The Mallard Flyer

William D. Starnes—Managing Partner—Hockessin Office
1041 Valley Road, Hockessin, DE 19707
Ph: 302-239-1654 - Fx: 302-397-2675
bill@mallardadvisors.com

Paul S. Baumbach—Managing Partner—Newark Office
750 Barksdale Road, Ste 3, Newark, DE 19711
Ph: 302-737-4546 - Fx: 302-397-2675
paul@mallardadvisors.com

Inside This Issue

April, 2011

Notices

Newark Office:
Ed is on vacation from May 5th to May 11th. Pam and Paul are attending the NAPFA National conference in Salt Lake City from May 18th to 20th, and Pam will take vacation through May 24th.

Hockessin Office:
Sherry will be out of the office from April 4th to April 13th spending time in St. Martin. Bill will be out of the office the week of April 18th vacationing in Virginia. Bill is attending a conference June 1st to 3rd, and will be at the beach the week of July 27th.

Nebraska Nuggets

Paul S. Baumbach

For fifteen years now in this newsletter I have reviewed the annual shareholder letter from Warren Buffett, the CEO of Berkshire Hathaway (based in Omaha, Nebraska). Berkshire has increased its book value by 490,409% over the past 46 years (that's a 20% compound annual growth rate). When someone has racked up numbers like that, it is worth hearing what he's saying. In this article I examine a few passages from his letter, and then reflect on what it might mean for you.

Berkshire began as a very small operation, but is now a conglomerate of a very wide variety of businesses. It is so large now that little deals are hardly worth the effort. Buffett is looking for large deals (he completed the purchase of railroad Burlington Northern Santa Fe last year). He writes "We will need both good performance from our current businesses and more *major* acquisitions. Our elephant gun has been reloaded, and my trigger finger is itchy."

Self-awareness is valuable for investors, to recognize your own scale, to understand perspectives. Berkshire has to seek major acquisitions because it is gigantic, with a mountain of cash standing by. If you have a well-diversified portfolio with fifteen mutual funds, **don't pay equal attention to all fifteen funds**. Pay the most attention to the ones with the most money invested in them. If one fund has twice as much invested in it as the next largest holding, spend twice the time reviewing it. In well-designed portfolios, the most volatile positions will be small ones. Don't lose sleep over a fund losing a large percent, if you only have a small amount invested in it. **Focus on the forest, not the trees.**

Several of Berkshire's businesses were hit hard by the reces-

Continued On Page 2

Mallard Announcements

Bill Quoted in Consumer Reports
Bill Starnes was quoted in the March 2011 issue of Consumer Reports Money Advisor. The article was titled, "Beware These 3 Costly Traps: Affluent retirees need a plan to avoid higher Medicare rates and taxes on Social Security."

Credentialed
In March Susan Lehnerd was awarded the CFP® certification. In March Pam Baumbach was awarded the CDFA™, Certified Divorce Financial Analyst designation. Paul Baumbach was named the Dean of Investments for NAPFA University (NAPFA U), which provides continuing education for Fee-Only financial planners across the country. Paul leads a group of NAPFA planners in conducting training in investment matters at NAPFA conferences and boot camps and webinars.

sion, and the housing meltdown. However Buffett is not anxious—he is a very patient investor. "A housing recovery will probably begin within a year or so. In any event, it is certain to occur at some point…. At Berkshire, our time horizon is forever." Berkshire has benefited handsomely over time from having the luxury of that timeless horizon.

As I emphasize in my Firewall Investing lectures, most investors have a longer time horizon than they realize, and have plenty of time to wait out downturns. Few investors have unlimited time horizons, but most can wait five, seven, or even ten years before they **must** sell stocks. This has been plenty of time to wait for a recession to end and for stocks to recover (we had two market declines and rebounds in the past eleven years). Knowing your true time horizon can help you avoid making the costly mistake of selling stocks during a weak market, rather than waiting a year or two or three. There have been substantial rewards for investing with a long time horizon.

Buffett writes a section entitled **Life and Debt**. He notes the dangers of irresponsible borrowing (leverage). "But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in the third grade – and some relearned in 2008 – any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people."

Investments rarely go to zero, but they can fall sharply, and paper profits can evaporate quickly. This is one of the **justifications for regular rebalancing**, cutting back your most profitable investments. Once you have reduced a profitable position, you have locked in some of the gain, even if the investment subsequently falls sharply. 2010 provided many ups and downs, and therefore many opportunities to rebalance. 2011 (with the Japanese earthquake, tsunami, and nuclear plant crisis) is already on pace to continue the turbulent path. **Do you plan to take advantage of this opportunity to rebalance and seal in some of your profits, and buy bargains?**

At the end of this section, Buffett notes that "By being so cautious in respect to leverage, we penalize our returns by a minor amount…. We will be equipped both financially and emotionally to play offense while others scramble for survival. That's what allowed us to invest $15.6 billion in 25 days of panic following the Lehman bankruptcy in 2008."

This is a good time to talk about cash (money markets). Today most money markets yields are near zero, and yet **there are some compelling reasons to hold cash in your portfolio**. At some times, but certainly not today, cash earns a decent yield. Cash can provide emergency liquidity (if you need to dip into your portfolio to pay for a new roof, for instance), without needing to sell any investments that are currently at low prices. Finally, cash can serve as 'dry powder,' a storage location for money that you want to have available at a moment's notice to take advantage of a compelling investment. This is the role that Buffett describes above in the post-Lehman crisis.

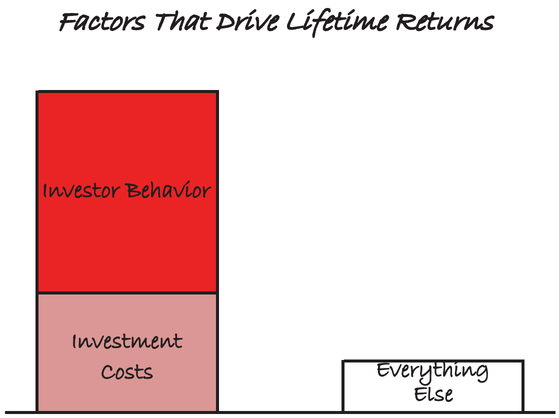
This brings us back to scale. Many investors find themselves stressing over the near-zero earnings on their cash. Yet most investors have less than 5% in cash. Focus on where 95% of your portfolio is. That is where your time is better spent.

In the coming months, focus on scale and perspective in your investing. Consider the time horizon for your portfolio. How long can you hold off on selling stocks the next time they fall sharply? Ask now, so that you are better prepared when it starts, so that you can make a better-considered decision. Understand the multiple reasons for having cash in your portfolio, and determine if you want to maintain an 'opportunity pool.'

By taking these steps, you will be following in the footsteps of one of this country's greatest investors.

Paul Baumbach is the managing partner of Mallard Advisors' Newark office.

As I mentioned on my audio CD titled Investment Success, the two primary factors impacting your actual lifetime investment returns are investment costs and investment behavior. Even if a someone is invested in the most well constructed portfolio ever created, their lifetime returns could be very poor as a result of bailing out in the midst of a market bottom. Therefore, again, it is ***investors*** who have more of an impact upon lifetime returns than ***investments***.



It has been clearly proven (over and over) that most investors do not earn the returns of the funds they invest in because they move into top performing funds after most of the good returns have been earned. Then investors bail after most of the losses have been incurred.

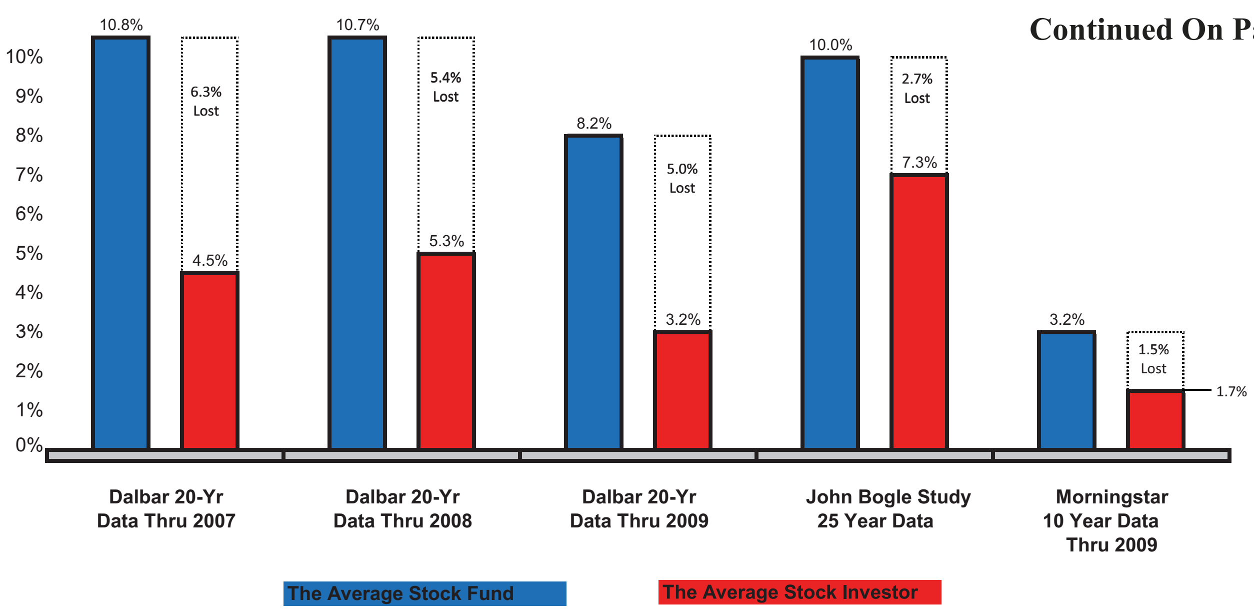
It is not just the poor timing of funds themselves, investors also tend to ramp up their fund purchases at the top of the stock market cycle and sell out at the bottoms. This investor behavior results in investors earning very poor returns relative to the funds they invest in.

Supporting Research.
The most popular source of this type of research is from *Dalbar, Inc*. *Morningstar* also calculates investor returns for every fund and compares them against the fund returns. Below are the results of several studies from several sources. ***Average Stock Investor Return*** is a dollar-weighted return. This means that it takes into account the size and timing of investors' purchases and sales. For example, if investors put a lot of money into a fund and the fund does poorly after that (i.e., they "bought high"), the investor return will be low relative to the fund's published return. Same if investors pull a lot of money out of a fund during a period of poor performance and the fund does well afterwards they will have "sold low". Naturally this type of poor timing will result in poor returns.

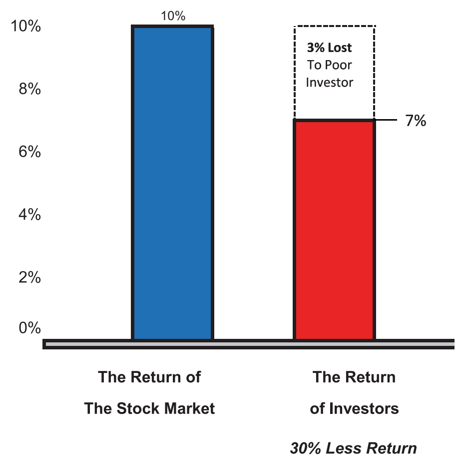
The latest DALBAR study shows the investor return in all equity funds in the 20 years ended in 2009 was 3.17% while the same equity funds returned 8.20% during the same period. It doesn't say it directly but it implies that investors' poor market timing cost them 5% a year for 20 years. In addition to the 2009 Dalbar study, I have illustrated the results of several of these studies from various sources in the chart below.

While the exact percentage of lower returns varies

Continued On Page 4

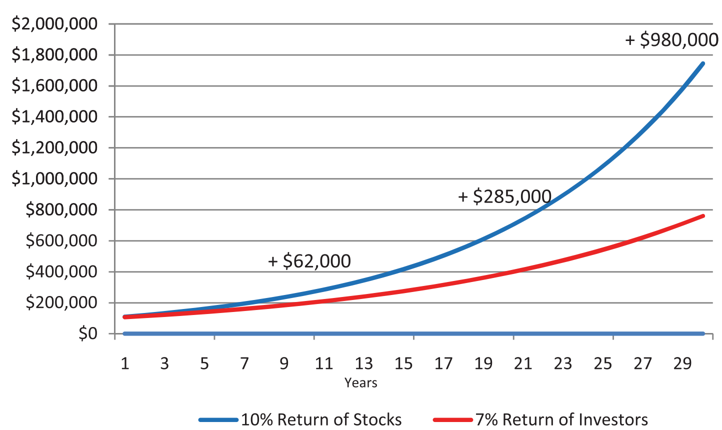


upon researcher, time period, and sector of the stock market, regardless, all the studies have one thing in common – investors real life returns are far less than the investments themselves. In fact, investors returns are generally 30%-50% lower than the investments themselves!!!



What is Going On Right Now?
Is this poor investor behavior going on right now? Of course it is – to one degree or another. The Leuthold Investment Group tracks net inflows and outflows in U.S. focus equity funds with a recent peak in mid February. These are the <u>highest net inflows since January 2004</u>. This clearly shows why so many mutual fund investors grossly underperform both the market averages and the average performance of mutual funds as shown in the various studies. The pattern of panic selling in market declines and lack of participation in recoveries has repeated itself year after year.

There have now been 16 weeks of net inflows for U.S. equity funds, with these inflows trailing off somewhat with the Middle East unrest and the earthquake in Japan. <u>Does this mean with all of the cash inflows, you should sell equities?</u> **No.** While this type of contrarian information is valuable, it is far more likely to "pay off" at the valuation extremes. We are likely not there yet.



The Cost of Poor Investor Behavior.
If the cost of poor investor behavior are returns of about 30%-50% less than stock returns, this means that if the stock market earns 20-year returns of 10% (average annual), then the average investor only earns 7% each year.

Let's make this real as illustrated in the chart at the top of the page. A difference of 3% lower annual returns on a $100,000 investment amounts to a portfolio that is <u>lower</u> by $62,000 after 10 years, $285,000 LESS after 20 years, and $980,000 LESS after 30 years! Investors bear the risks associated with investing in equities, but don't obtain the rewards.

Naturally, as you can see, one of the most valuable services that an advisor can provide is to help clients avoid mistakes that lower their returns.

Unfortunately, it is not as easy as saying "don't run with the herd", or "don't time the market". Like losing weight, investing is simple but it is not easy. It is not easy because money is fraught with emotion, family history (childhood), financial trauma (such as bankruptcy, or bear markets), and it is influenced by our core values and beliefs (and some of our beliefs may not be rational). So, even though intellectually, we know we should not time the market, <u>at times our fears may overwhelm our logic resulting in timing related mistakes.</u>

Investors can overcome these mistakes by having an advisor they **trust**, who communicates and sticks to a strong well grounded **investment philosophy,** who helps their clients set and achieve **well-defined goals**, and assists clients in identifying and avoiding their **inherent pitfalls**.

While most ***investors*** allow their unchecked emotional reactions to blow their lifetime performance, we remain steadfast in our conviction that ***our clients*** can and will avoid these common investment mistakes.

Bill Starnes is the managing partner of Mallard Advisors' Hockessin office.