The Mallard Message

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Frequently Asked Questions

1. What is Fee-Only™ money management?
When a financial professional is fee-only™, they do not accept any sales commissions. Therefore, when you receive a recommendation, you don't have to worry whether the commission is affecting the recommendation.

2. Why don't you use E*Trade or a similar deep discount brokerage firm?
In order to perform my job well, I need to accurately know where my clients' assets are, and what they are worth. The brokerage firms I primarily use, Vanguard and Waterhouse Securities, provide institutional services, including transaction and price downloads for multiple accounts. I obtain this information daily, in a form that my portfolio software understands. Using a firm such as E*Trade would require more time and effort to maintain this critical information. I would have to charge my clients a higher fee as a result.

3. I don't live in Delaware. Does it make sense to consider working with Mallard?
I have clients who live in Delaware, Maryland, Pennsylvania, New York, Illinois, and Asia. Using the phone, FAX, mail, delivery services, and periodic visits, I work hard to remain connected to my clients. It is easier for me to meet with clients who live in Delaware, however I remain in touch with all of my clients. I sometimes combine business and pleasure, by visiting clients before or after a nearby conference, or a vacation. Over Thanksgiving, my family visited friends in Cleveland. I took the opportunity to visit a new client in Chicago during one of those days.

Winter Plans

I will be back in my son's classroom leading a unit on investing on most Thursday mornings from December through April. I do not expect to be out of the office for two or more business days other than from February 17th through the 21st when I will be on vacation.

Whenever I am away from the office for more than one business day, I check my phone messages and return all urgent ones.

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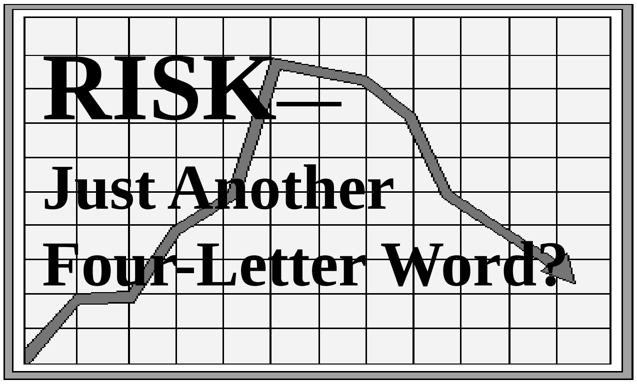


RISK— Just Another Four-Letter Word?

At a conference in October, I had the opportunity to hear Peter Bernstein speak. He is a long-time editor of The Journal of Portfolio Management, '*a Harvard graduate and former member of the research staff of the Federal Reserve Bank of New York*', and has '*managed billions of dollars of individual and institutional portfolios*'. His recent book, AGAINST THE GODS: The Remarkable Story of Risk, examines risk throughout civilization. In his speech, he was able to apply historical mathematic breakthroughs to current investment dilemmas.

Leibnitz was asked the question 'who will live longer, this particular 20 year old or this particular 60 year old'. He responded that **nature has rules, "but only for the most part"**. Obviously the 20 year old has a greater likelihood of outliving the 60 year old, however there are uncommon situations where the opposite would occur.

"Will I earn greater returns if I place 90% of my portfolio in stocks, or if I put 10% of my portfolio in stocks?" Certainly in **most** circumstances, the 90% stock portfolio will outperform the 10% stock portfolio. However (and literally), don't bet the house on it. There are calendar quarters when bonds outperform stocks (including the third quarter of this year), and if you go back a few years (pre-1991) you can find full years during which stocks fared worse than bonds.

Yes, over a sufficiently long time period, and certainly on average, stocks outperform bonds. Unfortunately, the greater potential of stocks comes at a price: greater uncertainty. Bernstein pointed out that '**the long run**' is sometimes clung to as an excuse, and that you cannot rely on it to bail you out.

Pascal was a brilliant mathematician who during his lifetime alternated between academic, hedonistic, and ascetic pursuits. He was asked how he would bet, on whether there is a God or isn't. He concluded that since you cannot decide by way of reason, you must decide how you will act based on incomplete information. He suggested that you **consider the alternatives, and the implications in the case in which you are wrong**. This is one of the reasons that he spent the end of his life secluded in a monastery.

Internet and technology stocks have sizzled this year. The NASDAQ composite is up 72% so far this year. How can you avoid considering whether you should invest heavily in these stocks and mutual funds? In the second half of 1998, Yahoo! rose almost 200%. Then by April it doubled again! How tempting it was to join the gravy train. If you had shifted half of your money into Yahoo at that time, in less than three months Yahoo dropped by half and **you would have lost 25% of your wealth**.

During the Q&A Bernstein pointed out that **'uncertainty in the long run in greater than uncertainty in the short run'**. Many in the audience were puzzled by this, and appeared to disregard it. I found it to be extremely important. In his example, if asked to predict the Dow Jones in twelve months, most people in the audience would offer guesses from 9,000 to 13,000 (between a –15% to a +15% return). In other words, if you had $110,000 currently invested in the Vanguard S&P 500 Index fund, you would expect it to be worth between $90,000 and $130,000 in one year.

What will it be worth in ten years? Certainly the range of annual percentage returns would diminish from the 30% range just given, perhaps to only a range from +5% to +15%. Yet the dollar range would explode! Given that percentage range, your fund could be worth as little as $180,000 to as much as $445,000. So even though the uncertainty of the range of percentages fell by two-thirds, the dollar range uncertainty **increased** by over six times! Health insurance premiums are due in dollars, not percentages.

Perhaps in our childhood we learned everything we needed about risk: look before you leap, don't put all of your eggs in one basket, and there is no such thing as a free lunch!

YEAR 2000

What is Mallard Doing?

Are you sick of this yet? I'm ready to get to it, get through it, and get past it! To this end, I have adopted a three-step plan.

The first step is to establish communication with my clients. This week I am writing to each of my clients and providing them with my cell phone number, home phone number, and home email. I will be trying to contact each client in early January, and I encourage them to try to contact me.

The second step is to establish communication with the brokerage firms that hold my clients' assets. I want to quickly ensure that I am able to obtain accurate and timely data from them.

The final step is to assess the investment implications of the New Year. Some stocks may have declined sharply and appear to offer tremendous opportunity. Perhaps worried investors will have shifted some of their wealth into these 'safer' investments, and bond yields will have dropped as a result. If so, it may be worth bucking the trend and shifting money from bonds to stocks. Clearly, without the first two steps, I would be wasting my time with the third step.

In the past month I have been closely monitoring the transfer of assets we have requested between brokerage firms. I will continue this critical task. For two clients who currently have lump sums in cash, we have examined the choices for getting the money invested, and have generally selected a longer timetable than we would have if Y2K was not around the corner.

Three Month Activity

In this section I review the significant investment actions I have taken over the twelve weeks ending December 9th.

MUTUAL FUNDS

I continue to use Fremont Bond, Hotchkis & Wiley Short Term and several Vanguard bond funds for most new purchases. I have begun using the SPDRs as an alternative to an S&P 500 index fund. I have started to use two small cap funds from Robertson Stephens, and a unique mid-cap fund that applies the academic field of behavioral finance to investing. I have begun using Scudder International in place of the Vanguard International Growth fund, and have reduced my use of the Vanguard Windsor II fund.

BONDS

I purchased $95,000 of individual bonds, primarily municipal, while a similar amount was called, matured, or sold to raise cash. Several clients prefer individual bonds which provide a certain return during a set time period, rather than bond funds that do not offer this.

STOCK PURCHASES

I purchased nine US, one foreign stocks, and one venture capital interest. Many of the purchases were related to year-end tax loss harvesting, and represent stocks that were sold five weeks earlier, or later.+

STOCK SALES

I sold eleven US stocks and one foreign stock was bought out. Most of the stock sales were tax motivated, and others were motivated by reducing positions that had appreciated strongly (the markets have been kind in 1999).

Recent Conference

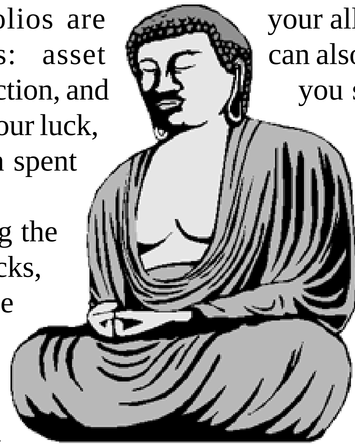
In early October I attended a NAPFA Northeast regional conference in New York City. I attended sessions on small-cap stock investing, selecting individual stocks, asset allocation applications, private accounts versus mutual funds, economic outlook for the new millenium, and I moderated two sessions with mutual fund managers. I also saw Peter Bernstein speak, as I describe in this issue's article on risk.

My family joined me; my son Mike and I walked the Brooklyn Bridge one morning, and all three of us attended a reception on Ellis Island, and a tour of Wall Street.

My son, Mike, at the Wall Street subway station.

I was a facilitator at the 1999 Delaware Everywoman's Money Conference in November. I shall be offering four educational seminars in 2000 on investment topics (general investing, stocks, bonds, mutual funds). Be on the lookout for an announcement in the mail in February.

An Enlightened Approach to Asset Allocation



Returns from investment portfolios are generally attributed to four factors: asset allocation, market timing, security selection, and luck. You cannot systematically alter your luck, and therefore much attention has been spent on the first three factors.

Asset allocation refers to selecting the balance between money markets, stocks, and bonds, and has been considered the most important of these factors ever since 1991 when Brinson, Singer, and Beebower (BSB) published a research paper. The paper concluded that asset allocation 'explains 93.6% of the variation in portfolio' returns, with market timing and security selection taking up the remaining 6.4%. For this reason, portfolio managers have become obsessed with asset allocation.

Over the past year or two, William Jahnke of Financial Design.com LLC has been waging a war of sorts on the application of the BSB report, and its 1998 update by Brinson, Hood, and Beebower (BHB). While I initially scoffed at many of Jahnke's propositions, more recently I have found his points well worth considering.

His primary conclusion is that the 93.6% refers to the **variability** of returns, not to the returns themselves. He objects to those who mislead investors into believing that the study concludes that 93.6% of **returns** are due to asset allocation decisions. I care far less about the variability of returns than I do the level of returns.

Security selection refers to which large US stocks you purchase, say once you have decided to increase your allocation to this asset class by $20,000. This can also refer to which large US stock mutual funds you select. Day-traders take this discipline to a new level.

Over the past three years, I have to admit that concentrated stock positions have a dramatic impact on portfolio returns, some positive, and some negative. This experience supports Jahnke's arguments, that security selection can have dramatic impact on the level of portfolio returns. Yet I remain cautious, due to the risk of concentrated positions.

Market timing refers to shifting money between stocks and cash. It is often associated with market timing firms that have a hotline informing subscribers when to shift completely into and out of the market. Mark Hulbert has made a career out of following the results of newsletters of this sort, and has concluded that in a given year 80% of these approaches fail to beat the S&P 500, and of the 20% that beat it in one year, 80% of those fail to beat the S&P the succeeding year.

I do not advocate market timing of that sort. Rather, I prefer to market time by using advanced dollar cost averaging to invest lump sums, through regular rebalancing, and by applying a 'strategic asset allocation', in which I slightly increase allocations to areas that I find particularly attractive, and reduce others that I consider overpriced.

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