



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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### QUARTERLY LETTER

The Third Quarter of 1989 witnessed continued gradual moves toward stability in economic data. When we read the charts in the "Money & Investing" section of the Wall Street Journal, we read them from the bottom up. They currently tell us the following:

First, commodity prices are flat to down, confirming our previous expectation (based on slow money growth) that inflation is rolling over and likely to decline. Recent reports on the wholesale and consumer price indices also confirm this, but consensus fears still focus on inflation.

Second, the dollar has been trading in a range of about 10% for two years now. This is the first period of stability exceeding six months since 1980. (And you don't hear much about the trade deficit any more because the numbers are steadily improving.)

Third, short-term interest rates, after peaking in the spring, fell in June and were allowed by the Fed to fall further in July. To us, this Fed action was the surprise of the third quarter. We expected the Fed to wait for additional evidence of economic slowdown

before lowering short-term rates. By acting when they did, the Fed governors made a recession less likely and boosted stock prices in July and August.

Fourth, long-term interest rates declined (driving bond prices up) beginning in March. The interesting point here is that long-term rates started down while short-term rates were still moving up. This is unusual! Normally long rates follow short rates and the bond markets follow the Fed. Recently, the bond markets have anticipated (trusted?) that the Fed has inflation under control. The recent numbers on slow GNP growth, declining inflation and lower short-term interest rates have served to validate that trust.

The stock market reacted to lower short-term rates with strength in July and August. Of greater interest to us is that the strength was selective, reflecting good values and good earnings.

Everyone asks, "Which way is the market going?" This was the key question when business economics were overwhelmed by changes in inflation and interest rates, as they

were from 1965 to 1982; or dominated by changes in the dollar and interest rates, as they were from 1980 through 1987. If we are right that changes in these areas are now much more modest and subdued, the relevant question today is: "Which companies are doing well and are undervalued?"

When I entered this business in 1968, inflation, interest rates and the dollar had been stable for 15 years. Consequently, price/earnings ratios had been stable for 15 years. Investors believed that, for a given company, if the earnings went up the stock price would go up. We believe we are returning to such times, and are therefore looking for such companies.

#### October 16, 1989 Addendum:

Once again the quick money players have even us a chance to buy good companies cheaply. On Friday, October 13, 1989, financing for a leveraged buyout of UAL Corp. fell through. People who had bid up various stocks on takeover hopes immediately sold them out, taking many other stocks down with them. Where we like the company and the price, we're buying.

### WHAT IS RISK?

When people seek investment advice, the first response from professionals is usually "How much risk can you take?" The ensuing discussion is then governed by the concept of "risk."

In today's financial world, however, the definition of risk used by professional financial planners and stock brokers has become completely divorced from the definition of risk used by most people.

## WHAT IS RISK? (Continued)

We believe most people define risk as the possibility of losing money. At Muhlenkamp and Company, we define risk as the probability of losing purchasing power (i.e., money adjusted for inflation.) Wall Street defines risk as price volatility. By Wall Street's definition, those securities whose prices move the most (up or down) in a short period of time are considered the "riskiest." Those whose prices don't move, like certificates of deposit, are the "safest." We reject this definition of risk. We call price volatility "volatility."

In the late 1960's and early 1970's when Wall Street and academia started using computers to study patterns in stock prices, they too spoke of volatility, but few people read the articles. So they began calling volatility "risk" and more people took notice. Unfortunately, they have gone on to speak of volatility risk as if it were the ONLY risk, and have built elaborate portfolios, often with little or no thought to the underlying assumptions.

Feature articles in The Wall Street Journal on September 19 and 20, 1989 (copies available on request) state that many pension funds are now investing in real estate. Despite poor returns, pension fund managers are doing so because real estate prices (which are set by appraisal) seem to fluctuate less than stock prices (which are quoted every day). These people have convinced themselves that real estate is less "risky" than stocks simply because the price does not fluctuate daily. We would like to make several points: The first consideration in investing is time horizon. Most investors, like most business people, should have a time horizon of at least three years, the minimum time for long-term dynamics to come into play. Pension funds have time horizons best measured in decades. For a pension fund to worry about how much the prices of its assets fluctuated in 1987 makes about as much sense as a farmer worrying about how much his crops grew in February or a ski shop owner worrying about his sales in July. For both of these businessmen a year is the minimum period of measurement, and since each can expect two or three poor years in a decade, a three to five year period is the more appropriate minimum. The same is true of pension funds.

Pension funds should truly be long-term investors. Yet Wall Street's concentration on the "risk" of volatility has pension funds focusing on QUARTERLY returns. (The longest base we have seen for the measurement of volatility is one year.) The real irony is that these same pension funds are overseen by people who know that in their business the appropriate time frame for measurement is at least three to five years. We have seen any number of astute business people who manage their companies for long-term real growth, but manage their pension funds by criteria which are short-term and artificial.

For twenty years, we have watched corporate management invest pension funds in a manner that is the opposite of what they were currently doing in managing their companies. They continue to do so today. To improve their corporate returns, today many companies are selling real estate and buying back stock. Their pension plans are simultaneously doing the exact opposite (buying real estate and selling stocks). Obviously they're using different criteria in evaluating these assets. We fail to understand why.

Many people are impressed with the money they make on their houses. They price their homes once every five or ten years and are perfectly willing to wait six months to get a fair price when selling. Warren Buffett has said he wouldn't care if they closed the stock market for two years. Peter Lynch says the market (i.e., daily prices) is irrelevant to investing. Both have great investment records. So the answer seems to be, if you want to get rid of the "risk" of volatility, don't price your portfolio so often. We don't understand why pension funds are happy to do this with their real estate investments but not with their company (stock) investments.

A caveat: volatility is a risk. If you have to sell on October 19, 1987, either for financial or psychological reasons, it's a very important risk. But the solution is not to get into a position where you have to sell in a short period of time. Any businessman who didn't keep enough working capital to get through the slow season would be called a fool. Any farmer who didn't set money aside for seed would soon be bankrupt. Any investor who invests money he needs for groceries in the next few months will soon be called needy.

To be successful as an investor, you must adopt the attitude and time perspective of a businessman, not that of an hourly employee. We tried to point out in the "Time Bomb" essay of issue # 9 that the securities whose prices are least volatile short-term are most likely to cost you purchasing power long-term. Conversely, those assets which are most likely to enhance your purchasing power long-term are often most volatile in price short-term. Wall Street's focus on the short-term and its faulty definition of "risk" lead most people to the exact opposite (and wrong) conclusion.

The second parameter in the discussion of risk is the possibility of losing money. Any investment asset has the possibility of losing money, even though the probability of gain is high. That's the reason for diversification. But this does not mean you should diversify into poor investments. A financial planner might tell you that if you have stocks, bonds, real estate, mortgages and commercial paper, you are diversified. But he's looking at pieces of paper, not the companies (read people) behind them. We will tell you that if your real estate is under a Sears store, your mortgage is on the Sears store, your stock is in Sears, your bonds are Sears bonds and your commercial paper is with Sears, you are not diversified. You simply have several agreements with the same company. And Sears management is working to MINIMIZE your return on four of these five agreements. Why would you want management working against you? We believe you are much more diversified if you invest in good companies in five different industries. Finally, to put the management of these companies to work FOR instead of against you, own their common stock.

## MUHLENKAMP FUND NEARS \$1 MILLION MARK

Muhlenkamp and Company is happy to announce that the Muhlenkamp Fund is approaching the \$1 million mark in net assets under management.