The Mallard Message

Volume 2 Issue 1 March 1998
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Frequently Asked Questions

1. **Are you seeking new clients?** Yes! I have fourteen clients, and plan to grow to thirty clients. If you know of somebody who would be interested in learning more about Mallard, please drop me a line. I would prefer meeting with both you and your friend; can I treat you both to lunch? While I am looking forward to a new yellow pages ad next month, I know that investors value personal recommendations the most when selecting financial advisors.
2. **Do you work with mutual funds?** Unlike many other money managers, I believe that the client's situation (not the manager's preferences) should dictate whether individual securities such as stocks and bonds, or pooled securities such as mutual funds, are most appropriate. Many clients have existing portfolios of mutual funds. They may or may not have enough assets to build a properly diversified portfolio of individual securities. In these cases I identify the mutual funds that offer a cost-effective diversified exposure to various classes of investment assets, such as US bonds, US stocks, and international stocks.
3. **Do you work with individual stocks?** Other clients come to me with an existing portfolio of individual securities. In most of these cases, the income tax and transaction cost of any large change is unwarranted. Furthermore, investing in individual securities in a taxable portfolio offers some income tax advantages, in the control over the realization of capital gains. I therefore work with the client to achieve as much diversification as possible within their portfolio, while controlling all costs.
4. **What should I do with my fixed (or variable) annuity?**—First, make sure that you include it when you review your overall investment portfolio--it's your savings! I typically group fixed annuities with client's bond investments when I analyze the portfolio composition. Many of my clients have transferred their existing fixed and variable annuities to a lower-cost variable annuity program, such as that offered by Vanguard. It is important to first understand any exit charges that may apply, the features and costs of the new program, and the investment characteristics of the "subaccounts" in the new program (these are similar to the individual mutual funds offered by a mutual fund family).
5. **Does Mallard offer any seminars?** Yes. I would like to offer one in May. If you have any suggestions for topics or dates, please let me know. Thanks!

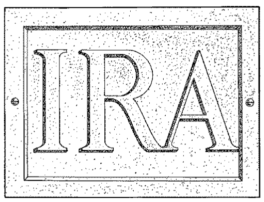
Roth IRA—Is it right for you?

Inside This Issue

The Roth IRA was passed into law in 1997, and yet did not become available until this year. While I no longer consider myself an authority on different types of retirement accounts, I would like to offer a few comments on the Roth IRA.

With the Roth IRA you make a contribution without obtaining a deduction on your income taxes. However, unlike traditional IRAs, all distributions from Roth IRAs (including both your earnings and your original contributions) are non-taxable under most circumstances.

Some advisors characterize the compound growth inherent to investing as the eighth great wonder of the world. Unfortunately, with traditional IRAs, you need to share much of this with the IRS. The Roth IRA permits you to avoid income taxes on this wonderful growth.



To further complicate matters, you may have the opportunity to transfer money from your traditional IRA into a Roth IRA, and thus to avoid income taxes on future growth. There are restrictions on these transfers, which are based on your annual income. If you make this type of transfer to a Roth IRA, you will need to pay income taxes on the amount transferred.

Finally, there is a provision to spread the income tax due on such a transfer over four years if the transfer is done by December 31, 1998.

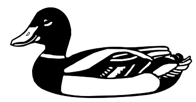
Whew! Now that I have offered some of the facts of the Roth IRA, why is this area such a minefield? First, it is new. Advisors (financial, legal, accounting) are trying to quickly build their knowledge of each of the features. The government is refining the aspects of the law that are unclear, making this a moving target.

No analysis of the benefits and drawbacks is complete without a clear description of assumptions. One critical assumption is whether the US income tax system will remain basically the same for the rest of your life. I recently read an article in which the author suggests that in the future the IRS may subject Roth IRA withdrawals to AMT, Alternative Minimum Tax. This change would seriously undermine the benefits of the Roth IRA.

In conclusion, the Roth IRA, whether you should use one, and whether you should transfer IRA funds into one, are very complicated matters. Before you proceed, ensure that you and/or your advisor carefully consider the implications of each move, along with the assumptions.

Is Warren Buffett a Mallard Client?

No, despite rumors to the contrary, Warren Buffett is not a client of Mallard Asset Management. These rumors apparently surfaced (solely in my mind) when Berkshire Hathaway's 1997 Chairman's Letter included two paragraphs of duck analogies, among them the following: 'In a bull market, one must avoid the error of the preening duck that quacks boastfully after a torrential rainstorm, thinking that its paddling skills have caused it to rise in the world.' Please do not hesitate to scold me if you catch me preening!



As always, the Chairman's Letter contains a generous amount of investment wisdom and wit. Possibly taking cues from Fed Chairman Greenspan, Buffett avoids declaring the US stock market poised for a fall: 'we have absolutely no view on that matter'. Instead, he explains that the high prices of today's stocks make it difficult for him to find attractive new investments.

Buffett offers an investment exam question: 'If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period?' His answer is to hope for a lower stock market, that only those 'who will be sellers of equities in the near future should be happy at seeing stocks rise'. As this is a bit counter-intuitive fact, it is worthwhile for investors to remind themselves of this insight when reviewing their portfolios.

Humility--Despite his deserved reputation as a top investment manager, Buffett has made mistakes. He explains that his experience investing in Salomon was 'both fascinating and instructional', although at times he 'felt like the drama critic who wrote: "I would have enjoyed the play except that I had an unfortunate seat. It faced the stage."' He also demonstrates modesty about investment successes. Regarding an American Express investment, 'this holding has proved extraordinarily profitable thanks to a move by your Chairman (Buffett) that combined luck and skill -- 110% luck, the balance skill.'

Three Month Activity

In this section I will review the transactions over the three months ending March 15th.

Portfolio Returns—Until I increase my understanding of the regulations dealing with 'advertising portfolio returns', I will not disclose this information. I do, of course, report the investment returns (including the effect of contributions and withdrawals) for client portfolios in my quarterly reports. Generally, client portfolios fell in the fourth quarter of 1997, although typically by less than they rose in the third quarter.

Mutual Funds—Of course there is the normal dividend reinvestment that occurs regularly, and the reinvestment of year-end capital gain distributions. Other activity in mutual funds in the past three months has focused on asset allocation decisions. Additionally, I sold some funds to realize built in taxable losses in taxable accounts. Also, I have shifted all of client funds from Sogen International to Sogen Overseas to obtain a 'purer' exposure to non-US markets. I continue to favor Vanguard for bond funds, index funds, their International Growth, and Specialized funds. I like several non-Vanguard stock funds, for both US and international equity investing.

Bonds—I purchased two municipal bonds for one client to replace the principal which was repaid from a municipal bond Unit Investment Trust. In a second portfolio, I purchased US Treasury notes and a bank CD for very short term investment purposes. Both municipal bonds and the CD were purchased from a 'boutique' brokerage firm, which in each case offered a better price than what was offered at the 'captive' brokerage house (Waterhouse Securities). I do not receive any benefit from these savings, other than the satisfaction of knowing that the client's next portfolio review will include a greater return.

Stock Purchases—Due to the makeover I described in an earlier article, and due to the need to invest new contributions, many stocks and closed-end mutual funds were purchased over the past three months. These companies include Air Express, AMP, AstroSystems (a company with a large stake of AstroPower, a Delaware company which just went through an IPO), Cummins Engine, Hewlett Packard, Intel, ITT Industries, Motorola, Nabors Industries, National Semiconductor, Norfolk Southern, Pairgain Technologies, Pep Boys, Pioneer Electronic, Safeguard Scientifics, Sony, Texas Instruments, and Unitrode. Closed end purchases (all at discounts, of course) included Baker Fentress, Brazil Fund, Irish Investment, Latin Discovery, and Tri-Continental.

Stock Sales—Many stocks were sold in the past three months. Sales of $10,000 or more included Aetna, AT&T, Bank of New York, Colgate Palmolive, Cypress Semiconductor, Echlin, Ford, ICN Pharmaceuticals, Korea Electric Power, Outback Steakhouse, PP&L Resources, Seagate, and Singapore WEBS. Some of these sales were tax-motivated or related to the makeover. Most of the others were due to low projected annual returns, after nice stock price appreciation.

"Portfolio Makeover"

Over the past three months, I have been busy transforming a client's overall portfolio. This client received an inheritance recently, and also had significant balances in his retirement plans. From my years of work as a financial planner, I recognized this as a good opportunity to reduce income taxes.

This client's taxable accounts were producing dividend and interest income of more than 4% annually. The IRA accounts produced approximately a 2.5% yield. Through a complete redistribution program, we were able to reverse this relationship. This should reduce his ordinary taxable income by approximately $7,500 each year.

This change required a close review of each position. Fortunately, most of the investments in the taxable account had been purchased or inherited in the past year. As such, realized capital gains were manageable. Also, I was able to the IRA account purchase two of the bonds in the taxable account. In this manner, we were able to avoid the middleman, saving several hundred dollars.

Can this type of portfolio makeover reduce your taxes? First determine whether you have a fairly even balance between your taxable and your retirement plan portfolios (say 50/50, or even 65/35). Next, ensure that your taxable holdings do not have large unrealized capital gains. Finally, find out if your taxable holdings are generating more ordinary income than your retirement accounts. If all of these conditions are met, then you may be a good candidate for a profitable makeover.

Conferences

I attended a luncheon seminar in which John Neff was the featured speaker. Neff has earned a place among the very best investment managers of the 20th century.

In February, I attended a conference that focused on Pennsylvania-based stocks. I attended sessions on several companies whose stock is held in one or more client accounts, including Safeguard Scientifics and Vishay International.

I am helping to organize the 1998 NAPFA Northeast Mid-Atlantic Regional Conference, to be held in Philadelphia in November. I have been active identifying speakers on the topics of investments, and related to computer software, and I am working with the firms that will be exhibiting their products at the conference.

I will be attending the 1998 NAPFA National Conference in Memphis, from May 13th through May 16th. I will check my phone messages on Thursday night, and will return calls as required on Friday.