

In December we learned that upwards of \$50 billion had been lost by investors who had trusted Bernie Madoff Investment Securities, in the largest Ponzi scheme in history. In a Ponzi scheme, money from new clients is used to provide returns to older clients, and all Ponzi schemes eventually fail when clients begin asking for their money back, more money than new clients are providing.

The Madoff scandal was disclosed in late 2008, and it couldn't have come at a worse time. Most investors had seen their stocks and stock funds fall from 35% to 50% in the first eleven months of 2008. Now news comes that many investors had 100% losses, due to their use of Madoff's firm.

Many investors had chosen Madoff's firm the same way that most investors choose an advisor—Madoff had a good reputation (he was the past chairman of the NASDAQ stock exchange), he had an impressive client list, possibly exclusive, and of course he was registered by the SEC (although reportedly only for a few years). The clients and advisors who recommended him pointed to records of steady returns, 1% every month, like clockwork. His firm was the sixth largest on Wall Street in 2008, according to Wikipedia.

How can you be certain that you are not a victim of 'the next Madoff'?

Smell Test—Do your results (or those you are being promised) appear too good to be true? **Steady** results much higher than bank CDs are not possible. To get results higher than CDs require risk, the risk of results being lower (even negative) from time to time. Steady returns or high returns—choose one, as you can't get both.

Madoff also claimed that he didn't charge advisory fees, that his compensation came purely from the trading costs which he earned from the transactions. I'll wager that not a single Madoff client tried to compute exactly what they were paying Madoff.

Black Box—Do you understand what your advisor is doing? I am very skeptical of so-called black box approaches (where an advisor feeds a bunch of data into this formula and presto, the answer comes forth). If an advisor cannot explain what they are doing with your money in a way that you can explain to a colleague, then I would steer clear.

At Mallard, we use a mix of stocks and bonds (or stock

funds and bond funds), with the balance based on the individual client's tolerance for risk, displayed need for higher returns, and on our judgment of the level of risk in various classes of investments. Our clients earn investment results based on the results of the underlying markets (money markets, bonds, US stocks, foreign stocks, etc). There is no mystery or black boxes in our approach.

Total Control—Madoff held all of the cards. He was not only the advisor, he also served as the custodian and bookkeeper of his clients' money. As such, all statements came from his office, and this enabled him to falsify statements for years, without discovery.

SEC—I am absolutely floored by the apparent complete incompetence of the SEC in protecting clients from Madoff's Ponzi scheme. The SEC was created in the 1930s specifically to protect clients against this kind of harm. I used to be proud that Mallard is regulated by the SEC. The SEC's reputation is going to have to be re-earned.

Even with the SEC's tarnished reputation, you should still examine a prospective advisor's Form ADV, which large firms are required to file annually with the SEC. Does it make sense to you? Madoff's Form ADV claims that he had only 23 accounts, and that he had no more than five clients in any state other than New York, and that his firm has over fifty non-clerical employees. That should have failed the smell test. His ADV also noted that in the past he had violated a 'minor rule', a violation in which he was censured and paid a \$7,000 fine. Together, a review of Madoff's Form ADV should have served as a red flag to potential and current Madoff clients, and to SEC examiners.

In the meantime, follow these two steps to reduce the risk of falling victim to these schemes.

Protecting Wall—Ensure that the individual managing your investments is not also producing your only statements. At Mallard we use third-party custodians such as TD Ameritrade and TIAA CREF. In addition to holding (custodying) client assets, these firms also deliver statements directly to our clients, so that we cannot fabricate statements. When adding assets to your accounts, you should never write out a check to the advisory firm, but rather should always make checks for contributions out to the custodial firm.

Many readers use brokers at firms such as Morgan Stanley and Merrill Lynch.

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Paul's Schedule / Newark Office:

Paul plans to attend the TD Ameritrade conference in Las Vegas from February 3rd to 7th, and a Technology Conference in Dallas from February 26th to 28th, at which he will serve on a panel of technology-advanced financial planners.

Bill's Schedule / Hockessin Office:

Sherry will be out of the office after her wedding from February 9th to February 20th.

Next Newsletter:

The next newsletter is scheduled to be mailed in early April.

THE MALLARD FLYER

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Three Keepsakes From 2008

New calendar years bring with them hope for change and new beginnings, and if there is any year I have ever wanted to exit, it has been 2008! With the S&P 500 losing 37% of its value, entering into 2009 is a relief. The turmoil in the markets over the last year and particularly over the past four months has been very painful and from a historical standpoint unusual. While entering into a new year feels good, in reality, the trading days will continue to unfold one by one with the usual disappointments, volatility, and surprises. Paul and I read a lot of information during this painful time of stock losses, and have kept you updated on the stock market, economy, and our thoughts with newsletters, e-mail, and phone calls. Through it all, there are three important lessons to remember.

1. The world is risky and unknowable by anyone

The market can turn on a dime for reasons that are unknowable and uncontrollable. While it may seem there are "experts" out there that can see the future, there aren't (at least not consistently). There are those experts who "don't know where the market is going", and those who "don't know they don't know". Unfortunately, the livelihood of many advisors and commentators depends on their appearing to know. Because short-term stock market returns are unknowable and unpredictable, reacting to the unknowable is useless.

The world stock markets are also risky. They are risky no matter the investment horizon. And you should not take on more risk than you have the ability, willingness, or NEED to take. Risk is always present but is normally *lower* when the market is undervalued and is in panic mode, and *higher* when everyone is making money. When the outlook is the worst, future returns are likely to be the highest. In fact, history shows that when 10-year annual average returns fall to 1% or less (as they have over the last 10 years), the subsequent 10-year annual average returns have been 10.7%.

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Mallard Announcements

Congratulations to Sherry Vannoy. Sherry is getting married on February 7th 2009 to Roger Jamieson. They are then headed off to Aruba to celebrate. Sherry has worked with Bill over 10 years and serves as the financial paraplanner in the Financial Planning division. Everyone is delighted for Sherry.

Paul is presenting a seminar on Annuities—The Good, the Bad, and the Ugly at the Newark Free Library on February 9th in the evening. Call the Newark office for more information.

2. Focus on the controllable

Last year in this newsletter, I spoke about the importance of placing our energies and focus on those things that we can control, such as how much money you earn, how much you save, rather than worrying about the things you can't predict or control.

So much time, worry and energy is spent on evaluating, discussing, and projecting things like rate of returns, inflation, interest rates, or who the next president will be. While certainly important to our portfolios, these things are just not under our control. Worse, they are impossible to consistently predict and therefore profit from.

In considering the shorter-term, accurately forecasting world political events, terrorism, the economy, and the markets borders on impossible. But while we at Mallard have very little confidence in the ability to make successful investment decisions based on short-term predictions, we have a high level of confidence in our ability to make the best long-term decisions with our clients by focusing on the controllable factors each day. By doing so, there is a high probability that the future will take care of itself.

3. The stock market is a leading economic indicator

The stock market is a "leading economic indicator". This means that it moves up and down in expectation of changes in corporate profits (and our willingness to pay for these profits) and how these profits will change as a result of changes in the economy.

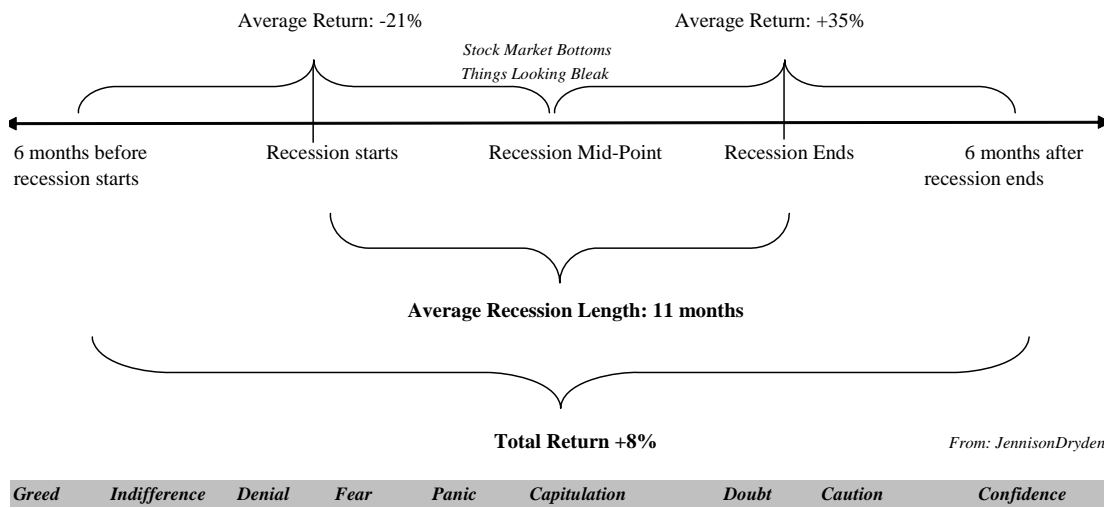
The table below shows the average statistics for the previous nine recessions (not including the current) and returns for the S&P 500 during these times. First, notice how the returns of the stock market begin to decline prior to the recession start, and begin their ascent prior to the recession end.

In fact, markets typically bottom about half-way through recessions—when things look their bleakest and we are at a recession mid-point.

This is why you want to avoid selling stocks when things look the bleakest or when there is panic in the street. After the market bottoms about halfway through a recession, it is then followed by an average gain of 35% over the next twelve months. Much of this gain is front-end loaded and in order to participate in it, you must remain fully invested. If you wait until the "economy has stabilized" to get back into stocks you will miss most of the returns. As Warren Buffet recently said, "If you wait for the robins, spring will be over". Missing out on these returns can be devastating, especially if you participated in the losses.

Avoiding the -21% loss shown below and participating in the 35% gain is seductive because it plays on both our fear of loss, and greed for returns. However, playing the timing game can just as easily result in the opposite.

At the bottom of the picture is the emotional cycle that typically occurs during an economic cycle and includes emotional movements from greed to panic and capitulation. Panic and capitulation occur when "things look bleak" and usually result in selling at market bottoms. This is when the outlook is the worst, recession is in full swing, headlines are gloomy, and stock returns are at their lowest. While this is the hardest time to be a contrarian and buy stocks, in general when the outlook is the worst, future returns are likely to be the highest. It takes courage and discipline to act, but if you remember that while the reward may not be immediate, the reward will likely come. Don't invest along with the emotional cycle shown below and understanding that the stock market is a leading economic indicator will help.



Let's face it, most of us have paid the price of risk in 2008. Now let's wait patiently to be rewarded for this risk in 2009!



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

Let's start with a few things that are known, visit one change that may (or may not) happen, and finish with an item that's closer than you might think.

Qualified Charitable Distributions – Sometimes referred to as QCDs, these special IRA distributions were first allowed back in late 2006, but *only* through the end of 2007. In October of 2008, as part of the infamous \$700 billion "Bailout Bill," QCDs were retroactively authorized for 2008, and for all of 2009 (but not beyond). This allows individuals who are over age 70½ to have *pretax* funds sent directly from their traditional IRA to their favorite charity or charities (most, but not all, charities qualify) — free from federal income taxation, without having to itemize deductions at tax-filing time.

A few additional details are notable. 1) QCDs count toward satisfying an individual's required minimum distribution (RMD) for the year (either as an owner or beneficiary), 2) the annual QCD dollar limit per person is \$100,000, and 3) the payment must be made directly to the charity. Use of QCDs is most beneficial for taxpayers who use the standard deduction rather than itemizing, and next best for taxpayers who are significantly affected by AGI (adjusted gross income) limits, for instance in calculating how much of their Social Security benefits are taxable.

Capital gains tax rates – In 2008, most long-term capital gains were taxed at 15% for taxpayers in the 25% and higher marginal tax bracket (and at 0% for individuals in the 15% and lower brackets). This year the capital gain rates revert to the previous 20% level (and at 10% for lower bracket taxpayers). Finally, the capital gain tax rates fall 2% (to 18% and 8%) for gains from assets held five-years or more.

Dividends tax rates – In 2008, qualifying dividends were taxed at 15% for taxpayers in the 25% or higher marginal tax bracket (0% for individuals in the 10% and 15% marginal tax brackets). However, in 2009, dividends will be treated as *ordinary income*, subject to standard marginal tax rates. This can significantly increase taxes for those who depend on sizeable dividend income from their portfolios.

RMDs for 2009 – Congress passed a law that allows IRA owners and beneficiaries to essentially disregard IRA distribution requirements for 2009! This one-year exception is designed to provide some relief to taxpayers who have suffered setbacks from the 2008 decline in the stock market, and is especially helpful to taxpayers who have sufficient resources without this mandated taxable income.

Converting IRA assets to a Roth IRA – Okay, maybe I'm getting a little ahead of myself on this one, but I think that it's worth a little advance notice. In 2010, the income limits for converting assets from traditional IRAs to Roth IRAs will disappear! This will provide many opportunities to those who have not been eligible in the past. Some of the possible advantages of completing a conversion include: 1) controlling the year in which distributions from traditional IRAs are includable in taxable income (which may be beneficial from Social Security benefits tax planning and possible marginal tax rate reduction), 2) reducing the overall size of your taxable estate, and 3) providing tax-free income to your Roth IRA beneficiaries.

Ed Mink joined Mallard's Wealth Management Division in May 2008.

I wouldn't worry about fictitious statements from these firms, as long as the statements are produced at an office other than where your broker works, and as long as your actual broker is not able to directly control the statements that you receive.

Trust, but validate—Word of mouth recommendations are valuable, but still use your own good sense when meeting with a potential advisor. Ensure that their explanations pass your smell test, that they do not promise what no one else seems to be able to achieve (such as steady results month after month, even when all markets are falling), and that

they do not depend on some secretive black box system which they can't explain well enough to you that you can explain it to a colleague.

These common-sense steps will reduce your chances of making a poor decision in selecting an investment advisory firm, as thousands of Madoff's clients learned, too late, that they had done.

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

