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WAKE UP AMERICA; HOUSES DON'T MAKE MONEY!

America is slowly awakening from the dream of benefiting financially from owning a home. We all know that homes that sold for \$40,000 in the mid-1960s are worth \$120,000 today. It is obvious that anyone who owns such a home has made \$80,000. It's obvious, but it's also wrong.

Prices throughout the economy have tripled since 1965. Therefore, housing prices had to triple to maintain their value. Anyone who bought a house for CASH in 1965 and sold it today would get just enough money to buy (before commissions and fees) the identical house next door. Some may call that a profit, but the buyer hasn't improved his financial position.

Nevertheless, in the past twenty years, many people HAVE improved their position dramatically through home ownership. But they didn't make money on the house; they made it on the mortgage.

During the decade of the 1970s, interest rates were below the rate of inflation in housing prices. Borrowing at 8% tax deductible to buy a house appreciating at 10% made money for people throughout the 1970s. Today, interest rates are well above inflation; and if you borrow money, it costs you money.

The accompanying plot represents annual mortgage rates for the last thirty years, adjusted for taxes (at a 50% rate) and for inflation (at the annual change in the Consumer Price Index). For much of the period 1968 to 1980, after-tax interest rates on mortgages were less than the inflation rate. In fact, mortgage

rates were 8% or less as long as savers were willing to accept 5 1/2% on their passbook savings. This allowed borrowing at 8% to buy houses appreciating at 10%. When borrowing money at 8% (4% after taxes) to finance a home appreciating with inflation at 10%, purchasing power increases by a net 6% of the amount borrowed. You get paid to borrow money! As the plot shows, from 1968 to 1980, this net gain averaged 4% per year, or \$4,000 on a \$100,000 mortgage. So the key to getting ahead between 1968 and 1980 was to buy a big house with a big mortgage.

The dream ended in 1981 and the awakening is just now occurring. As the chart shows, it now costs money to borrow money (Real after-tax mortgage rates have turned positive). By shopping around, savers learned they could do better than a passbook with CDs or money market funds. This caused mortgage rates to rise at the same time inflation in housing prices was coming down.

In 1986, mortgage rates of 10% (5% after taxes) exceeded the inflation rate of 2% by 3%, and led to a \$3,000 real cost on that same \$100,000. A considerable change from the gain of \$4,000 experienced from 1965 to 1980. In addition, the after-tax cost of borrowing is increasing as a result of the new tax bill.

Today, many people continue to buy big houses with big mortgages, stretching and adding incomes to meet the 10 or 12 percent interest payment on a house which appreciates only 3 or 4 percent per year. They don't realize that the house will not appreciate enough to cam a profit; they awaken too late to the real cost of borrowing in the 1980's.

SYSTEM UPGRADE

As the roster of Muhlenkamp clients grows, so grows the amount of information regarding client positions, trades and performance processed each quarter. Recently, because we reached the limit of our previous system's capacity, we purchased new portfolio management software designed for use with the IBM Personal Computer. This new software increases our client data processing capacity more than fifty times, and improves the quality of information available to us as portfolio managers.

Up-to-the-minute reports on Muhlenkamp holdings by account, broker and asset class, as well as performance reports, are now available to us as part of the portfolio software. In addition, with our new modem and communications software, we have gone "on line" to get security prices, earnings estimates and other information. This will save the time previously used transferring this information from hard copy. In sum, these "system upgrades" will afford us more time monitoring the marketplace and less time bookkeeping.

QUARTERLY LETTER

The Second Quarter of 1987 witnessed some possible turning points of long-term significance.

Our foreign trade balance is now improving in dollar as well as unit terms. This should relieve some of the pressure on the dollar, which is beginning to act as though it has bottomed. Such a bottom is not yet assured, however, and fears of a free fall in April and May hit the bond and stock markets hard. The bond market and interest-rate-related stocks have not yet fully recovered from these fears, although parts of the stock market have.

The budget deficit dropped significantly as people paid their 1986 tax bills. Such bills included taxes on large capital gains voluntarily taken in 1986 due to the tax law changes.

(Very little mention has been made of the incentive in 1987 to take losses.) While improving, the budget deficit problem is nowhere near solution, and spending restraint by Congress remains as important as ever.

Based on 4% inflation and current earnings levels, the stock market has become fully priced. Those of you who have been with us since 1980-82 know that we then talked about the possibility of a good investment decade. We argued that if Reagan could get inflation under control, as he seemed to be doing, interest rates would come down, driving stock and bond prices upward. This has happened. For stock prices to increase from these levels, corporate earnings must improve while inflation remains below 5%. Fortunately, this may happen.

As a precedent, the decade of the 1950's looked much like the past seven

years. During the 50's, inflation declined from 7% to 1%, allowing stock P/E multiples to expand from 7 to 17. In 1960, Benjamin Graham (who wrote the book on Security Analysis) was quoted as saying the market was fully priced. Yet prices advanced for another eight years! They rose in concert with earnings; P/E's were remarkably stable.

To us, the message is that some of the key variables are probably changing, and the market may be more volatile during this transition. If as we expect the stock market is becoming earnings driven, positive earnings surprises will drive individual stocks up and negative surprises will drive them down. Consequently, we've become a little quicker to sell at the hint of bad earnings, and shortened our purchase list to those companies expecting good gains.

To IRA or not to IRA?

A financial planner recently described IRA investing under the new tax law as "no longer a slam dunk." By this, he meant that the previously straightforward decision to fund one's IRA to the maximum permissible is no longer so straightforward. The Tax Reform Act of 1986 has made the choices more complex. Here are the basics of the new rules:

If you are not covered by any company retirement plan, the old rules still apply. You can make a fully deductible contribution up to \$2,000 apiece for a two-income couple, or up to \$2,250 for a one-income couple. If you are covered by a company plan, the old rules apply as long as your adjusted gross income (AGI) is below \$25,000 (\$40,000 on a joint return).

If you are covered by a company plan and your AGI is between \$25,000 and \$35,000 (\$40,000 and \$50,000 on a joint return), you still get some deductions, but you lose \$1 worth of deductions for each extra \$5 you earn. According to an example provided by the IRS, a single taxpayer with \$31,619 in AGI is entitled to a \$676 deduction, rounded off to \$680. He or she can still contribute \$2,000 to an IRA, but the remaining \$1,320 will not be deductible.

Once your AGI tops the \$35,000 (\$50,000 joint) level, there is no allowable deduction as long as you are covered by a company plan. However, you are still allowed to make a \$2,000 nondeductible contribution. "What good is an IRA if contributions are not deductible? Nondeductible contributions will still compound tax free, and an IRA compounding at 12% free of tax doubles in six years. If taxed at 33% this doubling takes nine years.

There are disadvantages to nondeductible contributions under the new law, however. Because deductible and nondeductible contributions will be taxed differently upon withdrawal, IRA account holders must segregate these contributions each year on their tax returns. This record-keeping headache will be borne by most IRA custodians, but the ultimate responsibility for accurate records rests with the taxpayer. Also, IRA accounts are still subject to withdrawal restrictions. Some might question the logic of taking money on which taxes have already been paid and subjecting it to these restrictions. Finally, today's historically low tax rates might not last. A contribution today may be taxed at a higher rate upon withdrawal in the future.