



# Condor Capital

## Investment Management

July 2007

### Condor Capital

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Equities continue first  
quarter rally

Fixed Income  
experiences mild  
decline

Emerging markets  
outpace other  
international asset  
classes

#### *In this issue:*

Second Quarter 2007

Inheriting a 401(k) Plan  
Account

Estate Tax Repeal:  
Ramifications and Outlook

Ask the Experts

## Second Quarter 2007

Global equity markets continued their first-quarter rally into the second quarter, briefly surpassing their March 2000 peak. Investors' bullish sentiment was driven by a continued wave of corporate mergers & acquisitions, as well as private equity deals. Although stocks declined modestly in June due to concerns over losses in the sub-prime mortgage market and higher global interest rates, the markets proved resilient and managed to hang on to most of their gains for the quarter.

The U.S. market, as measured by the broadly diversified S&P 500 Index, posted an impressive 6.3% gain. Large cap U.S. growth stocks led the pack with the Russell 1000 Growth Index posting a 6.9% gain versus 4.9% for large value, as measured by the Russell 1000 Value Index. Growth stocks' outperformance can partly be attributed to strength in the technology sector, as the technology-driven NASDAQ surged 7.7% for the period. Meanwhile, higher interest rates weighed on returns for value strategies, which tend to focus on more cyclical, interest-rate sensitive sectors such as financials and utilities. Small cap companies, on the other hand, as measured by the Russell 2000 Index, returned relatively sub-par returns of just 4.4%. During the quarter, larger, multinational companies generally outperformed smaller companies because they are more insulated from higher interest rates and benefit from the lower U.S. dollar.

On the international front, the MSCI EAFE Index gained 6.7% for the quarter, mirroring returns in the U.S. Fueling international gains was solid economic growth in Western Europe, which persisted despite higher interest rates in the region. Emerging markets continued their outperformance of other global asset classes, with the MSCI Emerging Markets Index posting a gain of 14.9%, as China and India's soaring export-driven economies continued to attract capital.

Contrary to the strong run within the equity marketplace, the bond market, as measured by the Lehman Brothers Aggregate Bond Index, declined 0.7% during quarter, causing

yields to rise. Fixed income investments were negatively impacted due to positively revised estimates surrounding U.S. economic growth prospects, which diminished expectations that the Fed would cut rates later this year. Ongoing tightening by European central banks in order to ward off inflation also contributed to the bearish mentality among bond investors.

The Federal Reserve continued to remain on the sidelines, keeping its target interest rate steady at 5.25% for the eighth consecutive meeting. While the Fed is still keeping a close eye on inflation and the housing market, it sees economic growth rebounding in the second half of 2007.

#### Outlook

Going forward, we believe the outlook for the markets looks favorable. Interest rates are still low by historical standards, which should bode well for consumer spending and corporations. For 2007, corporate earnings are expected to grow about 8.5% year-over-year. While this is a sharp deceleration from the 15% growth witnessed in 2006, it is still above the historical average of 6-7%. Meanwhile, 2008 earnings are expected to rebound to almost 12%. We believe stock prices generally follow corporate earnings. Of course, second quarter 2007 earnings season is now upon us, which means earnings announcements will be closely watched by Wall Street for any signs of deterioration.

With inflation within the Fed's comfort zone, we do not expect the Fed to raise rates for some time to come. On the other hand, we do not envision a rate cut either, since the economy appears to be hitting on all cylinders. While the slowdown in the housing market and losses in sub-prime mortgage securities warrant attention, we do not see any disaster looming on the horizon. The strong labor market, coupled with low interest rates, should help buoy housing. Meanwhile, the sub-prime mortgage contagion appears to be well-contained and is widely believed not to pose systemic risk to the financial system.

*One Source...  
... Many Solutions*



*You can't leave money in a 401(k) plan or IRA forever. The federal government requires that you begin taking distributions (called "required minimum distributions," or RMDs) after the participant's death. In general, if you roll 401(k) funds into an inherited IRA, you'll be able to take these RMDs over your life expectancy. But if you're a nonspouse beneficiary, and the 401(k) plan requires that you take distributions within 5 years after the participant's death, be careful--if the participant died before age 70½, you'll need to complete your rollover to the inherited IRA by the end of the year following the year of the participant's death. If you don't, you won't be able to take distributions from the inherited IRA over your life expectancy. Instead, you'll have to withdraw all the funds from the IRA by the end of the 5th year following the participant's death.*

## Inheriting a 401(k) Plan Account

When you inherit a 401(k) plan account, the options available to you depend on a number of factors, including the terms of the 401(k) plan and your relationship to the deceased 401(k) plan participant. In general, you'll have four options: take an immediate distribution, disclaim all or part of the assets, leave the money in the 401(k) plan (if the plan permits), or roll the funds over to an IRA.

### Should you take the cash?

Obviously, if you need the funds immediately, taking a lump-sum distribution from the 401(k) plan may be your only viable alternative. But you'll have to pay ordinary income tax on the distribution (except for the amount of any after-tax contributions and qualified Roth distributions). Special tax rules may apply if the plan participant was born before January 2, 1936--consult a tax professional for details.

A lump sum might also be attractive if you're entitled to a distribution of employer stock. You may be able to pay ordinary income tax on just the participant's basis in the stock, and defer tax on the appreciation (called "net unrealized appreciation," or NUA) until you sell the stock in the future--at capital gain rates.

### What's a disclaimer?

When you disclaim (i.e., refuse to accept) 401(k) assets, they pass instead to the plan participant's contingent beneficiary, or estate if there is no contingent beneficiary. In general, you must give the plan written notice of your intent to disclaim the funds within nine months after the participant's death. But be careful not to exercise control over the funds in the meantime (for example, by choosing a distribution option or by exercising investment control), or you may lose your ability to disclaim the funds.

A disclaimer may be an attractive option if you're sure you won't need the funds, and the transfer to the contingent beneficiary makes good economic and estate planning sense.

### The problem with 401(k) plans

If you're like most beneficiaries, your goal will be to stretch payments out as long as possible, taking full advantage of the tax deferral offered by retirement plans. This means either

leaving the assets in the 401(k) plan, or rolling them over to an IRA.

For most, leaving the funds in the 401(k) plan isn't the best choice for two reasons. First, the investment alternatives available to you in a 401(k) plan are limited to the ones selected by the employer. Second, the distribution options offered by a 401(k) plan typically aren't as flexible as those available in an IRA. In fact, many 401(k) plans require beneficiaries to take distributions shortly after the participant's death.

### Roll the funds over to an IRA

Unless the 401(k) plan offers a unique investment alternative, rolling the 401(k) assets over to an IRA will usually be your best choice. IRAs offer virtually limitless investment options. And when it comes time to take distributions from the plan, IRAs offer the most flexible payment provisions. But, before deciding on a rollover, make sure you understand any fees and expenses that may apply.

If you're a surviving spouse, you'll have to decide between rolling the funds over to your own IRA, or to an IRA that you establish in the participant's name, with you specified as the beneficiary (this is referred to as an "inherited IRA"). Which should you choose?

In most cases, you'll be better off rolling the funds over to your own IRA. Rolling the funds over to an inherited IRA is typically appropriate only if you're not yet age 59½ and you think you'll need the funds before you reach that age. That's because distributions from an inherited IRA aren't subject to the 10% early distribution penalty tax. (In contrast, distributions from your own IRA before age 59½ are subject to the 10% penalty tax unless an exception applies.)

If you're not the surviving spouse, you don't have the option of rolling the 401(k) assets over to your own IRA. But thanks to the Pension Protection Act of 2006, you may be able to make a direct rollover of the 401(k) funds to an inherited IRA. A 401(k) plan isn't required to offer this option, so check with your plan administrator. This new rule applies to distributions you receive after 2006.

The rules governing inherited 401(k) plan accounts are complex. A financial professional can help you sort through the alternatives, and make the decision most appropriate for your individual circumstances.

## Estate Tax Repeal: Ramifications and Outlook

The Economic Growth and Tax Relief Act of 2001 gradually phases out the federal estate tax until its complete repeal in 2010. However, under the same law, the estate tax is scheduled to return in 2011.

Since 2001, there have been a number of failed attempts to make the estate tax repeal permanent. In fact, there are still several bills in Congress that include provisions to eliminate this tax. While it's clear President Bush would sign such legislation, the recent changes in Congress make it less likely he'll get the chance to do so. The question remains, though: Will permanent repeal become law, and if so, what are the potential ramifications?

### Good-bye estate tax, hello capital gains tax

Repeal does not mean that tax on wealth transfers from one generation to the next will disappear. While currently a tax is imposed on estates, after repeal, a tax will be imposed indirectly on inheritances in the form of capital gains tax. Here's a simplified explanation.

Under the current tax system, property that is transferred to heirs at the owner's death typically gets a "step-up" in tax basis. Generally, tax basis refers to the cost the owner paid to acquire the property, and is used to compute capital gains tax when the property is sold. For example, let's say Mr. Smith buys property for \$50,000, which becomes his tax basis, and sometime later sells the property for \$60,000. Mr. Smith's computed capital gain for tax purposes is \$10,000.

When property is transferred by gift, the recipient receives a "carryover" basis; the tax basis in the hands of the person making the gift generally becomes the recipient's tax basis. So, let's say that Mr. Smith gives the property in the above example to his son, John. Mr. Smith's \$50,000 tax basis carries over to John, and when John subsequently sells the property for \$60,000, John recognizes the \$10,000 capital gain.

However, when property is transferred because of the owner's death, the tax basis is stepped up to its current fair market value. Again using the first example, let's say that John receives the property through his father's will. John's tax basis is stepped up to \$60,000, the property's fair market value. When John subsequently sells the property for \$60,000, John recognizes no capital gain on the transaction.

One of the consequences of estate tax repeal in 2010 will be that the step-up in tax basis will be lost. Heirs will receive a carryover basis on inherited property, and will recognize the capital gain (or loss) when the property is sold at some point in the future.

What will this change in the tax system mean for American families? According to the IRS, estate tax affects only 2% of the most wealthy Americans. Capital gains tax, though, can affect anyone who owns capital assets. Therefore, unless the step-up in basis remains, estate tax repeal is likely to result in creating a higher tax bill for a greater percentage of less wealthy Americans. Further, repeal will create a paperwork headache for heirs who will have to determine the decedent's tax basis in the property they've inherited.

### Pros and cons of permanent repeal

Proponents of permanent repeal regard the estate tax as morally unfair and an obstacle to family business continuity and growth. Critics call permanent repeal a boon to the mega-rich and fiscal suicide in a time of budget deficits, a Social Security and Medicare crisis, and war. The confusing reality is that there is statistical evidence both for and against the arguments presented by each side.

One thing is certain, however: Dealing with the uncertainties of the current state of the estate tax is a burden on Americans and their financial planning professionals who must reevaluate estate planning options every year. For many on both sides of the issue, sensible reform is a preferable alternative to the success or failure of permanent repeal.

### Outlook

In 2007, the Democrats regained power in Congress after 12 years of Republican control. The new Congress has been pursuing a fresh agenda, putting estate tax relief on the back burner. When the issue does resurface, it's likely that Congress will support reform over full and permanent repeal. Reforms such as lowering the estate tax rates to match capital gains tax rates and/or increasing the exemption amount have been proposed. Other options that have been discussed include doubling the exemption amount for married taxpayers, phasing out the tax over a five- or ten-year period, and replacing the estate tax with an inheritance tax (which would merely move the tax burden to the heirs). It remains to be seen what will be done, if anything.

*According to the Center for the Study of Taxation in April of 2006, 3 out of 4 Americans want the estate tax repealed or significantly reduced.*



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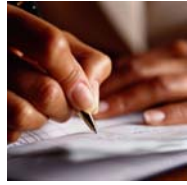
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## Ask the Experts



### How can I protect the personal items in my car?

Personal items left in your car may be easy targets for thieves unless you make an effort to secure them. Especially likely to be stolen are small yet expensive electronics, such as portable navigation devices, cell phones, and portable DVD and music players, as well as valuable sports equipment such as golf clubs.

Although it may seem obvious, locking your car is still the best way to protect your possessions. Don't leave windows or your sunroof open, either, even in hot weather.

To prevent crimes of opportunity, never leave valuable items in plain sight. Today's thieves don't necessarily bother to rip CD players out of the dashboard (although some still try) because it's so much easier to pop a navigation device off the windshield or grab small electronics that have been left on the seat. Even though it may be a hassle, lock valuables in the trunk, or better yet, take them with you.

You may be surprised to learn that personal property in your car is generally not covered by your auto insurance policy unless it's permanently installed (e.g., a radio). However, personal items are generally covered by your homeowners or renters insurance, subject to a deductible, and up to certain limits.

If you routinely carry expensive items in your car and need additional coverage, look into purchasing a rider or endorsement to your homeowners or renters policy. And keep in mind that some policies will provide coverage only when signs of forced entry are present--yet another reason to lock your vehicle!



### Do I need rental car insurance?

When you rent a car, you need insurance, but that doesn't necessarily mean you need to purchase it from the rental car agency. You may already have adequate coverage through your regular auto insurance policy or even through your credit card company.

Purchasing insurance from the rental car agency may significantly increase the overall cost of renting a vehicle, so do your homework before you show up at the rental counter. Start with a visit to the rental agency's website, where you can usually preview the types of coverage you'll be offered and read up on the terms and conditions.

One popular type of coverage generally offered is the Collision Damage Waiver (CDW), sometimes called a Loss Damage Waiver (LDW). If you purchase this waiver, you may not be held responsible if your rental car is stolen or damaged. But you may want to decline the CDW if you own a vehicle and have comprehensive or collision coverage, because the coverages you have and the deductibles

that apply to your own vehicle generally extend to your rental vehicle. Call your insurance company, though, if you have any questions about what is and is not covered. (Different rules apply to business or overseas travel.)

Next, call your credit card company. Coverage varies from card to card, but many cards do offer some protection (the coverage will be secondary to any insurance coverage you have). To receive protection, you generally have to decline the CDW and charge the entire rental car transaction to the credit card supplying the coverage. Make sure you understand all conditions that apply.

The bottom line is that if you don't have coverage through your auto insurance policy or your credit card, or you want extra protection, you'll likely need to purchase it from the rental car agency. But never wait until you're standing in front of the rental agent to decide, because if you do, it's easy to end up buying insurance you don't really need.