The Mallard Flyer

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Announcements

Paul & Bill's Schedules: Paul and Bill will be attending a NAPFA Conference in Philadelphia, October 22-25. Paul will also attend a Managers Funds conference in Connecticut, November 19-20. He will also be out November 27-28 and from December 24th to January 2nd, although he expects to be checking faxes and e-mails.

Bill will be vacationing at Disney World from October 3rd to October 10th. Bill will be attending a Cambridge Advisors conference November 4-6.

Annual Disclosures: If you would like an updated version of our SEC Form ADV Part II, or Privacy Statement, please let us know and we will mail them to you.

Gotta Tip?

Paul Baumbach

I have probably heard as many bad jokes about TIPS (Treasury Inflation Protected Securities) as about Mallard. That is probably a good thing, for discussions surrounding bonds are traditionally quite boring, and TIPS are more complicated than most bonds. Levity may well complement this dry topic. In this article I will examine inflation, its history, its impact, its likely future, and what role TIPS can play in your portfolio.

Inflation used to matter. While the CPI, the consumer price index, rose by more than 10% in 1974, 1979, and 1980, it hasn't been higher than 3½% since 1990. You may be tempted to conclude that inflation is dead, is yesterday's battle, and that you need not worry about it. To make this determination, let's see how inflation has and might affect stocks and bonds.

Inflation matters to stocks. In previous periods of notable inflation, companies have been able to pass on much of their increased costs by raising the price of their products. This is called *pricing power*, and this has been absent in recent

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Frequently Asked Questions

Is the Conference You Are Planning Here Yet?
Paul has been chairing the planning committee (on which Bill serves) for over two years. The conference, the 19th annual NAPFA Northeast conference, will take place in Philadelphia from October 22nd to 25th. Bill has invited the director of the Delaware Money School (on whose board Bill also serves) to attend this excellent conference for Fee-Only advisors. While Paul expects to be furiously 'fighting fires' in the coming weeks, he hopes for a return to normalcy by November.

How Can I Learn More About Basic Estate Planning?
The new edition to the Mallard Advisors' Audio Seminar Series is now available. It is called ***Basic Estate Planning*** and serves as an educational supplement for our clients going through the financial planning process. The seminar covers topics such as: Why You Need A Will, How Assets Transfer At Death, Trusts, and Selecting Fiduciaries. You can hear a sample from the CD at our website, or stop by to pick up a copy. Also, the first audio seminar CD titled ***Creative Budgeting*** is also available to all of our clients.

Is there a new fax number?
Yes, 302-397-2675. This is a high-tech eFax service which is much more reliable (and less likely to issue a high-pitched tone in your ear).

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years. Technology prices decline every year, car prices are declining 2% a year, and the internet has made comparison shopping easy. Thus when inflation next rises, companies will likely have a much harder time coping than in the past, due to their weak pricing power.

Inflation matters to bonds—a lot. As anyone with a mortgage knows, interest rates they pay have fallen sharply in the past few years. Bond investors similarly have seen interest rates they receive fall. When bond rates are low, inflation (even low inflation) takes a larger bite out of returns; a 2% inflation rate takes a third of the return when bond rates are at 6%, but a full half when bond rates fall to 4%. Should rates remain low for a while, and should inflation rise, bond investors will find it very difficult to out-earn inflation.

We thus would like to know 1) what could cause inflation to remain low, 2) what could cause it to rise, and 3) which direction it is likely to head.

Why might inflation remain low? If the current course continues (low pricing power by companies, due to easy comparison shopping; and low manufacturing costs, due to China's ability to make just about everything cheap), then inflation may remain in the 1% to 3% annual range.

Why might inflation rise? The primary suspect is the U.S. budget deficit. Should this continue unabated, the Treasury will need to print money faster and faster, making it less and less valuable, the definition of inflation. There are additional causes, including foreign investors shifting money away from the U.S.

Some view the **trade deficit** as a serious problem, and the U.S. and other leading governments have begun pressuring China to permit its currency to appreciate freely, rather than to continue to be pegged at 8.28 Yuan to the U.S. dollar. However, if China were to let the Yuan move with the market, then global manufacturing costs would rise. You may recall this as one of the two factors listed above that is keeping inflation low.

For these reasons, **I expect inflation to rise in the coming few years**, at least to 3%. Five-year treasury bonds are paying 3% today. Once inflation gets to 3%, that 3% yield will only enable you to tread water. That doesn't seem like a good investment to me. Ten-year treasuries yield 4%. That, too, seems paltry.

So what should an investor do for the bond portion of their portfolio when inflation is rising? Time for a TIP—TIPS are treasury bonds with a twist; they pay an interest rate **plus** a measure of inflation (CPI). Compared with treasuries, their interest rate appears low, but this is misleading since it is supplemented by the CPI 'kicker'. Thus while TIPS interest rates are about 2% less than normal treasury bonds, as long as inflation is at least 2% they will return as much as normal treasuries, and most importantly, should inflation rise to 3% or more, TIPS (when you include the CPI kicker) will outperform normal treasury bonds.

What are some downsides to TIPS? **TIPS are complicated**. The way they pay investors is convoluted, and the taxation is aggressive. For this reason I recommend, when possible, investors use TIPS in tax-sheltered accounts such as IRAs. Another disadvantage is that since TIPS have only been around since 1997, and since inflation has been tame during those years, you cannot see how TIPS have performed during inflationary periods.

Why not Gold? When I worked with Richard May at RKM Advisors, we used a three-legged stool to protect portfolios against inflation. One leg was real estate (through REITs and real estate funds), another was natural resource (including energy) funds, and the last leg was gold and precious metals funds. In the past several years I have come to the conclusion that while gold was a very good hedge against inflation during the 1970s, gold's price is no longer driven primarily by inflation. Its price is also affected by other factors, including sales/purchases by central banks, hedge fund activity, and manic investors chasing yesterday's star. These other factors have often overwhelmed gold's success in hedging inflation. I therefore have stopped using gold (and precious metals) funds as inflation hedges. TIPS, however, are by definition excellent ways to protect a portfolio from inflation.

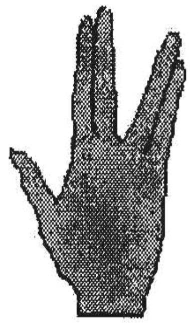
My TIPS—I have begun recommending that clients start building TIPS into the bond portion of their retirement portfolios. This gradual approach can better handle volatility in TIPS yields in the coming years. I expect at least half of my clients' bond holdings within IRAs to be TIPS and TIPS funds by 2008.

Paul Baumbach is the managing partner of Mallard Advisors' Wealth Management Division.

Live Long and Prosper

Bill Starnes

When the Vulcans made initial contact with the human race in the movie *First Contact*, the words "Live Long and Prosper" were the first words spoken as they exited their space-craft. No, I'm not a Star Trek geek, just a big fan. For many reasons, our prospects of a long life seem almost inevitable, but it will be up to each of us to ensure that we prosper during these many years.



Death is the great mystery as it comes to each of us in our own due time. Family members, friends, enemies, strangers, and even the rich and famous cannot avoid it. Mortality as a fact of life is closely related to virtually all aspects of financial planning work. To generate a sensible combination of financial planning recommendations, mortality is one of the many factors that must be considered. In fact, I quickly think of life expectancy when I hear questions such as:

- Should I take the lump sum or the pension income option from my employer?
- What survivor option should I elect with my pension?
- How much can we spend in retirement?
- When should I begin taking Social Security?

With such ubiquity, it would seem that an understanding of life expectancy is essential to any of us considering major life-impacting decisions.

As you know, we explore the issue of mortality as part of the planning process. We discuss medical history and family history in an attempt to go beyond the actuarial tables (remember, half of all of us will outlive the mortality table's mortality age) to capture a mortality age that we all feel is realistic.

How Life Expectancies Will Change.
Life spans have been increasing annually at about 0.67 percent. Developments in medical science, at least in the developed nations, will easily lead to longer and healthier lives. But how long is long?

Futurist, Peter Schwartz, in his new book *Inevitable Surprises*, discusses the issue of life expectancy. He says that life expectancy changes due to medical advances will begin having a significant impact beginning as early as 2007. He says, "It is certainly plausible that a significant number of human beings might live to age 150 by the year 2125. More likely, we will find ourselves able (with some medical interventions) to live to 120, and our children to live to 150. Even if none of this comes to pass, however, it is inevitable that a significant number of people in industrialized countries will live to 100. A society in which millions of people routinely live past 100 or 110 would be significantly different from any society that human beings have ever previously known."

So what changes will result in this longevity? Schwartz discusses two avenues of research that seem suggestive of this inevitability in the future. The first is cellular metabolism and the second has to do with regeneration and replacement of human cells and tissue. In addition, diseases that are fatal today will likely be eliminated including cancer, Alzheimers, diabetes, heart disease, and a number of infectious diseases.

How Will A Longer Life Expectancy Affect You?
How will a longer than anticipated life expectancy affect you? Consider the following:

- Will you want to "fully retire" at 55, 60, 65 or 70? In the 1970's when the average life expectancy was 70, it made sense to retire fully to enjoy a few well-earned years of rest and relaxation. But what if you can expect to live vigorously until age 100 or beyond? Retirement will no longer be about just rest and relaxation, but filled with education, adventure, alternative employment, and activity.
- How will your pension stay funded if many more of the recipients live much longer than the actuaries expected?
- How will longevity affect the already pressurized social programs of Social Security and Medicare?
- Will you have to work much longer than expected because you have to, and not because you want to?
- Will the old rule of thumb about the division of stocks versus bonds (100 minus your age) change to (150 minus your age) ensure you have a healthy dose of equities to help your portfolio last longer?
- Will annuitizing all of your assets (hopefully with a very secure insurance company) end up being the best investment of your life?

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Estimating Your Own Life Expectancy
What will your life expectancy be? No survey, actuarial table, questionnaire, or even your family history can predict your lifespan. "The genes you inherit determine about 20 percent of your life span; your lifestyle choices decide the rest," says Dr. Walter M. Bortz, past president of the American Geriatrics Society.

One rule of thumb (if you are male) is to take your father's age at their death, and the age of your father's father at their death (if they died of natural causes), average the results together, and add 10 years. If you are female, use your mother and your mother's mother.

There are also some "fun" on-line life expectancy surveys on the Internet. My favorite is Dean P. Foster's home page (http://gosset.wharton.upenn.edu/~foster/). From his page you can drill down to the "Life Calculator". Because an understanding of life expectancy can help us do a better job planning together, I would be thrilled if you sent me your individual results.

Do we need to re-run your plan assuming a mortality age of 125? I don't think so. What you want to do is ask yourself (after reflecting on your survey results, own lifestyle, and family history); "What is the longest I could see myself living". Then, you will likely have a reasonably conservative estimate of your own life expectancy.
We can then plan even better for your prosperous longevity.

Bill Starnes is the managing partner of Mallard Advisors' Financial Planning Division.

What Is This Mutual Fund Blow-Up?

Paul Baumbach & Bill Starnes

In early September Eliot Spitzer, the NY Attorney General, accused four mutual fund families of trading abuses. These families are Bank One (One Group funds), Bank of America (Nations Funds), Janus, and Strong. In the case of Bank of America/Nations Funds, in our opinion, the alleged actions were appalling and clearly crossed the line. Moreover, numerous people at the firm appear to have been aware of what was going on. With respect to the other three fund companies, the behavior also clearly crossed the line, but not as far.

The vast majority of fund companies that we know of are run in a basically ethical manner. However, in a business that has been enormously profitable for quite some time, the standards for measuring ethics have declined. In our view the situation can be summed up by simply asking the following question:

Does the fund company run their funds with the objective of considering shareholders' interests first and only then seek to maximize their profits? Or, do they seek to maximize their profits first and do the best they can for shareholders as a secondary objective? For many it is the latter.

In spite of these problems there are a number of great mutual funds out there and funds will continue to be valuable investment vehicles for investors. In addition, the ethics issues now in the headlines will result in continued pressures for some positive change in the industry. We've always included business and ethical considerations as part of our fund due diligence work.

Mallard clients' exposure to these groups is limited to Janus Growth & Income, One Group Ultra, Marsico Focus, some of the Strong bond funds, and several Nations funds within a 'captive' 401(k) account. There is no certain method to avoid well-crafted fraud. None of our clients' funds appear to have been affected by the alleged abuses. We will continue to monitor the organizations that manage our clients' mutual funds, and are pleased that the tools we use are increasing their attention to corporate governance issues.