The Mallard Flyer

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Notices

Paul's Schedule /Newark Office: Pam and Paul plan to attend the NAPFA National conference in Texas from May 17th to 19th. Paul will serve as a panelist on a session on methods of compensation for financial advisory firms.

Bill's Schedule / Hockessin Office: Bill has no scheduled vacation or time away from the office over the next four months. However, if not in, you may find him at the Hockessin park behind his office playing with his children.

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

Omaha Stakes

Paul S. Baumbach

This is Mallard's tenth year, and this is the tenth time that I've profiled the Omaha-based Berkshire Hathaway's annual report, which is written by legendary investor, and down-to-earth financial speaker/writer, **Warren Buffett**. In the past 41 years he has led Berkshire to more than double the annual results of the S&P 500 (22% annually versus 10%). Through the magic of compounding, doubling the annual returns over 41 years means that **Berkshire has outperformed the S&P by more than a factor of 50**. All of the quotes in this article come from the Chairman's Letter in the 2005 Berkshire Hathaway Annual Report. Where practical, I identify a few fun anecdotes, along with a few kernels of investment wisdom.

Buffett Nuggetts—Berkshire bought an insurance company a little while ago that held a number of **derivatives** which Buffett has been trying to eliminate. It has been much harder that he expected. 'Long ago, Mark Twain said: "A man who tries to carry a cat home by its tail will learn a lesson that can be learned in no other way." If Twain were around now, he might try winding up a derivatives business. After a few days, he would opt for cats.'

He includes a section cynically titled *How to Minimize Investment Returns*, in which he points out how many investors are hurting their results by chasing returns and utilizing high-cost consultants. He urges investors to keep a keen eye on the costs of investing, which have risen sharply in the past several years (he is particularly critical of hedge funds that charge performance fees). Despite the fact that, in total, investors can only earn the sum of what their investments (the underlying

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Mallard Announcements

Hockessin Office: As a reminder, Bill and the Financial Planning Division have moved to Hockessin, Delaware. For the convenience of our clients, we have had a large mail slot installed in the front door for dropping off tax documents, or other needed information when we are out of the office. Only Bill, Sherry, and our office assistant have keys to this door.

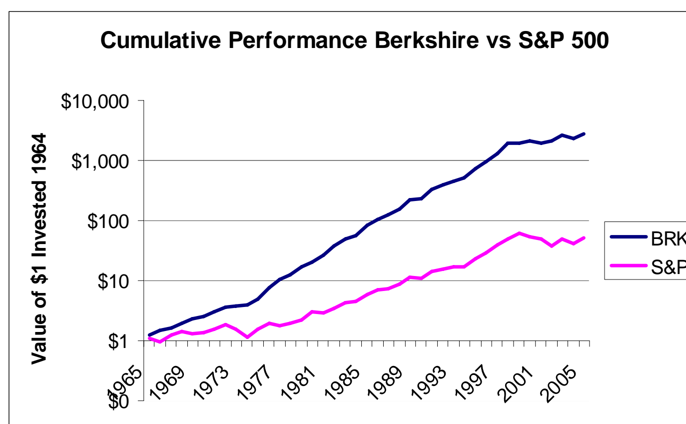
Newark Office: The Newark office has had several personnel changes recently. After many years as Mallard's Office Administrator, Margaret Badger left to pursue studies at the University of Delaware, with a goal of teaching music in the schools. Laura Belfi, our intern from the UD graduated in December, after three years at Mallard. We wish both of them the best.

UD junior Kier Wilson joined us in December, and works most afternoons. In February, Jen Deery joined Mallard as Office Manager. She typically is in from 9-2, five days a week. She lives in Newark with her husband Mike and two children, Jocelyn and CJ.

companies) earn, many investors are **encouraged to play the "beat-my-brother" game**. This performance game is most often recommended by those looking for the biggest cut.

Buffett notes that Sir Isaac Newton was a genius in Physics, defining three Laws of Motion, but was a failure in investing. Had his genius included investing, Warren suggests that Newton might have discovered "the Fourth Law of Motion: *For investors as a whole, returns decrease as motion increases*."

At Mallard we recommend that investors focus on the big issues, to resist the temptation to leap at short-term fads, and to resist the 'get-rich-quick' sales pitches from brokers and investment managers.



Warren notes that Berkshire is so financially solid that they could take out a lot of debt for additional investing. He dismisses this approach, noting that, 'Over the years, a number of very smart people have learned the hard way that a long string of impressive numbers multiplied by a single zero always equals zero. That is not an equation whose effects I would like to experience personally, and I would like even less to be responsible for imposing its penalties upon others.'

Buffett raises the implications of the brutal 2005 hurricane season. As Berkshire includes a substantial amount of insurance companies, it would be hurt more than most if **global climate change** produces 'disasters dwarfing Katrina'. John Neff in January recommended that investors lighten up on companies such as St. Paul Travelers, with significant exposure in the Southeast, for just this reason. Buffett notes that since they are not certain about the future (trend for hurricanes), they must prepare for the worse (that hurricanes get progressively worse). In the insurance industry, this means that Berkshire will charge more for the mega-catastrophe policies they provide. This 'hope for the best but prepare for the worst' approach makes sense in much of life, and investing.

Warren feels that **the US stock market is a bit overpriced**. The businesses he owns 'are not selling at anything like bargain prices.' He figures their earnings and their stock prices will grow 6-8% a year, quite a bit less than in the past. 'Their managers, of course, think my expectations are too modest—and I hope they're right.' We also are preparing ourselves and our clients to expect such modest future returns from stocks, and also are willing to be proven wrong by stronger results.

Buffett invested directly in foreign currencies in recent years, and this 'indeed cost us money in 2005 and is likely to do so again in 2006. In contrast, the ownership of foreign equities is likely, over time, to create a positive carry—perhaps a substantial one.' He notes that the triple deficit (budget, current account, and trade) is quite worrisome, but could continue for quite some time. That said, 'Either Americans address the problem soon in a way we select, or at some point the problem will likely address us in an unpleasant way of its own.'

We agree that investors should look beyond the US. We are hopeful that foreign bonds will help complement US bonds, despite the failure of this approach in 2005. We are true believers that smaller foreign stocks can do a nice job in supplementing US stocks. We differ a bit with Buffett, as we do not feel that large (multinational) foreign stocks complement US stocks well; we feel that US-based Motorola and Finnish Nokia will likely behave similarly. Rather, where practical we try to be 'nation-blind' when selecting large companies (and large company mutual funds), and choose the 'best in breed' amongst large companies, regardless of their country of origin.

There is a recurring theme in this annual report: successful investing requires that you pay more attention to the risk of loss than the potential for gain. Clearly you cannot argue with Warren's results!

Paul Baumbach is a Managing Partner in Mallard Advisors' Wealth Management Division.

Tax Planning Tips—That Pay Year After Year

William D. Starnes

With tax season now almost over and most returns prepared, it is a good time to reflect on how to continue good tax record keeping habits throughout the year.

Think of your tax preparer as a dentist. A dentist works on your teeth once each year with a finite service—such as a cleaning. However, your dentist doesn't come to your house to brush your teeth each day. That is your job. The dentist can only work with what you have provided to him—hopefully a years worth of brushing. Just like a dentist, a tax preparer can only work with the records you have accumulated over the prior months. Therefore, it is up to you to do the record keeping necessary to legally minimize your overall tax liability.

What is great about good tax-planning (as substantiated by good record keeping) is that once you have gotten a tracking system in place, you will reap the benefits year after year. Thus, good tax planning is just like an annuity that pays benefits each year.

COST BASIS OF YOUR PERSONAL RESIDENCE

Most people have a good idea of what they paid for their home, but have no idea of the true tax-cost basis. Knowing your cost-basis is important as the difference between the sale price and the cost-basis is taxable as a capital gain. Ensuring that you make your cost-basis as high as possible will therefore lower your potential tax.

But wait-a-minute Bill, I thought I don't pay taxes when I sell my home? Here is how it works, each married couple is allowed to exclude $500,000 worth of gain ($250,000 if single) on the sale of their personal residence. Therefore, if you bought a home for $100,000 in 1982 and are now selling it for $700,000, you have $600,000 worth of gain. However, since you are married, you are eligible to exclude $500,000 worth of gain from the sale. This would leave you with a taxable gain of $100,000. However, as mentioned earlier, what you paid for the home may not be your true tax-cost-basis. Say you have spent $100,000 to build an addition. That improvement would be added to your cost basis, therefore resulting in no taxable gain.

Because the exclusion is not adjusted for inflation, while the price of homes rises by about 1% greater than inflation, that exclusion will become smaller with each passing year. In addition, many folks don't sell their homes until after a spouse has died, leaving them with an exclusion of only $250,000 rather than $500,000. This can easily drop them into taxable gain territory.

Since improvements add to cost basis, and reduce capital gains, keeping track of improvements is very important. In the above example, if the $100,000 of improvements can't be documented, you will have to pay on $100,000 of capital gains. It is amazing how just a little record keeping can lead to enormous tax savings.

How much you spend for improvements should not be a mystery. Included in your Personal Financial Tracker is a page titled "Home Improvements" where you can track all of your improvements. You never know when you will sell your home or need to prove your cost basis in your home. Further you can't count on that $250,000 and $500,000 exclusion being there when you sell—tax law changes frequently. Home prices can escalate, you can become widowed, etc. You simply need to be prepared with a listing of all improvements. Backing up each item on your list should be invoices and cancelled checks which prove that you paid the bills.

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Tax Planning Tips...Continued From Page 3

If you would like help calculating the cost basis of your residence, please bring this up at our next appointment.

BUSINESS MILEAGE

If you are self-employed, you can deduct your business mileage. Whether you use the mileage method or the actual expense method, you must have a written record that proves your business percentage use. Various records can be used, but the IRS three-month sampling record is the preferred choice for those of us who know about it.

With this method, you keep a mileage log for three months and then apply that percentage to either:

- The miles you drove for the year, or
- The expenses you incurred for the year

The three months must be consecutive and must represent your driving pattern.

Therefore, the first step in proving your vehicle deductions is to have a mileage record of your business use.

Also in the Personal Financial Tracker is a page titled "Tax Deductible Auto Expense Diary". Even if you are not self-employed this diary is excellent for tracking charitable, medical, and business mileage to see your financial advisor.

NON-CASH CHARITABLE CONTRIBUTIONS

Most of our clients are very good at keeping record regarding their non-cash charitable contributions. Therefore, I will only make a few recommendations. First, if we prepare your returns, we don't need the substantiation. However, you must have the substantiation in the event of an audit.

The substantiation needed is based on the market value of the contributions as follows:

- $250 or less: A receipt from the charity is not needed if it is impractical to obtain. For example, when property is left at the charity's unattended dropsite.
- $250 to $500: A receipt from the charity is required.
- $501 to $5,000: In addition to a receipt from the charity, you must also describe how the property was acquired (purchase, gift, inheritance, etc.), the date is was acquired, and the adjusted cost-basis of the property.
- Over $5,000: In addition to the previous requirements, a written appraisal must be obtained.

In all cases, a "reasonable detailed description" of the contributed property must be recorded. Not only do "three bags of clothes" not suffice, but it also limits your total deduction.

I highly recommend using the "Non-Cash Charitable Contribution" tracking sheet in your Personal Financial Tracker in order to ensure that a reasonably detailed description is obtained. This is done by jotting down a description of EACH ITEM donated. This itemized deduction can easily double your contribution. If you are able to increase your charitable contributions by $1,000—that leads to a higher refund of about $300. $300 for an extra 10 minutes of record keeping is pretty attractive.

Finally, if making an unusually large value of contributions, consider snapping a photo of the donated items prior to dropping them off.

So, as you can see, with a record keeping system in place (i.e. The Personal Financial Tracker), good habits will pay dividends year after year—just like an annuity.

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