The Mallard Flyer

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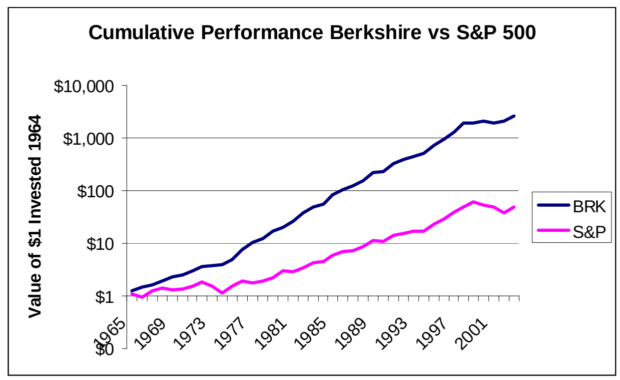
Paul Baumbach

Eight years ago I began a tradition of reporting to you some nuggets of wisdom I found in the Berkshire Hathaway (based in Omaha, Nebraska) annual report written by legendary investor **Warren Buffett**. He has earned his reputation in the past 39 years by leading Berkshire to more than double the results of the S&P 500 (22% annually versus 10%), despite lagging the S&P in 2003. All of the quotes from this article come from the Chairman's Letter in the 2003 Berkshire Hathaway Annual Report. The reason that I like to review his report is that Warren can often raise complex investment issues in a very clear manner, and further that I greatly admire his investment approach and results.



Bear Market Pointers—Buffett continues to share lessons learned during The Great Bubble. Berkshire has several large holdings in public companies, including Coca Cola, American Express, Gillette, and Wells Fargo. Buffett considers the portfolio fairly valued, but points out 'If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I.'

Warren admits that very few avoided being caught up in the hype of the late 1990s; that he was not immune. I often tell clients that we are all cursed with an investment weakness—being human. As such, it is very hard for us to restrain ourselves when things are going well, or to stick to a plan when things are looking dreadful (let alone adding dollars to a sinking market).

Low Interest Rates—Buffett notes that he and other investors had a tough time in 2003 due to the 'pathetically low interest rates' on money markets, 'a condition that will not last'. However he is unapologetic about having a large allocation to cash: 'It's a painful condition to be in – but not as painful as doing something stupid. (I speak from experience.)' I, too, have maintained fairly high levels of money markets and

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Announcements

Pictures of Bill and his family fill two pages of the latest issue of *Kiplinger's Personal Finance* in an article in which Bill was interviewed. The article, titled, "Smart Choices For Future Scholars" is about what financial professionals have to say about the alternatives to 529 savings plans (e.g., Delaware College Investment Plan).

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very short-term bond funds for clients. Low interest rates do compel us to search harder for yield from safer investments, but they do **not** justify jumping to risky investments.

Buffett's Betting Against the Buck—Buffett notes that Berkshire invested in foreign currencies for the first time in 2003, 'as I became increasingly bearish on the dollar. I should note that the cemetery for seers has a huge section set aside for macro forecasters' (macro forecasters predict broad trends such as exchange rates, interest rates, and rates of inflation). He and many others fear that the trade and fiscal deficit the US runs jeopardize our country's future economic strength. 'As an American, I hope there is a benign ending to this problem', yet in 2003 Berkshire began to hedge its bets. I have included non-US bonds in most client portfolios. In 2003 I began using a bond fund which is global, able to shift into and out of the dollar as the manager sees fit.

Corporate Mismanagement—Buffett continued his criticism of **corporate governance**. He blasts the level of executive pay, pointing to the failure of compensation committees on corporate boards to act responsibly when setting executive pay. He faults the system in which 'the negotiation has a "play-money" quality'—four million sounds too low, let's make it six!

Buffett's last assault is on the **mutual fund industry**, where it seems like a new investigation is launched weekly into funds that 'trampled on the interests of fund shareholders in an appalling manner.' Warren is especially incensed that despite the wealth of evidence of malfeasance by fund managers, no mutual fund board has terminated the contract of the offending management company. Buffett points out that many directors receiving 20%, 30%, or even 50% of their total income from director fees can still be deemed independent by the current rules, and that this is 'nonsense'. He suggests that mutual fund directors annually affirm that 1) they have looked at other management companies and feel that this is one of the better ones, and 2) they have negotiated a fair fee. Don't hold your breath.

Putnam is one of the most prominent mutual fund families found guilty of abuses. The Mallard approach places priority on factors such as stable management, superior after-expense results, and consistency/style purity. As Fee-Only™ advisors, we naturally steer clear of high-expense fund families such as Putnam, since they benefit salespersons more than investors.

Move Over Oprah—This is the first year that I recall Warren sharing his book picks. He mentions Bull! by Maggie Mahar describing The Great Bubble, The Smartest Guys in the Room by Bethany McLean and Peter Elkind, describing the Enron fiasco, and In An Uncertain World by past Treasury Secretary and Wall Street executive Bob Rubin, covering 'what happens when politics and economics intersect' (this is a quote from Warren's review of the book I found on Amazon.com). Buffett also recommends the recent revision of classic The Intelligent Investor by Benjamin Graham. All four are very highly rated by Amazon readers. I am hopeful that I will have read them all before next year's list comes out.

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

The Gift That Keeps On Giving

Margaret Badger

Non-cash charitable donations may be the most overlooked tax deduction in America. Whatever your family has grown out of, grown tired of, or grown enough of, may be passed on, leaving a pristine place and a good feeling in its wake.

But giving can give you even more. If you itemize, you are permitted to take a deduction of the fair market value of items given to charity. Most of us give away bags of clothes and other household items each year, but we miss out on tax savings because we don't know their real fair market value.

To solve this dilemma, Intuit has a tax software program called **It's Deductible** which has compiled a comprehensive fair market valuation on thousands of items, in accordance with IRS guidelines. The assessments I have done this year with **It's Deductible** have resulted in values which translated to tax savings that are several hundred dollars more than the givers anticipated.

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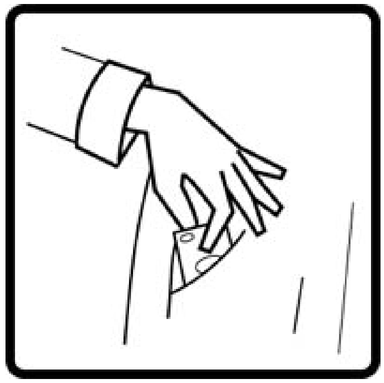
Who's Hand Is In Your Pocket ?

Bill Starnes



Glenn Daily, a fee-only life insurance consultant has created the universal symbol of financial services: a hand reaching into your pocket. As you know we believe in working with our clients with two hands on the table (and none in your pocket). We do this by telling you what our fee is (in dollars) and what services you can expect to receive. Unfortunately, as illustrated in the logo to the right, in the financial services industry this is hard to come by.

This is most obvious in the insurance and investment industries. However, it is more pervasive than just these two industries. Recently I sold my home in Delaware and purchased one in Pennsylvania. This drew my attention to several other "hand in pocket" players in the real estate industry. As you are reading the rest of this article please note my main point: understand how people are paid as that will uncover their motivations and the conflicts between your financial security and theirs.

Real Estate Agents
Without real estate agents, I would be sur-

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The range of items evaluated, from wedding dresses to varieties of flutes, from tennis rackets to kitchenware, has increased from last year's program. Electronics can also be evaluated, through an online deluxe feature (costing $10 more) that taps into the most recent information. For items that **It's Deductible** does not evaluate, there are simple steps to gauging your own assessment. As an example, several online tools can help you arrive at a recommended value of a car that you donate.

In addition, **It's Deductible** will keep track of medical expenses, monetary donations, property donations and evaluate educators' tax deductions.

"I'm proud to be paying taxes in the United States. The only thing is I could be just as proud - for half the money."—Arthur Godfrey

It's Deductible and its key competitor, **DeductionPro** from H&R Block, both bravely claim to save you $300 more than you currently anticipate your donations are worth. Both programs cost around $20. A March 2004 Wall Street Journal article compared the two products, and found the **It's Deductible** program superior based on its ease of use, and comprehensive database.

Like firewood that warms you twice (once when you chop, stack or haul, and once when you burn it), donating is endlessly worth your while: stack your items and make a list (take a picture for your records, It's Deductible will apply your digital photos right on your print out), haul your items to the charity of your choice, get a receipt, deduct the mileage to and from, sit fueling your computer file with your list of items, and let the warmth of the savings seep into your purse strings. Contributing to the availability of consumer goods helps to support our society, as does paying income taxes—but which do you prefer?

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prised if ¼ of real estate sales would ever occur. Agents have one primary motivation – getting to the settlement table. It only takes an understanding of how they are paid to uncover their motivation. Agents are paid a percentage of the sales price, therefore the house must sell. Most people think that real estate agents are motivated to get the highest sales price (since their fees are a percentage of the sales price). Not true. Agents motivation lies in getting the deal done, not sabotaging it by irritating the other party. An agent would much prefer that you lower the price of your home by $10,000 than lose the deal. Six percent of $10,000 is only $600 and the agent may be lucky to receive ¼ of this ($150).

Real estate listing agents get paid a percentage, but the reality is that this percentage translates into real dollars. 6% of a $300,000 house is $18,000. That fee is spread around between the seller's agent, buyer's agent, seller's broker, and buyer's broker. Each sees about ¼ of the commission. The system is so good at reaching into your pocket that it doesn't even feel like your pocket. This is because you don't perform the transaction and then pay the agent. Instead, their fee comes right out of the sales proceeds before you even see the proceeds. Again, agents are necessary, but you better understand their motivations.

Mortgage Brokers

A mortgage broker shops for the best mortgage deal for you – great! Unfortunately, the mortgage broker may be shopping for the best deal for himself. It is easy to get seduced by the lowest rate offerings on www.bankrate.com, but you will likely find brokers who provide no service, or try to push a particular mortgage product. Why? They get a bigger cut from the lender for that particular product. Recently a mortgage broker tried to sell me a mortgage product had so many bells and whistles it sounded more like one of those magical life insurance policies guaranteed to solve all of your financial problems. Typically, the more "magical", the higher the commision.

Again, all it takes to understand the conflict of interest is to understand how the mortgage brokers are paid. While it seems that they are working for you by negotiating with many lenders to find the best loan for you, their compensation is based upon how much money they can get out of you. This can be either in the form of a higher interest rate or through additional points. Generally, the higher the rates or points the broker can get you to pay, the higher the commission the broker gets from the lender. In other words, the broker's motivation is not to get you the best deal, but to push you into a costlier loan than necessary.

Fortunately, there are ethical mortgage brokers who will disclose their fees up front and I can provide you with a name if you ever desire.

The Government

If a financial transaction is going on, you can bet that Uncle Sam will also have his hand in your pocket – it is called transfer tax. Your share of this tax on a sale will be 1.5% and on the purchase will be another 1.5%. Unlike broker fees it cannot be negotiated or eliminated. Like a broker's fee it is quoted as a percentage and is taken right out of the sales proceeds. Why are fees taken right out of proceeds? For the same reason taxes are taken right out of your pay…it is far easier to collect the fee than to ask you to write a check. To quote Baptiste Colbert, comptroller general of finance to Louis XIV of France, 1665 to 1669:

"The art of taxation is to pluck the goose so as to obtain the most feathers with the least amount of hissing."

I agree, but would change the line as it relates to the financial services industry to; *The art of collecting fees is to pluck the goose's feathers from where the goose won't notice they are missing.*

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