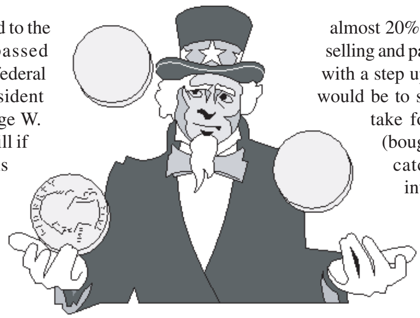
Death Tax Reform vs. Investment Strategy



Death tax reform jumped to the forefront as Congress passed legislation this year to repeal federal estate taxes. Although President Clinton vetoed the bill, George W. Bush is likely to sign such a bill if elected in November. What is the most likely form of death tax reform, and how should that change your investment strategy?

If federal estate taxes are repealed, the repeal would likely be accompanied by the elimination of the cost basis step up rule, at least for large estates. When taxpayers die, under current law the cost basis for their stocks and bonds are raised to the value at the date of death. This can dramatically reduce the income taxes that would otherwise be due when an heir sells inherited stocks. It also can dramatically reduce the paperwork otherwise necessary to research the cost basis for inherited shares. The current step up rule is a mixed blessing. The downside is that the promise of a future step up can lead people to make investment decisions purely for tax reasons. When managed primarily from a tax standpoint, many portfolios over time are clogged with concentrated positions with low expectations for future growth.

A more comprehensive strategy is warranted. Many investors view the choice only as selling now and paying almost 20% to the government versus not selling and passing the stock onto your heirs with a step up in cost basis. A better view would be to see how many years it would take for the new stock investment (bought after paying the taxes) to catch up to the original stock investment.

For example, you may have a stock that pays a 1% dividend but is not expected to grow more than 2% in price for the next few years. You therefore expect this "old" stock to return 3% for several years. Let's assume that it has risen strongly in the ten years you have held it. For simplicity's sake, I will assume that you would owe exactly 20% of the value for federal and state income taxes on the gain from a sale.

Let's further assume that another stock (the new stock) is expected to return 15% a year, between its dividend and stock price growth. Since it is expected to return more than 10% a year more than the old stock, you could sell the first stock, pay the taxes, and be ahead in only about two years.

You will also likely end up with a better diversified portfolio, one with smaller fluctuations due to its reduced exposure to a single large position. Reviewing the after-tax consequences of investment alternatives is part of comprehensive money management.

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The Mallard Message

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Inside This Issue

Autumn Plans

I have no set travel plans this quarter, other than a likely winter break in late December. While traveling this past summer for more than two weekdays, I have brought my laptop (I am tapping on it now on an Amtrak), so that I can not only keep up on email, but also monitor accounts online.

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. **What do you do?** Mallard offers Fee-Only™ Comprehensive Money Management. As a money manager, I make the investment decisions for clients' portfolios. As a Fee-Only™ professional, I receive my income exclusively from my clients, and do not accept commissions or any other income as a result of my recommendations. As a Comprehensive money manager, I insist on understanding everything pertinent while developing a custom Investment Policy Statement for each client.
2. **When will you next offer seminars?** I will likely hold them in November, on Tuesday evenings. The topics will again be General Investing, Stocks, Bonds, and Mutual Funds. I will send a mailing out when the dates, times, and location are set.
3. **Will I see you at the 2000 Delaware Everywoman's Conference?** Yes, I plan to be a facilitator for the conference on Saturday, November 4th.
4. **What's new at Mallard?** My wife Pam is planning to join the firm as the office manager and "para-planner". She earned a BS degree in accounting, and she earned the CPA designation (now inactive) when we lived in Maryland. Jennie Gallons completed her summer "internship" in August, and may find time during her senior year to help out a little.
5. **How do you research stocks?** I subscribe to several analysis services, currently including Value Line, Zacks, DBC Insite, Hoovers, and Morningstar. However before adding a stock to a portfolio, I first discover whether it will complement the existing holdings. Before I remove a stock from a taxable portfolio, I review the after-tax implications.
6. **Is Mallard accepting new clients?** Yes. Do you know someone who is frustrated with their broker or advisor? If their advisor is unable to understand the entire financial picture (including income taxes), who seems to care more about getting it done than getting it done right, and who lacks the level of competence they seek, please pass on my card, or the million dollar bill (with my phone and email) I've enclosed. I would appreciate the opportunity of discovering whether I can help better meet their needs.

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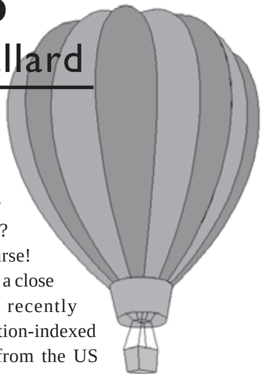
TIPS
from Mallard



What is a problem for investors but a solution for balloonists? Inflation, of course! (Hot air comes in a close second.) I recently researched inflation-indexed treasury bonds from the US government, and presented my findings at a NAPFA financial planners' study group. TIPS stand for Treasury Inflation Protected Securities. These bonds pay a modest interest rate but also are increased twice a year to match consumer inflation. They are auctioned by the Fed, and in many ways are similar to "normal" Treasury notes and Treasury bonds. They are also available through a few mutual funds, including one from low-cost Vanguard and one in TIAA/CREF's plan for teachers.

TIPS income is taxed somewhat similar to zero coupon bonds (where some taxes are due on growth that is not received directly). Therefore, they make more sense in an IRA (or 403b) than in a normal taxable account. For taxable accounts, there are I-bonds that are similar to EE bonds since income taxes on all of their return (interest and inflation-linked growth) can be deferred until you redeem them.

Earlier this month, these bonds were paying between 3.7% and 4.0% PLUS the rate of inflation. For the next several years, should inflation remain below 2.5% as it has for most of the 1990s, then these would not be too attractive. Some economists feel that globalization and the internet will continue to keep inflation low. Rising oil prices in the past year, and the implications of our tight labor market argue for rising inflation. Should this gloomier forecast come to pass, then the TIPS will be a very good choice.

Conference Update

I attended the annual Northeast/Mid-Atlantic NAPFA conference the week of September 21st. I attended many sessions, including ones on tax-efficient money management, alternative investment options, raising financially responsible children, saving for college education using qualified state tuition programs, the future of social security, the 2000 elections (presented by Congressman Barry Frank), common mistakes in estate planning using trusts, and the future of the financial advisory industry.

I enjoyed the opportunity to have numerous discussions with other advisors from the northeast, exchanging ideas of what works and what does not when striving to solve our clients' problems, assisting them to define and reach their goals, and building successful firms.

It was as a result of these discussions that I decided Mallard needs Pam to join the staff. This will enable me to have enough time to provide new clients the same high level of dedicated attention that my twenty-one ongoing clients have come to expect.

At the conference I met with two trust companies based in Delaware that are used by professional investment advisors. These firms enable you to consider an alternative to the typical bank trust departments that often suffer from high employee turnover, unresponsive, impersonal contacts, and one-size-fits-all approaches to investing. Rather than settle for such an arrangement, consider a team approach, with the administrative work done by a trust company, and the investment work done by an independent money management firm. Mallard serves as the investment advisory firm for two revocable trusts and one irrevocable trust.

E-Update

I have arranged for the address paul@mallardasset.com for my business email. Personal email can be sent to home@mallardasset.com. Email sent to these addresses is forwarded to my current email provider; this is sort of like call-forwarding. Therefore messages from me will list a different email. Feel free to use your email's Reply feature to respond to messages from me, but please ensure that your email's Address Book uses the address listed above. I will cancel my mamcorp@concentric.net account before December.

I have not yet developed a website (although you can correctly guess that it will be www.mallardasset.com). Other than posting newsletters, quarterly Market Reviews, and ADV forms, I haven't identified any dynamite content for it. Do you have any suggestions?

Three Month Activity

In this section I review the significant investment actions I have taken over the thirteen weeks ending September 15th. This year has provided many opportunities to rebalance portfolios including buying more shares of stocks and funds that had dropped quite a bit.

MUTUAL FUNDS

I have begun using or increased my use of the Acorn International, CREF Growth, Domini Social Equity, Dresdner RCM Global Technology, Fidelity Diversified International, Fremont Bond, Janus Enterprise, Janus Overseas, Liberty Newport Japan Opportunities, RS Diversified Growth, TIAA Real Estate, several Vanguard choices, and the William Blair International Growth funds. Note that two of my clients have employer retirement accounts which were moved to Fidelity; this involved a large number of changes. I reduced Cohen & Steers Realty, CREF Equity Index, Dreyfus Midcap Index, Fremont Bond, Hotchkis & Wiley Short Term Investment, Janus, Neuberger & Berman Socially Responsive, two Warburg Pincus Japan funds, and several Vanguard funds.

SPECIALIZED FUNDS

I purchased several closed-end and other exchange traded funds, including Central Securities, Europe Fund, European Warrant, Invesco Global Health Sciences, S&P 500 SPDR's, and the Telecomm HOLDR.

BONDS

I purchased over $200,000 of individual bonds, primarily municipal, while $225,000 in bonds was called or matured.

STOCK PURCHASES

I purchased several US stocks this quarter: AstroPower, Dana, Ford (after the tire controversy) JDS Uniphase, Kopin, Lucent, Nokia, Safeguard Scientifics, Salton, and Staples. A few purchases were directly requested by clients. Note that this week I am looking at selling Lucent to get the tax benefit, since it has fallen since we purchased it.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 sixteen US stocks during this period. These were fairly evenly split between taking gains to reduce the risk of the price falling back and/or controlling large positions, and taking losses (getting a tax deduction in return for admitting a mistake).

Conservative Options

In the past several quarters, I have been using options in one client's account, at his urging. Initially I was skeptical given the reputation of options as a high-risk class of investments. Through my CFA studies I knew that options can be used to reduce risk, however I did not have first-hand experience to confirm this academic view. I have been so pleased with this strategy that I have begun using options with other client accounts.

The primary way that I use options is to sell call options on shares of stock that we already hold (this is called a "covered call"), at prices greater than the current stock price. In this manner, my client receives a premium for giving up the right to profit, should the stock rise above the option strike price by the time the option expires. This premium is received whether the stock goes up, down, or sideways.

I primarily do this with a stock that has a bit of unrealized gain. This is fairly similar to placing a limit order to sell the stock a few dollars above the current price, except that you receive money if it doesn't reach that point.

By selling a covered call, compared with just continuing to hold the stock, the main downside is if the stock rises and we are forced to sell the stock, and realize the gain. This disadvantage is muted, due to the premium already received, and the fact that this only happens when the stock price has risen a bit since selling the call option. Options are more complicated than using stocks alone, and when misused, can lead to large losses. They also involve greater transaction costs (although I have asked TD Waterhouse to offer option trading on their online trading platform, and thus reduce the cost schedule).