Margin of Safety....continued from page 3

Home Equity Available—Open a home-equity line of credit. Do this before the worst occurs. Just try getting a line of credit (with a reasonable rate) with no job!

Cash is King—Ideally you should have 10% of your gross income in fully liquid and accessible cash—checking, savings, or money markets. This is non-negotiable and should be achieved regardless of your current debt or savings levels.

Keep twice this amount (20% of your gross income) in "emergency cash". This type of cash is less liquid and therefore higher yielding and can include U.S. Savings Bonds, Cash Value Life Insurance, CD's, short-term bonds, etc. Don't begin saving this until all of your high-interest non-mortgage debt (i.e., credit cards) is paid off.

Cash is the one asset that gives you the ability to choose your own future on your own terms. Borrowing with home equity in times of need is not on your terms, but on the terms of the bank. Selling investments in times of need (and when the stock market is down 20%) is also not on your own terms, but that of the markets' whims. Cash allows you to start a business, weather a job loss, get by until your disability kicks in, stay at home with the children, or put a down payment on a second home. Doing these things is far more difficult or risky without cash.

Cash is king. If you don't have any—get some! How? By living beneath your means and saving 10% or more of your income. Yes, this may mean driving an old car, taking smaller vacations, deferring purchase of that plasma TV—whatever. You may not like any of these alternatives, but saving is not supposed to be easy!

Retirement Savings—Regardless of your level of job security or the reality of other risks, keep funneling about 15% of your gross income into your retirement savings. These savings reduce your taxes, attract matching funds, and are the primary source of our future financial security. Also non-negotiable.

These funds feel inaccessible, yet *can* be touched for an emergency. For example, Roth IRA contributions can be withdrawn anytime with no penalty or taxes. 401(k) funds are accessible after age 55 (and you have left the employer). Even prior to age 55, withdrawals can occur with income taxes and a 10% penalty. However, if as a result of your crisis (say job loss) you drop from the 25% Federal tax bracket to the 15% bracket, you are still in the same position after paying taxes and penalties! This is because you saved 25% in taxes when the money went in, and now you are paying 25% in taxes (15% income tax + 10% penalty) as the money comes out.

Eliminate Credit & Debit Cards—Everyone should remove their credit and debit cards for three months to get back in touch with the spending of "real money". These cards only make it easier for you to ignore prices and buy things you don't need and likely can't afford. I spoke about this on my audio seminar CD titled "Creative Budgeting".

Carrying consumer debt is a very clear sign of living beyond your means. Living beyond your means and carrying debt creates a big barrier to building a margin of safety.

In fact, by removing these convenient spending methods, you will draw your awareness to your spending by making each purchase a conscious event. Taken further, I would even say that you want to make spending as painful as possible—and cash will help you do this. With spending more painful, saving (including the elimination of debt) becomes more likely to occur. This will result in building a larger margin of safety.

Hide The Money—If you give yourself full access to your money, it is more likely to be spent. Put your excess cash into vehicles that ***feel*** less "spendable". In other words "out of sight, out of mind". This is also called creating an environment of artificial scarcity. This sets you up to accumulate more easily this margin of safety.

An ideal vehicle for this type of cash is U.S. Savings Bonds. Savings bonds have a unique combination of yield, tax benefits, safety, and a feeling of inaccessibility. They are a very good way to ensure that the funds are only used for true emergencies.

Building your margin of safety from many angles will help to protect you when change occurs in the form of tough times. It will come.

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Inside This Issue

April 2008

Notices

Paul's Schedule / Newark Office:
Paul will be out of the office from Monday, May 12th, to Saturday May 17th to attend the Napfa National conference in Long Beach, CA.

Bill's Schedule / Hockessin Office:
Bill will be out of the office from Tuesday, May 13th to Saturday, May 17th to attend the Napfa National conference in Long Beach, CA.

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

Where Are The Gurus?

Paul S. Baumbach

'Respect your elders' was taught to me at an early age. This is one reason that I regularly look to learn from those with more experience than me. (This reminds me of the truism—Good decisions come from experience, and experience comes from bad decisions.) For several years I have sought out insights from two gurus in particular, John Neff and Warren Buffett, and regularly report on the most useful lessons in this newsletter.

For many years, I have gone to hear John Neff speak in Philadelphia in January. Neff ran the Vanguard Windsor fund for decades, and outperformed the S&P 500 by 3% annually during his tenure. I made a pilgrimage to Philly to gain a few gems of knowledge from the sage.

This year, I was disappointed. In his later years, he has limited his areas of expertise, and so he no longer has the broad perspective that he had in the past. At the lecture on January 3rd, he noted that 'the stock market is more attractive than the bond market'—not the most timely call, given that the S&P 500 fell 9% in the next three months. He also predicted that Rudy Guliani would win the nomination of the Republican Party.

I also jump to read the annual report to shareholders of Berkshire Hathaway, written by legendary investor Warren Buffett. This year I was disappointed by his presentation. In the past, Buffett could be counted on to provide wonderfully insightful tips for investors. He had a few this year ('if a business *requires* a superstar to produce great results, the business itself cannot be deemed great'), but nothing to get excited about.

This ties into the question of where are today's great mutual fund managers. Where is today's John Neff? I am convinced that it is entirely possi-

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Mallard Announcements

Bill and Paul To Speak at Conference
Bill and Paul will both be panelists at session of the NAPFA National conference in Long Beach, California in May.

Susan to Sit for CFP Exam
Susan, having finished her one year CFP program at the Unviersity of Delaware, will be sitting for the CFP exam in July.

Bill Runs First 5k
Bill ran his first 5k trail run at White Clay Creek State Park and came in third place (for his age group)!

Hockessin Office Hires Office Manager
Christina Crawford is the new part-time Hockessin office manager.

Where Are The Gurus?...continued from page 1

ble we will not get another Peter Lynch (legendary skipper of Fidelity Magellan during its glory years in the 80s) for the next decade—I am unwilling to make predictions beyond 2018 at this time.

I think there are two reasons for the apparent lack of superstar talent, managers of broad stock funds which regularly outperform their peers. First, the market and environment is incredibly crowded. Where there used to be hundreds of funds, now there are thousands. My Prius stands out in the Mallard parking lot, but is lost in the Christiana Mall lot, despite the political bumper stickers. We slice and dice the investing markets much more than we did twenty years ago, so exceptional generalists such as Lynch are few and far between. Bill Miller was on the short-list, but his weak results in the past few years have knocked him off.

The second reason for the lack of superstar fund managers is the growth of hedge funds. These turbo-charged funds are free of most regulation, and assess incredible fees. Buffett talked about the ridiculously high costs to hedge fund investors in his last annual letter. He noted that they are great deals—if you are the manager, but they are most often rotten deals for investors. So if you can run billions very, very well (or if you can convince someone of this), you will make much more money running a hedge fund than a mutual fund.

This leaves me still searching for gurus, and for great general fund managers. In the meantime, I'll settle for gaining small insights from a variety of great managers of more specialized funds. Unfortunately, the 'respect your elders' rule gets turned around, as occasionally these wise managers are at times younger than I am.

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

Buying a Pension

Paul S. Baumbach

This is another 'teaser article'. I plan to prepare a seminar on Annuities—The Good, The Bad, and The Ugly—later this year. This article is designed to explore one type of annuity, where you 'buy a pension'.

Wall Street Journal columnist Jonathan Clements has recommended single-premium immediate annuities (SPIAs) for years, noting that most retirees would avoid a lot of stress if a larger portion of their monthly income was guaranteed to last their entire lives, and was not subject to the ups and downs of the markets. Boston University professor Zvi Bodie recommends that retirees determine how much monthly income they need in retirement, and use SPIAs to provide all of this income, perhaps cashing out their entire portfolio. Academically, this approach has merit; however, the real world has additional challenges.

One major challenge is that SPIAs have traditionally been offered only with commissions that can make the difference between a good deal and a bad one. Another is that most SPIAs are offered like company pensions, with set monthly benefits which do not rise over time. A common deal-breaker is that most SPIA benefits cease at the owner's (or spouse/partner's) death, even if the death is premature. All three of these shortcomings prevented me from recommending SPIAs until 2007.

Due to recent advances in packaging of SPIAs, all three shortcomings can be overcome. The most significant development is that many insurance companies are now offering SPIAs without the layer of commission. There is a clearinghouse built to serve the fee-only advisor who doesn't take a penny from the insurance company, which obtains low-cost quotes from multiple companies, and enables advisors to 'comparison shop'.

Several companies now offer annual increases, either a set percentage, or with the level of CPI inflation. This helps ensure that your SPIA check is as valuable to you at age 95 as 70. Many companies also offer SPIAs with a 'return of premium' feature. As an example, a 65-year old married couple could pay $100,000 and get a $486.73 monthly benefit, which increases 2% each year, and which continues as long as either is alive. If they both die prematurely, the contract will continue to pay out the benefit, for 14 years and 8 months from the start, when it will have paid out the $100,000 purchase price.

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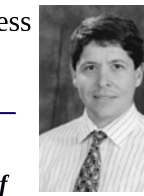
Buying a Pension...continued from page 2

Paul S. Baumbach

The elimination of the commissions and the more useful features such as annual inflation increases, have enabled fee-only™ planners, including myself, to consider integrating SPIAs into retirement plans. There are cases where SPIAs aren't needed, and in most others I would still only recommend that a small portion of the portfolio be used to buy a SPIA. However, this is a real change from two years ago.

I love managing investment portfolios for my clients, and planning how their portfolios will support their dreams during retirement. However, I admit that having all of your retirement income dependent on the markets can cause stress, stress which can limit your dreams. Secure, lifetime streams of income can be very comforting in retirement. It even can take stress away from the advisor!



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Margin of Safety

William D. Starnes

So many Americans live on the edge - the edge of job loss, divorce, disability, or bankruptcy. They live paycheck to paycheck and constantly hover so close to the edge that financial disaster is only a push away. That push can come at anytime without warning. This is one reason I pound the tables about having a **<u>margin of safety</u>** in order to protect from the unexpected.

This margin of safety can be built up from a variety of angles, and I would like to briefly review a few of them in this article.

<u>Refinance Your Home</u>—It may sound counterintuitive to refinance or extend the duration of a loan, but I suggest keeping an eye on interest rates and consider refinancing your primary (and possibly some secondary mortgage debt) mortgage with a <u>30-year mortgage</u>. Consider this when interest rates drop *over* 1/2 a percentage point from your current mortgage rate. How is financing your home over a 30-year time period creating a margin of safety?

Flexibility! Even with a higher interest rate than a 15-year mortgage, a 30-year mortgage makes a lot of sense in that the flexibility of the lower monthly payment provides a margin of safety against the worst. You can always make larger than needed monthly payments if desired (although I would typically never recommend this) and can even (if you are so inclined) pay off the mortgage early if things go well. But if things don't go well, you will appreciate the fact that you can drop your payment to the minimum, greatly improving your cash flow and greatly deceasing the possibility of losing your home.

<u>Always Be Insured</u>—If you have only group term <u>life insurance</u> and lose your job, or worse lose your job and then die, you will have lost an important safety net for your family. Group term life insurance can be cost effective for some, and (in some cases) is even convertible to personal insurance upon leaving a job (at a cost). However, you have lost your flexibility in the event of the worst. Buy private term life insurance in an appropriate amount. Consider Ameritas Direct or www.term4sale.com. Buy more than you think you need. The piece of mind is invaluable.

Disability insurance is another way to ensure that when you are skating on thin ice, you don't fall into the frigid waters of debt or bankruptcy. Most financial advisors agree on the grave importance of disability insurance, yet most clients won't buy it. It is expensive and most have some limited coverage through their employers. This limited coverage is cost effective and sufficient at the lower income levels, especially if you also qualify for Social Security Disability.

However, individual disability insurance is vital for above average income clients with a family to support. This is more than an academic question for me as I know firsthand the fear associated with not being able to work and support a family during the two years I went undiagnosed with Lyme disease. I was lucky and felt very comfortable with my two disability policies in the event of the worst. They provided piece of mind and a nice margin of safety against the uncertainties of life.

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