

pendent advisors put their clients first. The brokerage industry managed to get a specific exemption by the SEC, **enabling brokers to avoid SEC oversight**, and avoid being held to a fiduciary standard, if their financial advice is only 'incidental' to their brokerage work. Do investors understand that brokers put their firms' interest first?

Last year TD Ameritrade conducted a survey of 1,000 investors and found that the majority of investors incorrectly thought that brokers had a fiduciary responsibility for their clients, and 86% said that their choice would be impacted if they understood that there were unequal levels of protection between investment advisors and brokers.

Brokers went too far with this exemption—they **talked the talk but refused to walk the walk**. In their masquerade, they were portraying themselves as financial advisors to clients, and yet to the SEC brokers claimed that this was incidental, and they therefore were exempt from government oversight. They wanted it both ways. They were taken to court, and the case dragged on for several years. One Mallard client submitted their thoughts during the public comment phase:

"I have a financial advisor who is not a broker specifically because my account was formerly at Merrill Lynch and I felt that the broker was pushing Merrill Lynch financial instruments, did not have a knowledge of the market as a priority and did not understand that my preference is for individual stocks and not mutual funds. I dropped Merrill Lynch as a result and am very satisfied with my financial advisor."

As a half-step, the SEC in 2005 began requiring that brokers include wording in their client agreements similar to the following in order to avoid SEC oversight:

"Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits,

and our salespersons' compensation, may vary by product and over time."

Of course, how many investors read the fine print of their client agreements? The courts were asked whether this step sufficiently protected investors from brokers' conflicts.

The case was finally decided this March, when **the US Court of Appeals overturned the exemption**. The court said that if a broker charges asset-based fees, they must register as an advisor, and meet these higher standards. The brokerage industry asked for 120 days to adjust to the new guidelines. Many brokers are stopping fee-based accounts, however others, including Merrill Lynch, are changing nothing. They are mounting a campaign with regulators 'to preserve our client's choice', which is another way to say 'to preserve our firm's ability to confuse our customers'.

I expect that in the coming weeks more brokerage firms will relent, permitting their brokers to accept the higher responsibilities of serving as a fiduciary to their clients. Note that many individual brokers welcome the court decision, and are pleading with their brokerage firms to permit them to act as fiduciaries. There are higher compliance obligations, however this is exactly the point. **Investors deserve to understand whether their financial advisor puts the investor's interest first, to understand their advisor's conflicts of interest, and to have their advisors properly regulated** to avoid or minimize the brokerage industry's scandals (Merrill Lynch's Henry Blodgett, Smith Barney's Jack Grubman, Morgan Stanley's sales contests, among others). If an advisor is unwilling to put the investor first, they should not be permitted to masquerade as a trusted, fiduciary advisor.

The National Association of Personal Financial Advisors (NAPFA) Consumer Education Foundation sponsors www.focuseonfiduciary.com, with much more information on the difference between advisors and brokers, including how to find a fiduciary advisor. Sermon over. I'll put away my soapbox now.

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Paul's Schedule / Newark Office:

Paul and Pam will be out of the office on August 1st to 3rd, for our annual trip with friends to camp and raft in Jim Thorpe, PA.

Bill's Schedule / Hockessin Office:

Bill will be on vacation the week of July 16th in Cape May, NJ. Bill will also be camping in Jim Thorpe, PA the week of August 20th. Both Sherry and Cindy will be in the office during these weeks.

Next Newsletter:

The next newsletter is expected to be mailed in early October 2007.

Retirement Spending—How Much is Too Much William D. Starnes

In a prior article I spoke about savings rates prior to retirement. In this article, I will comment on spending rates in retirement—how much is too much. To over-simplify, the evaluation of a client's financial security and more practically their "safe retirement spending" is a matter of illustrating all retirement assets/income relative to the expected *cash outflows* (i.e., spending).

I will often use the analogy of a dam holding huge quantities of water (i.e., the value of the total portfolio) and releasing the water slowly as needed (i.e., withdrawals). Things can affect the water level and/or the demands on the water, such as a drought (i.e., bear market). But nothing impacts whether you have a plentiful reservoir or a parched lake-bed more than the **on-going releases of the water**. In other words, you must monitor and keep your spending (and therefore withdrawals) within your means. "Within-your-means" is the very same important success factor used to build this wealth in the first place.

But determining what "within-your-means" requires in terms of withdrawals is one thing, and having the discipline to stick with it is another. The most well researched rule of thumb for determining "sustainable withdrawals" from your portfolio requires determining and using an appropriate safe withdrawal rate.

What is a Safe Withdrawal Rate?

A safe withdrawal rate has traditionally been defined as the highest **initial** withdrawal rate that almost virtually guarantees that the "portfolio" will last for at least 30 years. Your total portfolio value is divided by the initial withdrawal rate to determine the amount of dollars to be with-

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Mallard Announcements

New Office Manager

The Financial Planning Division's Hockessin Office has hired a part-time office manager, Cindy Cheyney. Bill has known Cindy for 16 years starting as co-workers at MBNA. Cindy has been a stay-at-home mom with two children, Quinn (10) and Brooke (8). Cindy's hours are minimal in the summer, but will work 10am—2pm, Monday through Friday, beginning in the fall.

Comments on TD Ameritrade

Over the last several months TD Ameritrade has been struggling with some of the consolidation issues associated with the merger of Ameritrade and TD Waterhouse. Most prominent have been problems with statement mailings, response times, and website availability. As mentioned in our newsletter at the time the merger was announced, "a merger will bring about short-term irritating changes". Our offices are working hard to insulate our clients from the impact of this transition. We will keep you informed of future developments of the merger.

drawn in the first year. In subsequent years, you no longer use the withdrawal rate. Instead, you take the same dollar amount and adjust it for the prior years' inflation figure.

For example, a single fellow retires at age 65 with no other anticipated income from any source. He has a \$1 million dollar (tax-deferred) investment portfolio invested with 60% of the value in stocks. He needs to take withdrawals from the portfolio annually and beginning immediately. To the extent possible, he wants the portfolio to last for 30 years (his age 95). With a withdrawal rate of 4.5%, he can withdraw \$45,000 from his portfolio this first year and all future years (yet adjusted for actual inflation). This is his total withdrawal and must be used to pay for **all** of his expenses.

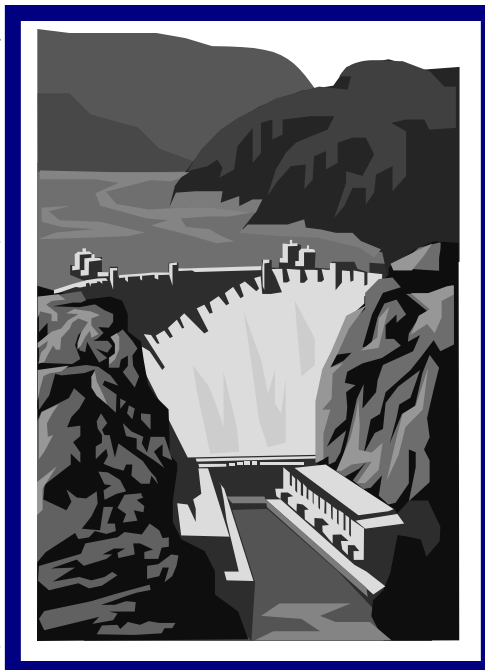
What is the Safe Withdrawal Rate?

The pioneer of this research vein is Bill Bengen, who recommends to his own clients a withdrawal rate of anywhere from 4% to 5% of his clients' portfolios. More specifically, he calculates the safe withdrawal rate at 4.15%, but justifies going up to 5% for clients for a variety of reasons including:

- the length of time the client wants the portfolio to last—if longer than 30 years, the withdrawal rate must therefore be lower.
- If the client wants to leave an inheritance to heirs/charity—if they want to leave money to heirs, the withdrawal rate must therefore be lower.
- Asset allocation—if the portfolio has a higher percentage of stocks, then the withdrawal rate can therefore be higher.
- Rebalancing frequency—withdrawal rates can be increased with an appropriate frequency of rebalancing the portfolio.
- Amount of certainty desired in not running out of money—if a client wants absolute certainty of not running out of money versus moderate certainty, then the withdrawal rate must therefore be lower.
- Adjustment of the withdrawals as a result of investment returns—making adjustments to withdrawals

in light of investment returns allow a higher withdrawal rate.

Bill Bengen's conclusions have been challenged and expanded upon by Jonathan Guyton who calculates the safe withdrawal rate at about 6% when other rules are followed. His March 2006 article can be found at www.fpanet.org/journal/.



However, blindly using a withdrawal rate strategy can be misleading, especially when people misunderstand how the withdrawal rate formula works or when they avoid considering their unique circumstances. Life is not fixed—other income sources start and stop, and expenses come and go. These changes will impact your personal withdrawal rate.

Instead, withdrawal rates applied by an advisor familiar with your unique situation is best. This is because a mandated annual inflation-adjusted withdrawal rate is not always best from a tax, cash flow, or financial security standpoint and must therefore be put into context.

Also, some people may need much larger withdrawals in early years (e.g., until Social Security begins) which may necessitate smaller withdrawals in later years. Others may require the opposite (e.g., due to large expected long-term care). I spoke at greater length about these and other cautions of withdrawal rates in the March 2005 issue of Financial Advisor in the cover article, "Time & Money—Do you understand all the assumptions you are making regarding clients' withdrawal rates?"

Withdrawal rates are just one excellent method (if used with care) to ensure that you are not letting too much water out of the dam. We want to ensure you maintain your reservoir and don't end up with a dry lake bed.



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

A recent court case decision has brought to the forefront the difference between advisors and brokers. In this article, I will explore the differences and the implications of the court's decision on investors.

This discussion required a definition of a **fiduciary**: a financial advisor held to a fiduciary standard, required to act with undivided loyalty to the client, including disclosure of compensation and of any corresponding conflicts of interest. Why do Merrill Lynch and other brokerage firms avoid the term fiduciary like the plague? Why does this matter, and why should an investor care whether they use an advisor who accepts fiduciary duties, who acts in the investors' best interest?

Let's begin by considering the real estate market. We know that there are **real estate brokers**. They receive their income based on the value of the properties sold for which they represent the buyer and/or the seller. As such, their pay depends on the transaction, and the size of the transaction. How does this affect how you should use this broker?

Regardless of whether it is right for you, a real estate broker has an incentive to convince you to buy a more expensive home, as their commission would be greater. A broker has no **financial incentive** to tell you that you are better off either renting, or remaining in your house. This isn't to say that there aren't any real estate brokers who provide good advice, sometimes counter to their financial interests; rather my point is that it is far less common. Most importantly, it is critical to understand the inherent conflicts before seeking the advice of any professional.

There are also brokers in the investment world, lots of them. They are employees of brokerage firms which earn money based on transactions, **both visible and invisible**. For instance, mutual funds will often pay brokerage firms part of the fund's annual fee. This helps brokerage firms pay their brokers to pitch particular mutual funds, regardless of whether they are the

best for the investor. When a broker sells a customer a wrap fee account, approximately one-third of the fee (2-3% annually for a stock account) goes to the broker each year, for having 'brokered' the deal. This, however, is not the only manner in which financial advice is provided.

Fee-Only™ advisors are independent of any parent company; we are not employed by brokerage firms. In essence Fee-Only™ advisors are employed directly by their clients. We refuse money from mutual funds, brokerage firms, custodians, etc. 100% of our income comes directly and only from our clients. Why? So that we can provide **advice untainted by that conflict of interest**.

Fiduciary: a financial advisor held to a fiduciary standard, required to act with undivided loyalty to the client, including disclosure of compensation and of any corresponding conflicts of interest.

Investors have been fleeing the brokerage industry for several years, as these conflicts have become better understood. The brokerage industry has taken steps to avoid this exodus, not by eliminating the conflict, but rather by obscuring it. Their brokers began masquerading as independent advisors. In a victory to investors, **this masquerade is finally coming to a halt**.

Independent advisors are overseen by the Securities and Exchange Commission (SEC), or for smaller firms, by their state regulatory board. The SEC and state boards are part of the government, and their mission is to protect investors. In contrast, brokers are overseen by the NASD, an industry group of fellow brokers, with no incentive to protect investors. This self-regulatory body is analogous to having the **foxes guard the hen-house**.

Not surprisingly, in this dual system brokers are held to a much lower standard, a 'suitability' standard—is the investment suitable, good enough. Independent advisors, however, regulated by the government, are held to a **fiduciary standard**, to put the client first.

This dual system was based on the assumption that investors understand that brokers are serving the brokerage firm first and the investor second, while inde-