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Principle 5—Costs Matter.
As with cholesterol, there are good and bad costs. In investment accounts at firms like Schwab, TD Ameritrade, and Fidelity, there are mutual funds which are ‘no transaction fee’ (NTF), as you can buy and sell them without paying a fee. At times, the same fund is available in a different ‘share class.’ While you would have to pay a transaction fee to buy/sell it, it would have lower annual costs, typically 0.35% less per year. When you are buying enough of a fund, and planning to hold it long enough (commonly a year or more), it is often a good idea to pay the transaction fee to buy the lower-cost fund.

Investors often avoid selling a stock that has gone up sharply in price since its purchase. Sometimes they justify this by telling themselves that they are saving the taxes they would have had to pay on the gains. There are two weaknesses to that viewpoint. Oftentimes the taxes due are modest, while the risk is substantial. If you have a stock that doubled, but is overpriced, it often makes sense to sell half or all of the stock. You would likely pay only 10% of the value of the stock in taxes, but in so doing you would avoid the risk of the stock falling 15% or more, and you would avoid the need to pay the tax on the gain upon a later sale. The taxes on the gains of an overpriced stock are often well worth paying (a good cost). Even more importantly, stocks are purchased for their return, and an overpriced stock hurts a portfolio.

Extending the cholesterol analogy, an LDL level of 135 normally isn’t good, but if it had been 165, a level of 135 is very good. Annual expenses of 1.25% are expensive for most mutual funds. However, if you are looking at a group of Emerging Market stock funds, annual expenses of 1.25% are good, as the average Emerging Markets stock fund charges 2% annually. Similarly, if you are considering choices in your company retirement plan, 1.25% may be on the low end of your choices. High costs and low costs can be relative.

Principle 6—Taxes Matter.
I have applied the results of recent research into Asset Location, the study of which investments are best suited for a taxable account and which for a retirement account. This research indicates that you can earn an extra ¼% to ½% annually (after taxes) if you optimize this, although it is nearly impossible to measure this advantage. Few advisors and few investors utilize this edge. Look at the investments in your taxable account and your IRA. If they look the same, you aren’t tax-optimized.

I also prefer to monitor the cost basis for every single investment in taxable accounts. I harvest losses, and am very deliberate in which lot I use when recognizing gains. This requires more work and systems; however, it should result in more money in your pocket at the end of the day.

A portfolio is more like a garden, that requires not only planning and planting, but also watering, weeding, pruning, and harvesting.

Principle 7—Rebalancing Matters.
The first three principles hold that it is important to design a portfolio well at the beginning. A portfolio is not like a sculpture that is created once and is then available to admire. A portfolio is more like a garden, that requires not only planning and planting, but also watering, weeding, pruning, and harvesting. Without regular rebalancing, a portfolio will get too aggressive or too conservative.

I have shared seven principles for managing investment portfolios. You can adopt and adapt them as you wish. Your Investment Philosophy can guide you in the practical affair of managing your portfolio in good, bad, and even ugly times.

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

The Mallard Flyer

William D. Starnes – Managing Partner – Financial Planning Division
1041 Valley Road, Hockessin, DE 19707
(Ph) 302-239-1654 - (Fax) 302-397-2675
Bill@MallardAdvisors.com

Paul S. Baumbach – Managing Partner – Investment Advisory Division
273 East Main Street, Newark, DE 19711
(Ph) 302-737-4546 - (Fax) 302-397-2675
Paul@MallardAdvisors.com

Inside This Issue

July 2008

Controlling Your Financial Future

William D. Starnes

At Mallard, while we counsel clients on their investments and even manage their investments for them, we are truly **comprehensive financial advisors**. We recognize that our clients’ investments are only one part of their overall financial picture. However, investments (and especially the rate of return) can get more attention from clients than needed. While your rate of return is very important, our clients’ financial security is actually dependent on many factors that are even more controllable than the rate of return of the investment portfolio.

As Paul mentions in his article on page 3, return and risk go hand in hand. Therefore, in its most simple form, in order to maximize your ***long-term expected return***, you are actually simply choosing how much short-term risk you are willing to accept in order to shoot for this expected return. This is done by choosing how much of your portfolio is allocated to stocks. So, while your long-term rate of return is controllable through your asset allocation decision, your short-term rate of return is not.

Certainly, your long-term expected rate of return is important, but there are other factors that you have more short-term control over.

Which column of financial factors in the table below should you focus your energies on?

Uncontrollable	Controllable
Interest Rates	Taxes
Inflation	Income
Who controls Congress	Diversification
The future of Social Security	Lifestyle & Savings

Certainly, it is the controllable factors that you should focus on. Many people spend too much time evaluating, discussing, or worrying about the factors that are not under their control.

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Notices

Paul’s Schedule / Newark Office: Pam and Paul will be camping in Jim Thorpe, PA August 6th to 8th. Susan will be on vacation the week of August 11-15. Ed will be out of the office August 27th through September 2nd, and will be out the week of September 15-19.

Bill’s Schedule / Hockessin Office:
Bill and his family will be in Cape May, NJ July 14th through July 18th. Bill will also be out of the office the week of August 11th camping in Jim Thorpe, PA.

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

Mallard Announcements

Ed Mink joined the Newark team on May 5th. He is a student in the CFP program and the University of Delaware, and is currently working at Mallard Monday through Wednesday. Ed joins Susan as a portfolio administrator, and both are excited about becoming advisors at Mallard in the future.

Ed and Susan both live in Maryland—Ed in Rising Sun and Susan in Havre de Grace.

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So, let's briefly discuss some of the controllable factors that most people should focus their energy and time on.

The first factor is how much you earn. While it may seem in the short-term that your income is not under your control, it is. By learning new skills, adding recognizable value to what you do, obtaining more education, and knowing what your market value is, you are in a far better position to command a higher salary. When it comes to building your career, you have to plant some seeds, and you better plant a lot of them, because you can't tell which ones will sprout.

Whether you are an employee or self-employed, treat yourself as if you are self-employed! No company will take care of you for life. Pensions are disappearing, and health insurance costs are rising. You must continually think of yourself as a free-agent. Just like an athlete that does his personal best, and works well with the team, he is also focused on being "shown the money". If you think like a free-agent, you will no longer fear getting laid off. You will know your value, and you will know who will pay for your value. This will make you more attractive to an employer.

Remember, what you *spend* today creates today's lifestyle, but what you *save* today creates tomorrow's.

The second factor is how much you save—permanently! Sending $200/month to ING Direct is not savings if the money will be spent on a vacation later in the year. That is slush savings, not permanent savings. I have written about savings targets in the past based on your age, current savings, and income. The bottom line is that most of us need to be saving about 15% - 20% (including the employer's contribution) of our gross salary to permanent savings. Those who delay savings may need to save 25% of their salaries. **<u>Remember, what you spend today creates today's lifestyle, but what you save today creates tomorrow's.</u>**

The third factor is tax savings. It is everyone's patriotic obligation to pay their legal share of taxes, but not one penny more! Overpaying happens all the time through poor record keeping, or tax ignorance. We emphasize tax education, building portfolios that consider tax-efficiency, amending prior year returns, integrating taxes into our financial planning via annual tax planning, and even preparing clients' tax returns. One of the best ways for clients to legally minimize their overall tax liability is through understanding deductions and how to keep the records necessary to substantiate the numbers reported on your tax return.

The fourth factor is diversification among the major asset classes. Asset allocation at its most basic level is the conscious decision to split your investment portfolio between risky assets (i.e., stocks) and lower risk assets (i.e., bonds & cash). This split is the prime determinant of the amount of risk in your portfolio, and your expected long-term returns. Therefore, it must be the first and most important decision any investor makes. More important than selecting the investments that underlay each of your chosen asset classes.

For example, today there are 26,000 mutual funds and ETF's, but *relatively speaking* how much differentiation is among the choices in each asset class? It is like trying to choose between the Post and Kellogg's brands of raisin bran cereal. I am sure the manufacturers believe there is a world of difference, or at least it is their job to convince us that there is. But frankly, most of us can't distinguish the two cereals in a blind taste test. And that is the way it has become with many mutual funds. Don't let the dizzying array of choices confuse the fact that asset class investing is more important than the selection of the underlying investment vehicles.

The fifth factor is buying the right cost home and trading up as your income rises. A home is an investment in the traditional sense, but it is also an investment in the quality of our lives.

A home provides tax free gains, positive financial leverage, deductible mortgage payments, interest rate protection, inflation protection, and a place to raise your family.

If you don't own a home, buy one now. If you own a home, you should evaluate the benefits of trading up to a more expensive home.

Focus on the controllable factors ***each day***, and there is a high probability that <u>the future will take care of itself</u>!

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

Philosophy 101

Paul S. Baumbach

Wikipedia has six definitions for Philosophy. The fifth is *a system of principles for guidance in practical affairs*. A philosophy can define for you what is true and what is false, and can help you when making tough choices. All investors regularly face tough times, and this has been a banner year for tough times for investors. I have my own Investing Philosophy, which I apply to clients' portfolios. In this article I will share some of the core principles, and in the process perhaps you can explore your own Investing Philosophy.

Principle 1—Fundamental Truth.
Returns and risk are tied together; investments that may provide great returns always come with substantial risk. Over time, stocks have regularly outperformed bonds; however, in the past stocks also have suffered much greater losses than have bonds.

Principle 2—Risk Matters.
It is critical to get the right balance of risk for a portfolio. The simplest way to measure a portfolio's risk is to examine the percentage of the portfolio invested in stocks and stock funds. If the stock level is too low, the investor will inevitably regret it during a surging stock market, and will be tempted to 'buy high.' Similarly, if the stock level is too high, the investor will almost certainly regret it during a falling stock market, and will be tempted to 'sell low.' Both of these temptations are hazardous to a portfolio's health, and can best be avoided by identifying up front the 'right' level of risk for that investor/portfolio.

Principle 3—Diversification Matters.
Once you determine the 'right' level of stocks for your portfolio, how do you allocate those dollars? Certainly you don't buy one individual bond with the bond money and one individual stock with the stock money. When investing in bonds, I direct 80% to high quality bonds, with the remaining 20% invested in high yield and foreign bonds.

Stocks are much more complicated. There are at least four factors I consider when evaluating stocks for a portfolio—company size, foreign or domestic, industry, and single-stock concentration. Used properly, these factors can help create a broader, well-diversified portfolio, resulting in smoother results. As an example, I prefer a 2:1 ratio at this time for US:foreign stocks. I use this ratio to reflect that, while US stocks currently make up approximately half of all stock market capitalization, most US investors would be uncomfortable with the volatility that could result from a 50% allocation to foreign stocks. I do expect to bring the foreign portion from 33% towards 50% in the coming years, as stronger growth abroad continues to reduce the US share of the global stock market, and this growth should be accompanied by more stability from the largest foreign companies.

Principle 4—Research Matters.
Whether researching stocks or mutual funds or exchange-traded funds (ETFs), you make better decisions when you have good information. I use research from Morningstar, Value Line, Zacks, and fi360 for fund and stock analysis. Stock analysis is quite different from fund analysis—stock analysis is forward looking, while fund analysis is backward looking. When analyzing a stock, I focus on where it is going, and how much it will likely earn in the coming years. Just as important as whether you expect it to earn a boatload in the future is whether you are paying a boatload for the privilege. I create a ratio to measure the risk and return (remember the fundamental truth) to tell me whether the potential reward is worth the present cost.

With mutual fund and ETF analysis, you aren't considering risk and return as much as you are examining its system and its approach. While no guarantee, the past can be quite revealing into a fund's systems. I examine several factors, including past performance, manager tenure, style 'purity,' and cost. This analysis helps me see which funds appear to have the best chance of continuing to excel.

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