SUMMER 2003

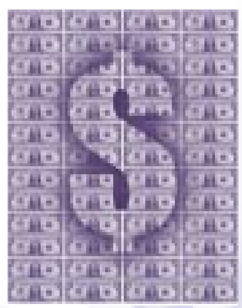
BWFA Advisor

BALTIMORE–WASHINGTON FINANCIAL ADVISORS, INC.

Fee-Only Retirement & Estate Planning, Investment Management, & Tax Services

Important New Services for Our Investment Clients

By Saxon Birdsong, MBA



We are announcing **two new services** and a **small increase in our fees,** which we will begin implementing in July.

For more than a year now we have been evaluating ways we can improve our oversight of your investments. Like you, we have grown increasingly concerned about the behavior of corporate executives and whether boards of directors and outside auditors are doing their jobs to protect the interests of shareholders.

We have observed over these last two years that our traditional sources of independent research are simply not effective enough in identifying certain problems that might exist within individual companies. Accordingly, in our search for better solutions we have identified two services that we think can help.

Proxy Voting

The first service is offered by Institutional Shareholder Services, Inc. (ISS). ISS provides thorough and highly detailed analyses of management proposals to shareholders, and recommends how shareholders should vote in order to protect their interests. In addition, ISS will give BWFA the operational capability to cast proxy votes on behalf of our clients. Using ISS will provide you with three distinct advantages:

- ♦ **It will give you a significant and meaningful voice on important issues.**
- ♦ **It will relieve you from the task/responsibility of voting proxies.**
- ♦ **It will significantly reduce the amount of unsolicited mail you receive.**

Evaluation of Corporate Boards

The second service is offered by The Corporate Library (TCL). TCL provides detailed analyses and evaluations of corporate boards of directors. The company has developed a series of specific measurements (metrics) which provide insight into how well the board is doing its job: overseeing management of the firm, managing the audit process, dealing properly with executive compensation, etc. TCL reduces their quantitative and qualitative analyses into a one-letter "effectiveness score" and provides important insights not available elsewhere.

If you would like to see a sample of the excellent analyses done by ISS or TCL, please give us a call and we will send you a sample.

Important Additional Information About These New Services

- ♦ These services will benefit all clients, and there is no way we can make them optional.
- ♦ Both companies charge fees for their services. To help defray a portion of the cost of these improvements, BWFA will charge you an additional **$10 per quarter.** No other fees apply from BWFA, ISS or TCL. We have done everything we can to keep these fees as low as possible.
- ♦ You will need to sign paperwork on each of your accounts, authorizing us to vote your shares.
- ♦ Chasity Crawley will be contacting all Investment Management clients in the near future to begin implementing the new service.

Contact Our Client Board

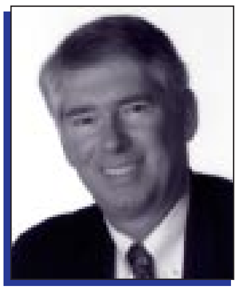
Our Client Advisory Board members have volunteered to speak with anyone who has questions about the new services or any other aspect of BWFA. Call Leslie at (410) 461-3900 if you would like any of their names and phone numbers. You may also learn more about our Client Advisory Board by visiting our website at www.bwfa.com.

It's going to take everyone involved in the investment process to improve the fairness and integrity of our financial markets. We hope you share our view that these changes are a positive step toward this goal.

As always, we are very interested in your feedback. Please give us a call or e-mail your comments.

Fee FO Only ™

Retirement & Estate Planning



By Bob Ray

Look Before You Leap—Ten Opportunities to Save Taxes at Retirement

If you are contemplating retirement, careful financial planning can often save significant taxes during your retirement years. Although the strategies listed below may not apply to everyone, many more opportunities exist. Speaking to a financial advisor before you retire can help you identify the strategies that will most benefit your unique situation.

Roth IRAs

If you have not been eligible for Roth IRAs in the past due to high earned income, you may qualify in your final year of work as you transition into retirement. In subsequent years, part-time income or spousal income may also qualify you to contribute up to $7,000 per year in a Roth IRA that will grow tax-free.

Roth IRA Conversions

Your tax rate may drop in the early years of retirement as you withdraw previously taxed savings to cover your living expenses. If your Modified Adjusted Gross Income is less than $100,000, you can move funds from traditional IRAs and 401(k)s to a Roth IRA. You pay tax on the funds moved at your lower tax rate, and the funds in the Roth IRA will grow tax-free. In addition, this reduces the amount of your required minimum distributions because Roth IRAs are not subject to the minimum distribution rules.

Tax Bracket Planning

By mixing previously taxed savings withdrawals and IRA withdrawals to cover your expenses in retirement, you can achieve the lowest possible tax bracket without losing the benefit of other tax deductions. By withdrawing some IRA funds prior to age 70½ you reduce the required minimum distribution amount, possibly saving additional taxes during retirement.

Employer Stock Held in 401(k)s

Highly appreciated employer stock can be removed from 401(k) plans at retirement. This is a taxable event, but you will initially pay taxes only on the purchase value of the stock. Later, when you sell the stock, all of the appreciation will be taxed as capital gains subject to a maximum tax rate of 15%. This compares to leaving the stock inside the 401(k) and paying tax on withdrawals at ordinary income tax rates, which can go as high as 35%.

Stock Dividends

Recent tax legislation makes high-dividend-paying stocks extremely attractive investments in taxable accounts. The dividends are now subject to the same tax rate as capital gains (maximum 15%). For retirees who need income from their investments to live on, these stocks are a tax-friendly solution.

Asset Allocation

While dividend-paying stocks are a good choice for your taxable account, other income-producing investments such as Limited Partnerships, REITs and taxable bonds are still best held in a retirement account. Income considerations may override tax decisions, so your portfolio should be tailored to your individual needs.

Vacation Homes

If you are thinking of selling your vacation home, first consider living in it for two years after you are retired. This will qualify the property as a principal residence and allow you to exclude up to $500,000 (for married filing joint) of gains on the sale.

Investment Properties

If you are contemplating selling investment property, you may reduce your taxes by using a Section 1031 like-kind exchange. You are allowed to defer the tax on the gain from the sale of your property, if you use the proceeds to purchase other investment property. If you use the proceeds to purchase units in a real estate partnership, you can also continue to receive income from your investment, diversify your real estate holdings, and avoid the hassles of investment property ownership.

Charitable Giving

If you have a large asset with substantial appreciation, such as company stock or farmland, you may benefit by setting up a Charitable Remainder Trust. You would contribute the appreciated asset to the charitable trust, which can sell it with no tax consequences, thereby avoiding the capital gains taxes. The trust would reinvest the entire proceeds and provide you with income for life. Your charity would receive whatever value is left in the trust at the end of your life. You would also receive a current tax deduction for your contribution, which would lower your taxes today.

Life Insurance

Many retirees no longer need life insurance. If you have a policy with a large cash value and a low cost basis, you could do a 1035 tax exchange to a low-cost annuity. This would allow you to maintain the tax-deferred status of the cash value. If you selected a variable annuity, you could improve your investment options. In addition, you would no longer have insurance premiums charged against your policy, so the value could accumulate faster.

If you would like help with any of these tax strategies, please call BWFA and set up an appointment with one of our advisors.

Investment Management

Whom Can You Trust?

By Kim Anderson, CFP

If you are outraged by the recent scandals on Wall Street, you have good reason to be. Along with you, many Americans who watched their fortunes rise and fall with the stock market bubble of the late 90's are dismayed to learn that the major brokerage houses where they entrusted their money contributed significantly to their losses. Ten of the largest Wall Street firms, including Morgan Stanley, Merrill Lynch and Smith Barney, have agreed to pay a record $1.4 billion to settle government charges of fraud. The allegations center on ways these firms took unfair advantage of their retail clients in order to generate fees from their large commercial clients.

Wall Street Deception

The SEC's litigation release, dated April 28, 2003, has revealed that Morgan Stanley and others were compensating research analysts based on the degree to which they helped win investment banking business for the firm. In addition, when soliciting investment banking business, the firm implicitly suggested that analysts would provide favorable ratings of the prospective client's stock. These arrangements encouraged the firm's research analysts to tout the stocks the firm was offering to the public, regardless of the stocks' merits. Internal e-mails revealed that analysts were privately trashing the very stocks for which they were giving strong buy recommendations.

The same SEC release also showed that Morgan Stanley and others paid other brokerage firms to publish positive research reports on stocks Morgan Stanley was issuing to the public. These so-called "research guarantees" helped hype the stocks and drive up the prices retail investors paid for these stocks.

Is Change Coming?

Many retail investors who trusted the buy recommendations coming from these firms are now feeling duped. Will the settlement provide any consolation, and, more importantly, will it cause much needed change in the industry? Likely, no. Phillip Purcell, the CEO of Morgan Stanley, was quoted in the Washington Post on May 1, 2003 as saying "I don't see anything in the settlement that will concern the retail investor about Morgan Stanley." This comment prompted William Donaldson, the Chairman of the Securities and Exchange Commission, to accuse Mr. Purcell of displaying "a troubling lack of contrition."

The reforms, which are intended to reduce conflicts of interest, only go as far as relocating research and investment banking departments in different offices and creating separate legal and administrative staffs. These reforms may have little effect on a firm's desire to keep a corporate client happy with a favorable analyst recommendation.

An Alternative

Fortunately, as an investor, you do have other options. You can choose to work with an independent, fee-only advisor who is not tied to the conflicts of interest inherent in these large brokerage firms. When you work with a fee-only advisor, neither the advisor nor any related party ever receives compensation contingent on the purchase or sale of a stock or any other financial product. This ensures the advisor has only your best interests in mind.

If you are interested in learning more about fee-only advisors or would like a list of advisors in your area, you can contact the National Association of Personal Financial Advisors (NAPFA) at 1-800-366-2732 or on the Web at www.NAPFA.org. NAPFA does more than any other professional organization to ensure the competency of its members, and to steer consumers to experienced, fee-only financial professionals who can provide the independent financial advice consumers are looking for.

Tax Services

New Tax Law Offers Tax Saving Opportunities

By Bob Cassel, EA

The Accountant's Full Employment Act of 2003 (also referred to as the Jobs and Growth Tax Relief Reconciliation Act of 2003) has been signed. But before you groan, there is quite a bit of good news for our clients, including reductions across the board in marginal income tax rates, dividend income tax rates capped at 15%, capital gains tax rates capped at 15%, increased child tax credit amounts, increased alternative minimum exemption amounts and more. This article focuses on the tax planning opportunities that have come about as a result of these changes.

Tax Rate Reduction

Tax brackets have been lowered by 2% across the board. Except for the lowest two tax brackets (10% and 15%) all of the higher tax brackets have been reduced by 2%. The highest tax bracket (which used to be 38.6%) has been reduced to 35%. Unless you are making estimated tax payments, you really don't have to do anything to take advantage of these reductions. Beginning in July, your employer is requested to begin using updated payroll withholding tables that will effectively reduce your total federal tax withholding for the year to reflect the lower marginal tax rates. So, by the end of December, you should have received the full benefit of the 2% reduction in tax rates. Your state income tax withholding has not been affected by these tax law changes, so your state withholding should not change in July.

Tax planning opportunity—You may be able to reduce your federal estimated tax payments. We can recalculate your estimated tax payments and set you up with new coupons. Call us and we'll explain how this service will help you.

Marriage Penalty Relief

This legislation is the first sign of REAL marriage penalty relief. It consists of two provisions:

- **The standard deduction for married taxpayers is now double the amount for single taxpayers.** If you are not itemizing deductions, you will now receive the same standard deduction as two single persons. This, in combination with the next change, goes a long way toward providing relief to married taxpayers.
- **The 15% marginal tax bracket is doubled for married taxpayers.** This means that more of a married couple's income is taxed in the 15% marginal income tax bracket. An extra $9,200 (using last year's tax brackets) for married taxpayers will be taxed at 15% instead of 25%. That's a tax savings of $920.

Tax planning opportunity—Married couples should look at reducing their withholdings or estimated tax payments. Even though the payroll tax tables will change in July, the effects of the changes will not completely account for the tax savings for married filers. Bring us your end-of-month pay statements from June and August and we'll recommend adjustments to your withholding or estimated payments so that you see the advantage of your tax reduction now, rather than in a refund check next April.

Expanded Write-Offs for Business-Related Expenditures

If you are a business owner, there are now two huge incentives to purchase business-related equipment in 2003. The first, and probably most valuable, is the increase in the amount of business equipment purchases you can write off in the year you purchase them. That limit used to be $24,000, but is now $100,000. The second incentive applies primarily (although not exclusively) to businesses that have gross revenue over $400,000. These businesses cannot use the $100,000 first year write-off. However, they will benefit from the 50% first year depreciation write-off, up from 30%.

Tax Planning Opportunity—We have two thoughts. Estimated tax payments could be affected. We can help revise and reduce the estimated payments for you based on your projected expenditures for equipment. Secondly, if you have a high percentage business use of a vehicle, there is a large incentive to purchase larger (and heavier—more than 6,000 pounds) vehicles and take advantage of this expanded first year write-off.

Alternative Minimum Tax Relief

The exemption available for income that is subject to the alternative minimum tax has increased to $58,000 for married taxpayers and $40,250 for single taxpayers.

Tax Planning Opportunity—Persons with incentive stock options (above water) can now exercise and hold a larger number of shares without incurring the dreaded alternative minimum tax. This takes careful planning, so contact BWFA to speak to an advisor. Secondly, persons with income above $125,000 who have been "slipping" into the alternative minimum tax zone may avoid that tax and be able to reduce withholding or estimated tax payments. We can run the estimates for you.

We hope we've given you a few tax planning ideas that have come about as a result of this new tax legislation. Call us, e-mail us, or come in for an appointment and we'll talk about implementing the strategies that will benefit you.

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