MALLARD ADVISORS, LLC

The Mallard Flyer

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October 2005

Notices

Paul's Schedule:
Paul and Mark will be at a conference in Boston from October 5th to 8th.

Bill's Schedule:
Bill will be out of the office October 5th and 21st and November 23-25th.

Next Newsletter:
The next newsletter is expected to be mailed in early January 2006.

Office Closings:
The office will be closed on November 24th and 25th, and there will likely be only limited office hours during the last week of December.

Human Behavior & Investing

Mark Shryock

We have all seen examples of optical illusions. One of my favorites is the checkerboard whose black squares contain tiny white squares in certain corners. When viewed from a normal distance the checkerboard appears to be warped. However, when you concentrate on a row or column only, you notice that what at first appears to be a warped checkerboard is a normal checkerboard with truly square, alternating, black and white spaces. (Go to www.images.google.com to see an example.) What do optical illusions have to do with investing? They are both susceptible to misinterpretation: humans are hard wired to fill in the gaps of information in their environment.

Behavioral Finance is a study of the effect human behavior has on financial decision making. Even though our understanding of human behavior has advanced immensely with the studies that have occurred in the past 150 years, finance theorists and economists have only recently begun to acknowledge the human factor in financial decision making! Understanding how human behavior influences investment decision making can be very useful to an investor. My goal is to cover some of the basic behavioral pitfalls in this article. However, if you begin to see yourself, as I did, in many of the following descriptions of investing behavior, I highly recommend that you read The Psychology of Investing, by John Nofsinger. It is the source for this article and is part of the Chartered Financial Analyst body of knowledge.

John states in his book: "The brain does not work like a computer. It frequently processes information through shortcuts and emotional filters to shorten the analysis time. The decision arrived upon through

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Mallard Announcements

Sherry's husband, **David Vannoy**, died suddenly on September 14th. Our hearts, thoughts, and prayers have been with Sherry and her family. Obviously this is a major transition time for Sherry who after taking some time off will be returning to her normal morning schedule.

Through the **Delaware Money School**, Paul is leading a free Tax Smart Investing seminar on Tuesday evening, October 11th, from 6:30-8:30pm. Call the office if you are interested in attending.

We are proud to acknowledge that we were recently placed among the top 200 wealth management firms in the country by ***Bloomberg***. In its national survey, Bloomberg ranked Mallard Advisors 199th of the Top 500 Wealth Management firms for 2005. The article is posted on the website under Client Resources > Newsletters and Articles.

There are several documents that are available to our clients at all times including our **Business Continuity Plan, Privacy Statement, and SEC Form ADV Part II**. Form ADV is used to communicate important information about our practice to our current and future clients, and to the SEC (our regulatory agency). All of these documents are updated at least annually. If you would like a copy of any of these documents, please give us a call.

this process is often not the same decision you would make without these filters. I refer to these filters and shortcuts as psychological biases. Knowing about these psychological biases is the first step toward avoiding them."

This basically sums up what I want to share in this article. It is our nature to pursue investments in an irrational way.

Past Outcomes – Our brain has evolved through millions of years of experiences into a learning machine primarily designed to keep us alive, not to make us good investors. In our childhood we learn that when we play with fire we get burned. We learn that history repeats itself. Although we use the past to predict the future, rarely is the future an exact replay of the past - especially in the area of investing. In fact, when trying to predict how security prices change over time, mathematicians tell us the formula that best fits is the '*random walk with a drift*'.

Randomness is not a very comforting reality for humans who have rationalized a world of action/reaction. When the random act occurs, with positive or negative outcomes, we find it discomforting. Our brain has evolved to help us avoid the negative and learn from it. When we cannot predict the future we fill in the missing data with best guesses. This often leads to a false sense of security and confidence, especially when our most recent guesses have been correct.

Investing is basically a guessing game. The better the information you have, generally the more accurate your guesses. However, no one investor has perfect, much less near perfect, information, otherwise they would be successful and rich beyond anyone's dreams.

When investors rely on past outcomes and fill in incomplete information with practical guesses they exhibit the traits of behavioral investors. None of us is immune. The challenge to all investors, especially professionals, is to understand these traits and avoid the natural instinct to repeat them. Professionals are trained to focus instead on the tenants of modern portfolio theory. With modern portfolio theory the high costs, poor diversification, and erosion of returns that behavioral investors experience, are avoided.

Here are a few behaviors that represent behavioral investing. With each I will describe the behavior from the investor's view and then indicate how the professional is trained to avoid the behavior:

House Money - a behavioral investor who experiences a gain or profit from an investment will often take greater investment risks with the profits than they would with the original capital, as if the profits were expendable. Investment professionals do not view profits as separate from the rest of the portfolio. The risk exposure of the entire portfolio is defined in the client's Investment Policy Statement and their risk preference changes when necessary as a result of a client review.

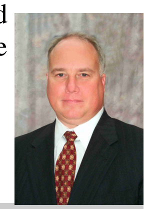
Snake Bite – a behavioral investor is often reluctant to invest after experiencing a loss. The effect is magnified in proportion to the magnitude of the loss. Investment professionals know that the unpredictability of the markets lead to both losses and wins. They do not hesitate to invest, and use diversification and a portfolio approach to minimize the impact of losses, and favor gains.

Break Even – a behavioral investor may be willing to take greater risks to get back their capital after a loss than the risk they were willing to take in the original investment. Professionals seek better return for the same risk, and should not accept an alternative with the same expected return but greater risk.

Familiarity – The behavioral investor has a tendency to invest in stocks of local companies, or the company they work for, because they "know" the company. Usually, they are not considering the fundamentals of the company in the investment decision. Professionals will not let familiarity get in the way of doing the research before making the investment decision. (This behavior is unrelated to decisions to invest in Employee Stock Ownership Plans or company stock in 401k plans. However, these purchases are common sources of poor diversification in a portfolio.)

Representativeness - Behavioral investors love to invest in the stocks of "good companies". Here "good" is not defined by an analysis of the fundamentals of the subject company, but by the advertising campaigns of the company, their public relations campaigns, or their history of being a "solid performer". Professionals know that the current value of a company is a reflection of its expected future performance – which can turn on a dime. Enron and Worldcom were considered "good" companies at one time.

I have touched on just a few of the ways our humanness gets in the way of a rational approach to investing. The most important thing I learned from studying behavioral finance is how easy it is to make investment decisions like a human rather than like a rational investor. Modern Portfolio theory helps overcome these foibles and, when applied correctly, improves the likelihood of positive returns while reducing risk.



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Real Estate—Will The Gravy Train Derail?

William D. Starnes

Virtually everyone is now talking about the housing boom of the last several years. Some call it a bubble, while others argue that it's a rational response to supply and demand, or a result of wage increases and mortgage capacity. Therefore, in this article I'd like to discuss the support behind each possibility.

Is There a Housing Bubble?
With memories of the stock market bubble still fresh, the big increases in home prices in recent years is raising concerns about the possibility of a "housing bubble." It's certainly true, for example, that housing prices in many markets have had a big move upwards in recent years and this is reflected in the nationwide aggregate data. House prices, especially in certain larger markets such as New York, Boston, and much of California, have skyrocketed. These statistics, along with increasing media focus, certainly give the appearance of a speculative bubble. And in the end they could prove right at least in these markets. But the issue is not at all clear cut.

Arguments For a Bubble
For a bubble to be present, history shows us that certain factors are typically present. A few of them include the availability of easy credit, an unawareness of history, and failure to utilize traditional valuation methods.

Easy Money. The popularity of adjustable-rate and interest-only mortgages has caused concern that they are further elevating already lofty housing prices, a trend that's raising fears of a crash that could plunge the economy into a recession. Often existing home owners continue to use the equity in their homes to buy second and third homes for speculative purposes. When interest rates rise, some will no longer be able to afford their mortgages, leading to an increase in defaults, opening up supply, and finally driving down prices. In addition, demand could drop with the high cost of borrowing. Economics 101 tells us that low demand and higher supply isn't good for prices.

This time it's different. It was John Templeton who said that the most expensive words in the English language are, "This time is different". Real estate is cyclical and prices will not continue to rise forever as they have.

The increasing number of amateur speculators, real-estate cocktail chatter, and the volume of books and courses about getting rich in real estate all scream "BUBBLE!" Certainly we all remember this occurred in the late nineties with growth stocks. Now, I hear the likes of Dolf Delross (who has associated himself with best selling "Rich Dad" Robert Kiyosaki) on the radio peddling his real estate program. Basically, his message is that you can get rich quickly and easily in real estate with little risk. When it comes to investing, high returns are associated with high risk. If you are ever promised high returns with no risk, turn 180 degrees and do not walk – run! What Dolf Delross is really saying is that he doesn't think his listeners are intelligent. Otherwise, he would give up peddling his courses to the poor and/or ignorant and instead, he would borrow to the hilt, purchase as much real estate as possible, and go to Hawaii (where his infomercials are filmed). This time is not different.

Ignoring Valuation. In commercial/rental real estate, valuation is calculated by dividing the net income of the real estate by its market value. This produces what is known as a capitalization rate (similar to a stock's dividend yield). It is easy to see in our local rental market that because prices have risen strongly while rents (i.e., gross income) have not risen, that cap rates have fallen. In other words, to justify a purchase a buyer must now ignore traditional valuation methods and instead must rely solely upon ***anticipated*** price appreciation. Justifying an investment solely upon anticipated price appreciation, rather than the net income it can produce, is speculation - not investment.

Bubbles occur when lots of people begin buying SOLELY because prices have been going up. When this occurs it is fed by the media, water cooler stories, and our own greed. Eventually it feeds itself, like a bonfire, until all the fuel (easy credit) is exhausted and the pop occurs. Unfortunately, human nature seems to increase the attractiveness of investments after their prices have risen greatly, when in fact this has actually made them riskier and less likely to have strong future returns.

The temptation to jump on the gravy train is very hard to resist, but you don't want to jump a train just as it pulls into the station. One piece of rational advice that applies to any investment is: at times of great optimism, future returns are likely to be lowest; and when the outlook is the worst, future returns are likely to be the highest. What is the popular outlook for the housing market right now: optimistic or bleak?

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Arguments against a Bubble
There are other statistics that suggest a national real estate collapse is unlikely.

While home price appreciation in some areas has far outpaced income, making home ownership increasingly less affordable, housing **on average** is still relatively affordable. The most recent readings from the National Association of Realtors' Housing Affordability Composite Index show that a median-income family has 17% more income than what is necessary to qualify for a mortgage on a median-priced home. This measure is a very important barometer of where the housing market is, since it incorporates mortgage rates and income levels, both of which are needed to understand the homeowners' ability to service their home loans, which ultimately is more relevant than isolated data points (i.e., absolute numbers) like how much prices increased in 2004.

As mentioned above, what drives home prices is loan size (i.e., credit), which is dictated by mortgage rates and income. This is why looking at the absolute numbers in the areas that appear to be in bubble territory (California, New York City, Boston, etc.) can be misleading. In fact, these areas attract a larger proportion of high wage earners whose mortgage capacities are among the highest on earth.

The popularity of interest only and adjustable-rate mortgages has caused concern, but fixed-rate loans account for 78% of outstanding mortgages, suggesting that the impact may not be as damaging at the national level as some fear. It is possible that regions such as California, where sharper price rises have led to wider use of ARM's, would be more impacted. But it is also possible that lack of supply in those markets—which has driven prices faster than in other areas—could also mitigate the impact of softening demand.

A Fall?
What could make housing prices fall in these local markets? When at least one of two things happen: mortgage rates rise, or the average income in these locales fall. The reality is that home prices are strongly impacted by what's going on in their regional economy, and extrapolating to the entire country doesn't give an accurate picture. On average, however, it would be very unusual to see a huge decline in aggregate prices nationwide. In fact, at the national level, housing prices in general have not dropped by more than a percent or two in housing downturns over the past 30 years. Rather than sharp falls over short periods, it is more likely we would see a number of years of flat or slightly declining home prices.

Conclusion
I do think speculative behavior is occurring in the residential and rental markets and some of these folks will get burned. However the up-front cost and lack of liquidity of real estate will keep it contained. Although there are individual behaviors that are associated with bubbles, the national statistics say otherwise. Therefore, I am not convinced there is a nationwide housing bubble and I don't believe a crash in national housing prices is imminent.

However, considering the current level of optimism, I would suggest that future returns will not be nearly like those of the recent past. If you are planning to buy real estate now in order to get on the gravy train - DON'T DO IT. If you are buying real estate because you need a place to live, or because the numbers work – ALL ABOARD!

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

Brief Credit Report Updates

Pam Baumbach

Free Credit reports are now available at **www.annualcreditreport.com**. You can receive one free credit report annually from each of the three reporting agencies. Options for credit scores (FICO) and debt analysis are available at a cost.

While organizing the affairs of my father, who passed away in August, I discovered that you can contact each of the credit reporting agencies and request that a "deceased" alert be placed on their account. This can reduce the chances of identity theft. **www.idtheftcenter.org** Fact 117 has specific information on steps you can take to reduce the chances that a deceased family member's identity will be stolen.

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