

Earlier this year I wrote about “Retirement Savings—How Much is Enough?”. In that article I discussed the importance of saving and appropriate savings targets based upon age, current savings, and asset allocation. However, the next question could easily be, “**Where** Should I Save My Money?”. It is an important question as the correct answer will aid you in building a faster and/or strong level of financial security.

Available Savings Vehicles

This savings can be directed to a variety of places including:

- Deductible Retirement Plan
- Tax-Free Retirement Plan (Roth 401k)
- Roth IRA
- Taxable Investment or Savings Account
- Deductible IRA
- Non-Deductible IRA
- Variable Annuity
- Mortgage principal pre-payments
- Employee Stock Purchase Plan

But from a tax efficiency standpoint, where should the first dollar of your available savings go? For this article, I will ignore the availability of a Roth 401(k) or Roth 403 (b) as they still are not widely available. I will also assume that savings can occur beyond typical maximums. While unrealistic, it allows an illustration of all the saving options in order of decreasing attractiveness.

Generally, I would approach your savings in the following order. **First, you always want to contribute an amount to your employer sponsored retirement plan UP TO the full employer match.** This is free money we are talking about!

Second, you want to save the maximum available in a Roth IRA, if you qualify. For married couples, if your adjusted gross income is over \$160,000 you cannot save here.

Tax-free earning accumulation is generally better than tax-deferred earning accumulation. The easiest way to think about the difference between a deductible IRA (or 401k)

and a Roth IRA (or Roth 401k) is the following. With the Roth, you pay tax on the seed (i.e., the contribution—because you don’t get a tax deduction), but reap the harvest (the distributions) tax-free. With an IRA / 401(k), you deduct the seed, but pay tax on the harvest.

While this seems like a no-brainer when you think about it (and when you run the numbers), it remains a difficult proposition for some clients. This is because you must give up an immediate reward (the tax-deduction and corresponding savings) for a deferred, and therefore less certain reward (tax-free withdrawals in the future).

Some clients are even concerned that tax laws will change and eliminate or reduce these tax-free earnings associated with the Roth IRA’s. I think that while a change could occur, grandfathering legislation would be passed to protect taxpayers who have already made contributions.

Another benefit of having money in a Roth IRA is that the contributions are liquid. You can withdraw your contributions anytime with no taxes and no penalties.

Third, you want to add to your employer sponsored retirement plan beyond the matched level up to the maximum possible. Typically this is \$15,500 for those under age 50 and \$20,500 for all others.

At this point you are maximizing your savings strategies AND you are obtaining tax-diversification. Tax-diversification maximizes your tax-planning at withdrawal time and helps to minimize the impact from changes in tax legislation. I wrote about the benefits of tax-diversification in our October 2006 newsletter.

Next, if available and attractive, also consider participating in your employee stock purchase plan (ESPP). However, speak with Paul or me before doing so to ensure you are minimizing your risk (typically by an immediate sale) and maximizing your returns (one that provides attractive terms).

With the Roth, you pay tax on the seed (contribution), but reap the harvest (distributions) tax-free.

With an IRA or 401(k), you deduct the seed, but pay tax on the entire harvest.

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Notices

Paul’s Schedule / Newark Office:

Paul will be attending the NAPFA Northeast conference in Hartford, CT, from October 17th to 19th. The Newark office will be closed on Thanksgiving, Christmas, and New Years Day. Paul and Pam are expecting to take vacation for the week of December 17-21.

Bill’s Schedule / Hockessin Office:

Bill will be attending the Alliance of Cambridge Advisors National conference from October 24th—29th.

Next Newsletter:

The next newsletter is expected to be mailed in early January 2008.

THE MALLARD FLYER

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Caveman Investing

Paul S. Baumbach

How are we as investors limited due to behavior that has been hardwired into our brains since the dawn of time? A client recommended that I read The Only Three Questions That Count—Investing by Knowing What Others Don’t, by advisor, author, and Forbes columnist Ken Fisher. It includes a very clear description of these limitations, and offers ways for investors to rise above these counter-productive instincts.

The third chapter includes a very good explanation of **behavioral finance**, the study of how human nature leads investors to make bad decisions. I have studied this field a bit for several years, and have read and heard authorities cover this topic extensively, generally in a high level, academic fashion. Fisher does a nice job of explaining behavioral finance in a clear ‘Main Street’ manner.

He begins by blaming evolution. He states that “most of our shortcomings in seeing markets correctly stem from cranial hardwiring derived from many eons of evolution and are so fixed in our brains that we can’t escape them.” We are not doomed, however. He notes that we can **improve our odds** by raising our awareness of this hardwiring, recognizing when we are being cavemen, and then by rising above it.

Fisher’s basic premise in this book is that as investors we should strive to exploit areas where we know more than the markets. Markets are doomed to exhibit ‘cavemanisms’, and every time that we can recognize this and fight the temptation, we improve our chances of outperforming the market.

One human tendency is to ‘accumulate pride and shun regret’. When something goes well, we like to **Continued On Page 2**

Mallard Announcements

Personnel Changes

Susan Lehnerd joined Mallard Advisors’s Wealth Management team in July. She is working in part as a Portfolio Administrator. In addition to her work at Mallard, Susan is enrolled in the University of Delaware’s Certificate in Financial Planning Program, pursuing her CFP designation. Prior to her career change, Susan taught math for 10 years at the community college level. She has an MBA from Loyola College in Maryland.

Bill’s Article Picked-Up By Cambridge Advisors

The article Bill wrote for the October 2003 issue of the Mallard Flyer titled, “Live Long & Prosper” was picked up and published by the Alliance of Cambridge Advisors for the summer edition of their Financial Focus newsletter.

Money School Class

Paul is presenting a two-session course on **Retirement Income Planning** through the Delaware Money School. It will be held on Monday, October 29th and November 5th, from 6:30-8:30pm at the Newark Library. Call the Newark office to register.

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take full credit, and assume that this superior skill will produce similar good results in the future. When something goes poorly, however, we eagerly look for factors (beside ourselves) that caused it, convinced that it was not our fault. This often results in our becoming overconfident of our skills, in our avoidance of selling a losing investment (as that would force us to fully accept the pain of regret).

Overconfidence can be very expensive to an investor. It can lead to insufficient diversification (I know this stock, I can put 20% of my savings into it). Fisher points out that the Enron fiasco was not only caused by criminal mismanagement and total lack of objectivity by their auditors, but also by the overconfidence of Enron's employees and investors, who felt that their investing ability justified holding large amounts of a single stock (Enron). Fisher recommends 'accumulating regret and shunning pride' to achieve superior results.

Fisher introduces '**confirmation bias**' as the tendency for prehistoric man to develop a preference for their favored hunting ground, whether or not it yielded superior results. Investors still harbor the 'instinct to seek out information confirming our preset notions and rejecting or overlooking contradictory evidence.' I know that I often prefer hearing a speaker who shares my investing philosophy.

Patterns are developed by our brains to more quickly process information. A caveman may note that one neighbor died when hunting in one area, or another neighbor had no problem eating berries of that type, and would then define patterns. Subconsciously we are always defining and comparing patterns, whether or not they actually exist. My personal thesis is that the popularity of the Survivor/American Idol/Dancing with the Stars shows, and, for that matter, lotteries, is due to our mental wiring that leads us to believe we can guess the unguessable. Many investors study stock charts in an attempt to predict future stock prices. I agree with Fisher when he suggests that investors should resist this temptation to act on patterns which aren't actually there.

Hindsight bias refers to our tendency to inflate past successes and downplay past failures. This also leads us to presume that a stock that has done well in the past will continue to do so, and vice versa. Accumulating regret and shunning pride will also work to reduce such hindsight bias, and help you see things more clearly.

Order preference describes our desire to have life nice and simple - orderly. We prefer a mutual fund that rises 5% one year to two equally-weighted funds where one rises 15% and one falls 8%. 'Order preference causes you to focus on the individual parts and makes you lose sight of what is important.' Investors should focus on the forest, how the overall portfolio is faring, and avoid obsessing on the trees, the individual stocks/funds.

Fisher suggests that we can work to rise above our 'Stone Age brain', by 'getting our head out of the cave'. Start by accumulating regret and shunning pride. Locate the lesson in each failure, and recognize luck's role in each success.

This can lead you to lessen your overconfidence, which can lead you to 'place smaller bets'. Fisher recommends exploiting your advantages, but doing so in a measured manner, and never 'betting the farm'. Combating overconfidence can enable you to recognize when you feel that you know more than the market, but also to recognize you could be wrong in that assessment.

In a later chapter, Fisher argues strongly for benchmarking your portfolio. By identifying a measurable target for your portfolio, and by focusing on the whole rather than the individual parts, you can shield yourself from some of the more expensive mistakes that caveman investors make.

At Mallard we strongly advocate for setting allocation targets, benchmarks, for investors' portfolios, and for making only limited deviations. While Bill and I spend a lot of time studying the individual pieces of client portfolios, we encourage our clients to spend much more energy on considering 'the big picture'.

Ken Fisher's [The Only Three Questions That Count](#) book can help investors identify how to develop and use their knowledge to improve their odds of investing success. The book's thorough discussion of behavioral finance can help readers identify when to fight our hard-wired instincts which often lead us to make poor investment decisions.

Paul Baumbach is the managing partner of Mallard Advisors' Investment Advisory Division



Comments on TD Ameritrade

At Mallard, we accept no compensation from TD Ameritrade or from any other discount broker we recommend to our clients. That puts us in the enviable position of being able to evaluate and recommend the discount broker we think is the best overall for our clients.

We have selected TD Ameritrade (TDA) as the primary custodian for our clients; we have close to \$100 million custodied at TDA. In the past four months most of our clients have had to suffer inconveniences as a result of TD Waterhouse's merger with Ameritrade. Our offices have been working hard to keep our clients insulated from the impact of this transition. Furthermore, in September TD Ameritrade's computers were hacked, and some email and mailing addresses were captured by a spammer.

So why do we continue recommending TD Ameritrade as the discount broker for our clients?

There are two significant reasons—they help our clients better achieve their goals, and they help our company better manage our clients' investments. TD Ameritrade is the third most popular custodian for independent advisory firms, and they would love to make it to number two or number one. We feel that for this reason TD Ameritrade tries harder than Schwab and Fidelity to satisfy their customers.

Most often, transaction fees are lower at TD Ameritrade, which helps clients squeeze out higher returns. With

stock trades, TD Ameritrade does a better job at 'price improvement' than the industry average, and its major competition. Price improvement is finding the best price when buying or selling shares of stock (or an exchange-traded fund).

Finally TD Ameritrade does a nice job of coming to Mallard first with questions, rather than bothering our clients. We prefer this arrangement, where we are responsible for helping to resolve these administrative issues.

Mallard has invested significant time and money into systems to help us stay on top of our clients' portfolios. These systems require our custodians to regularly share information: transactions, prices, and positions. TD Ameritrade has one of the best technology platforms in the industry, which helps us better serve our clients.

There are alternatives to TD Ameritrade, and since we are independent of TD Ameritrade, we periodically review these alternatives. None are perfect. In fact, one of the best ways we keep abreast of the services of other providers is by listening to other fee-only advisors complain about the alternatives in our industry "discussion forum". In other words, a change in brokers may simply result in jumping from the frying pan into the fire.

While TD Ameritrade has stumbled a bit in 2007, at this time we still feel they offer the best overall value compared to the alternatives to our clients, and to Mallard.

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[Finally, direct all remaining dollars towards your taxable investment account.](#) This could include your TD Ameritrade account or ING Direct savings account.

Common Mistakes

Generally, you do not want to make mortgage prepayments towards principal. Mortgages are good. They provide inflation protection, interest rate protection, and positive financial leverage. By sending in pre-payments (for most) you are unconsciously agreeing to invest at a rate that is far lower (after-tax) than other available vehicles with similar or lower risk. This, of course, depends on your interest rate and tax bracket.

Generally, do not invest in variable annuities. These provide tax deferral with no deduction, high costs, less investment flexibility, and are confusing to most investors.

Saving in the most tax-efficient manner will generally improve your financial security. However, it is the act of SAVING that is the most important activity. You can no longer let indecision over finding the perfect savings vehicle stop you from expanding your savings plan today.

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

