others are short-term.

Negative indicators are:

- Long-term interest rates are lower than short-term interest rates suggesting the economy is weakening or heading toward recession ("inverted yield curve").
- Corporate profit growth is slowing from 18% to 10% or lower.
- GDP (gross domestic product) – a measure of economic activity has slowed considerably from the 3% - 4% range down to 2% to 2.5%.
- Residential housing is clearly in the beginning stages of a slump. Notice of Default filings on home mortgages have now reached a higher level than the previous real estate correction during the 1990s.
- The profit forecast for the two dominant sectors of the economy in 2006 (energy and materials/chemicals) are expected to decline from the mid-twenties to 1%-3%.

Positive indicators include:

- Inflation pressures have declined and are expected to be below 2% annually; oil prices have dropped considerably.
- Employment figures remain strong making the prospect of a broad housing collapse and a sharp reduction in consumer spending increasingly unlikely.
- Interest rates remain relatively low by historical comparisons.
- The service industries remain strong and growing and may more than offset declines in housing and manufacturing.
- Conflict in the Middle East and world instability appears to be subdued compared to mid-2006.

The uncertainty surrounding the true economic health of our economy and whether consumers' willingness to keep spending will prevail is too difficult to discern with confidence at this time. Because of the mixed

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economic signals and unpredictable nature of the markets during this transition period, we will continue to maintain a more balanced or conservative posture compared to the previous 5 years. As always, we will continue to monitor and review the economic environment as new information becomes available. We encourage your questions or comments and look forward to meeting with you for a more detailed discussion.

TAX, RETIREMENT SAVINGS AND OTHER CHANGES FOR 2007

Among many of the changes that became effective on New Year's Day are higher contribution limits for 401(k) plans, a decline in the top estate-tax rate and the annual inflation adjustments for income tax brackets, personal exemptions, the standard mileage rate and several other items.

Retirement Saving. The maximum contribution limits will increase in 2007 for the most common employer-provided retirement plans:

	Under Age 50	Age 50 & Older
401(k) & 403(b) Plans	$15,500	$20,500
IRA Accounts (same as 2006)	$4,000	$5,000
Defined Contribution Plans	$ Lesser of 100% of wages or $45,000	

Individuals should strive to make the maximum annual contributions to employer-provided retirement plans before considering personal savings accounts, annuities, non-deductible IRA accounts, etc.

IRA (Transfers) Charitable Contributions: One year (2007) remains for taxpayers age 70 ½ or older to take advantage of transferring up to $100,000 directly from your IRA to a qualified charity. The transfer (charitable contribution) is not taxable income and counts toward your required minimum distribution.

Technical requirements for outright gifts

a) Donor must be at least age 70 ½.
b) Qualified charitable distributions may not exceed $100,000 in the aggregate.
c) The provision applies to calendar years 2006 and 2007 only.
d) Charitable contribution must be from an IRA – not a qualified retirement plan (pension, 401(k), profit sharing plan, 403(b), SEP-IRAs, etc.).
e) The check or gift payment must come *directly* from the IRA to the charity. If the check is paid to the IRA owner who then endorses the check to the charity, it must be reported as taxable distribution to the IRA owner.
f) Only outright gifts are eligible. Gift annuities, charitable remainder trusts, donor advised funds, etc. are not eligible.
g) The (gift) payment would normally *fully* qualify for a charitable income tax deduction. This means the entire (gift) payment must qualify as a charitable contribution and thus eliminates distributions used for auctions, raffle tickets, fund-raising dinners, etc.

Who is most likely to benefit?

- Individuals who take mandatory minimum required IRA distributions, but don't need additional income.
- Individuals who wish to give more than the deductibility ceiling (50% of adjusted gross income).
- Individuals with higher reported incomes who are already subject to reduced itemized deductions and personal exemptions.
- Individuals whose major assets reside in their IRAs and who wish to make a charitable gift during their lifetime.
- Individuals who intend to leave all or part of their IRA balances to charity at death.

Also note, any cash donations to charity no matter how small now requires a "bank record" such as a cancelled check, or a receipt from the charity in order to deduct the donation.

Estate Tax: The top federal estate-tax rate for estates of people who die in 2007 is reduced one percent to 45%.

Inheriting Employer Retirement Plans: A new law will benefit many people who inherit money from an employer-provided retirement plan such as a 401(k) Plan *from someone who wasn't their spouse.* Prior to 2007, inheriting money in a retirement plan from someone who wasn't your spouse could often lead to a required taxable distribution and unexpectedly high income tax bill. Under the new law, a child, domestic partner, or any other non-spouse who inherits money in a qualified retirement plan can transfer it directly into an IRA. The transfer to an IRA allows the heir to stretch out distributions over numerous years rather than taking the entire taxable distribution in a lump sum. In the past, only IRAs could be inherited by non-spouses and transferred to an IRA. This change will allow many people who have "significant others," children, relatives, etc. to leave remaining balances in company retirement plans under the same favorable rules as surviving spouses.

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Extending this rollover or transfer opportunity to non-spouse beneficiaries will significantly reduce the income tax implications upon receiving an inherited retirement plan balance and allow the beneficiary to accumulated greater wealth over his or her life expectancy.

Technical requirements: Transfers must be made directly from the trustee of the retirement plan balance to the beneficiary's IRA custodian (bank, brokerage firm etc.). If the (inherited) retirement plan balance is made payable directly to the non-spouse beneficiary by check, and the beneficiary deposits the check in a personal or IRA account, the entire sum is not eligible for the rollover rules and the entire sum is subject to state and federal income taxes. Distributions must be made via direct trustee-to-trustee transfer, the IRA must be set up as an *inherited* IRA and required minimum distributions must be taken annually over the beneficiary's remaining life expectancy.

TWENTY MORE YEARS

We begin 2007 in our 21st year as family wealth advisors in San Diego. We appreciate the trust and confidence you have placed upon us to assist you in making better financial decisions and preserving your wealth. We sincerely thank you for the opportunity to serve as your financial advisor and will continue to work hard to preserve that trust and confidence over the next twenty years.

Looking forward, we encourage our clients to make an annual appointment with us to review their goals and circumstances. An appointment is especially important if there has been, or soon will be a change in your financial situation, investment objectives or family circumstances. Now is the best time to discuss whether an update is appropriate for trusts, wills, or health directives. If you have not met with us over the past twelve months, we encourage you to call and schedule an appointment. We wish all of you a happy, healthy and prosperous New Year.

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Best regards

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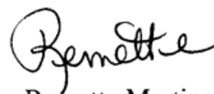
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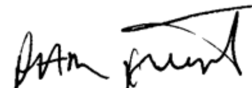
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