



HARRIS & HARRIS GROUP, INC.®

Venture Capital for Tiny Technology

SECOND QUARTER REPORT 2006

FELLOW SHAREHOLDERS:

The venture capital business, the business of Harris & Harris Group, has always been violently cyclical. And funding of venture capital firms (which are usually organized as partnerships) by limited partners has always exacerbated that inherent cyclicity. Dating back to the infancy of venture capital after World War II, there have been capital-market cycles, in which bull markets that enable venture-capital-backed companies to complete initial public offerings (IPOs) are followed by bear markets in which relatively few IPOs are completed. Limited partners tend to increase their allocations to venture capital funds when there is a lot of IPO activity, and thus historical venture capital returns are high; and to cut their allocations when there is a scarcity of IPO activity, and thus historical venture capital returns are low. In keeping with the limited partner funding cycle, venture capitalists are in general able to negotiate better terms for their venture capital investments during the bear markets, and encounter the most competition for investment opportunities during the bull markets. In general, therefore, returns on venture capital investments initiated during bear markets are higher than such investments initiated during bull markets. (Shareholders who want to learn more about the cyclicity of venture capital may wish to obtain a copy of the out-of-print classic, *Venture Capital at the Crossroads*, by Bygrave and Timmons, published by Harvard Business School Press in 1992.)

Accordingly, we were delighted to see a well-researched, but gloomy, front-page article in the August 3, 2006, issue of *The Wall Street Journal*, entitled, "Silicon Valley's Backers Grapple With Era of Diminished Returns." The article quoted industry experts on the bleakness of the outlook for venture capital and pointed out that the "cumulative returns for the past six years remain negative, still smarting from the dot-com meltdown," and that "last year there were 56 venture-backed IPOs in the U.S., just a quarter as many as in 1995." Best of all, from our point of view, the article cited scaling back by college endowments of their commitments to venture capital.

In this context, during the first half of 2006, we accelerated our pace of venture-capital investments in nanotechnology. Altogether, we invested more dollars in the first half than we did in our previous record full year: \$18,165,017 in the first half of this year, versus \$16,251,339 in all of 2005. During the second quarter of this year alone, we invested a total of \$8,752,253 in privately held companies working at the nanoscale. Three of these investments were initial deals, in which we invested a total of \$5,000,547; the remaining \$3,751,706 was invested in four follow-on deals in portfolio companies in which we held pre-emptive rights to participate in future rounds of financings.

So far this year, we have made five initial investments, and in all five of these deals, we have been the lead investor. The lead investor typically negotiates the price and terms of a deal with the investee company. Acceptability as a lead investor by entrepreneurs and by older, larger, tier-one, venture capital firms is a hallmark for a venture capital firm. We do not insist on being the lead investor when we make an initial investment in a company, if we like the company and the terms. But we believe that the increasing frequency with which we have been leading deals is a sign of the development of our business franchise.

Fortuitously, the adverse stock market conditions that have prevailed in recent months, accompanied by an especially poor environment for venture-backed IPOs, has had no adverse fundamental effect so far, that we can discern, on our Company or on our portfolio companies. We entered this year with record amounts of cash and had no plans to make an offering of our shares. And, as we had pointed out in our letter to shareholders in our 2005 Annual Report, "we [were] not aware of any potential blockbuster nanotechnology IPOs, either from our portfolio or elsewhere, that [were] being scheduled for 2006."

If, however, the current weak stock market portends an economic slowdown accompanied by cutbacks in capital spending by large corporations, many of our portfolio companies would experience difficulty introducing their new products. Conversely, if some economists are correct that accelerating capital spending will be the new locomotive of the economy as consumer spending moderates, our portfolio companies should find themselves in an economic environment conducive to the introduction of new products. Eventually, bull markets follow bear markets, and periods of ebullient IPO activity follow periods of IPO torpor.

As always, we thank you, our shareholders for your understanding of the cyclical nature of our business and your support of our business throughout the cycles. Meanwhile, our deal flow remains robust, and we are investing vigorously in tiny technology with the intent of building an exceptional, albeit highly cyclical, growth business.

Charles E. Harris
Chairman and Chief Executive Officer
Managing Director

Douglas W. Jamison
President and Chief Operating Officer
Managing Director

Daniel V. Leff
Executive Vice President
Managing Director

Alexei A. Andreev
Executive Vice President
Managing Director

August 16, 2006

This letter may contain statements of a forward-looking nature relating to future events. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. These statements reflect the Company's current beliefs, and a number of important factors could cause actual results to differ materially from those expressed in this letter. Please see the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, and the Company's report on Form 10-Q for the quarter ended June 30, 2006, filed with the Securities and Exchange Commission, for a more detailed discussion of the risks and uncertainties associated with the Company's business, including but not limited to the risks and uncertainties associated with venture capital investing and other significant factors that could affect the Company's actual results. Except as otherwise required by Federal securities laws, Harris & Harris Group, Inc.®, undertakes no obligation to update or revise these forward-looking statements to reflect new events or uncertainties. The references to portfolio company websites have been provided as a convenience, and the information contained on such websites is not incorporated by reference into this letter.

Unaudited Schedule of Investments*

(As of June 30, 2006)

Investment	Shares/ Principal	Value
AlphaSimplex Group, LLC Limited Liability Company Interest	--	\$ 4,058
BridgeLux, Inc. Series B Convertible Preferred Stock	1,861,504	1,000,000
Cambrios Technologies Corporation Series B Convertible Preferred Stock	1,294,025	1,294,025
Chlorogen, Inc. Series A Convertible Preferred Stock	4,478,038	785,000
Series B Convertible Preferred Stock	2,077,930	<u>364,261</u>
		1,149,261
Crystal IS, Inc. Series A Convertible Preferred Stock	274,100	199,983
Secured Convertible Bridge Note (including interest)	\$68,568	<u>69,382</u>
		269,365
CSwitch, Inc. Series A-1 Convertible Preferred Stock	6,700,000	3,350,000
D-Wave Systems, Inc. Series B Convertible Preferred Stock	2,000,000	1,793,722
Warrants at \$0.85 expiring 10/19/07	1,800,000	<u>0</u>
		1,793,722
Evolved Nanomaterial Sciences, Inc. Series A Convertible Preferred Stock	5,870,021	2,800,000
Exponential Business Development Company Limited Partnership Interest	--	0
Innovalight Inc. Series B Convertible Preferred Stock	16,666,666	2,500,000
Kereos, Inc. Series B Convertible Preferred Stock	349,092	960,000
Kovio, Inc. Series C Convertible Preferred Stock	2,500,000	3,000,000
Mersana Therapeutics, Inc. Series A Convertible Preferred Stock	68,452	136,904
Series B Convertible Preferred Stock	616,500	1,233,000
Warrants at \$2.00 expiring 10/21/10	91,625	<u>0</u>
		1,369,904
Metabolon, Inc. Series B Convertible Preferred Stock	2,173,913	2,500,000
Molecular Imprints, Inc. Series B Convertible Preferred Stock	1,333,333	2,000,000
Series C Convertible Preferred Stock	1,250,000	2,500,000
Warrants at \$2.00 expiring 12/31/11	125,000	<u>0</u>
		4,500,000
NanoGram Corporation Series I Convertible Preferred Stock	63,210	64,259
Series II Convertible Preferred Stock	1,250,904	1,271,670
Series III Convertible Preferred Stock	1,242,144	<u>1,262,764</u>
		2,598,693
Nanomix, Inc. Series C Convertible Preferred Stock	9,779,181	2,500,000
NanoOpto Corporation Series A-1 Convertible Preferred Stock	267,857	32,490
Series B Convertible Preferred Stock	3,819,935	1,110,073
Series C Convertible Preferred Stock	1,932,789	842,503
Series D Convertible Preferred Stock	1,397,218	433,138
Warrants at \$0.4359 expiring 03/15/10	193,279	<u>0</u>
		2,418,204
Nanosys, Inc. Series C Convertible Preferred Stock	803,428	2,370,113
Series D Convertible Preferred Stock	1,016,950	<u>3,000,003</u>
		5,370,116
Nantero, Inc. Series A Convertible Preferred Stock	345,070	1,046,908
Series B Convertible Preferred Stock	207,051	628,172
Series C Convertible Preferred Stock	188,315	<u>571,329</u>
		2,246,409
NeoPhotonics Corporation Common Stock	716,195	67,736
Series 1 Convertible Preferred Stock	1,831,256	1,831,256
Series 2 Convertible Preferred Stock	741,898	741,898
Series 3 Convertible Preferred Stock	2,750,000	2,750,000
Warrants at \$0.15 expiring 01/26/10	16,364	164
Warrants at \$0.15 expiring 12/05/10	14,063	<u>140</u>
		5,391,194
Nextreme Thermal Solutions, Inc. Series A Convertible Preferred Stock	1,000,000	1,000,000
Polatis, Inc. Series A-1 Convertible Preferred Stock	16,775	47,828
Series A-2 Convertible Preferred Stock	71,611	<u>204,172</u>
		252,000
Questech Corporation Common Stock	646,954	781,520
Warrants at \$1.50 expiring 08/03/06	8,500	0
Warrants at \$1.50 expiring 11/21/07	3,750	0
Warrants at \$1.50 expiring 11/19/08	5,000	0
Warrants at \$1.50 expiring 11/19/09	5,000	<u>0</u>
		781,520
SiOnyx, Inc. Series A Convertible Preferred Stock	2,334,994	750,000
Solazyme, Inc. Series A Convertible Preferred Stock	988,204	385,400
Starfire Systems, Inc. Common Stock	375,000	150,000
Series A-1 Convertible Preferred Stock	600,000	<u>600,000</u>
		750,000
Zia Laser, Inc. Series C Convertible Preferred Stock	1,500,000	0
Total		<u><u>\$50,933,871</u></u>

HARRIS & HARRIS GROUP, INC.[®]
CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES*

	<u>ASSETS</u>	
	June 30, 2006 (Unaudited)	December 31, 2005
Cash, U.S. government and government agency securities and cash equivalents	\$ 66,135,126	\$ 97,464,153
Investments, at value	50,933,871	33,187,333
Restricted funds.....	1,942,840	1,730,434
Receivable from portfolio company	0	75,000
Interest receivable	590,101	248,563
Prepaid expenses	293,709	2,993
Other assets.....	205,118	229,644
Total assets	<u>\$ 120,100,765</u>	<u>\$ 132,938,120</u>
 <u>LIABILITIES & NET ASSETS</u> 		
Accounts payable and accrued liabilities.....	\$ 3,344,448	\$ 3,174,183
Accrued profit sharing.....	210,786	2,107,858
Deferred rent.....	24,727	31,003
Current taxes payable.....	1,354,504	1,514,967
Taxes payable on behalf of shareholders.....	0	8,122,367
Total liabilities	<u>4,934,465</u>	<u>14,950,378</u>
 Net assets	 <u>\$ 115,166,300</u>	 <u>\$ 117,987,742</u>
 Net assets are comprised of:		
Preferred stock, \$0.10 par value, 2,000,000 shares authorized; none issued.....	\$ 0	\$ 0
Common stock, \$0.01 par value, 45,000,000 shares authorized at 6/30/06; 30,000,000 at 12/31/05; 22,585,085 issued at 6/30/06 and 12/31/05.....	225,851	225,851
Additional paid in capital.....	122,265,187	122,149,642
Accumulated net realized income	2,314,191	3,781,905
Accumulated unrealized depreciation of investments	(6,233,398)	(4,764,125)
Treasury stock, at cost (1,828,740 shares at 6/30/06 and 12/31/05)	(3,405,531)	(3,405,531)
Net assets	<u>\$ 115,166,300</u>	<u>\$ 117,987,742</u>
 Shares outstanding	 <u>20,756,345</u>	 <u>20,756,345</u>
 Net asset value per outstanding share	 <u>\$ 5.54</u>	 <u>\$ 5.68</u>

HARRIS & HARRIS GROUP, INC.[®]
CONSOLIDATED STATEMENTS OF OPERATIONS*
(Unaudited)

	<u>Three Months Ended June 30</u>		<u>Six Months Ended June 30</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Investment income:				
Interest from:				
Fixed-income securities	\$ 780,265	\$ 202,132	\$ 1,582,627	\$ 428,482
Portfolio companies	0	(48,390)	0	(9,780)
Miscellaneous income.....	5,000	4,975	7,500	5,124
Total investment income	<u>785,265</u>	<u>158,717</u>	<u>1,590,127</u>	<u>423,826</u>
 Expenses:				
Salaries, benefits and stock-based compensation.....	804,151	614,610	1,590,512	1,182,300
Administration and operations	406,092	487,144	728,541	809,106
Profit-sharing provision	0	2,012,465	0	1,700,871
Professional fees	97,938	218,122	387,825	490,587
Rent	57,381	51,180	118,619	99,861
Directors' fees and expenses	94,900	55,082	180,802	140,741
Depreciation.....	16,128	16,073	32,896	31,342
Custodian fees.....	2,562	6,135	12,562	11,699
Total expenses	<u>1,479,152</u>	<u>3,460,811</u>	<u>3,051,757</u>	<u>4,466,507</u>
Net operating loss	<u>(693,887)</u>	<u>(3,302,094)</u>	<u>(1,461,630)</u>	<u>(4,042,681)</u>
 Net realized gain (loss) from investments:				
Realized gain (loss) from investments	1,500	(1,386,741)	13,453	(2,427,785)
Income tax expense.....	9,931	634	19,537	4,851
Net realized loss from investments	<u>(8,431)</u>	<u>(1,387,375)</u>	<u>(6,084)</u>	<u>(2,432,636)</u>
 Net (increase) decrease in unrealized depreciation on investments:				
Change as a result of investment sales	0	1,766,210	0	2,956,491
Change on investments held.....	(580,679)	9,925,106	(1,469,273)	8,287,230
Net (increase) decrease in unrealized depreciation on investments	<u>(580,679)</u>	<u>11,691,316</u>	<u>(1,469,273)</u>	<u>11,243,721</u>
 Net realized and unrealized (loss) gain from investments	 <u>(589,110)</u>	 <u>10,303,941</u>	 <u>(1,475,357)</u>	 <u>8,811,085</u>
 Net (decrease) increase in net assets resulting from operations:				
Total	<u>\$ (1,282,997)</u>	<u>\$ 7,001,847</u>	<u>\$ (2,936,987)</u>	<u>\$ 4,768,404</u>
 Per average basic and diluted outstanding share	 <u>\$ (0.06)</u>	 <u>\$ 0.41</u>	 <u>\$ (0.14)</u>	 <u>\$ 0.28</u>
 Average outstanding shares	 <u>20,756,345</u>	 <u>17,248,845</u>	 <u>20,756,345</u>	 <u>17,248,845</u>

*Selected quarterly financial information. The information contained herein does not include the full unaudited quarterly financial information. Please see the Company's report on Form 10-Q for the quarter ended June 30, 2006 for the unaudited financial information and notes thereto.

Portfolio Company Websites

<u>Portfolio Company</u>	<u>Website Address</u>
AlphaSimplex Group, LLC	www.alphasimplex.com
BridgeLux, Inc.	www.bridgelux.com
Cambrios Technologies Corporation	www.cambrios.com
Chlorogen, Inc.	www.chlorogen.com
Crystal IS, Inc.	www.crystal-is.com
CSwitch, Inc.	www.cswitch.com
D-Wave, Inc.	www.dwavesys.com
Evolved Nanomaterial Sciences, Inc.	www.ensbio.com
Innovalight, Inc.	www.innovalight.com
Kereos, Inc.	www.keros.com
Kovio, Inc.	www.kovio.com
Mersana Therapeutics, Inc.	www.mersana.com
Metabolon, Inc.	www.metabolon.com
Molecular Imprints, Inc.	www.molecularimprints.com
NanoGram Corporation	www.nanogram.com
Nanomix, Inc.	www.nano.com
NanoOpto Corporation	www.nanoopto.com
Nanosys, Inc.	www.nanosysinc.com
Nantero, Inc.	www.nantero.com
NeoPhotonics Corporation	www.neophotonics.com
Nextreme Thermal Solutions, Inc.	www.nextremethermal.com
Polatis, Inc.	www.polatis.com
Questech Corporation	www.questechmetals.com
Solazyme, Inc.	www.solazyme.com
Starfire Systems, Inc.	www.starfiresystems.com
Zia Laser, Inc.	www.zialaser.com

Venture Capital Investments at June 30, 2006

Investments, at Value

Tiny Technology	\$50,929,813	99.9%
BridgeLux, Inc.	1,000,000	
Cambrios, Inc.	1,294,025	
Chlorogen, Inc.	1,149,261	
Crystal IS, Inc.	269,365	
CSwitch, Inc.	3,350,000	
D-Wave Systems, Inc.	1,793,722	
Evolved Nanomaterial Sciences, Inc.	2,800,000	
Innovalight, Inc.	2,500,000	
Kereos, Inc.	960,000	
Kovio, Inc.	3,000,000	
Mersana Therapeutics, Inc.	1,369,904	
Metabolon, Inc.	2,500,000	
Molecular Imprints, Inc.	4,500,000	
NanoGram Corporation	2,598,693	
Nanomix, Inc.	2,500,000	
NanoOpto Corporation	2,418,204	
Nanosys, Inc.	5,370,116	
Nantero, Inc.	2,246,409	
NeoPhotonics Corporation	5,391,194	
Nextreme Thermal Solutions, Inc.	1,000,000	
Polatis, Inc.	252,000	
Questech Corporation	781,520	
SiOnyx, Inc.	750,000	
Solazyme, Inc.	385,400	
Starfire Systems, Inc.	750,000	
Zia Laser, Inc.	0	
Non-Tiny Technology	\$4,058	.1%
AlphaSimplex Group LLC	\$4,058	
Exponential Business Development Company	0	
Total*	\$50,933,871	100.0%