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**ADVISORS, LLC**

# THE MALLARD FLYER

PAUL S. BAUMBACH – MANAGING PARTNER – WEALTH MANAGEMENT DIVISION  
WILLIAM D. STARNES – MANAGING PARTNER – FINANCIAL PLANNING DIVISION

273 EAST MAIN STREET, SUITE E, NEWARK, DE 19711-7331  
(PH) 302-737-4546 · (FAX) 302-397-2675  
WWW.MALLARDADVISORS.COM · INFO@MALLARDADVISORS.COM

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## The Trade-Off

Bill Starnes

One of the most basic investing relationships is that of risk and reward. Investments that offer potentially higher returns are accompanied by higher risk factors. In the book, *The Intelligent Asset Allocator* by William Bernstein, the author shares a simple, yet powerful, analogy regarding risk and return:

“Imagine that you work for your rich but eccentric Uncle Fred. He is a conscientious and kind employer, and after some years in his service he decides to let you in on the company pension plan. You are 30 years old and will work for your uncle until you retire in 35 years at age 65. Each year he will contribute \$5,000 to your retirement account. Further, you must pick ahead of time one of two investment choices for the duration of your employment:

1. Certificates of deposit with a 3% annualized rate of return, or,
2. A most peculiar option: At the end of each year Uncle Fred flips a coin. Heads you receive a 30% investment return for that year, tails a minus 10% (loss) for the year. This will be hereafter referred to as "Uncle Fred's coin toss," or simply, the "coin toss."

The first choice gives you a fixed rate of return, and in fact an absolutely certain lump sum at the end of your 35 years. You are adept with a financial calculator, and in a few seconds determine that this option will yield a sum of \$302,310 with which to support your golden years. You realize that inflation will diminish the future value of this princely sum. In fact, if inflation is also 3%, you will be left with only \$107,436 of current spending power.

The second choice confuses you at first. The thought of losing 10% of your hard-earned retirement money with the toss of a coin is too much to bear. What if you have a string of losing years? If you get tails all 35 years, you could be left with only a pittance for your retirement. On the other hand, if you get heads all 35 years you know that you will bankrupt poor Uncle Fred with

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## Notices

### Paul's Schedule:

Paul will be taking several long weekends in August (including August 4th-8th), camping, and heading to the beach.

### Bill's Schedule:

Bill will be in Cape May, New Jersey the week of July 12th-16th. Bill will also be out of the office August 6th camping.

### Office Closings:

The office will be closed Friday afternoon on August 6th.

### Next Newsletter:

The next quarterly newsletter is scheduled for distribution on Wednesday, October 6th.

## Announcements

### Bill Asked To Write For the Delaware Money School

Bill has been asked by the Delaware Money School to write a series of articles on finding a financial advisor. The first in the series, *Who Needs A Financial Advisor*, appeared in the July-September issue. The Money School is a community based effort to provide objective free financial education in a hassle-free environment. Each quarter about 80 classes are offered on a variety of financial topics. If you would like a copy of the most recent issue, you may request one at 302-792-1200.

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your gains—he will owe you \$162,000,000!”

Mr. Bernstein’s analogy is nearly identical to the choice each of us face when deciding between the “safety” of cash equivalents and the “gamble” of investing in stocks. If over the 35 years, you flipped heads 50% of the time and tails 50% of the time (ignoring the sequence of flips for simplicity); you would achieve an annualized rate of return of 8.17%. Therefore, the second option offers the chance of superior returns but with the small risk of even poorer results than option one. In addition, you must experience the emotional angst of flipping the coin knowing that in the shorter-term losses can mount. However, it is the 3% return which is even more frightening when you consider that after inflation the 30 year old will most certainly eventually be old and broke.

The story illustrates rather accurately the trade-off between risk and return. A fundamental law of investing is that in the long-run you are compensated for bearing risk. Conversely, if you seek safety, your returns will be low. Risk and reward are intertwined and cannot be

separated. In fact, Bernstein points out that if an “advisor” suggests they can obtain high returns with very little risk, you should make for the door.

Some are in the enviable position of not having to take on any investment risk. However, most of us must strike that delicate balance between risk and desired returns. That balance (typically called your investment policy) is expressed in the allocation of your total investment assets across stocks and bonds/cash. It is developed after considering many factors, including your financial security, desire to leave an inheritance, comfort with volatility, amount of time until the dollars are needed, etc.

Now, with the “market” in fair-value range, it may be a good time to re-evaluate your comfort with the shorter-term risk that the investment markets provide while recognizing how that decision can affect your future returns.



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

## U.S. Savings Bonds—EE or I

**Bill Starnes**

With both EE savings bonds and I savings bond available from the U.S. Treasury, many clients ask which they should buy.

### Why Buy U.S. Savings Bonds

Well, everyone should have cash. Of that cash, so much should be fully liquid and accessible (i.e., checking, savings, money markets) in order to cover your month to month needs. Your remaining cash (i.e., emergency cash) should be in the safest, yet highest yielding (after-taxes) cash equivalent available. In addition, your emergency cash should not burn a hole in your pocket when the next quasi “emergency” comes along. U.S. savings bonds fit the bill for emergency cash in that they are backed by the full faith of the U.S. government, are high-yielding, tax-favored, and fairly liquid - yet they don’t “feel” liquid.

### EE & I Bond Differences

First let’s review the differences between the EE and the I.

**Interest** – Interest on EE bonds are based on 90% of the five-year Treasury yield and is reset each month. In other words, you get a good yield and future interest rate protection. Currently the EE bond rate is 2.84%. The I bond has two parts to the

interest: a fixed rate assigned at the purchase and remaining for the life of the bond and an inflation indexed rate that is adjusted every six months based on changes in the CPI. The fixed rate is the “real” (i.e., after inflation) return that an investor would receive. Currently the I bond rate is 3.39% with a 1% fixed rate and a 2.38% inflation rate.

**Purchase Price** – EE bonds are purchased at ½ the face value whereas I bonds are purchase for 100% of the face value (you pay \$100 for an I bond with a \$100 face value). This is why you occasionally hear of give-aways of \$10,000 in U.S. savings bonds. In reality, the bonds only cost \$5,000 for the promoter, but they advertise double the amount in face value.

**Purchase Limitation** – You can spend \$30,000 (\$60,000 face amount) on EE bonds, while you can spend \$30,000 (\$30,000 face amount) on I bonds. These limitations are per registration (i.e., person), per year.

### EE & I Similarities

- They both earn interest **Continued On Page 3**

In April I attended the NAPFA National conference in Toronto. NAPFA is the national Fee-Only financial planning organization to which Bill and I belong, the same one whose 2003 Northeast conference we organized last October. One of the reasons that I signed up for the Toronto conference was the **first-rate speakers** who were presenting, including Burton Malkiel.

Malkiel is the Princeton University professor who wrote **A Random Walk Down Wall Street** thirty years ago. This book, now in its 8<sup>th</sup> edition, argues strongly that investing offers no free lunches. In Toronto, Malkiel restated the book's premise: 'a blindfolded monkey can throw a dart at the stock pages in a newspaper and do as well as a stock analyst'. I read this book as part of my CFA™ studies; it is extremely good.

Malkiel's book is based on the theory that **the stock market is efficient**, that all useful information is 'in the market' (already reflected in the stock prices), and that you can't prove that analysts who study stocks are able to separate stocks going up from stocks that go down.

In recent years the field of behavioral finance has shown that **most of us believe that we are slightly better than average** at any given task—my choice for a lottery number is better than yours, I'm a better driver than most folks, my choice for a stock is likely to outperform, .... There are numerous studies which show that our confidence is often misplaced. It reminds me of the *Prairie Home Companion's* Lake Wobegon, where everybody's children are above average—this is fiction by definition.

Malkiel does not dispute the presence of superior stocks, analysts, managers. He challenges your ability to identify them in advance. "We don't know who **tomorrow's** Warren Buffett is". In the past 33 years, less than 4% of mutual funds still in existence outperformed the S&P 500 by 2% a year or more. So, how much work will you do to chase that slight 4% chance that

you'll find that perfect manager? The odds are against you!

Malkiel feels that **expenses and turnover matter** very much, even for IRA/401k/403b investing. He estimates that a fund with 100% annual turnover (such as from the average large-cap US stock fund) gives up 1% in annual returns.

In times when returns from investments are low, expenses take a larger cut. Malkiel feels that **expenses matter even more in the future**, since he expects that we are in a 'single digit world', where future annual returns from stocks will be between 7 and 8%, and 4-6% for high quality bonds.

Charles Ellis, in his (terrific) book **Winning the Losers Game**, extends Malkiel's thesis by explaining how individual **investors can achieve their financial goals without trying to 'beat the market'**. He emphasizes keeping expenses and turnover low, and abandoning performance chasing (hot managers, stocks).

Designed partially in reaction to Malkiel's work on market efficiency, index funds are designed to keep expenses and turnover low. Malkiel notes that it is not that simple—index selection and index composition matters. He strongly prefers **'free-float' indices** to pure cap-weighted ones. Many companies own significant holdings of shares in other companies (such as the portion of McDonalds held by Berkshire Hathaway). These shares that are held by other companies are excluded from free-float indices but are included in cap-weighted ones. This makes **free-float indices more representative of shares actually being traded**.

The international MSCI EAFE index was altered a few years ago to reflect free-float, and international stock managers who had regularly beat the old EAFE are having a very difficult time keeping up with the 'new EAFE'. S&P is considering adjusting their indices to reflect free-

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## U.S. Savings Bonds... Continued From Page 2

for 30 years.

- The interest income does not have to be reported for federal tax-purposes each year, rather it accrues (i.e., they are federally tax-deferred).
- They are both state tax-free.
- You must hold them for one year prior to cashing them in.
- There is a three month interest penalty if cashed within five years.
- Rates are updated each May and November.
- There are no fees or commissions.
- They can be used tax-free for education if several conditions are met.

### Which Bonds Should I Buy?

In the book *U.S. Savings Bonds*, Daniel Peterson examined the returns of both bonds in a historical context. What he discovered was that the EE bond has returned an average of 2% greater than inflation. Since the fixed rate of the I bond is now only 1% (the fixed rate was originally 3.4% in 1998!) he currently gives an edge to the EE bond. However, his study was during a time of lower inflation (the last 15 years). In addition, savings bonds are typically held for the long-term, therefore, EE and I bonds will leap-frog each other during various time periods depending on the level of interest rates and inflation.

Therefore, I recommend that bond buyers split their purchases equally between I and EE bonds, getting protection from both inflation and interest rates.

## Efficiency Expert...Continued From Page 3

float, providing further support for Malkiel's point that **index composition matters**.

Speakers at conferences such as Toronto provide me with the opportunity to **challenge my thinking**, and often to improve the Mallard approach with a new twist. At Mallard I already use index funds in most accounts, primarily for large-cap US stocks. In the future, I will consider broader indices (with lower turnover) for US stocks. I expect to increase my use of international (free-float) index funds. Despite Malkiel's sup-

port for indexing all stock exposure, I am less likely to index smaller-cap US since smaller-cap US stock funds have enjoyed more success in outperforming their benchmark indices than large-caps. I will, however, keep my ears open in case small-cap indices become harder to beat (more efficient) the way that international has become.

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



## The Great Debate

At the recent NAPFA National conference in Toronto, the biggest draw was The Great Debate, between professors **Jeremy Siegel and Zvi Bodie**. In this article I review some of the top points made by each, including Siegel's expectations of future investment returns.

Both had studied under MIT professor and Nobel Prize in Economics recipient Paul Samuelson. Siegel is the oft-heard stock-enthusiast, author of Stocks for the Long Run. He often points to his Wall Street Journal editorial in March 2000 questioning whether technology stocks were over-valued. Bodie co-authored one of my CFA textbooks, Investments, and has received press lately by raising fundamental objections to current investment practices.

Zvi Bodie offered a **strong rejection of traditional portfolio design** (as proposed by both Siegel, and William Bernstein, whose work Bill reviews in his "Trade-Off" article in this issue). He suggests that **the 60/40 paradigm** (60% invested in stocks, 40% in bonds) for the average investor is **invalid**, if not ludicrous. He feels that this is analogous to, when preparing dinner, deciding what ratio you want of flour and egg. Shouldn't you first ask what you are making?

Bodie recommends that portfolios be constructed in the same manner as many pension funds, based on **projected cash flows**. If you know that you will need \$40,000 a year beginning in 2010, then buy individual bonds or another investment which will deliver the required cash flow with the level of certainty you desire. Only after the expected withdrawals are matched with specific assets that will provide the required cash flow can the remainder of the portfolio be invested for growth/risk.

Jeremy Siegel held firm to his conviction that the **higher expected future returns of stocks justify placing a healthy amount of stocks in the average investor's portfolio**. He expects short term bonds to outperform inflation by 2% annually, intermediate term bonds by 3 to 3.5%, and for stocks to outperform by 5 to 6% annually.

Siegel concurs with Malkiel (see my "Efficiency Expert" arti-

cle) that we are in a single-digit world. He recommends that 1/4 to 1/3 of stocks should be invested overseas, and he feels that a 20 PE is justified for US stock markets; it is currently almost 22, indicating that stocks are either a little overvalued, or their earnings need to rise a bit to justify the markets' current level.

As usual, I found myself in the middle of the debate, obtaining value from both perspectives, but also feeling that pure allegiance to either is inadvisable if not dangerous. I agree with Bodie that an investment policy which disregards the flow of money into and out of a portfolio is a recipe for disaster. I also agree with Bodie that risk tolerance is not simply based on the investor's time horizon. Yet I find that Bodie has too little real-world grounding. There are few if any investment solutions currently available that investors can use to follow his recommendation. More worrisome, Bodie is unconcerned with 'underperformance regret'. How would you feel if in forty years, all of your cash flow needs had been met, but in your last days you are left with \$100,000 having earned 5.0% a year in the past forty, while your twin has a more rocky road, but still has \$750,000 left because she invested for more growth and averaged 7.25% a year?

Siegel does a nice job of sorting through decades of data to provide strong historical perspective during uneasy times. I appreciate the well-reasoned projected returns he shares. As with Bodie, Siegel comes across as too academic. He appears unconcerned with a different 'underperformance regret'. If your twin earned the stable 5% a year and ends on her last day with \$100,000, how would you feel if you had a more rocky road, and due to a rough bear market at the start or end of your investing life, in your last days you were down to \$10,000?

Speakers who present both sides of an issue are rarely invited back, and a discussion between two couldn't be billed as The Great Debate. It was no surprise that each presented a drastically different perspective. While I reject either speaker's total message, I found that each offered valuable insight that helps me create my mosaic view of investing and wealth management.