Which is Worse:
Buying a Car or Root Canal?

In this issue Pam Baumbach continues her journey on the web. Here she reports on the web resources she used this summer while shopping for a car. If you do not have access to the Internet you can contact Pam and she will send to you the information you seek.

Having done both within the last three months, I could have done without buying the car. Paul will attest to how hard I am on cars. As a result, buying a used car is a better economic decision for us. When buying a used car, there are a lot of unknowns. Therefore, making an informed decision requires a lot of research, time, frustration and patience. But we had a plan...

My role in car buying is to do the research, locate the winner(s), narrow it down to 3 to 5 serious candidates and then Paul moves in (well informed) for the kill.

Undoubtedly the best weapon in our search was INFORMATION. I'd like to share with you my research sources, how I used them and what I liked/disliked about them.

www.consumerreports.com Best known for their magazines and books with unbiased product comparisons, their website offers unlimited online access for $3.95 per month. There is a lot of information here including car-buying tips.

When researching a car you could research either new or used cars. It sorts by many features including price, type, and make. This helped me to narrow down my focus. If you have decided on the model you can get an overview of the car, and reliability ratings by category and year. They also tell you the average dollar range for purchasing the car by year.

www.kbb.com This is the Kelley's Blue Book site, sometimes associated with the resource used car dealers rely on to value your trade-in. I loved the website (and it's free!). You get to choose if you want prices for your current or prospective cars. You can choose a dealer or private sell. You also put in mileage, equipment, and condition. When you are finished entering the information you get a page with a picture, criteria used, and a final dollar figure. While these are approximates, they are a great starting point. I had printouts of my outgoing and incoming cars when I visited the dealers.

www.carfax.com Carfax.com has an interesting service that researches a car based on its vehicle ID number (VIN). The service costs $14.99 for one VIN report, but only $19.99 for unlimited reports for one month. You can input the VIN of the car and it will check numerous databases. It tells you about the registration; was it leased, purchased, a fleet car, and mileage every time it went through DMV (shows every time it was sold). It also searches databases for reports of salvage, lemons, rebuilt, flood damage, and fraudulent, rolled back or broken odometers.

One dealer informed me they do a Carfax report on every car (some dealers will show you their report for free-if you ask), so I immediately ran to my computer and entered my outgoing car VIN so I wouldn't have any surprises. I also ran every serious candidate; the report listed the version of the vehicle (like LS or EX) and the equipment that should be on the car. The report is limited and is not a guarantee, although they do offer a $5,000 title insurance certificate for every VIN they run.

Web sites for local car dealers-Several websites had links to car dealers, although few were local to Newark. I also went through the newspaper and looked at the direct websites of local dealers. While it was interesting to surf, they did not have a large selection, and the sites did not seem to be current (a week can make a difference!). I preferred visiting the lots and seeing the cars for myself. These sites may be more helpful when shopping for a new car.

Stocks are Undervalued
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in dividend yield should result in 1.5% growth in profitability. This is my contention. I believe that the sharp decline in dividend yield has no impact on whether the US stock market is overvalued. Instead it indicates that US companies have been more responsive to their tax-sensitive investors than in many countries.

While the PE ratios and dividend yields are providing misleading warning signs, past market returns have created a Clearance Sale. The broad US stock market index, the S&P 500 was down 34.5% from March 31, 2000 through September 21, 2001. It hasn't been that low for three years. Intelligent investing requires an asset allocation approach, one that matches the level of risk (likelihood and magnitude of losses) with the investor's tolerance, and the portfolio's need for potential returns. The asset allocation approach's success requires that it is adhered to in good and bad times. Just as it would have been a mistake to shift to all technology stocks when they had red-hot returns in February 2000, it would be as large of a mistake to abandon US stocks now. Selling US stocks now is the functional equivalent of driving your car by exclusively looking in the rear view mirror. Look ahead-the sun is rising!

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The Mallard Message

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

Frequently Asked Questions

1. **Did you ever get your website up?** Yes. By September 1st www.mallardasset.com was up and running. It contains information on the firm, company news, articles, tips, links to useful financial websites, stock quotes, and some interesting calculators. Try it out and let me know what you like and how I can improve it. The Articles & News section includes the alert I sent to clients late on September 11th. If someone asks you for information on Mallard, please feel free to refer them to the website.
2. **Did you change offices?** Also on September 1st, Mallard moved offices. We are in the same building as before, and on the same floor. We moved from the suite on the northwest side of the building to the suite on the south. Clients need to use the entrance and staircase closest to the parking lot to get to our new office. The office has four rooms, comprising more than twice the space of the prior office. We are still considered Suite E, and our phone numbers have not changed.
3. **Did I hear that you were quoted in BusinessWeek?** Yes, the October 1st issue has an article "Don't Let Panic Rule Your Portfolio", and includes a quote from me that 'selling into a crisis "can result in receiving fire-sale prices"'. The full article is available under Articles & News section of the Mallard website.
4. **Will you be offering seminars soon?** Yes. On Monday evening, November 12th, beginning at 7pm, I shall be presenting an Investing Fundamentals seminar. On the following Monday evening, I shall present Mutual Fund Investing. These seminars are part of the community-based Delaware Money School (www.delawaremoneyschool.org), and are open to all. This is open to the public, so please feel free to invite a friend. Both seminars will be held in the conference room of our new suite, so space is limited and reservations are necessary.

Autumn Plans

My next conference is in Vermont from October 16 to 20. I hope to attend several of my son's football games on Tuesday and Thursday afternoons in October and early November. I also expect to close the office on Thanksgiving Day and the following day, and to have limited office hours from December 24 through January 1st.

Whenever I expect to be away from the office for more than one business day, I send an email to my clients. I also check my phone messages and return all urgent ones while I am away, and often I check my 'traveling email account'—<mamcorp@yahoo.com>.

Inside This Issue

WTC Implications

To better understand how the stock markets have reacted to dramatic events in the past, I reviewed a chart of the S&P 500 since just after the conclusion of WWII. It showed the constant upward trend, despite major events such as Sputnik, the Cuban Missile Crisis, JFK's assassination, Nixon's resignation, the 1987 Stock Market crash, and the Gulf War. While the general upward trend despite these events was comforting, I wanted to do some further digging.

I examined the average annual return for four-year periods. I chose that duration to recognize that investors are prepared for bad quarters and an occasional bad year, but we like to believe that a bad market will rebound within a 'reasonable' amount of time. During this fifty-five year period, the average four-year annual return was 9%. This included three times when the average annual return for four-year periods was negative. The first was the post-WWII period, ending in mid-1950. The second was during the Vietnam War, ending in 1970. The third period began with Nixon's resignation in mid-1974 and continued until early 1978. This last period of course coincided with the OPEC oil embargo.

After the post-WWII slump, average annual returns for trailing four-year periods rose swiftly to 10%, and later to almost 20%. After the second slump, returns rose to less than 5% for the next four years, when the third slump occurred. The third slump was followed by a quick rise above 10%, a few years near 5%, and then the extended bull market run with returns above 10% for most of the rest of the 1980s.

Despite a strong start, over the past four years the S&P 500 is up a very slight 1.7% annually, while many investors have flat, if not slightly negative returns. It therefore seems quite likely that the market is quite close to a low, and should soon begin a recovery. The 9/26/01 Wall Street Journal reports that many economists expect the Dow Jones to rise to 10,000 (up more than 15%) in the next year. This rosy forecast is despite their belief that the US economy will shrink for the remainder of 2001.

I tend to agree, that the economic recovery will begin by mid-2002, that we are near a market bottom, and that a stock market recovery will have begun within a few months. For a point/counterpoint discussion, read two later articles.

Top Holdings

In this section I review top holdings for client accounts (greater than $100,000 when consolidated). The data for this report comes from the September 10, 2001 positions.

Mutual Funds—Artisan Mid Cap, Columbia High Yield, EuroPacific Growth, Fidelity Diversified Int'l, Fidelity Long-Term Income, Janus Overseas, Scudder Int'l, four Vanguard stock index funds, two Vanguard bond funds, Vanguard Int'l Growth, and William Blair Int'l Growth are all large holdings. I eliminated RS MicroCap Growth fund during the three months, largely due to the April management change.

Specialized Funds—No closed-end funds are held with $100,000 or larger positions. S&P 500 SPDRS and S&P Midcap 400 SPDRs are the two large holdings of exchange-traded funds.

Bonds—I added $135,000 of a 6% CD, $175,000 of some 45-day commercial paper, and $125,000 of a 30-day piece of commercial paper during the three months. The 30-day paper matured during the period.

Stocks—Exxon-Mobil, Providian, AstroPower, and GE all are held at $100,000 or more. Additional shares of each of these four were either purchased, or transferred in during the three months. For one client a large position of AEGON was sold with the after-tax proceeds moved to Providian during this period.

Conference Report

In October I will attend the 2001 NAPFA Northeast MidAtlantic regional conference in Burlington, Vermont. In addition to attending many presentations, I will be leading a roundtable on Stock Selection.

There is no Delaware Everywoman's Conference this year. I am hopeful that it will return in 2002, as I enjoyed working with it in 1999 and 2000.

I have agreed to co-chair the 2003 NAPFA Northeast MidAtlantic regional conference in Philadelphia. These come to the Philadelphia area every four or so years, and my study group is in charge of its organization. Other than my sprained ankle, the last one in 1999 was a great success.

Stocks are Overpriced

I offer two views on the state of the stock markets-whether it is safe or not to go back into the water ...

The S&P 500 has indeed fallen 33% in the past year, however the PE, a measurement of how expensive the stock market is, has only fallen 5% during that time from 27.7 to 26.2. We are far from a market low, and those seeking bargains should be wary of catching falling knives!

We are in a recession, and it will get much worse before we recover. The Fed is ill-equipped for this battle; it has few weapons suitable for this conflict. The interest rate cuts they have implemented in the past nine months have little if any impact on the cause of the recession, which is a dramatic mismatch between capacity and demand. New property and equipment were added at a feverish pace when it appeared that the 'new economy' would enable US companies and consumers to achieve stable, high rates of growth. There is now a glut of capacity and inventories, a glut that will only be eliminated with real growth, growth that is not around the corner. Lowered short-term interest rates will not reduce the glut.

Consumers have carried the economy for the past year, apparently based on the theory that this is just a dip, and that their portfolios will recover in a few months. We are at the point where many investors will come to believe that the recovery is far off, that their financial picture is seriously eroded, and that they will have to cut back. This, in turn, will further delay the economic recovery, perhaps by more than a year. The rest of the world cannot help us; they need us to recover and to pull them along. They are in worse shape than we are! The September 11th tragedies will only strengthen the consumer's need to be more cautious, as layoffs compound the impact of a second year of double-digit stock market losses.

Growth investing has fallen hard, trailing value investing for the past eighteen months. However, it had six straight years of outperformance before that. Thus while valuations of growth stocks have fallen from the stratosphere, they remain much too high.

GE and Microsoft have the largest market cap of any US stocks. Even with the recent drop in the US stock market, they have PE ratios between 24 and 27, based on projected 2001 earnings, despite expectations that both companies will grow their future earnings at only a 16% annual pace. An oversimplified rule-of-thumb states that the PE for a stock should be no greater than its expected future earnings growth rate. If GE and Microsoft are 50% overpriced based on this general rule, it is not much of a jump to conclude that so is the overall market.

Stocks are Undervalued

The alternatives to stocks stink! The two-year Treasury bonds now yield 2.85%, less than the 3.31% rate of inflation for the past two years. It is one thing to invest with a risk of losing money; it is quite another to invest with a certainty of loss.

There are two factors that are not appreciated in most market reviews that examine PE ratios to determine whether the US stock market is overvalued. The first is that we are very close to 'trough' comparisons. We are in an earnings recession, and one that is affecting a large number of US companies. At this time a great many companies are expected to post their lowest earnings this year, with a recovery next year. Since the PE ratio divides a stock price by its earnings per share, when the denominator is at a short-term low, the PE ratio will spike up. When earnings recover, the PE ratio will drop back. If we are indeed in the trough of an earnings recession, PE ratios are artificially quite high (overvalued), but will correct automatically in the next few quarters. Therefore, apparently high PE ratios are unreliable as indicators of market value at this time.

The second factor that is often ignored is that corporations, with the full support of investors, have changed the manner in which investors are compensated. Before the 1990s investors received approximately 3% dividend income and 6% price appreciation annually from US stocks.

As dividend yields have fallen to approximately 1.5%, there appear to be two interpretations. Perhaps the 50% decline in dividend yield is due to an overall drop in corporate profitability, and we should expect stock price appreciation to also fall in half, for future total annual return from US stocks of 4.5%. The second choice is that stock prices will fall until the yield rises again to 3%. This would call for US stocks to drop by 50%. If this takes five years, each year you would receive between 1.5% and 3% yield, but would suffer 10% price drop, for average annual returns of approximately -8%.

I reject both of these views. Dividend yields did not fall in half because companies' profits fell. Profits rose, strongly, from 1980 to 2000. Instead of maintaining their dividend yields, US companies slowed the growth of the dividends, and let the normal price growth of the stock cause the dividend yield to fall gradually. By retaining more of the profits each year, US companies were able to reinvest money to grow the company, money that would otherwise be paid to investors and taxed. The real question is whether reinvesting in US companies is wise. If so, a 1.5% decline

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