Buffett's Revenge

Every year I devote a newsletter article to the annual report for Berkshire Hathaway, a company that has partial and complete holdings of many other companies. Berkshire has been run by Warren Buffett for more than thirty-five years. Since 1965, the S&P has returned a total return of 5,383% (with dividends), while Berkshire has gained 207,821%. Buffett has been one of the most admired value investors, primarily by practicing louder than he preaches.

Fortunately, he does occasionally preach. Specifically, he pens the Chairman's letter in the Berkshire annual report each March, and he speaks at the annual meeting each April (the Capitalists' Woodstock).

Last year he apologized for the poor performance in 1999, when Berkshire's book value rose only 0.5% versus the S&P 500's 21.0% gain, an apology I thought to be unnecessary. It is not surprising that in a tough year like 2000, **Berkshire outperformed the S&P by more than 15%**, rising over 6% while the S&P fell more than 9%.

Perhaps due to my kind words last March, Buffett maintained his avian theme (last year it was ducks) in the 2000 report. He details Aesop's formula for valuing all assets purchased for financial gain: "a bird in the hand is worth two in the bush". He does point out that his grandsons might update the axiom to "a girlfriend in the convertible is worth five in the phonebook."

Buffett suggests that three questions be asked by investors: how certain are you that there are indeed birds in the bush, when will they emerge and how many will there be, and what is the risk-free interest rate (generally the yield on long-term US bonds). With those answers, 'you know the maximum value of the bush – and the maximum number of the birds you now possess that should be offered for it. And, of course, don't literally think birds. Think dollars.'

Buffett also addresses speculation, 'in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it.' Berkshire avoids this; 'we bring nothing to the party, so why should we expect to take anything home?' He points out that the difference between investing and speculation becomes blurred when there are recent speculation triumphs. 'Nothing sedates rationality like large doses of effortless money.'

Warren Buffett notes that during speculative bubbles investors behave like Cinderella at the ball. They know that overstaying the festivities will bring pumpkins and mice. 'But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands.'

The 2000 Annual Report is available at Berkshire's website: www.berkshirehathaway.com. As always, it is worth reading. Due to the great relative results in 2000, and on the heels of a disappointing 1999, this year the question was whether Buffett would specifically say 'I told you so'. In typical Buffett style, of course, Warren instead uses homespun wit and self-depreciating humor to instruct rather than criticize or gloat. Thanks, Warren!

Mallard Asset Management Corp.
273 E. Main Street, Suite E
Newark, DE 19711

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The Mallard Message

Mallard Asset Management Corp. Paul S. Baumbach, CFA, ChFC, President 302-737-4546

Inside This Issue

Spring Plans

I will be attending the 2001 NAPFA National Conference in Phoenix, and will be away from the office from Tuesday May 15 through Tuesday May 22. It is also possible that I would take a long weekend in June to head to the beach. Other than that, I do not expect to be away from the office for two or more consecutive work days. Whenever I am away from the office for more than one business day, I check my phone messages and return all urgent ones.

Conference Report

In February I headed to San Diego for the annual TD Waterhouse National Advisor Conference, where I enjoyed the sessions quite a bit. I learned more about the web platform Waterhouse had recently revamped. I especially appreciated the session offered by Joseph F. Hurley, CPA (profiled last quarter by Pam in her College Bound article) on Section 529 Plans.

I attended a panel with managers from three international stock mutual funds, one with three value managers, and a third with three technology stock fund managers (including the manager of the Dresdner RCM Global Technology

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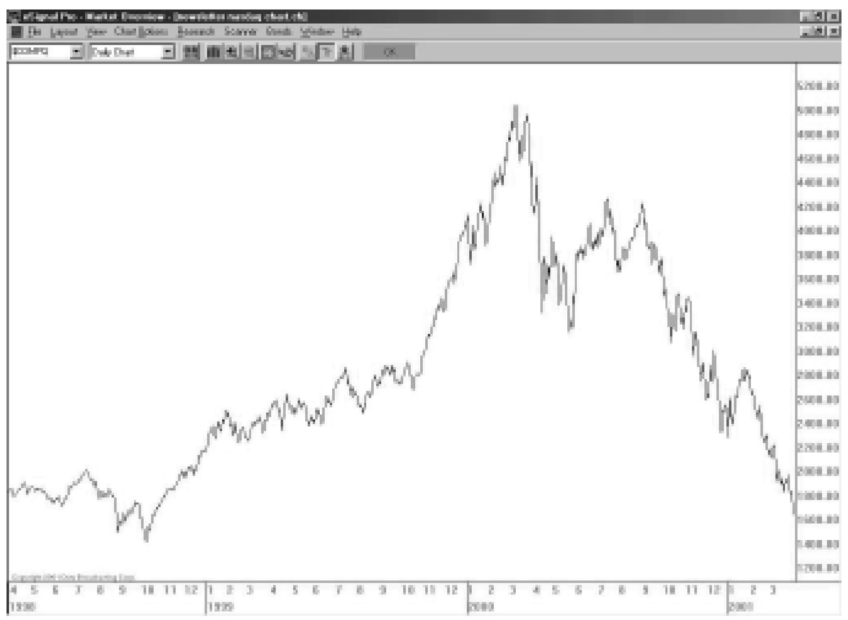
Frequently Asked Questions

1. **What's this I hear about a recent IRA change?** In January the IRS released proposed regulations dramatically simplifying the RMD, required minimum distribution rules for IRAs when the owner is 70½ or older. There is now a single table based on the owner's age. While these are only proposed, taxpayers may apply the changes to their 2001 distributions. I believe that in most cases the new table will result in lower RMDs.
2. **What does Mallard do?** In its fifth year, Mallard offers investment advice on a Fee-Only basis to individuals. The core of the business is the ongoing asset management offered to twenty-four clients with an average portfolio size of $500,000. Ongoing monitoring and regular reporting is offered for a fee typically from 0.7% to 1.0% annually. One-time investment reviews are also offered. The cost depends on the particular project, but is often between $400 and $600.
3. **When will Mallard shut its doors?** I plan to stop accepting new ongoing clients when Mallard reaches $20 million under management (versus over $13 million currently). Obviously the investment returns for the past year, or lack thereof, have not helped reach this target. Nonetheless I suspect that I should be able to reach this point within three years, at a level of approximately 34 clients. I don't believe that I would be able to provide the level of service I desire if I continued to accept more ongoing clients past that point. As time permits, I expect to accept one-time projects even after Mallard reaches its asset goal.
4. **How was your Amsterdam trip?** We had a very nice time, despite the cool and damp climate. We enjoyed the sights, the museums, and visiting with our friends (who are on sabbatical there). I have recently added a third Dutch stock to client holdings, and Pam has just finished planting some Holland bulbs at home.

Time to Surrender?

The S&P 500 index has fallen for four consecutive calendar quarters, for a 22% drop in the past year, and is down 8% over the past two years. The NASDAQ fell more than 32% just in the past quarter, and 60% in the past year. It is down 25% in the past two years, despite its 85% rise during the first of those years. The accompanying graph shows the heights and depths the NASDAQ has traveled in the past three years. Is it time to hunker down, shift to bond funds, and wait out a five-year bear market? I don't think so.



There is one critical weakness in shifting out of stocks out of concern for an upcoming decline. Specifically, you assume the responsibility for knowing when to shift back, and the responsibility to act on this impossible knowledge. You run the very real risk of missing the start of a recovery, and of paying higher prices when you shift back into the market.

The price of a stock is typically based on two factors, its profits and its reputation amongst investors, the emotional appeal. When you expand this to entire markets, a stock market's value is based on the country's economy, and the confidence that the investors have in the country. Further complicating the equation, stock prices and market index levels are typically based on future profits.

Therefore, to decide when to shift back into the market, you need to accurately forecast when the company (economy) will turn around, in advance, and you need to foresee when investors' sentiment will return.

The approach that makes the most sense to me is to construct a target asset allocation during 'normal times', an allocation that spreads the portfolio's risk amongst bonds, US stocks, and foreign stocks. Then regularly adjust the portfolio when the allocations drift away from the targets.

When markets drop as sharply as they have for the past year, do not shift your targets away from stocks, but rather take the following two steps. First, recommit yourself to rebalancing based on the allocation you set in the past. And second, when the market recovers (and it will), revisit the allocations. You may find that you had overestimated your tolerance for the ups and downs associated with high levels of stocks.

William Bernstein, an investment advisor and author of The Intelligent Asset Allocator, says: "Rebalancing is the only form of market timing that works." Amen.

Top Holdings

In past newsletters I reviewed past purchases and sales. This time I instead review top holdings for client accounts (greater than $50,000 when consolidated). The data for this report comes from the March 31, 2001 positions.

Mutual Funds— There are several large holdings of Vanguard funds (Total Bond Index, Short Term Corp Bond, Index 500, Index Extended Market, Intl Growth, Index Value, High Yield Bond, Mid Cap Index, and LifeStrategies Growth). I had recently shifted dollars from Vanguard Total Bond Index to Short Term Corp Bond. Columbia High Yield, EuroPacific Growth, Fidelity Diversified Intl and Long Term Income, Fremont Bond, Janus Overseas, Oppenheimer Real Asset, RS Diversified Growth and MicroCap Growth, Scudder International, and William Blair Intl Growth are other large mutual fund holdings.

Specialized Funds— Central Securities, Royce MicroCap Trust, and Royce Value Trust are the three large holdings of closed-end funds. Nasdaq 100 HOLDRs, S&P 500 SPDRS, and S&P Midcap 400 SPDRs are the three large holdings of exchange-traded funds.

Bonds— Clients hold more than $2 million in individual bonds, however almost all are lots of $25,000 or less.

Stocks— Aegon, Applebees, AstroPower, Corning, D R Horton, Duke Energy, Exxon, GE, Philips Electronics, Merck, New Plan Excel Realty, Providian, Texas Instruments, and Tyco are the large holdings of stocks. Corning was new to Mallard this past quarter, while Nokia was eliminated.

Paper Overload

Thanks to Pam Baumbach for submitting this article.

Most people make life resolutions around January 1st, and paperwork resolutions around April 15th. "Next year I will be more organized and it will not be this crazy ever again!"

Sound familiar? Yet as you begin to throw out old papers, you will likely encounter the perennial concern: "I might need it!" This can be a valid reason. Let's explore what needs to be kept, and what does not warrant keeping.

Tax related:

The IRS can audit you within three years from filing for "good faith" errors, six years from filing if you understated gross income by 25% or more, and forever if you failed to file or filed a fraudulent return.

So, am I shredding all my returns more than 6 years old? No! I intend to keep my tax records forever. It is not that I don't trust the IRS, just that common sense and security concerns compel me to hold on to them. They offer an excellent annual financial review, and take up less than an inch of storage space per year.

I am going through the past returns to ensure they have all the supporting documentation. These can be checks or receipts for charitable contributions, child care, medical expenses, mortgage interest, professional dues, retirement contributions, 1099's, W-2s, but nothing extra.

The IRS requires "Proof of Payment" for an item to be deductible. This means you must save the canceled check or receipts of payment. If you don't receive your checks back you will need your statement showing that the check was deducted from your account. For credit card slips you will need the credit card statement showing the charge on your account. All of the information for completed years will fit into one folder per year. You can accumulate current year tax items until the next tax prep time.

Home Sweet Home:

Homeowners need to keep records relating to the cost basis of their homes. These records are a great reference for itemizing the improvements to the home when preparing to sell it, or when determining how long ago a particular repair was completed (did we replace the roof ten or fifteen years ago?). Records to keep include the closing sheet from the purchase of your home, any documentation relating to improvements of the home, and insurance records for floods/fires/other casualties. Utilities and regular maintenance do not affect your home's cost basis, so they do not need to be kept unless you use a portion of your house for business.

Investments:

Your records should include the original purchase for all stocks, bonds, and mutual funds held in taxable accounts (there is no tax requirement to track this in your IRA, 401k, 403b accounts). This cost information should include the date and the price (after transaction costs). If there have been reinvested dividends or stock splits, you need to keep the statements that show each such transaction.

Many investments issue a consolidated annual summary. Save these and discard the statements that cover smaller time periods. Should your records be incomplete, the investment firm (brokerage, mutual fund company, money manager) may be able to research the necessary information. Alternatively, you may be able to use the Internet to research past prices (Paul sometimes uses bigcharts.com and its Historical Quotes feature). When you sell an investment in a taxable account, you will need this cost information for preparing your Schedule D, or when you provide information to your tax preparer.

So what CAN I get rid of??

Some examples are:

- Utility bills after verified to be correct and paid (two exceptions are if you want to show a perspective home buyer your utility history, or if you deduct the business use of your home)
- Credit card receipts – once they are verified on your statement and if they are NOT tax related (these items go with your tax return prep file—remember to keep the corresponding statement for Proof of Payment).
- Records for sold vehicles (unless car is used for business and then it is a tax related item)

What do I do with the left over items? Here is the gray area. Each person needs to determine his or her comfort level with letting go of paper. I think I am going to keep most of the left over stuff and next year I will make a second pass, feeling more comfortable that I didn't need what I tossed the previous year and I should be more willing to let go of even more.

Good luck with your purging. Now to start shredding 15 years of utility bills…

Conference Report

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fund). One session covered industry changes, including the impact of Merrill Lynch portraying their brokers as financial planners. One final session I attended was offered by a Pittsburgh advisor who has developed an advanced structure for monitoring mutual funds and managers.

Delaware residents do not need to search too hard to find a justification to flying to San Diego in February. I was fortunate to get a bonus with high quality sessions. Next year's conference is in Orlando, and Pam and Mike are already packing.