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QUARTERLY LETTER

The Second Quarter of 1989 witnessed further evidence of a slowing U.S. economy. The Federal Reserve Board's tight two-year hold on the growth of money and gradual increase in short-term interest rates are having the desired effect of slowing GNP growth. The latest monthly numbers do not yet show lessening inflation, but weakening commodity prices and modest growth in wages suggest that slower growth is on the way for the Consumer Price Index as well.

The surprise in the second quarter was the strength of the dollar. But dollar strength is relative to other currencies, so they must be considered as well. In particular, the yen and deutsche mark were weak, probably due to political problems in Japan and Germany. A more telling episode may have been the turmoil in China. The problems in China seemed to result in the buying of dollars (instead of gold, for instance), implying that international investors view the U.S. as a safe haven

and do not expect increased U.S. inflation any time soon. To appreciate why investors avoid currencies undergoing inflation, see our "Time Bomb" essay on the effect of inflation on the value of money.

The net result of a slowing economy, controlled inflation and a rising dollar was lower interest rates and higher bond prices. Rates on long-term treasury bonds dropped a full 1% in the second quarter, from 9.25 to 8.25. Though the bond market may now be a bit ahead of itself, interest rate pressures remain downward and should stay that way for some time, indicating that quality bonds should do well. A recent move by the Federal Reserve Board to reduce the Federal Funds rate in line with other short-term rates tends to confirm this.

The drop in interest rates allowed the general stock market to work its way higher. Within that context, financial stocks such as banks and savings and loans moved up nicely. A slowing

GNP generally means lower profits for companies in cyclical industries; many paper and chemical company stocks were flat to down during the quarter for fear that their earnings would collapse in 1990. We think these fears are overdone, but expect them to continue until the markets get a better handle on the extent of the slowdown. We continue to hold shares of some leading cyclical companies selling at low multiples of earnings and cash flow and/or those with diverse end markets. We may increase our positions in cyclicals if it appears the economy and earnings are not as weak as the market is currently discounting.

We repeat our warning: The Fed appears to be navigating masterfully between too rapid growth and recession, but the risks of recession are greater now than any time since 1982. This is not a time to flirt with companies with marginal staying power or weak balance sheets.

DEFUSING THE INFLATION TIME BOMB

We received a number of responses and questions to our "Time Bomb" essay, most ending with "So what should I do about it?" Here is our response:

The intent of the essay was to point out that long-term investment planning which focuses only on dollars and income, while ignoring purchasing power and assets, can be a trap. Dollars must be adjusted for inflation to get purchasing power, and incomes must be adjusted for the loss of purchasing power. Without these adjustments, assets will be depleted and so will income.

The problems that arise from neglecting to make these adjustments have come to the fore over the last 30 years as inflation created large differences between nominal and real interest rates. They have been exacerbated by the fact that many people now seek to retire and live off the income produced by their assets for 20 or 30 years. If you are planning this same sort of "live off the income" strategy, we cannot emphasize the following point enough: **ONLY THOSE RETURNS IN EXCESS OF INFLATION CAN BE SPENT IF PURCHASING POWER IS TO BE MAINTAINED OVER LONG PERIODS OF TIME.**

Given the task of maintaining purchasing power versus inflation, an investor faces three "natural" investment markets: short-term debt, long-term debt and equity. We will cover each in turn.

Short Term Debt

From the borrower's perspective, short-term debt finances such items as installment and credit card purchases, corporate inventories and government's working capital. From the saver's perspective, short-term debt includes passbook savings accounts, treasury bills, certificates of deposit, commercial paper and money market funds. Anyone who has a 9% CD, for example, and is paying 18% on a credit card balance is participating on both sides of the short-term debt market (and paying dearly for the privilege). Historically, rates available to savers on these investments have roughly equaled inflation. That is, with no effort and little "risk" you've made no real money (after inflation). Only since 1981 have these rates

consistently exceeded inflation, after being well below inflation during the 1970s. Because returns in the short-term debt markets cannot be expected to beat inflation for long periods of time, there is no reason to believe the current premium over inflation will endure.

Long Term Debt

From a borrower's perspective, long-term debt finances factories, homes and government spending. From an investor's perspective, long-term debt takes the form of Corporate Bonds, Fannie Mae and Ginnie Mae Mortgage pools and Treasury and Municipal Bonds. Differences in interest rates among these securities reflect credit worthiness, time-to-maturity and taxation (municipals). Historically, long-term debt of good quality has returned about 2-3% annually over inflation. In the 1970's it returned substantially less. In the 1980's, substantially more. (For a look at these same numbers from a borrowers perspective, see "Houses Don't Make Money.") There is no reason, however, to expect to earn more than 3% over inflation for very long.

Therefore, if you own long term bonds and want to maintain purchasing power, count on spending only about 3% of your assets per year. If you think inflation and interest rates will decline and want to "lock in current rates, make sure the bonds you buy are non-callable.

Equity

Equity investments represent ownership and are normally long term. Equity ownership can be real estate, tangible assets or business enterprise. It can be sole ownership, partnership or shares in a corporation. Most -investors hold real estate through sole ownership of their homes, and corporate enterprise through shares of stock. Corporate shares are usually more "liquid" than real estate, i.e. they can be bought and sold much more readily. This advantage is partly offset by the short-term volatility of share prices. The key is to focus on the long-term nature of equity investing, and not get caught up in short term price oscillations.

Long-term studies of total returns from owning (common stocks of) corporations demonstrate returns of 4-6% annually over inflation. Some of this return comes as dividends and some as capital gains.

No one disputes that returns from equity investments are higher than those from debt. However, there is a lot of misleading opinion as to why they are higher.

Corporate stocks provide higher returns than corporate bonds because management works FOR the stockholder and AGAINST the bondholder. No management will borrow money (issue bonds) unless it expects to profit from the investment of those funds in its business. Thus, the return on stockholder's equity MUST be higher than corporate interest rates. Otherwise management **will** cease to borrow, driving interest rates down. In 1981 and 1982, when long-term interest rates exceeded the average corporate return on shareholder equity, the above observation convinced us that interest rates had to fall.

Similarly, every corporate treasurer has the same incentive to call high rate bonds and reissue low rate bonds that you and I have to refinance our high rate mortgages: it saves money. Looking at it from the lender's perspective, that's why most of the bonds we buy are noncallable. We want to avoid having our high return investment rolled into one with a lower return.

Wall Street types say stocks provide higher returns than bonds because they are "riskier". But Wall Street's definition of risk is volatility, i.e. how much prices fluctuate on a daily, weekly, or monthly basis. We believe most people's definition of risk is the probability of losing money. These are fundamentally different views.

In 1987, stock market volatility was very high, both up and down. No one complained about the volatility up, only the volatility down. The total return for the twelve months was roughly zero. Any businessman will tell you that to have a disaster and break even for the year isn't bad. The key is to view equity investments as long-term business investments, with a horizon of at least three years. This means that if your planned use for the funds invested is next year's vacation, or college tuition 2 years from now, don't buy long term stocks or bonds. But if you'll need the funds for retirement 10, 15 or 20 years down the road, don't worry about price oscillations.

One reason people feel good about their homes as investments is because they price them only once every 5 or 10 YEARS. Some of these same people will call their stockbroker for quotes every few HOURS. They would do better in the long run to price their portfolios as infrequently as their personal residences.

In the end, your choices for defusing the inflationary time bomb are:

Short Term Debt: Don't expect returns above the inflation rate for long periods of time.

Long Term Debt: Expect returns of 2 or 3 percent over inflation, but not every year. Use a 3 to 5 year horizon.

Equity: Expect returns of 4 to 6 percent over inflation, but again not every year. Use a 3 to 5 year horizon.

In all cases, buy value and don't buy junk. If you don't know how to differentiate between value and junk, accept bank CD rates and make no money (after inflation). Or hire someone who CAN differentiate and whose investment approach makes sense to you.