



Muhlenkamp & Company, Inc.

December 2007

Dear Investor:

It's December once again and we're getting calls from clients telling us to sell any stocks in which we have a loss in order to avoid paying capital gains taxes. In most cases, we think this is a mistake.

The purpose of investing is to make money after taxes. This has two parts: Make money; and, after taxes.

The tax part is fairly simple. Minimize the tax; and when you can, defer it. Minimize the tax means we prefer long-term capital gains and dividends to short-term capital gains and ordinary income. Currently, the maximum rate on long-term capital gains and dividends is 15%. It is unlikely to be lower than this in the foreseeable future and can only be avoided by holding the asset until demise. So, if long-term gains is the best you can do to minimize the tax, how long should you defer it?

The proper time to sell a security is when the underlying trend that drove its performance has matured. It's much like growing tomatoes. The whole point of planting tomatoes is to harvest ripe tomatoes, and the time to harvest them is when they're no longer growing. Similarly, the time to sell assets is when they're no longer growing. In investing, the growing season is often 3-5 years, or more. Note that this often means that you pay the tax on the harvest in a year when the asset price didn't grow. If you sell it while it's still growing, you probably sold it too early. The fact that Uncle Sam claims 15% of your gain is incidental to the process. The basic premise is the same. Harvest the crop and celebrate!

At Muhlenkamp, in our Fund and most of our private accounts, we realized sizeable gains (and paid the taxes) in 1999 and 2000 when the prior trend (including tech stocks) matured. Since then, we've owned a number of stocks in the housing, consumer spending and financial areas; and our portfolio values in these areas have increased substantially. Many of these assets have now matured, so we're harvesting the crop (and paying the tax). This was the goal we had when we bought them. Some securities we still hold because we believe their value and their price will grow nicely going forward.

Specifically, in 2007, we're likely to have a capital gains distribution of 15% of assets. On this gain, our investors will pay a tax of 15%. 15% of 15% is 2.25%. So the tax would be 2.25% of assets. But taking offsetting losses today does not avoid paying this tax – it merely defers it. If we earn 10% per year, the annual value of the deferral is 0.225% or 22 cents on \$100 in assets.

Many of you know that the strongest period of the year for stock prices is typically between mid-December and mid-January, averaging gains over 1½% since 1973. The strongest stocks during this period are usually the ones that did poorly prior to mid-December. In other words, the absolute worst time to take tax losses may be mid-December (probably because so many others are doing the same thing).

This is why we begin tax planning in August with a second round in October. Any losses visible in December, we would rather hold until January-February to get a start on next year's tax bill.

-- Ron Muhlenkamp

Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax advisor or legal counsel for advice and information concerning their particular situation. Neither the Fund nor any of its representatives may give legal or tax advice.