MALLARD ADVISORS, LLC

The Mallard Flyer

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October 2004

Notices

Paul's Schedule:
Paul and Pam will be at the 2004 NAPFA Northeast Regional conference in Mystic, CT, from October 20th to 24th. Paul will likely be at the 2004 Meet The Managers Conference in Stamford, CT, on November 17th and 18th. Paul will be out on election day, November 2nd, and Pam and Paul will be out of the office for much of the time from December 24th through January 2nd.

Bill's Schedule:
Bill will be out the afternoon of Friday, October 22nd, and all day Friday, November 5th.

Bill will be attending the Purses to Portfolios conference on Saturday, October 23rd, at the Bank One Center on the Riverfront. Bill will be staffing the NAPFA booth promoting Fee-Only, comprehensive financial planning.

Election Prognostications

Paul Baumbach

'Tis the season. Let me share my predictions for the investing world as of November 3rd, 2004, the day after the national elections here in the US.

Life will go on. The world does not revolve around the Presidential elections, despite what the media and the candidates say. Even if the candidate you favor does not win, investors will continue to save, consumers will continue to spend, businesses will continue to hire and fire workers, and to spend money on plants and equipment.

The President of the U.S. for the next four years will finally be decided, at least eventually. While recounts and legal battles could occur, our country has a structure to settle these questions.

Regardless of whether John Kerry or George W. Bush wins (I will go out on a limb and predict that Ralph Nader will **not** receive 270 electoral votes in November), **the economy will continue to move forward**. Steering the US economy has been compared with steering an aircraft carrier. It is reacting now to federal funds rate cuts that began in early 2001 and continued through 2003, and also to income tax cuts enacted in the past four years. Regardless of who wins, **Alan Greenspan** and the Federal Reserve Bank will continue their never-ending quest of moderation for the US economy. I sleep better at night knowing this.

Which candidate does the 'market' prefer? Conventional wisdom holds that the **markets would react** more unfavorably should John Kerry win. I expect that the market reaction to a Kerry victory would be smaller than predicted/feared. Should John Kerry become the next President, he will be constrained by a Republican House of Representatives, and

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Announcements

We are expanding our office space. On October 1st, we will be boosting our size from 700 to 1,300 square feet, with the addition of the three rooms adjacent to our existing five. Paul's Wealth Management Division will utilize the new three rooms, while Bill's Financial Planning Division will utilize a much larger amount of the existing rooms. We expect to complete the move by Halloween, including establishing a second conference room to help reduce conflicts when scheduling meetings.

We are excited about having enough space for our current needs and future growth. Both Divisions have **brochures which you can use to share** with any family, friends, and colleagues who might benefit from our personalized services. Call our office if you would like us to send any brochures to you.

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likely a Republican Senate. A Democratic President and Republican Congress would most likely lead to **gridlock**, and legislative economic surprises (which the market despises) are unlikely.

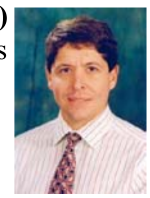
Should President Bush be re-elected, with a neutral if not supportive Congress, the markets will likely be satisfied, if not pleased. The reason is that this would be a continuation of the past four years, and, all else being equal, the markets hate change. Furthermore, the **markets generally prefer fiscally conservative agendas**, which have been more common in the past with Republican administrations.

The most important political issue to bond markets is what the next President will do with **the budget deficit**. Should the deficit continue to grow, or even remain at its very high current level, then even the Fed will find it difficult to help the country avoid a substantial rise in inflation. Should inflation rise, bond yields will also rise, and bond prices will plummet. Fortunately for bond investors, both major presidential candidates have expressed a determination to make a substantial dent in the deficit in the next four years.

Stock markets dislike uncertainty. I see **three major sources of uncertainty** at this time, the presidential election, the level and direction of oil prices, and future terrorism. Within a few weeks one of those three questions will be answered. I am also hopeful that oil price uncertainty will diminish in the coming months.

I do not expect the level of **terrorism** to diminish over the next year. I like to remind folks that Great Britain was subject to terrorism from the Irish Republican Army for many, many years. I think that our broader market has already adapted to uncertainty related to the current state of terrorism. Of course the impact of a 'second 9/11' is impossible to project.

These convictions lead me to expect that 2005 will be yet another year with ups and downs in the markets, and one that is no easier, nor harder, to predict than in the past. Having a plan, and sticking to it, is **the approach that I prefer in these (and just about all) times**. Traveling in new territory is always easier with a map.



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

Bad Behavior Can Hurt Your Investments

Studies say 15% of the time that [we think] we are absolutely, positively right about something, we're actually wrong. That's overconfidence, and it can be a financially dangerous behavior for investors.

Behavioral finance studies our irrational investment decisions. John Nofsinger, an expert in the field and author of *Investment Madness: How Psychology Affects Your Investing and What to Do About It* and *Investment Blunders of the Rich and Famous*, says our missteps fall into three categories.

Overconfidence. People exaggerate their ability to pick winners and their control over the market. Unable to admit mistakes, it is common to hang onto losing stocks or funds. "The overconfidence bias causes you to trade too much and take too much risk," says Nofsinger. "As a consequence, you pay too much in commissions and taxes, and you're susceptible to big losses."

Emotion. Fear and greed, rather than rational facts, rule many investment decisions. Worse, Nofsinger says, an "attachment bias" can make investors emotional about holdings. "You are emotionally attached to your family and friends, and so you focus on their good traits and deeds and discount their bad ones," he explains. "When you become emotionally attached to a stock, you may fail to recognize bad news about a company."

Simplification. Investors tend to see patterns in random events, such as stock price movements, and make investment decisions based on these false patterns. Also harmful, says Nofsinger, are the shortcuts people make to reduce complexity. "For example, we assume things sharing similar qualities are quite alike," he says. But this can lead to inaccurate conclusions. "You may put too much faith in familiar stocks," he says.

To steer clear of these ten-

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Social Security—Hope For The Best or Plan For The Worst?

William D. Starnes

The future of Social Security has come to the headlines a couple of times this year when Alan Greenspan weighed in on the topic. In February, he warned Congress to move quickly to fix the problem in order to avoid bigger problems with the economy later. Alan Greenspan is indeed familiar with the program as he was selected by Ronald Reagan to head the Greenspan Commission charged with warding off a potential crisis uncovered by the Board of Trustees in 1979.

Is the Social Security benefit valuable? Let's assume you have a couple, both age 66 where one is earning the maximum Social Security benefit and the other receives ½ of the maximum (typical of many of my clients). If they both live to 90, the lump sum value of their Social Security benefit would be $605,120!

To gain a clearer understanding of the future of Social Security and the changes that could reduce these valuable anticipated benefits, it is important to understand the basics of Social Security.

How Social Security Works

Income is collected for the Social Security program from your payroll taxes (shown as FICA on most pay stubs). Each person pays a flat rate of 6.2% on income up to $87,900. In addition, your employer also pays another 6.2% for a total of 12.40% of your income. If you are self-employed, you pay the entire 12.40%. This collected payroll tax is used to pay benefits to current Social Security recipients.

Social Security is a "pay-as-you-go" system that pays current recipients out of collected payroll taxes. If payroll taxes (income) exceed benefit payments (expenses), as is currently the case, the excess is added to the U.S. Treasury's general revenue and spent. In exchange for the excess funds, the U.S. Treasury provides unmarketable treasuries (i.e., IOU's) that are accumulated in the Social Security "trust fund". In addition, the interest earned by the trust fund from holding the IOU's is paid to the trust fund in the form of additional IOU's.

The Potential Problem

Just as Mr. Ponzi's investment scheme collapsed when the stream of new investors dried up, Social Security will also become unsustainable when the pool of new workers don't grow rapidly enough to pay the recipients of benefits. And because there is a coming onslaught of recipients (i.e., retiring baby boomers) with a much smaller pool of new workers to support their benefits, Social Security faces a serious funding crisis. Add to this rising longevity and the problem worsens.

The "Trust Fund"

Most Americans believe that Social Security is funded from a trust fund that is accumulating assets to meet future costs. Although, there is an account named the "trust fund", the excess Social Security taxes generated beyond current payments are not invested in productive assets with any tangible value. Instead they have been loaned to the U.S. Treas-

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dencies, you need to understand the impact they can have on your decisions, and take the time to recognize and avoid them. Nofsinger proposes several strategies.

Know why you're investing. Most people have only vague notions of their investment goals — maybe, "I want a lot of money so I can travel abroad when I retire," or "I don't want to be poor when I retire." Says Nofsinger, "These do little to give you direction. Nor do they help you avoid psychological biases that inhibit good decision-making. So be specific." During annual portfolio reviews, examine your progress toward your specific goals.

Establish quantitative investment criteria. These can help you avoid basing decisions on emotion, rumor, or other psychological biases. Instead, your investments should measure up in terms of price-to-earnings ratios, sales growth, and other quantifiable benchmarks that are important to you.

Control your investing environment. "Limit activities that magnify your biases," suggests Nofsinger. That may mean avoiding Internet chat rooms and message boards, checking your investments just once a quarter, and relying on an objective professional financial advisor to keep you from behaving like a bad investor.

This article was written by a professional financial journalist for Mallard.

ury, which uses them to finance other government spending (or reduce its need to borrow from the public). The Treasury then gives the trust fund an IOU. In other words, the government says it will pay the borrowed money back when it is needed.

So this begs the question. What happens when the trust fund surpluses are needed once the baby boomers are retiring en masse beginning in 2017? The trust fund IOU's will be presented to the U.S. Treasury for payment, and the U.S. Treasury will have to come up with the money. Where will it get the money? There are two options: first, it can increase revenues by increasing taxes or borrowing from the public. Second, it can reduce other spending and direct the saved dollars to paying off the IOU's. Since the second option is not likely, you can see that the trust fund's only real asset is the government's power to tax. So, whether or not there is a trust fund makes no difference to the viability of the program. There is a "trust fund", but its only asset is its claim on your future financial security.

So when you hear about the trust fund not being depleted until 2042, don't let that lead to any comfort, because the trust fund is irrelevant. The important thing is when the cash flow (payroll tax collections minus benefits paid) goes negative (as estimated by the Social Security Board of Trustees to begin by 2018), this will require the U.S. Treasury to come up with the money to pay off the IOU's...either by significantly increasing taxes or borrowing.

What This Should Mean To You

It is clear that with no changes, in its current form, Social Security will soon become unaffordable and eventually unsustainable.

There have been and will continue to be offered many options for reform. Because outright benefit reductions would mean political suicide, the changes will be more subtle such as increased taxation of benefits, change to the benefit calculation, reductions to the COLA, increases in the full retirement age, etc.

In the past, and as we are seeing now, politicians respond to the crisis by waiting as long as possible to deal with the problem. The political risks involved in raising taxes, cutting benefits, or both, give a strong incentive to defer action. Because of this and the fact that the young will have far less political clout than the baby boomers, benefit cuts or increased taxation will likely fall on the future beneficiaries rather than current or soon to be recipients. This will continue to magnify the problem of "intergenerational inequity", where the young will receive less benefits relative to their contributions.

What Can We Do?

I handle this in all clients' retirement projections by reducing the promised Social Security benefit by a certain percentage as dictated by the client's age (and income). This allows us to plan and compensate for the eventual changes. The changes will come in the form of some combination of higher taxation or lower benefits, leading to a realized reduction of anywhere from 0% to 35% of the current promised benefits. By recognizing the fact that a portion of the promised benefits will not be provided, we can help you compensate by adjusting your savings targets.

Also, you want to closely review your Social Security Earnings Benefit & Estimate Statement each year to ensure that you receive the benefits to which you are entitled—even if reduced. Review the spelling of your name, your birth date, and your earnings history.

What I Would Like To See Happen

I would like to see the program remain intact as much as possible, paying the benefits promised to all. I think the forthcoming changes should be shared by everyone and not just the young. I think there should be more straightforward honesty about the cash flow problem rather than emphasis on the irrelevant trust fund exhaustion date. I would prefer the changes begin as soon as possible, even if minor.

Finally, I would love to see reductions in other government spending in order to avoid the need for benefit cuts or increased taxation. Alan Greenspan agrees and in his testimony before Congress he said, due to the risks to future economic growth, he would prefer "to close the fiscal gap primarily, if not wholly, from the outlay side" rather than being handled exclusively through higher taxation.

Frankly, I hope for the best…that the necessary changes will occur using prudent and fair methods. In the meantime, I will continue to plan for the worst.

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