Socially-Responsible Questions

The May/June 2000 issue of the Financial Analysts Journal includes an article on Socially Responsible (SR) Mutual Funds, by Meir Statman of Santa Clara University. These funds restrict their investments based on certain criteria, such as avoiding defense contractors, nuclear energy providers, alcohol or tobacco companies, gambling companies, ecologically unfriendly firms, or those that do not follow certain guidelines in politically-charged regions, such as Northern Ireland.

The argument against SR investing is generally academic. It goes that anytime you limit your potential investments (such as avoiding companies whose names begin with an Q), you statistically reduce your expected returns. Often this will be followed up with 'earn the best return you can, and then deliberately direct a portion of your returns to the charitable causes you support'.

The argument in favor of SR investing is also two-pronged. It begins with the concern that returns earned from non-SR investing are ill-gotten gains, and forever tainted. A semi-academic argument notes that companies that ignore SR issues are more likely to encounter troubles down the road (do tobacco lawsuits sound familiar?). This argument points out that shares of stock in SR firms may produce greater returns than non-SR firms.

The next hurdle is to recognize that what is SR to you may not be SR to me. A recent Wall Street Journal article pointed out that three leading SR funds had very different top ten holdings, due to their different definitions of socially responsible. Some SR funds choose to invest in slightly objectionable firms to achieve change from the inside, by being activist shareholders.

I recently was asked to identify a good SR fund for a client, who specified several industries that he would like to avoid. My research quickly pointed to Amana Growth fund, an SR fund with strong past performance. However I found that this fund, that follows Islamic principles, does not exclude enough of the sectors that my client wished to avoid. This exemplifies the varying definitions of socially responsible funds.

The Financial Analysts Journal article pointed out that the Domini Social Index (DSI) was created in 1990 by Lydenberg, Domini, and Company as a 'capitalization-weighted index modeled on the S&P 500 Index', as 'a benchmark for portfolios that practice social screening'. Professor Statman (what a name!) found that the DSI not only outperformed the S&P 500 for most of the 1990s, but also did so on a risk-adjusted basis.

More important than the results of the index (in which you can not invest directly), Professor Statman researched the results of actual SR mutual funds, which you can buy. He found that SR funds perform in line with non-SR funds, although both groups generally underperform the S&P 500 (and therefore the DSI). This underperformance is typically attributed to the impact of mutual funds' expenses, and the drag that results from maintaining some cash in each fund for shareholder redemptions.

Therefore, it is quite proper to consider SR investing, whether you use mutual funds or stocks. For mutual funds, be aware that the average SR fund charges 1.50% in annual expenses. The average mutual fund that performs similarly to the S&P 500 charges less than 1.25%. Also be aware that specialty SR funds (small US stocks, or foreign stocks) are more rare. Most importantly, ensure that the fund's definition of Socially Responsible matches your own.

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The Mallard Message

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Inside This Issue

Summer Plans

I typically take long weekends during the summer, and this summer is no exception. I also will typically travel to visit a client or two in August. Unfortunately, I do not currently know when these trips will occur. I will contact clients and will leave a detailed message on my machine when I am traveling or on vacation. I know that I will be at a conference from September 20th until the 24th.

Whenever I am away from the office for more than one business day, I check my phone messages and return all urgent ones.

Frequently Asked Questions

1. **How did your seminars go?** I held four seminars in May on various investment topics. The material was designed to appeal both to beginning investors, and those who wanted to enhance their existing investment knowledge. They were well attended, with more than a dozen attendees each week. The feedback I received was very positive and supportive. I may offer another series of seminars this fall.
2. **What is meant by Fee-Only™?** My only income comes directly from clients, as fees. I do not receive any income from the brokerages, mutual funds, bond houses, or other financial institutions that my clients use. This Fee-Only™ approach is designed to avoid the conflicts of interest that commission arrangements can introduce: arrangements that produce more income when trading activity is greater.
3. **Are you a broker?** No, I am an investment advisor independent of any brokerage firm. I have established relationships with brokerage firms that offer cost effective services for my clients. However I do not receive any income from the brokerage, only from my clients. Therefore I am free of any pressure from the brokerage firm regarding how often to trade, and what to trade. I am also able to change the brokerage firms I use if the service is poor. Brokers are employees of brokerage firms who provide trading services to their clients, and who typically earn commissions on each trade, commissions paid by the customer.
4. **What's new at Mallard?** Jennie Gallons has begun work as an equity researcher. She has finished her junior year at the nearby University of Delaware, studying Finance, and will be working part-time during the summer. She is initially focusing on stocks, screening existing and potential holdings, and digging into the qualitative and quantitative pros and cons for each position. Welcome, Jennie!
5. **Are you accepting new clients?** In addition to the occasional one-time reviews, I have twenty ongoing clients (my goal is thirty). I therefore am accepting new ongoing clients. If you are interested, or know of someone who may be interested, please give me a call. I would be pleased to meet and discuss any questions and concerns, with absolutely no obligation. I will even treat for lunch!

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HOLDR & ETF Fever

WEBs, SPYDRs, and iShares, oh my! Wall Street has been very busy in the past year introducing 'exchange traded funds' (ETFs for short), and has been busier still inventing cute names for them. While they represent a new alternative, with new issues to tackle, in many cases they are worth considering.

Let me begin by describing non-ETFs. These are more commonly called mutual funds, or more properly open-end mutual funds. With well-known examples such as Fidelity Magellan and Vanguard Index 500, these are funds in which you buy and sell shares from the fund sponsor (Fidelity, or Vanguard in these two cases), and do so using prices that are set at the end of each business day. Ignoring the complication of share classes and loads, you always pay $1 for $1 of the fund; there is never a discount or premium.

Closed-end funds are also known as CEFs. These funds are purchased and sold like stocks, throughout the day. I have used them for years, and am especially attracted to the fact that they can often be purchased at a discount to their underlying value. And you thought that blue light specials were unique to the aisles of Kmart!

CEFs are particularly attractive in narrow markets, such as very small companies, and single foreign countries. They are attractive since the fund families are not obligated to buy back the shares, and therefore there is little risk of a dramatic price drop due exclusively to investors running for the exits. While owners of closed end funds certainly may sell their shares, these sales do not force the fund managers to sell the underlying shares, and therefore they can avoid a double whammy.

While CEFs often work well for patient investors, who can wait (sometimes years) for a discount to turn to a premium, impatient investors can be burned as a discount grows, rather than recedes. As such, the idea of a fund that can be purchased/sold throughout the day, and that always trades at its 'correct' value, has some appeal.

Enter the ETFs, the exchange traded funds. One nice extra feature is that most ETFs sport lower expense ratios than most CEFs and open-end mutual funds. Since ETFs are generally passive funds, they do not include ongoing professional fund management, and thus avoid that higher level of expenses. Instead, a set number of stocks are identified at the start of the fund, and these are maintained (likely by a computer) forever. Remember that without ongoing management, these funds do not sell stocks that seem to be on their way down. No one is minding the mint.

Barclay introduced single-country WEBS (World Equity Benchmark Shares) a few years ago. They have since renamed these iShares to match the product name for the slew of new ETFs they are introducing, generally based on S&P or Russell stock market indices. Website www.ishares.com contains more information. IShares have the highest expenses of the ETFs, at 0.60% annually.

Merrill Lynch invented the HOLDRs. The first was the Telebras HOLDR Trust, which contains shares of the pieces into which the Brazilian phone monopoly was divided (similar to AT&T's breakup in the early 1980s). Merrill Lynch has since introduced several technology HOLDRs and two healthcare ones. HOLDRs generally hold a limited number (often twenty) of stocks in a very focused industry. No website is yet available from Merrill Lynch, although there is information at www.amex.com/structuredeq/sp_holdrs.stm.

There are broad-based index ETFs, including one for the S&P 500, the S&P MidCap, the Dow Jones Industrial Average, and the Nasdaq 100. Recently nine SPDRs (S&P Depository Receipts) have been introduced that each hold one of the nine S&P 500 sectors. See www.sprdindex.com for more information.

I have begun using some ETFs in place of index funds. I have seen the price rise in the last hour of trading too many times, and therefore missed obtaining the bargain I thought I was getting when I called in the index fund trade. I strongly prefer to know the price I am paying for an ETF in favor of the uncertainty of placing an order at 2pm for an open-end mutual fund's 4pm pricing.

ETFs also enable you to more finely tune your portfolio, to match your unique requirements. Perhaps you want to emphasize Italy, or pharmaceutical companies, or financial firms, or business-to-business internet stocks. Most likely, there is an ETF or two to meet your needs.

Three Month Activity

In this section I review the significant investment actions I have taken over the thirteen weeks ending June 16th.

MUTUAL FUNDS

I have begun using or increased my use of the Dresdner RCM Global Technology, Dreyfus Mid Cap Index, Fremont Bond, Janus Overseas, Oppenheimer Real Asset, PIMCO Total Return, Scudder International, SIT Balanced, and a few Vanguard variable annuity subaccounts.

I continue to reduce the level of inflation hedges I recommend, selling Columbia Real Estate, Excelsior Energy, and Vanguard Energy.

SPECIALIZED FUNDS

I purchased several closed-end and other exchange traded funds, including B2B Internet HOLDRs Trust, Internet Architecture HOLDRs Trust, Irish Investment Fund, NASDAQ 100 HOLDRs Trust, New Germany Fund, S&P 500 SPDRs, and the S&P Midcap 400 SPDR.

BONDS

I purchased over $300,000 of individual bonds, primarily municipal, while $50,000 in bonds was called or matured.

STOCK PURCHASES

I purchased several US stocks this quarter: AstroPower, JDS Uniphase, Microsoft, New Plan Realty, RCN Corporation, and Safeguard Scientifics. Some purchases were directly requested by clients. I identified others as opportunities to pick up technology stocks that had fallen quite a bit in price during the Spring.

STOCK SALES

I sold twelve US stocks during this period. Most of the sales were done to realize gains from recent run-ups in prices (yes, some stocks actually rose during this time). These include AstroPower, Dress Barn, GE, Hewlett Packard, Kohls, and Providian.

Ready to Ditch Growth/Technology?

As soon as I wrote my piece in the past newsletter about increasing growth in portfolios, growth and technology stocks began their descent. That'll teach me! Actually, this provides a good opportunity to explain my approach to falling markets.

I have a cousin who trained to fly on the space shuttle. Part of the training involved performing a scientific experiment while riding in an airplane that did maneuvers which simulated zero gravity. The maneuvers earned the plane the nickname the "Vomit Comet". He found that the secret to holding onto his lunch was to focus intently on the experiment.

I am reminded of this lesson when markets are rising and falling sharply. Especially at these times, I try very hard to focus on maintaining portfolios' sector allocations, rather than the immediate direction of those sectors.

This allocation-focus caused me to maintain if not pick up the pace of technology purchases during the second quarter. In several cases, first quarter 2000 purchases dropped quite a bit in the second quarter. When this occurred in a taxable account, we often sold the position, and replaced it with a similar investment, content that the client would benefit from the realized capital loss on their 2000 income tax returns, while maintaining the investment exposure.

In falling markets, selling can be almost indiscriminate. Occasionally, stock in a 'better' company will fall more than the stock in a weaker competitor, due to its greater visibility. When this occurs, I will determine whether we can 'upgrade' our position, swapping from the weaker firm to the stronger firm, often with a tax benefit.

It is difficult for most investors, including me, to buy a stock while it is falling in price. It is human nature to say "a lot of smart people are selling this stock; why should I be buying it now?" As such, it was difficult to be a buyer of growth and technology in 2000. Only by maintaining the focus on the overall allocation can you strive to disregard the noise, and stick to the job of managing your portfolio according to your long-term goals.

Technology Corner-Mallard Update

I mentioned that I attended a conference in February on the Linux operating system. With a friend's help, Mallard now has a server running Linux. A high-speed Internet DSL line comes into the server and is shared with both Windows machines. The server runs 'firewall' software that is designed to secure our Windows machines from malicious hackers.

I am extremely pleased with the higher-speed Internet connection, so much so that going home to my dial-up modem seems pre-historic.

I have two email addresses now. In time, however, I will be migrating to a new (third) email address. So that you do not need to update your address books twice, I will continue to pull down email daily from my original email, mamcorp@concentric.net. I will keep you apprised.