EMPIRICAL WEALTH MANAGEMENT

January 8, 2008 **Fourth Quarter 2007 Client Letter**
"Portfolio Tax Management"

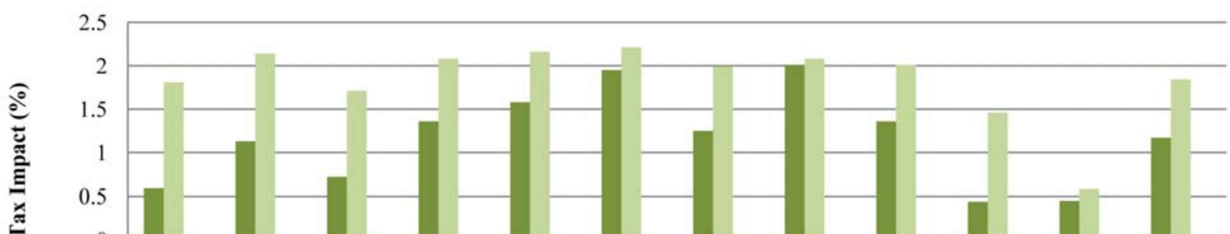
Introduction
2007 was a volatile year for the growth components of our portfolios*. Market volatility often provides unique tax savings opportunities and utilizing the tax code to your benefit is one of the ways we work to preserve and grow your wealth. In this letter we share techniques we use to manage taxes. Our investment philosophy dictates that we focus on things we can control first and foremost and while it is true that taxes cannot be completely eliminated, they can be minimized, deferred and managed in a way that may increase your net return relative to the average investor. In this letter we cover the following areas: ***Passive Asset Class Funds, Tax Managed Asset Class Funds, Year Round Tax Loss Harvesting, Security Location, Managing Year End Distributions, Specific Tax Lot Identification, Charitable Gifting of Low Cost Basis Investments, Monitoring Opportunities for Roth Conversions, Managing IRA Distributions.***

Passive Asset Class Funds
In 2002 the Securities and Exchange Commission (SEC) began requiring mutual funds to report both before and after-tax returns. In 2005 and 2006 mutual funds distributed capital gains and dividends of $129 billion and $418.5 billion (setting a record) respectively. The fund research company Lipper published a report on the effect taxes have had on mutual fund returns for the average stock fund investor over the past 20 years. Lipper found that the average investor gave up 17% to 44% of their returns to taxes. In 2006, taxes reduced returns by 1.3% which is more than the average stock mutual fund expense ratio of 1.2%**. Clearly, the SEC recognized the large effect taxes can have on returns.

It is our approach to invest in broadly diversified passively managed mutual funds. The research is clear that there are multiple benefits to this approach, one of those benefits being tax efficiency. Typically, passive funds experience less trading (within the fund) than the average actively managed fund for each relevant asset class. Figure 1 provided below presents data we pulled from an article done by Geoff Longmeier and Gordon Wotherspoon titled "The Value of Tax Efficient Investments". The paper appeared in the fall 2006 issue of the Journal of Wealth Management. The study covers a ten year period and shows the annual return lost to taxes by active mutual funds versus the loss of return to taxes by index funds.

Figure 1

Active Manager vs. Index by Category (%)
06/30/1995 - 06/30/2005



	Large Blend	Large Value	Large Growth	Mid Blend	Mid Value	Mid Growth	Small Blend	Small Value	Small Growth	Foreign Large	Emerging Markets	Equal Weight Avg
Index	0.59	1.13	0.72	1.36	1.58	1.95	1.25	2.01	1.36	0.44	0.45	1.17
Active Managers	1.81	2.14	1.71	2.08	2.16	2.21	1.99	2.08	2.01	1.46	0.58	1.84
Difference	1.22	1.01	0.99	0.72	0.58	0.26	0.74	0.07	0.65	1.02	0.13	0.67

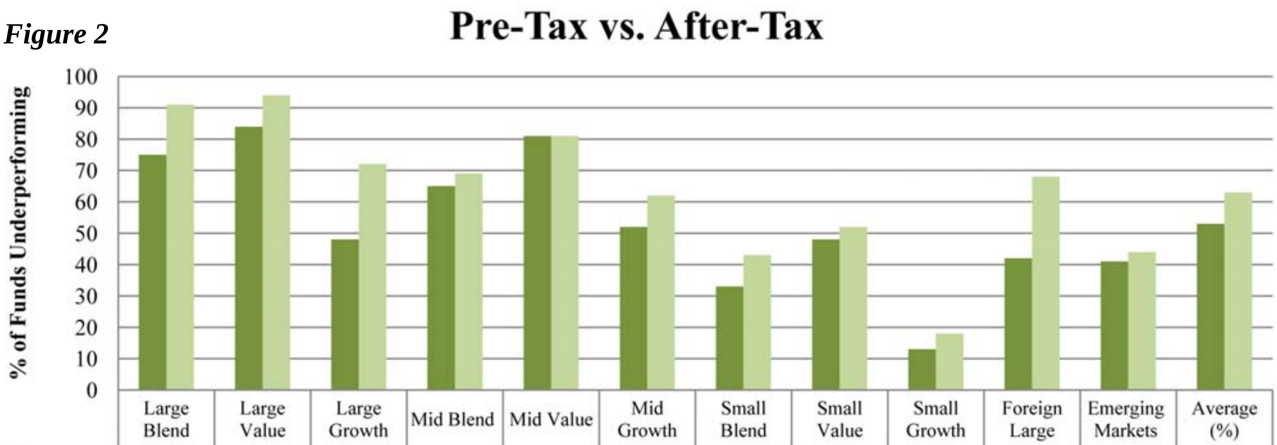
Corresponding benchmarks in order: Russell 1000, Russel 1000 Value, Russel 1000 Growth, Russel Midcap, Russell Midcap Value, Russell Midcap Growth, Russell 2000, Russel 2000 Value, Russel 2000 Growth, MSCI EAFE, MSCI EMF

* See this quarter's "Performance Insert" for year to date performance of funds, indices and model portfolios.

** Starting this quarter, you can find the expense ratios for the funds Empirical uses listed on the performance insert along with category average expenses (as reported by Morningstar). The Empirical fund expenses are significantly lower than the category averages, another controllable factor that we focus on.

In the U.S. blend category, active managers gave up 1.81% annually to taxes while the large blend index fund gave up .59% annually. This means active managers needed to add an extra 1.22% per year to the index return to break even with the index net of taxes. Figure 2 below (from the same study) demonstrates the difficulty of overcoming this hurdle by showing the percentage of active managers **underperforming** index funds on a post-tax basis for each asset class studied over the ten years. For example, 91% of large company blend mutual funds underperformed the large company blend index fund after taxes while 75% underperformed before taxes.

Figure 2



	Large Blend	Large Value	Large Growth	Mid Blend	Mid Value	Mid Growth	Small Blend	Small Value	Small Growth	Foreign Large	Emerging Markets	Average (%)
Pre-Tax	75	84	48	65	81	52	33	48	13	42	41	53
After-Tax	91	94	72	69	81	62	43	52	18	68	44	63

Corresponding benchmarks in order: Russell 1000, Russel 1000 Value, Russel 1000 Growth, Russel Midcap, Russell Midcap Value, Russell Midcap Growth, Russell 2000, Russel 2000 Value, Russel 2000 Growth, MSCI EAFE, MSCI EMF

Tax Managed Asset Class Funds

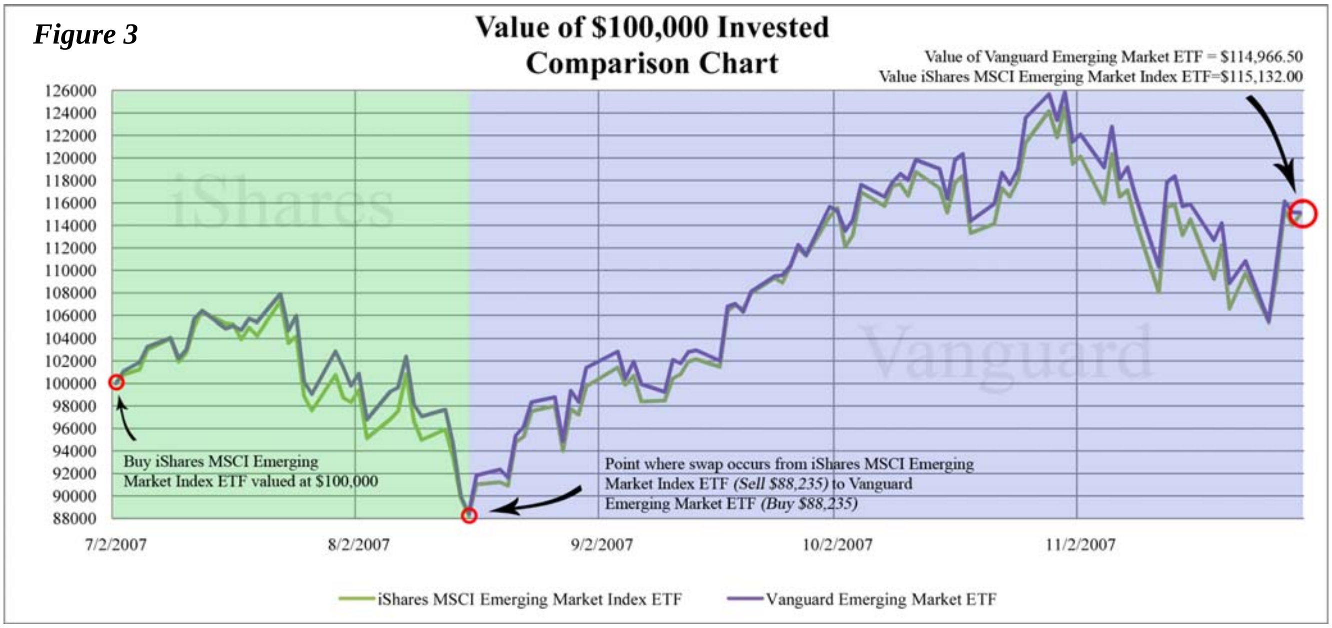
As shown in Figure 1, certain asset classes are less tax efficient than others even when using index funds. To combat this, we utilize tax managed versions where possible in taxable accounts. The structure and nature of exchange traded funds (ETFs) and exchange traded notes (ETNs) has brought another level of tax efficiency to our client portfolios over the last few years. ETFs have done a good job keeping capital gains distributions low and ETNs are designed in a way that they avoid distributions completely. This has been a great opportunity for us in the commodity asset class. We will continue to monitor new tax efficient vehicles as they emerge. In the future you will most likely see a shift toward the use of “Core” type funds in the equity portion of our portfolios. We will discuss more on our fund selection process and core funds in a subsequent letter.

Year Round Tax Loss Harvesting

Tax loss harvesting is a strategy we use year round to take advantage of market movements. If a fund declines far enough below the purchase price the fund is sold at the same time a substitute fund is purchased. The sell allows us to book a taxable loss while the substitute fund provides us continuous exposure to the target asset class. After 30 days have elapsed we can make a decision to swap back into the original position without triggering the IRS wash sale rules. Investors who do not engage in tax loss harvesting lose out on the opportunity to realize short term losses and defer capital gains until they are long term to take advantage of the differences in tax rates. The difference in tax rates provides a tax arbitrage of sorts (arbitrage in this case is the ability to earn a return without taking market risks).

Figure 3 below provides an example of this process. The investor purchased $100,000 of the iShares MSCI Emerging Markets exchange traded fund (ETF). By mid August, the $100,000 investment had declined to around $88,235 which is a loss of almost 12% in about a month and a half. The iShares MSCI Emerging Markets fund is sold for $88,235 and replaced with $88,235 of the Vanguard Emerging Markets ETF. At the time of this transaction a short term loss is realized for $11,765. This loss can now be used to offset future capital gains distributions from mutual funds in the portfolio or gains recognized because of the need to rebalance. Also, up to $3,000 of this loss may be deducted each year on the client’s tax return at their marginal tax rate, unused losses get carried forward into future years. In our example we see that while the Vanguard fund is not an exact replication of the MSCI Emerging Market Fund it tracks very closely with it. By executing a simultaneous swap we maintained our target exposure to this asset class and by December the $100,000 investment in the emerging market asset class had appreciated to $114,966 or close to 15% over the entire five month period.

Figure 3



This exercise can be performed across multiple asset classes and should be carried out all year long. The ability to perform this strategy is greatest when new money comes in to a portfolio. Eventually, stocks and other growth assets will appreciate to a point where even significant market declines are not enough to create losses on the appreciated positions. However, at some point gains need to be realized in order to rebalance. At that time, we make sure that we are realizing long term gains not short term gains. Further, the proceeds from the sells required to rebalance present us with new money going into underweighted asset classes, the new purchases present us with another opportunity to tax swap and reduce the gains recognized. We try to time the recognition of gains at the beginning of a new year so we have eleven months to harvest losses from the reinvested capital.

Some investors engage in tax loss harvesting but only at the end of the year, whereby they examine their securities at the end of the year for losses limiting the opportunity to one point in time. It is clear from our example that if you waited until the end of the year there would be no loss to harvest in the emerging markets asset class. The tax loss harvesting we do is one of the reasons we encourage clients to consolidate their taxable investments with us. If you are holding investments outside of our management and especially if you are directing cash to those investments we cannot fully maximize this approach for you.

Security Placement

Security placement deals with deciding how to divide investments between taxable and retirement accounts. The idea is to place less tax efficient securities like taxable bonds in retirement accounts. The issue is complex because the approach taken is dependent on each person's unique circumstances, investor psychology, approach to investing and outlook on future events. Our approach is to customize a strategy to each client's unique circumstances and revisit it regularly. The more we stray from a completely balanced portfolio in each account type (to capture tax benefits), the greater the need for the client to understand that all investments should be evaluated in a total portfolio context. The decision to focus on tax placement can bring about a behavioral finance issue referred to as mental accounting; it is our nature to separate our accounts and look at each one individually rather than evaluate them as a whole. The potential tax benefits can be lost from poor investment decision making if the investor cannot keep a "big picture" view and stay disciplined over the investment time horizon. As we meet with you regularly we will bring this issue to your attention and make sure that the approach we are using in your accounts is the best given your circumstances.

Managing Year End Distributions

At year end, mutual fund companies provide investors with estimates for the amount and timing of fund distributions. Distributions are typically divided into three primary areas, dividends, short term capital gains and long term capital gains. We retrieve estimated fund distributions in advance so we can take the appropriate course of action. When a mutual fund trades on the market with the distribution amount no longer included in the value of the fund (after the ex-dividend date) the fund value declines by the amount of distribution to be received. However, the price decline is offset by the value of cash received in the distribution. See Figure 4 below for a sample of how this works. The total economic value remaining to the investor (gross of taxes paid) is the same before and after the distribution.

Figure 4

Management of Year End Distributions

Post Distribution Adjustment to Basis with Reinvestment and No Reinvestment of the Distribution

No Reinvestment of Distribution	***Pre-distribution***	***Post Distribution***
Value of Fund	$10,000.00	$9,000.00
Cash	$0.00	$1,000.00
Total Value of Fund and Cash	**$10,000.00**	**$10,000.00**
Fund Cost Basis	$10,000.00	$10,000.00
Unrealized Gain/Loss	$0.00	-$1,000.00
Realized Gain From Distribution	$0.00	$1,000.00
Reinvestment of Distribution	***Pre-distribution***	***Post Distribution***
Value of Fund	$10,000.00	$10,000.00
Cash	$0.00	$0.00
Total Value of Fund and Cash	**$10,000.00**	**$10,000.00**
Fund Cost Basis	$10,000.00	$11,000.00
Unrealized Gain/Loss	$0.00	-$1,000.00
Realized Gain From Distribution	$0.00	$1,000.00

We manage around the year end distribution issue in a few ways. For money that is already invested in mutual funds we look at the gain or loss you have on a fund previous to the distribution and if you have a gain that is smaller than the distribution, no gain, or a loss we may sell the fund prior to the distribution. We will not pull you out of the market for any significant period of time; we will look for a viable substitute fund that is not making a large or any distribution. Keep in mind that if we realized a gain by selling a fund at the end of the year it is most likely because we found out the distribution you would have received by keeping the fund would have been larger than the gain incurred by selling it. Some of the exchange traded funds made little or no distributions in 2006 and 2007. This enabled us to use these types of funds as substitutes near distribution time to stay invested in the market. After the preferred fund makes the distribution, we evaluate a strategy to swap back into it.

Specific Tax Lot Identification

The IRS accepts a few different methods for calculating the purchase prices of mutual funds (cost basis). It is not uncommon to make multiple purchases of a single fund over the course of time. Purchases may be the result of new monies being added to the account, dividend reinvestments, or rebalancing. When a position is sold completely out of a taxable portfolio the method used to track cost basis does not matter because the resulting cost basis is the same across methods. However, if a partial sell is done and there were multiple purchases of the fund being sold, it is most advantageous to specify the shares with the highest cost basis (also those that have been held for one year or more) in order to realize the lowest amount of gain. This is the way we handle the cost basis issue within your taxable account and it is referred to as the “specific lot method”.

It is important to note that you should use our realized gain loss reports at the end of the year to calculate your net gain or loss from the sale of mutual funds. The 1099 you receive from your custodian should be used by you or your tax professional to get the most accurate account of distributions made by the funds. We are happy to speak to your tax professional directly and provide them with all the required reports as well. Most custodians default to an “average cost basis” method that calculates a blended cost basis from among all purchases. We discuss donating low basis security shares to charity as an alternative to donating cash below and using the “specific lot” method is the best way to handle this as well.

Charitable Gifting of Low Cost Basis Investments
Many of our clients have philanthropic goals and give regularly to charitable causes they support. In most cases these gifts qualify for preferential tax treatment. Often we find clients making cash donations and we frequently suggest gifts of highly appreciated securities be made instead. This is an even better approach when you redirect the otherwise donated cash to your investment accounts. The cash can be invested in new positions providing us liquidity and opportunities to tax loss harvest. We are currently in the process of writing a separate client letter describing the benefits of donating both cash and/or low basis investments of various types to a donor advised fund account. We will save a thorough discussion of the benefits and rules involved with donor advised funds for that letter. Please speak to us about this if you have any questions and look for the letter we are sending out this quarter.

Monitoring Opportunities for Roth Conversions
As a part of our regular review process we examine your income and tax situation and assess opportunities to convert traditional IRA assets into Roth assets. We sent a letter out previously that discussed the potential Roth conversion opportunities created with the 2006 Tax Increase Prevention and Reconciliation Act (TIPRA). Assuming TIPRA remains intact as is, starting in 2010 taxpayers will have the ability to convert a traditional IRA to a Roth IRA without being subject to the $100,000 modified adjusted gross income (MAGI) limitation. Also, for conversions done in 2010, conversion income can be split equally across the tax years 2011 and 2012. We regularly review conversion opportunities with clients and we will continue to track changes in the tax code between now and 2010.

Managing IRA Distributions
For clients who are in retirement or who are nearing retirement, we plan and periodically review the best way to achieve the maximum amount of after tax income over their lifetime. This process involves determining how much income to derive from a particular client's unique combination of taxable, tax free and taxed deferred investments. A part of this process is annually determining the appropriate amount if any to distribute from traditional IRA accounts.

This process should start long before an IRA owner is required to make minimum distributions (at age 70½). At age 59½ IRA owners have the option to begin making voluntary withdrawals from their IRA with no early withdrawal penalty (taxes will be paid). For those retiring earlier than 59½ there are other strategies to get at retirement assets penalty free; we will discuss those with you and your tax professional as deemed appropriate. We have several clients taking distributions from their IRA as a part of a long term strategy. As an example, if an IRA owner retired at age 60 and had absolutely no income from employment, pensions, or social security, we may suggest generating part of their required income from their traditional IRA. The value of this strategy is the ability to remove assets from the retirement account while minimizing the tax impact as a result of the low income.

Conclusion
Our goal with this letter was to establish the importance of managing taxes, show you the impact taxes can make on net returns and share with you strategies we use to manage taxes. The Lipper data and the study from the Journal of Wealth Management illustrate the results achieved by average investors and active mutual fund managers. When you compare those results to our approach of utilizing passive asset class funds, tax managed funds, year round tax loss harvesting, fund distribution management and the other techniques discussed; we believe that the average investor is unduly giving up returns to taxes. We appreciate the opportunity to serve as your trusted advisor and look forward to meeting with you in 2008.

Sincerely,

Kenneth R. Smith

The Empirical Wealth Management Team
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Chief Executive Officer