

# BEYOND THE HORIZON

4th Quarter, 2006 Issue

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## WHAT'S NEW

We have a good deal of news to pass along this quarter, most of it involving tax law changes coming from Washington and Harrisburg this summer. On August 17th, the President signed the Pension Protection Act of 2006 into law. This legislation includes provisions that affect IRAs, defined contribution pension plans such as 401(k)s, and 529 college savings plans.

**IRA Contributions and Catch-up Amounts.** The phased increases in IRA contributions and catch-up amounts introduced in 2001 will no longer expire in 2010 as previously scheduled but become permanent.

**IRA distributions to charities.** For the 2006 and 2007 tax years only, IRA owners who are age 70-1/2 or older can make a tax-free donation directly to a charity of up to \$100,000 from their IRA instead of taking a taxable distribution. The tax-free donation can be counted toward satisfying their required minimum distribution for the year.

**Rollovers by non-spouse beneficiaries.** Effective in 2007, non-spouse beneficiaries of a qualified employer plan, 457 or 403(b) plan can roll their distributions into an inherited IRA instead of having to take a lump-sum payment. This will allow them to take periodic distributions from the inherited IRA based on their life expectancy.

**Converting Traditional IRA to Roth IRA.** Previously, anyone whose adjusted gross income was more than \$100,000 could not convert a Traditional IRA to the tax-free Roth. However, the new law repeals any income limitations on conversions beginning 2010.

**Employer stock diversification.** Effective in 2007, plans must allow participants who invest elective deferrals and after-tax contributions and who receive employer matching to diversify those investments. Diversification for existing employer stock must also be phased in over three years (except for qualified older employees).

**Medicare premiums based on income.** For those with Medicare coverage, premiums will be higher for married individuals with income exceeding \$160,000 and for singles with income exceeding \$80,000 beginning in 2007.

**Kiddie Tax.** The age limit for the Kiddie tax increases from age 14 to age 18. The Kiddie Tax means that unearned income received by a child in excess of \$1,700 (for year 2006) is taxed at the parents' tax bracket. Under the new law, raising the age for the standard deduction to 18 gives money set aside for a child, which is outside of a college savings plan, more time to grow before earnings are taxed at the parents' tax bracket. This change is retroactive to the beginning of 2006.

**Tighter rules on donations.** There are now tighter rules on making donations of money, clothing and household items to charity. For clothing and household items donated after August 17, 2006, no write-off will be allowed unless an item is in good condition or better. Also, if the item's value is more than \$500, a deduction can't be taken without an appraisal. As for cash, you currently need a receipt to back up any charitable deduction of \$250 or more. Starting next year, you'll need a receipt or cancelled check to substantiate smaller gifts.

**529 college savings plans.** For federal income tax purposes, withdrawals from 529 plans for qualified education expenses will continue to be considered tax-free, as originally introduced in 2001. Their tax-free treatment will no longer expire in 2010, as previously scheduled.

**State income tax deduction on 529 plans.** Also passed this summer, contributions to any qualified tuition program as defined in section 529 of the Internal Revenue Code, including those offered by other states, will be deductible from income for Pennsylvania income tax purposes. The amount deducted for each designated beneficiary cannot exceed the annual limitation on gifts, which is currently \$12,000. The tax deduction is given to the account owner, regardless of whether or not they were the one who made the gift/contribution.

**Energy Tax Credit.** Don't forget about the tax credit for energy-efficient home improvements. The maximum credit is \$500 and applies to certain energy-efficient improvements made between 12/31/05 and 1/1/08.

**Refund of Excise Tax on Phone Service.** As a follow-up on an issue reported to you in our last newsletter, taxpayers will be eligible to file for refunds of excise taxes paid on long-distance phone service billed after February 28, 2003. In lieu of having proof of taxes paid, the IRS is offering taxpayers a credit based on the total number of exemptions claimed on the 2006 Federal income tax return. The standard amounts are \$30 for a person filing a return with one exemption plus an additional \$10 in credit for each additional exemption. The maximum credit will be \$60 per return.

For more information on any of the issues or changes mentioned above, please call our office.

*Sources: "Extension Explication", Investment Advisor, July 2006; "Pension Protection Act signed into law", American Funds website; "June/July 2006, No. 121, Qualified Tuition Programs—TAP 529", Pennsylvania Department of Revenue website; Kiplinger's Personal Finance Adviser, September 2006 issue; "IRS Announces Standard Amounts for Telephone Tax Refunds", Internal Revenue Service website; "How To Lower Your Tax Bill", Wall Street Journal, 9/13/06; The Kiplinger Tax Letter, 9/22/06.*

## MARKET UPDATE

Each quarter, we are compelled to bring you the latest update on the markets. We struggle to do so, feeling hypocritical in our approach. After all, we continually remind our clients the importance of taking a long-term perspective. But we do so to take the opportunity to share information you're NOT likely getting from the media.

With the Dow Jones Industrial Average above its all-time high and the S&P 500 close to its high, what does this mean for the markets? We've been telling clients for quite some time that things were not as bad, financially and economically, as the press implies. Pessimists feel we're headed for a recession. Some are touting that the consumer is tapped out and that the cooling off in housing will mean trouble in the coming quarters. Others say the Fed went too far and killed economic growth.

But is that what the markets are telling us? A slowdown in the housing market alone is not enough to have a significant impact on the economy. The bond markets surely are not acting as if inflation is out of control. Bond yields are close to where they were in June of 2004 before the rate hikes began. Regarding the issue of recession, you need a tight money supply, expensive money, and runaway inflation in order to have a recession. That is certainly NOT the case at present. If we were headed for a recession, consumer stocks wouldn't be acting the way they are. The Dow Jones U.S. Retail Index just reached a record high.

The pessimism we're seeing is actually comforting, unlike the overwhelming enthusiasm seen in 1999 and 2000 before the last bear market began. As an advisor, the time to worry is when investors, with no tolerance for risk, flock to stocks and stock funds as they did in 2000.

For the short term, we watch and wait as the quarterly earnings reports get underway. We have experienced 17 quarters in a row of double digit earnings growth and expect our 18th. This pace will eventually slow down, but a slowing rate of growth won't necessarily be negative.

Moving forward, we expect the overall theme to be "status quo". Barring any unforeseen occurrences, we continue to expect single digit returns for the markets for 2006 and 2007. Inflation should remain under control with interest rates possibly falling by mid 2007. With the exception of increases due to seasonal demands, oil prices should hover around \$60-\$65 per barrel. According to Kiplinger, GDP growth should continue to be modest. Lastly, retailers are anticipating good sales numbers for this coming Holiday season.

As setbacks occur — and they will — remember to keep things in perspective. When crude oil hit \$80 a barrel this summer and gas prices spiked to over \$3.00 a gallon at the pump, did any of us think they'd be back down to \$59 and \$2.20, respectively, in a matter of months?

*Sources: Charts obtained from Hays Advisory, LLC website; "Tocqueville Morning Notes" and "Weekly Focus" authored by Mike Williams, Strategist with Tocqueville Asset Management; Charts obtained from MarketWatch.com; Market Commentary with Jim Dunton of American Funds, 8/18/06; The Kiplinger Letter, 10/6/06.*

## INVESTMENT CORNER

We bring you an investment idea that comes from American Funds. It is called "Income Foundation". Income Foundation is a carefully crafted program using a combination of three mutual funds designed for investors who need income and moderate long-term growth but who are also concerned about volatility.

The concept of this investment strategy is to build a portfolio using three of American's mutual funds, all of which are managed to generate income. The first fund seeks high current income consistent with preservation of capital through a well-diversified portfolio of bonds. The second fund seeks to provide current income and, secondarily, growth of capital through a flexible mix of stocks and bonds. The third strives to provide growing income together with a current yield that exceeds U.S. stock dividends in general. By investing outside the U.S., this third fund also adds value by further diversifying the portfolio.

The Income Foundation concept has produced comparable returns with the S&P 500 but with lower volatility, as indicated by a low beta. Beta is a relative measure of an investment's sensitivity to market movements. The beta of the market is equal to 1. Therefore, a beta higher than 1 implies that an investment's returns have been more volatile than the market, while a beta lower than 1 implies that returns have been less volatile than the market. For the three-year period ended 6/30/06, the beta for the Income Foundation was 0.42.

Neither the funds used nor the concept of multiple funds in a portfolio are new to American Funds. We are highlighting this concept as a possible alternative to traditional income-producing vehicles such as annuities, bonds, preferred stocks, and CDs. The unique feature of this strategy is the opportunity for growth in addition to the current income being generated. In our opinion, this idea could also be used for investors who don't necessarily need current income. It could be suitable, as well, for an investor who is investing for growth but wants to minimize volatility.

Using three different funds also offers diversification within one investment. Because the Income Foundation strategy uses mutual funds, this is not a guaranteed investment and does involve risk. The diversification does not eliminate the risk of investing.

If you would like more information on this or any other investment strategy or product, please call our office.

HIGHLIGHTING THIS INVESTMENT STRATEGY DOES NOT IMPLY THAT IT IS SUITABLE FOR EVERY INVESTOR. FOR MORE INFORMATION ON THIS INVESTMENT IDEA OR TO RECEIVE PROSPECTUSES, PLEASE CALL OUR OFFICE.

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