The Mallard Message

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Mallard Asset Management Corp **(302) 737-4546**

Frequently Asked Questions

1. **Do you plan to grow beyond your current one-person size?** My initial response is no, however I note that two years ago I had no intention of starting my own firm in the first place. I have prepared some preliminary plans on how I would expand **if** Mallard gets to that point. The plans include constraints necessary to maintain the high level of personal attention that is integral to Mallard's approach to your portfolios. Expansion would solve some challenges related to coverage during vacations and illness, but would also introduce other challenges related to supervision and maintenance of quality of service. Again, I have <u>no</u> plans to expand Mallard at this time.

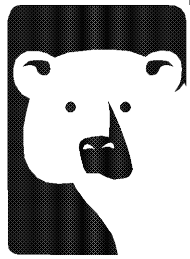
2. **Where is the stock market headed?** Note that I have yet to be invited to speak on Louis Rukeyser's "Wall Street Week" program. If the direction of the market was clear to me, then I suspect that enough others would come to the same conclusions, thus moving the market quickly. It takes two opposing perspectives to create a market, and it takes risk to produce opportunities for expected returns greater than those from bank CD's. As a student of 'Modern Portfolio Theory', I believe that portfolios are best diversified between types of assets which are expected to behave differently from each other. This diversification effort is more worthwhile than trying to predict the near-term direction of the US stock market.

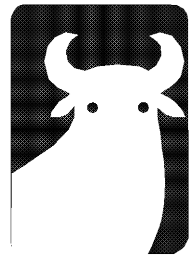
3. **Where are good investing opportunities?** Last summer my son and I were walking along a beach when we found a conch shell. We found this after a long walk away from the crowded swimming areas. In investment terms, this is called a contrarian approach. I find it hard to identify bargains amongst the S&P 500 stocks; there are just too many analysts, and too many index funds happy to purchase these shares at the current price regardless of the value. I prefer an 'desert island' approach. At this time, I am intrigued by the current lonely sites: Japan, and emerging markets (especially Asian). The best manner to apply this approach is to first set limits on these investments, based on an appropriate exposure to these areas (developed international, and developing international), and your existing allocation to these areas. Mike and I may have been able to find more conch shells if we went further down the beach, however we were also interested in getting back before dark.

Inside This Issue

Taking Stock

What drives my decisions to purchase and sell stocks? This simple question begins the journey into discovering one's investment philosophy. I suspect that the best method to examine this issue is to review the stocks that I have purchased and sold for clients during the past quarter.





Purchases—most of these have been in the category of 'bottom-fishing'. Typically a news story is released, and the stock's price plummets. I then review what I consider to be the underlying fundamentals, and when I am convinced that the reaction was unreasonable, I make a purchase. Eastman Kodak, Just for Feet, SBC Communications, Seagate Technology, and Station Casinos are all examples of this situation.

One of my portfolios is a fairly focused high-tech one. In this portfolio I purchased several electronic firms: Marshall Industries, Powell Industries, Sterling Electronics, and Vishay Intertechnology. Despite the aggressive goal of this portfolio, I have included a form of value-hunting to the process. For example, I waited to purchase Vishay several weeks until its price fell a bit. Note that this approach also produced missed opportunities (most notably Texas Instruments, which never passed the value hunt, and rose nonetheless).

Sales—There are three common reasons why I sell stocks. First, the stock's price has risen far in excess of its future prospects. This overvalued situation was involved with the sales of Cummins Engine, Petro Geo Services, and Safety Kleen.

A second reason is that the future prospects have fallen more than its price. When this occurs, it is often best to take the losses and find better prospects elsewhere. This was the case with Novell and UST Inc.

A third reason is to rebalance a portfolio, and reduce the concentration in a single stock or a single industry that has performed well in the past. This was the reason for sales of 3COM Corp, ICN Pharmaceuticals, Pfizer, and Schering Plough. In each case the position was merely reduced, not eliminated, largely due to the tax consequences of selling the complete positions.

Resources—I use Barrons, Baseline, Nikkei Weekly, Value Line, Wall Street Journal (print and online), and Yahoo as my primary resources. I also occasionally use Morningstar, and Standard & Poors. Note that Baseline, Wall Street Journal (online), and Yahoo regularly report on the research from brokerage houses.

It's Mutual (Funds)

Similar to the previous article on stocks, it is worthwhile to share my process of reviewing mutual funds. I am a strong proponent of passive mutual funds, yet I do favor the use of active managers in certain circumstances.

Passive Funds—These mutual funds offer very low operating costs (and brokerage costs), and offer very well-defined performance, by closely tracking a specified index. I use index funds from Vanguard except when a 401K/403B plan only offers index funds from another family. I use these funds for large US stocks, small US stocks, international stocks, US bonds, and some sectors. When I seek very specific asset allocation benefits, index funds often meet the need best.

Active Funds—There are many mutual funds that have a long track record at focusing on a specific market niche. This is reason that my portfolios contain positions in active funds from Cohen & Steers, Heartland, MAS, Northeast Investors, PBHG, Royce, SoGen, Vanguard, and Warburg-Pincus.

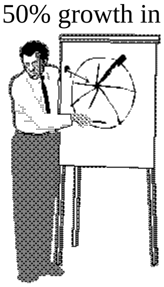
Closed-End Funds also deserve a role in many portfolios. They often provide access to focused market niches, including single countries. Examples of funds that I use for this purpose are Petroleum & Resources and Templeton Dragon.

Another strength of closed-end funds is the ability to purchase assets at a discount. This discount can both increase and decrease. In rare cases, the closed-end fund can 'convert' to open-end status, and thus eliminate the discount. This occurred in 1997 for a fund held in one of my portfolios: New Age Media was converted into the existing open-end T. Rowe Price Media & Telecomm after rising 34% (half from underlying stock gains and half from the elimination of its discount).

Resources—I use Morningstar heavily for mutual fund reviews. I also subscribe to a closed-end fund newsletter. I regularly read the semiannual reports on the active funds held in my portfolios. In this manner, I can determine the managers' review of the past, expectations for the future, and significant stock positions. I use the quarterly Lipper data presented in Barrons' to identify strong and weak market sectors (crowded and deserted market sectors).

Can't Get Enough?

As you may have guessed based on the 50% growth in the size of this newsletter, I enjoy speaking about investing, and about Mallard. If you have a friend who may be interested in considering Mallard, or if you have a group which seeks a speaker on investment matters, please give me a call.



What a (Tax) Relief!

Congress and President Clinton approved the Taxpayer Relief Act of 1997 this summer. There are several changes that affect portfolios. The most significant is the reduction in the maximum tax rate for long-term capital gains, from 28% to 20%. The term necessary to obtain this long-term rate was extended from 12- to 18-months, and is being phased in this year. This also impacts investors who are struggling with the decision of whether to reduce a concentrated position in low-basis stock versus holding it to death, thereby obtaining the stepped-up basis.

There is also a schedule for the increase of the estate tax exclusion from $600,000 to $1,000,000 (as of 2006). This affects the balance of assets between spouses seeking to minimize federal estate taxes.

There are several changes to IRA accounts. The most significant is the Roth IRA (named after the Delaware Republican who has championed this effort). This becomes effective on January 1st, and warrants a close look at its impact on your retirement goals.

Lower Vanguard Fees

Effective November 3rd, Vanguard will lower the transaction fees at four of its index funds, including two which I regularly use: Extended Market and Total International. As the funds grow in size, Vanguard achieves economies of scale, and can pass on the cost savings to shareholders through reductions in their fees. These fees are different from loads, which go to the fund family and/or salesperson. Vanguard's transaction fees go directly into the fund in which you are investing, so that the cost of investing your new dollars (commissions on purchasing new shares of the underlying stocks) will not hurt the performance of existing shareholders.

I fully support Vanguard's transaction fee structure. It is a responsible method to have investors 'pay as you go', and to protect existing, long-term investors from costs associated with new, short-term investors. It has an appeal similar to fee-only financial advice, in which the costs are well-disclosed, unbundled, and appropriate.

If you look at Fidelity's Emerging Market (actively managed) fund and Vanguard's Emerging Market Index fund, you find that the Fidelity fund has annual management and brokerage costs of 1.6%, while the **Vanguard fund costs 90% less**. As long as you hold the fund for two years or more, the Vanguard fund's transaction fees are more than compensated by the lower annual costs. Note further that the Vanguard fund outperformed the Fidelity fund for 1995, 1996, and the first half of 1997 (by 3.5%, 5.8%, and 19%, respectively). Coincidence? I suspect not.

Conferences

I attended the Financial Investment Management conference in August in Manhattan. I most enjoyed the opening session in which Charles Clough, Jr. (Merrill Lynch), Byron Wein (Morgan Stanley), and Marshall Acuff (Smith Barney) presented their outlooks for the markets. It was stimulating to hear Clough predicting lower inflation and Wein predicting higher inflation from the same podium, ten minutes apart.

I will be attending the NAPFA Northeast Mid-Atlantic Regional Conference in Alexandria Virginia from October 16th to 18th. NAPFA is an organization primarily of fee-only comprehensive planners, with a few stubborn fee-only money managers. Their regional conferences offer opportunities to keep abreast of changes in legislation, markets, and products that impact financial planning, and to network with fellow professionals. My local chapter will be organizing the next regional conference, tentatively set for November 1998 in Philadelphia.