THE MALLARD FLYER

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July 7, 2003

Announcements

Paul's Schedule:
Paul will be out of the office July 31st & August 1st camping with his family. Paul will also be out August 22nd.

Bill's Schedule:
Bill will be out of the office Friday July 25th camping with his family. Bill will also be out the week of October 6th-10th at Disney World.

While We Are Away:
When either of us are away, if possible, we check our phone messages and our e-mail. In addition, we both subscribe to www.gotomypc.com which allows us to access our PC's at the office from any internet connection. Finally, between Paul, Bill, Pam, Sherry, and Laura, someone is almost always here at the office during working hours.

Taxing Matters—A Summary of the 2003 Tax Cut Package

Three times in three years, Congress has passed major tax cut packages with the most recent being the third largest in U.S. history. One of the major goals of the tax cut is to help stimulate the economy by encouraging Americans to spend, save, and (especially for small business owners) invest.

In this article, we will summarize the major provisions of the Jobs & Growth Tax Relief Reconciliation Act of 2003. Many of the provisions are temporary, but like the government, taxpayers can also be reluctant to give up what has been given. For most of you, this act will provide you and your family with more disposable income this year, and result in a smaller tax bill next April. This will be done primarily through the new income tax rates and brackets.

Lowering your marginal tax rate. Your marginal tax rate is the percentage of each additional dollar earned taken by the Federal

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Frequently Asked Questions

WHAT IS NEW AT MALLARD ADVISORS?

We are so glad you asked! There are two bits of news to announce with this quarter's newsletter.

The Newsletter

Rather than producing two independent newsletters (The Mallard Call & The Mallard Message), we have decided to pool our efforts and create one Mallard Advisors newsletter (The Mallard Flyer). This joint newsletter will be issued about the first week of each calendar quarter.

Both of us will be contributing to this joint newsletter reporting on the areas we follow and feel will interest you. In addition, at times each of us will include "special inserts" in the quarterly newsletter directed at our own clients. We are hopeful that the new newsletter will provide a better scope of Mallard Advisors, our philosophies, and our services.

Office Space

We are e x p a n d i n g ! State Farm (also on the second floor) is leaving our building and we are acquiring a portion of their previous space. It is space that is connected to our existing suite and it will be used for filing, bookshelves, and seating for Laura, our part-time administrative clerk.

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government. For example, if your total taxable income is $120,000, and you earn an additional dollar, under the old law you would lose 30% of that dollar in Federal income taxes. Under the new law, you would now only lose 28%. This 2% savings could amount to $2,400 in tax savings. The law makes all of the 2001 tax rate reductions effective this year rather than being phased in over the next four years as provided under previous law.

Planning Tip: Since rates are cut effective 1/1/03, you could decrease your federal tax withholding and increase the contributions to your tax-favored retirement plan with no pain at all. In addition, you will also receive a deduction as a result of the increased retirement contributions. This is painless savings at its best.

Increase in the child tax credit. The tax credit will increase from $600 to $1,000 per child for 2003 and 2004. Eligible taxpayers will also receive a check this summer of the difference ($400) for each child claimed on their 2002 tax return.

Comment: This credit is eliminated for married couples with adjusted gross income of $110,000 or more.

Marriage penalty relief. Married couples filing a joint tax return will now have double the single person's standard deduction.
Planning Tip: It is time to get married and have children. Guys, there should be no more excuses, you have waited long enough just to avoid the "marriage penalty". In fact, if you don't itemize and you get married in 2003, the tax savings could pay for your honeymoon!

Capital Gains Tax Rate Reductions. For almost any investment held longer than one year and sold after May 6, 2003, you will likely only pay 15% federal income taxes on the gains earned by the investment. This is a drop from 20%. For those of you (including your children) in lower tax brackets (i.e., 10% or 15%) the capital gains tax rate will be only 5%! Not only that, but the 5% rate for lower income tax payers drops to zero-percent in 2008...but just for that tax year, returning to 10% in 2009 and beyond (under current law).

Planning Tip: If you have appreciated assets held for more than one year, seriously consider gifting them to children over age 13 (and therefore exempt from the "kiddie tax") rather than gifting cash. At the time of their eventual sale, your child could (if year 2008) pay zero capital gains tax rather than 15% if you sell the investment. So, if you have a $10,000 investment that has appreciated by $20,000 since purchase, rather than selling it yourself and using the proceeds of $27,000 ($10,000+$20,000-$3,000 of taxes) for your child's college education, gift the investment to your children (recall that the annual exclusion for gifts is $11,000 each year per giver). At the time of the sale, your family will have an Continued on page 3

2003 Tax Act Summary - 10-Year Forcast

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
CAPITAL GAINS										
Capital Gains Rates	20%	15%	15%	15%	15%	15%	15%	20%	20%	20%
Capital Gains Rates - for taxpayers in the 10% or 15% bracket	10%	5%	5%	5%	5%	5%	5%	10%	10%	10%
DIVIDENDS										
Dividends rate (taxed at capital gains)	N/A	15%	15%	15%	15%	15%	15%	N/A	N/A	N/A
Dividends rate (taxed at capital gains) - for taxpayers in the 10% or 15% bracket	N/A	5%	5%	5%	5%	5%	5%	N/A	N/A	N/A
INCOME TAX RATES										
Top Bracket	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%
Fifth Bracket	35%	33%	33%	33%	33%	33%	33%	33%	33%	36%
Fourth Bracket	30%	28%	28%	28%	28%	28%	28%	28%	28%	31%
Third Bracket	27%	25%	25%	25%	25%	25%	25%	25%	25%	28%
Second Bracket	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Initial Bracket	10%	10%	10%	10%	10%	10%	10%	10%	10%	No 10%

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additional $3,000 to keep. This is $3,000 that would have eventually come out of your pocket anyway, right.

Reduced Taxation on Dividends. Previously all dividends were taxed at your marginal federal tax bracket, but now will be taxed just like a long-term capital gain.

Planning Tip: The spread between dividend and capital gains tax rates and marginal income tax rates has increased. This makes the attractiveness of long-term gains (rather than short-term gains or ordinary income) in taxable investment accounts even more valuable than before. In addition, a host of other considerations must be addressed regarding the relative attractiveness of municipal bonds, REITS, annuities, etc.

Small Business Tax Changes. Small businesses are a large beneficiary of the tax law changes (hence are designed to be large "stimulators" via investment and employment) by receiving immediate (rather than delayed) deductions via accelerated expensing and depreciation rules.

This has been a very brief description of the tax cuts under the new law and does not cover all of the provisions and planning opportunities uncovered by the law. We continue to remain current on the tax law and how we can use our knowledge to assist you in maximizing your cash-flow, savings, and financial security. - Bill

Time to Overhaul Your Portfolio? Paul Baumbach

The recently passed tax act includes enough changes which affect financial investments (lower ordinary tax rates, and dramatically changed tax treatment of some dividend income), that **investors are wondering whether to reconfigure their portfolio**. It is common for investors to own stocks and bonds (whether directly or through mutual funds) in their portfolios, in taxable and retirement accounts (normal IRAs, Roth IRAs, 401k, 403b, …). In the **traditional model** investors place growth investments in their Roth IRAs, but load up their other retirement accounts with 'income' investments such as bonds and real estate funds. The taxable accounts are often dedicated to stocks and stock funds. This arrangement reflects the fact that 1) taxes matter, but 2) taxes do not outweigh the value of diversification.

It is reasonable to use a different approach, which I'll call the **retirement model**, in which the bonds and real estate funds are concentrated in the taxable account, and the stocks in the retirement accounts. This makes it easier to manage the monthly distributions (portfolio paychecks), and reflects that retired investors have two areas of taxation to manage, the taxation of their investments (dividends, interest, and capital gains) and the taxation of their IRA withdrawals. As with the traditional approach, the retirement model continues to recognize the effect of taxes, and to make some adjustments while reserving the dominant role for proper diversification.

These are not the only valid approaches, but rather offer two models to consider as a starting point for your plan.

The tax changes merely reinforce the traditional model. The lower tax rate on dividend income strengthens the reasons for focusing stocks in the taxable account, and focusing bonds and real estate funds in the IRA. As a more detailed fine-tuning technique, in the traditional model where practical, high turnover stock funds are placed in retirement accounts (preferably a Roth IRA). More tax-efficient funds are placed in the taxable account. These funds typically invest in larger, US companies, and often offer higher levels of dividend income. Again, the tax changes strengthen the traditional approach.

The more interesting question is **whether you should change your investment approach due to the tax act**. The most obvious questions are whether you should reduce your use of bonds, especially tax-exempt ones, and increase your use of (dividend paying) stocks. I consider the tax changes to be evolutionary, not revolutionary—I don't think that investors should make dramatic moves such as selling all of their bonds and buying loads of dividend-paying stocks, however they may wish to adjust their target allocations a bit. Do not let the tail wag the dog—don't buy a rotten stock just because it has a high dividend, and don't move a lot of money from bonds to stocks if you can't stomach the ups and **downs** of stocks. However I suspect that many investors have been paralyzed by investment indecision in the past year or two. Perhaps the tax changes will be enough to enable them to make decisions, even if the decision is to hold firm.

The tax law changes offer an opportunity to review your investment plan. Take the opportunity to examine how much risk your portfolio has, and whether you have considered methods to make your portfolio more tax-efficient. While you can not control the direction of the markets, you can manage the proportion of investment returns that make it to your pocket.

Does Anyone Really Vote Proxies?

Pam Baumbach

We do. A proxy is a shareholder's ballot to vote on company or mutual fund decisions. Many of our Wealth Management clients have accepted our offer to vote their proxies for them. This relieves them of the time to vote the proxies themselves, and/or of the guilt from not voting. We typically vote proxies the same for all clients, but can make exceptions where warranted.

From Good Idea to "The Law"

While we have followed informal guidelines for voting proxies in the past, the SEC ruled in March that effective August 6, 2003 any investment firm with the fiduciary responsibility to vote clients' proxies must have formal policies and procedures to ensure the proxies are voted in the best interest of the client. We are in the process of formalizing our policies and procedures, and will distribute the policy to our clients in the coming weeks.

What are typical questions raised on proxies? What factors do we consider when deciding how to vote on the issue?

Director Elections

Each year some, if not all, of the directors stand for election. In most cases there is exactly one candidate per seat. In the past we have focused on two issues, number of shares held and age. In this way we show support for directors who have a meaningful stake in the company on whose board they serve. We discriminate against older directors, voting against those who are 70 or older, with the single exception of Warren Buffett. In the future we will likely vote against candidates who hold both the CEO and Chairman positions, and we may vote against senior management in order to support increased independence of corporate boards.

Approval of Auditors

This issue had been a real snoozer until 2001, when Arthur Anderson was accused of neglecting to independently monitor Enron. Since then there has been a call for improved oversight by auditors. In the past we have supported auditors who have served in the past, assuming that they understand the company's issues better. We have also tried to understand situations where auditors change, usually a yellow flag. In the future, we will closely examine the balance of auditing and non-auditing work the auditors provide to each company in order to vote for auditors who appear to have sufficient independence.

Stock/Option Plans for Employees/Management/Board Members

These can be tricky issues. As shareholders, we do want these people to share a stake in the company, and have incentive to see the company's stock rise. However we do not want to have our share diluted unreasonably. As such, we favor stock plans to option plans, prefer that stock plans be broadly available (not only to top management), and prefer that all options are expensed to better reflect the true cost to the company of these forms of compensation. When the company is trailing its peer group, we will often vote against these plans to express our dissatisfaction.

Shareholders have the right to submit proposals. There are some common shareholder proposals, including:

Poison Pills

This is a legal technique that is normally dormant, but activates when a corporate takeover is proposed. When activated, shareholders who have held the stock for awhile (a year, for example), have greater voting rights than shareholders who recently acquired the stock. Poison pills have been introduced at many companies to discourage unfriendly takeovers, and help management retain control in these situations. Proposals to remove poison pills occur periodically. We typically support the removal of poison pills due to our conviction that pure democracy is the best approach for takeover issues.

Board Declassification and Cumulative Voting

These proposals are designed to make it easier to get rid of 'bad' directors of the board. Declassification forces all board members to be up for election each year, and with cumulative voting you can pool your votes for (or against) candidates you support (or oppose). We typically approve these proposals. Just this year some companies have initiated this proposal themselves, in order to raise their 'good corporate governance' scores.

Social Responsibility Issues

There are many issues in the 'socially responsible' arena. They can include environmental, discrimination, fair trade, safety, alternative energy, or animal rights, and often take the form of requesting management to provide an annual report on the company's activities in the area. We generally vote in favor of these proposals if we feel that they will provide useful information without having a detrimental impact on the company's finances or competitive position.

Each year we see an increasing number of shareholder proposals. It is encouraging to see apathy giving way to action. It feels like we can make a difference by exercising our right to have a say in big business. While the number of shares we vote are modest, there are many serious proposals that are sponsored by shareholders with even fewer shares. So, who really votes proxies? Everyone should.