Will They "Show Me the Money"?

[In this issue Pam Baumbach continues her journey on the web. Here she reports on the web resources available to help you monitor and affect your credit rating.] With interest rates so low and economic belt tightening going on, everyone seems to have mortgage financing, refinancing, and debt reorganization on their mind. How would I fare in the borrowing jungle?

My first step was getting a credit report. There are three major credit agencies: Equifax: (800) 685-1111 (www.equifax.com) Experian: (formerly TRW) (888) 397-3742 (www.experian.com) and TransUnion: (800) 888-4213 (www.transunion.com).

I ordered a report using Paul's SSN. There were a few old, forgotten accounts that needed closing. But I recognized all the accounts and agreed with the information. The report included past residences, public reports, collection accounts, how well you pay, current balance, high credit, and other credit inquiries.

I also ordered a credit report under my SSN. Different listings showed up; some credit cards were there that I had individually. I discovered that the three major reporting companies can have different information (you can order all three as a package at www.creditreporting.com for $30). The website includes a form letter and detailed instructions if you have a dispute. There is information on about how long different kinds of items remain on your report, how they are affected by divorce, bankruptcy, identity theft, and more.

I found an article in the March 19th Wall Street Journal about credit scoring: "Fair, Isaac Plans Credit-Score Help, But Watchdog Groups See Conflict". There is basically one company Fair, Isaac & Co, that uses statistics, probabilities and a "secret" mathematical equation to assign each credit report a score. **75% of all mortgage decisions use the score** in determining acceptance and the interest rate. The scores are used to statistically predict the quality of the borrower. This can affect the amount of a security deposit required and the interest rate charged.

In the insurance industry the score may be used to predict your likelihood to sue (various studies have shown that consumers with lower credit scores are more likely to file auto or home insurance claims). This prediction may increase your auto insurance rate regardless of your driving or payment history. This disturbed me.

The most informative website on the Fair, Isaac credit scoring is www.myfico.com. The website had general information on what the score is, how it is used and how you can improve your score. I ordered my Credit Score and report from Equifax for $13.

Another interesting area on the site was the "FICO Scores and Interest Rates". Scores in the US generally range from 300 to 850 (720 being the average). The website shows how mortgage (all kinds), equity loan, and auto loan interest rates correlate to the credit scores. You can also get the rates by state. In Delaware, the current rates by credit score for a 30-year fixed mortgage are 10.3 for 500-550 scores, 8.3 for 620-674 score, 6.6 for 700-719, and 6.4 for 720-850. I found it surprising that **mortgage rates could be 60% higher based on a score that few borrowers have heard of**.

With this in mind, I read my report. While I first looked at the FINAL NUMBER, the more interesting part was the rest of the report. This included how lenders view the score, factors that affect my score, and a summary with suggestions. The most interesting section showed the factors affecting my score. It listed the top four reasons my score was not higher, explained them, and gave suggestions for improving them.

The top factor in my report was that the "amount owed on accounts is too high", indicating that I am a "greater future repayment risk". WHAT?!? The credit report showed that I had **no delinquencies**. BUT, there **is** a statistical correlation between people who have larger balances on revolving credit and higher repayment risk.

To better understand it, I looked closer at my credit report. The problem was my Discover bill, where I concentrate my charging to maximize the cashback feature. The report takes the outstanding balance on my last statement regardless of whether or not I pay it in full each month or over time. While my other card balances were near zero, this one card had a balance at the time of the request fairly close to the credit line (part of that balance covers the airline tickets to Las Vegas for Paul's conference in May). Although this month my statement has a relatively high balance, it is not the norm. Most other times they would calculate a better score.

So what do I do? In my case, nothing. I was merely learning about the process. However, if I were going to refinance or apply for credit, I would be more aggressive about the factors, and make changes (like not making large purchases on my Discover card even if I was paying them off each month), or at least be better prepared for questions from the lender.

When considering borrowing money, I would do the footwork first, have as much of the information as the lender has, make sure I understand it, give myself enough time in case I want to improve on it, and forge ahead. I wish you an informed and successful journey when you next enter the borrowing jungle.

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The Mallard Message

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Inside This Issue

Frequently Asked Questions

1. **Did you forget to list the Mallard website in last quarter's newsletter?** Yes. Two people pointed out that while I discussed the website in the past newsletter, I neglected to provide its address. The Mallard website is www.mallardasset.com. I post this quarterly newsletter, the quarterly Market Review and Outlook, and a new article each month under Interesting Tips. If someone asks you for information on Mallard, please don't hesitate to refer them to the website.
2. **Are you still accepting new clients?** I have twenty-eight ongoing clients now. I want to accept enough clients to meet my business targets, while limiting the number of clients so my newest client receives the same high quality service that my first clients enjoy. At this time I expect to stop at about thirty-four clients.
3. **What is risk?** I have begun using a Risk Tolerance system from an Australian firm called ProQuest. In most cases the results merely confirm what we already knew, but they offer a quantification, and a confirmation of our past discussions on this critical topic. The scores range from 0 to 100, on a bell curve. Thus far scores for my clients range from 31 to 65. Pam scored a 47 and I scored a 54.

Thirty-Seven Years of Returns

In each March newsletter I try to review the annual report of Berkshire Hathaway, the holding company run by Warren Buffett and Charlie Munger for the past thirty-seven years. It owns substantial positions in American Express, Coca-Cola, Gillette, H&R Block, Moody's, the Washington Post, Wells Fargo, and private companies including GEICO insurance.

This year the annual report again offers enjoyable tidbits of Buffettisms. Warren spends quite some time describing the losses suffered by General Re, a 'reinsurance insurance company'. General Re's losses related to September 11th were in the billions of dollars. Buffett shares three principles of insurance underwriting, and notes that most were violated at General Re. While he claims to have known this before September, he does not want to shift the blame. **"I violated the Noah rule: Predicting rain doesn't count; building arks does."**

Buffett has regularly criticized aggressive accounting, such as that used at Enron. He writes '**Bad terminology is**

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Spring Plans

My next conference is the annual AICPA Advanced Investment Management Conference in Las Vegas in late May, where I will be presenting a session on Bond Investing. I will be gone from Wednesday the 29th through Sunday, June 2nd. I hope to attend several of my son's lacrosse games in April and May.

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, return all urgent ones while I am away, and often I check my 'traveling email account'—<**mamcorp@yahoo.com**>.

Economic Views

At the TD Waterhouse conference I attended in February I enjoyed four keynote speakers. I will share the highpoints of each in this article.

Steve Forbes—The first keynote speaker was Steve Forbes, CEO of Forbes, Inc, and Former Presidential Candidate. He began by sharing a bit of wisdom from his grandfather: "You make more money selling the advice than following it." Clearly a publisher's mantra.

He pointed out that the Enron debacle is analogous to the Penn Central crisis in 1970. At that time the Fed had to intervene to prevent the collapse of the commercial paper market. He suggested that term limits for corporate auditors is worth considering.

Frank Cappiello—This speech took place over lunch on Thursday. He is president of a large investment firm, and regular panelist on 'the show formerly known as Wall $treet Week with Louis Rukeyser'. He offered a very enjoyable talk.

There are **four things that can help start a bull market**: mood, money, momentum, and merger mania. Keep an eye out for a combination of these themes developing later this year.

Our economic recession began with a corporate pullback by early 2001. The international crisis that began on September 11th prevented a recovery in the second half of 2001. The confidence crisis brought upon by Enron and Global Crossing (and others) has further slowed the energy of a recovery that began in the 4th quarter of 2001.

Mr. Cappiello feels that we now have good fiscal policy, good economic policy, a strong US dollar, good demographics, and high levels of cash (on the sidelines). This normally would have enabled us to enter a strong bull market.

Mr. Cappiello looks for modest GDP growth of about 3.5% in 2003, inflation at 2%, unemployment at 5.5% to 6% (a lagging indicator), and the Dow Jones above 11,000 by year-end. He feels that current PE's do not matter, as they are based on depressed earnings. He is pleased that insiders are slowing turning into buyers, and that the inventory liquidation is pretty well over.

Robert Reich—Friday's morning keynote speaker was Robert Reich, Former Secretary of Labor under President Clinton. His talk was more concerned with the years ahead than the months ahead. The keys to US success in the years ahead are globalization, technology, and demographics. He noted that with the aging of the baby boomer generation, the retiree segment will be very politically powerful. He sees reductions in social security benefits quite unlikely, begging the question of how we will manage to keep the program afloat. He predicts an intentional and **dramatic increase in legal immigration**, which will enable the country to maintain a large enough workforce to fund the Social Security benefit checks destined for aging baby boomers.

Reich provides Three Barriers to Change. The first is the observation "We used to be more successful, let's go *Back to Basics*", moving backward rather than embracing change, and changing with it. The second is Only Dealing with Change Incrementally. Some forces are so significant that changes must be done all at once. One recent example is the conversion to the Euro (with the recent January 1st conversion to the new coins/currency). The last barrier Reich provided is an Unwillingness/Inability to See That the Underlying System is Changing. We are often too focused on short-term issues to recognize long-term changes.

William Seidman—The Chief Commentator on CNBC, publisher of Bank Director magazine, and past chairman of the FDIC and of the Resolution Trust Corporation notes that "Those who live by reading crystal balls end up eating ground glass." With that said, he shared his observations of the past year and his expectations for the future.

He sees deflation as a greater threat in the future than inflation. This is due to the impact of the increasingly global economy, and the total lack of pricing power by manufacturers.

It was the manufacturing portion of the economy that drove the economy into a recession. Even though manufacturing makes up only a small portion of the economy, its contraction was so severe that stability in the service industry and strength in housing prices (which have never risen in past recessions) were unable to prevent the current prolonged recession.

Seidman is not very bullish on the US stock markets, but this is due to his concerns over continued over-valuation. He notes that while the NASDAQ has 'cratered', the Dow remains expensive. He warns that Enron-itis will likely cause investors to abandon stocks more quickly on hints of impropriety, increasing the volatility of the markets.

He sees **strength in oil** (despite recent strength, oil prices are well below their peaks from late 2000). Russia is the #2 global exporter of oil. Western firms have been increasing efficiency (think of the steady improvement to PCs in the past twenty years and then consider the impact of this rate of improvement on oil extraction and refining). He notes that while interest rates primarily affect only borrowers, oil is significant to most everyone. Russia's need for trading dollars, and the resulting flow

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Top Holdings

In this section I review top holdings for client accounts (greater than $100,000 when consolidated), and purchases or sales of $50,000 or more for the past three months. The data for this report comes from the March 15, 2002 positions and for transactions during the prior three months.

Mutual Funds—Artisan International (new top holding), Artisan Mid Cap, Columbia High Yield, Federated Mortgage, Fidelity Diversified Int'l, Fidelity Long-Term Income, Janus Overseas, the Merger Fund (new top holding), three Vanguard stock index funds, three Vanguard bond funds, Vanguard Variable Annuity Equity Index and Small Company Growth, and William Blair Int'l Growth are all large holdings. I added $100,000 to Federated Mortgage, $75,000 to Merger, and $73,000 to Vanguard Index 500 during the three months, while I sold $62,000 of American Century Income and Growth (this position was transferred in).

Specialized Funds—No closed-end funds are held at $100,000 or more. S&P 500 SPDRS, S&P Midcap 400 SPDRs continue to be two large holdings of exchange-traded funds, along with newcomer MSCI iShares EAFE fund from Barclays. I added $185,000 to the iShares EAFE, and $165,000 to the S&P 500 SPDRS.

Bonds—I added $190,000 in bonds, primarily a very short-term municipal bond. $270,000 in bonds were called or matured. Due to the low-level of interest rates, I have been slow to reinvest proceeds from bond sales.

Stocks—GE and AstroPower continue as the sole positions at $100,000 or more. I sold all $107,000 of DR Horton due to it meeting our price targets, and sold all $66,000 of Tyco after it had recovered a little of its dramatic decline. During these three months I also sold all of Providian, another stock that used to be a large holding, and that proved to be a disappointment.

Thirty Seven Years of Returns

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the enemy of good thinking. When companies or investment professionals use terms such as "EBITDA" and "pro forma," they want you to unthinkingly accept concepts that are dangerously flawed. (In golf, my score is frequently below par on a *pro forma* basis: I have firm plans to "restructure" my putting stroke and therefore only count the swings I take before reaching the green.)

Warren Buffett expects the stock markets to offer only moderate returns for the next several years. Speaking of results, over the past thirty-seven years, the growth of the book value in Berkshire Hathaway has trailed the S&P 500 in only four years, most recently in 1999. It is very interesting that the NASDAQ peaked on March 10, 2000, and has since fallen 65%. Berkshire stock hit a low point on the same day, and has since risen 72%. Not bad.

Economic Views

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of oil appears to be quite beneficial to the US in the future.

He considers **Japan to be 'near crisis'** (his words). Their national debt is 140% of GNP; the US national debt peaked at 90%, and now stands at 45% of GNP. The banks provide 80% of lending in Japan, and they are near catastrophe (again, his words). He does point out that Japan has a very large position in US government bonds, and that this poses a serious risk to stability of US interest rates.

He concluded with a discussion of US productivity, which recently was measured at 3.5%. This is <u>twice</u> the level seen at this stage of most recessions, and if it remains this strong, all will be well. He notes that especially due to the service element of our economy, it is quite difficult to accurately measure the economy's productivity.

My Thoughts—The US economy is likely to continue to 'crawl out of' the current recession. There is a small chance that the recovery will be derailed if the consumer stops spending. This could be caused by concerns over unemployment or falling housing prices, or other reasons. Again, I consider this a small risk. However, if this comes to pass, it will likely take until 2003 to recover, and market losses could be large.

It appears more likely that we will gradually build on the recovery of the past few months. The US stock markets should gradually recover, as confidence slowly builds. This should encourage investors to stop hording cash, and steadily move money to stocks. Despite a wild ride in between, the US stock markets are at the same levels as they were four years ago (before the bubble). I therefore characterize myself as guardedly optimistic.