



MALLARD

ADVISORS, LLC

THE MALLARD FLYER

PAUL S. BAUMBACH – MANAGING PARTNER – WEALTH MANAGEMENT DIVISION
WILLIAM D. STARNES – MANAGING PARTNER – FINANCIAL PLANNING DIVISION

273 EAST MAIN STREET, SUITE E, NEWARK, DE 19711-7331
(PH) 302-737-4546 · (FAX) 302-397-2675
WWW.MALLARDADVISORS.COM · INFO@MALLARDADVISORS.COM

Inside This Issue

January 2004

Do More in 2004	1-3
Announcements	1
Zen and the Art of Portfolio Gardening	3-4

Do More in 2004

Bill Starnes

A reporter recently contacted me to ask what people can do in 2004 to move closer to financial security. I decided to focus on three things everyone should strongly consider, and will share my thoughts with you in this quarter's article.

Moving On Up

For most people, buying the right house is one of the best investments we can make. I am talking here about an investment in the traditional sense of the word as well as an investment in the quality of our lives. Let's talk about the home's investment value.

First, a home provides long-term leverage. Using an oversimplified example, let's say you buy a house worth \$200,000 and put \$40,000 down. If the house then appreciates at 4% a year, it will increase \$8,000 in the first year. That appreciation represents a 20% (tax-free) return on your \$40,000 investment. You can't get that type of return anywhere else with the low risk of home ownership.

Second, it provides on-going tax benefits which make the Continued on page 2

Notices

Paul & Pam's Schedule:

Paul and Pam will be attending the national TD Waterhouse Conference in Orlando February 4-7. Pam will be volunteering on Tuesday and Thursday nights during tax season for the Delaware Earned Income Tax Credit campaign that prepares tax returns for Delaware's working poor families. Last year Pam and Paul each worked for the project one day a week.

Bill and Sherry's Schedule:

Bill will be out of the office January 14-16th. Sherry will be out of the office February 10-17 vacationing in St. Marteen.

Announcements

Five Minutes of Fame—In November, Paul was a guest on the Money Matters program on regional cable channel CN8. He was joined by two NAPFA colleagues, and together they fielded many questions from the show's viewers. If you want to see Paul in a tie, let us know and we'll send a DVD with the 30-minute program on it. Paul was also quoted in the *Philadelphia Business Journal* in an October article on Fee-Only™ financial planning, and on *PR Newswire* in a release about the conference.

Moving Up—Pam, who works with Paul in the asset management division, has begun to study to become an AAMS, Accredited Asset Management Specialist. We expect that during 2004 she will be able to focus more closely on client matters, and less on purely administrative tasks. During reporting months, Pam will be able to perform more of the background work of getting each client's report ready for Paul who will then be able to focus on the interpretation of results, and the development of recommendations.

Bill Starnes was quoted in *Financial Planning* magazine regarding changes experienced by independent financial advisors as a result of the bear market.

home less expensive than it appears. This is because the government subsidizes the purchase, ownership, and sale of homes. Continuing with our example of a \$200,000 home, the monthly mortgage payment on the financed amount of \$160,000 would be \$959 (using a 30 year fixed rate mortgage at 6%). Perhaps you are currently paying \$700 per month in rent and don't feel that you could afford the extra \$259. Well, because the mortgage payments in the first year are made up almost entirely of interest, they are almost fully deductible. If you are in the 30% marginal (federal and state) tax bracket the net payment (after tax savings) will be only \$671. Better yet, in future years, the payment will stay the same, whereas if you rent, the payment will continue to rise.

Third, a mortgage provides interest rate protection. When you have a mortgage, you have more cash/investments than you would have if you paid off the mortgage. If interest rates increase, the yield on the cash will also increase, the home will appreciate, yet your mortgage payments are fixed.

Finally, the realized gains are tax-free (subject to certain limitations). So, if you were to own the \$200,000 home for 10 years and it appreciates at 4% each year, it will be worth \$296,000 at the end of ten years. If you sell it, you keep the \$100,000 of gain (less transfer tax and sales commissions). With other capital investments you would lose \$15,000 of the appreciation to taxes.

Homes are also an investment in the quality of our lives. It is the only investment you can really enjoy. Let's face it, you can't cozy up with your IRA statement as you could in front of the fireplace. We also come to identify our home over time with our families, providing a strong emotional tie. Finally, homes in better school districts provide better educations for our children.

So, in 2004, if you don't own a home, you should seriously consider buying one. I feel strongly that buying your first house is so critical to your financial

future that you just need to do it. Also, if you already own a home, you should evaluate the benefits of trading up to a more expensive home (which traditionally appreciates even more).

Melt The Plastic

For a minimum of three months remove every credit card from your wallet including MAC, gas, and department store cards. The only thing they do is make it easier for you to ignore prices and buy things you don't need and possibly can't afford. I spoke about this on my audio seminar series CD, *Creative Budgeting*.

By removing these convenient spending methods, you will draw your awareness to your spending by making each purchase a conscious event. Taken further I would even say that you want to make spending as difficult and painful as possible, and cash will help you do this.

Once you have removed all other forms of spending, you take out a fixed cash allowance each month (for you and your spouse). Now you will only spend if you have the cash in your wallet. Think for a moment how previously unconscious spending decisions turn into conscious decisions. For example, you are at work and your co-workers are going to your favorite restaurant for lunch (very tempting indeed!). You are in your fourth week of your allowance and only have \$20 left in your wallet. Yes, you can spend the \$20 at lunch, but you will then have an empty wallet for the rest of the week. The decision is yours...but now you are making a decision. Voila, conscious spending.

Hide the Money

No, I'm not talking about your mattress. I'm talking about putting money (that is not needed for immediate spending) in vehicles that feel less "spendable". This is called creating an environment of artificial scarcity.

But don't hide the money you need to operate on a month to month basis. For most Continued on page 3

Do More in 2004...Continued From Page 2

of you this should be about 10%-20% of your income and should be in cash equivalents that are easily accessible. However, your emergency cash should be less accessible. As most of you know, I love EE and I savings bonds for emergency cash because of the unique combination of yield, tax benefits, safety, and the fact that the cash feels “hidden”. They are a very good way to ensure that the funds are only used for true emergencies.

It's easy to “hide the money” using payroll deductions for retirement accounts, EE bonds, and medical savings accounts, but it is far more difficult to “hide the money” that is provided in your net pay. And it is important to save outside employer provided retirement plans. But let's face it, net pay that is deposited into a checking account gets spent unless you have put a system in place to ensure money gets saved.

The best method I have come across to hide “net pay” is to deposit it into a separate bank account (other than your checking account). Call this separate account your “income account”. Then, once

each month you transfer an amount from the income account into your “spending account” (i.e., checking account). But the amount you transfer from the income account into the spending account must be less than the total monthly deposits into the income account. The income account will then build up cash over time (or you can set up automatic deductions from the income account to an investment account).

By doing this you have essentially cut your spendable income. Cutting your income is the easiest method to cutting your spending. For example, let's say your boss told you your pay would be cut by 5%, what would you do? My guess is that initially you would make do by cutting your spending.

Summary

You can do more in 2004 to improve your financial security: Move On Up, Melt The Plastic, and Hide The Money.

Bill Starnes is the managing partner of Mallard Advisors' Financial Planning Division



Zen and the Art of Portfolio Gardening

Paul Baumbach

When creating this article about asset allocation, I was torn between a gardening analogy and a baseball analogy. I am rotten at both endeavors, but will proceed anyway.

Planning, planning, planning—I remember my grandfather sketching out his garden each year, ensuring that he rotated where his corn went, presumably to enable the soil to replenish itself with the needed nutrients.

When creating and managing a portfolio, investors need to plan. I am a strong advocate of a written IPS, investment policy statement. By writing the portfolio's ‘rules’ down, you are 1) saying that it is important enough to take the time to write, 2) recording the *to dos* and the *not to dos*, and 3) pro-

viding a system for review and change, a feedback loop.

Tis the Season—Different flowers bloom at different times during the year. If you would like a garden that is regularly producing beautiful flowers, then you need to plant a range of types of flowers.

Similarly, when planning a portfolio, it is critical to include investments that zig while others zag. I mean that you want to include investments that hold their value when the world is falling apart, and others that shoot upward when things are going well. For portfolios, most investors include money markets, bonds, US stocks, and foreign stocks. The stocks (or stock funds) will typically include both conservative and aggres-

Continued on page 4

sive ones. This is the **crux of diversification**. The simplest example is a Florida street vendor that sells both sunscreen and umbrellas—business is never bad!

Proper Pruning—Pam hates when I trim the hedges, I go bonkers. The ‘before and after’ shots rival a Chia Pet commercial. However without proper pruning, our hedges will overtake the siding, the windows, and our meter readers will send us hate mail.

Portfolios also need regular pruning. In this process you examine how the portfolio is balanced, how you want it to be balanced, and make some changes. This works out to be selling the strong performers and adding money to the weak. Peter Lynch, the legendary past mutual fund manager of Fidelity Magellan called it ‘picking the flowers and leaving the weeds’. How dare he confuse my analogy!

Portfolio rebalancing is very important to smooth the results. It would have lessened the pain of the past few years, pulling profits out of growth funds during the dot.com craze, and adding dollars during the dot.bomb bear market. It often feels foolish while it is happening, but feels good once a year or two have passed.

Weeding—Is anything less fun to a kid than weeding a garden? My knees hurt just thinking about it. Yet, this process of separating the good from the bad is necessary to enable the desired results to flourish.

At least every quarter I examine every mutual fund held by a client. I am looking for weeds, something that doesn’t look right, that is choking out my desired results. One service I use alerts me to manager changes, high expenses, style drift (you plant what you think is celery and a carrot appears), high volatility, and poor relative performance, when a fund earns less than similar funds, for short and/or long time periods. This helps me identify when to recom-

mend that these weeds be pulled. Most investors could do this one to two times a year, but should keep an ear out for significant developments such as manager turnover, and most recently, alleged involvement in scandals. Weeding is no fun, but you don’t want to try gardening without it (I gardened without weeding one year—with miserable results).

Harvesting—The primary purpose of gardening is harvesting, whether it be flowers or vegetables, or investments. This is why two critical portions of an investment policy statement describe the cash flow requirements (when money will be added or removed), and the time horizon for the portfolio. Portfolio investing requires knowing when it is harvest time, and which crops should be harvested when. This is a dynamic process, what will be ready to harvest in two years will largely depend on the economic developments between now and then. The harvest is typically tied to pruning, as it involves selling investments which have done well recently, and which the portfolio has more than it needs. Proper portfolio construction will often simplify this process by having investments that harvest themselves (such as bonds that mature just before the proceeds are expected to be needed).

National Pasttime—Having worn out the gardening analogy, I now switch. In baseball, no matter how good your shortstops are, you don’t put nine on the field. The same is true of pitchers. A great baseball team requires the mixing of diverse talents. In this manner, the team can best adapt to foreseen and unforeseen challenges. Portfolios similarly require planning, diversification, balance, monitoring, and managing. This increases the chances of building a successful record. Batter up!



Paul Baumbach is the managing partner of Mallard Advisors’ Wealth Management Division

