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QUARTERLY LETTER

To start with the obvious, since spring we have been wrong on interest rates. We expected the economy to muddle through, which it has, and should continue to do. We expected inflation to rise from the 1-2% level of 1986, but not to exceed 4.5%. This seems to be on the mark as well. We also said in July that the trade deficit was beginning to improve. Since then, the reported numbers have stalled, but we believe the positive underlying trend continues. Given a muddling economy, tame inflation and an improving trade deficit, we expected interest rates to edge down. Instead they have risen two points, driving bond prices down and discouraging any rise in interest-rate related stocks such as utilities, banks and savings and loans.

What happened? Although we said in January that a weak dollar might result in higher interest rates, we greatly underestimated the market's response.

After declining in March, the dollar has been relatively stable, yet interest rates continue to rise, often triggered by rumors or fears of a weaker dollar. Our error came in viewing dollar interest rates primarily in light of the domestic economy. Money has become a world commodity (not unlike wheat or oil) and the actions of other country's markets and governments (especially Japan and Germany), can have as much influence on U.S. interest rates as our own. Since these countries are much more sensitive to the dangers of inflation than ourselves, they have pushed their interest rates up to levels 5-6% over inflation, taking ours along with them. We believe Japan and Germany no longer have an incentive to raise rates; and therefore, with U.S. inflation in the 4-5% range, U.S. interest rates should go no higher. The returns available on long-term bonds are now competitive with U.S. stocks.

If we owned no bonds or interest sensitive stocks, we would view this as a buying opportunity, like 1982 and 1984. Having owned these securities for a year or more and being disappointed with their performance does not change the mental conclusion, but I will admit that it tightens the stomach. The payoff should finally come when interest rates stop rising. For stocks in general, earnings remain key and we are monitoring them closely.

The budget deficit is still a major problem. The solution is reduced spending. (The \$180 billion deficit divided by sixty million families gives a tax increase of \$3000 per family to close the deficit through higher taxes. Think what that would do to household budgets!) Yet our politicians insist on playing partisan and fractionated politics, often at the expense of the country.

MUHLENKAMP FUND ON TRACK

We're writing the prospectus for our new no-load mutual fund, and hope to have the Muhlenkamp Fund up and running by the first quarter of 1988. The objective of the fund will be no different from that of our individual accounts: **real returns 4-6% over the inflation rate with minimum risk**. We see the fund as a vehicle for all the people who call us with money to invest, but not enough to build a diversified portfolio of their own. Now we'll be able to serve all the folks we've sent to other funds over the years!

As the fund will be completely no load, no sales commission will be charged on share purchases, and no 12b-1 or "back end" load will reduce sale proceeds. Also, the agreement between the fund and the investment advisor (Muhlenkamp and Company) stipulates that total fund expenses, which include a management fee of 1% per annum, cannot exceed 2% of net fund assets or the advisor must pay the excess. As Forbes Magazine said in its 1987 Mutual Fund Survey, "there are two big things to keep an eye on in selecting a mutual fund: consistency and efficiency." We aim to be both.

We're currently selecting an auditor and a custodian for the fund. Look for more information on the Muhlenkamp Fund in your mailbox soon!

WORKER'S CAPITALISM TRIUMPHS; KARL MARX WOULD BE PLEASED!

As reflected in literature and the popular media from Dickens & Marx to Studs Terkel and Jesse Jackson, people have always viewed themselves as workers. As workers, they think of themselves as being in direct competition with owners and managers for a share in the wealth created by business enterprise. They see the return for their efforts in the form of a weekly or semi-monthly paycheck and often conclude that their pay would be greater if only the owners took less. People naturally think in terms of net, "take home" pay money, which is then spent on the day-to-day necessities and luxuries of life. Yet "take home" pay is only a pail of the benefits received for work. Other items, whether deducted from gross such as taxes, or those not appearing on the pay stub at all, such as medical insurance or pension benefits, are much less tangible, and are often taken for granted or ignored by the worker. Yet, the least tangible part of the paycheck, the pension benefit, has resulted in American workers owning a major portion of the business assets of the United States. The growth in pension and retirement assets has been so great that Peter Drucker calls wage earners "the only true capitalists in developed countries today."

Today the workers are owners; they just don't know it yet. According to Pension & Investments Age, in late 1986 the 100 largest U.S. Pension Funds had assets exceeding \$845 billion. Of these 100 funds, only 48 were corporate related. The aggregate market value of the 48 sponsoring companies was \$583 billion. Thus the 100 largest pension funds could easily own all of the shares of the (48) companies. Individually, the pension funds of the employees of 14 of these companies exceeded the total market value of their respective stocks. Thus, the employees of General Motors, through their pension plan, could buy all of the stock of their company. So could the employees of AT&T, USX, Alcoa, Lockheed, Union Carbide, Delta Air Lines and others.

Of the 100 largest pension plans not company related, most are plans for public employees. The California Public Employees Retirement

Plan exceeded \$37 billion, an amount sufficient to buy all the stock of General Motors and Ford. Similarly, the Pennsylvania State Employees Retirement Plan could have bought out USX. The Pennsylvania School Employees Retirement Plan, at over \$10 billion, could have bought out USX plus Alcoa. The list goes on and on.

One point is that workers already own a huge chunk of America's capital assets, yet are largely unaware of it. A person retiring from USX with a \$20,000 per year pension and a life expectancy of 15-20 years thinks he's poor. But if he receives the same amount in a lump sum he thinks he's rich. Same data, different perceptions.

Though the workers seem unaware of their ownership status, managers are rapidly becoming aware. Directors and managers see huge blocks of "their" stock in the hands of (potentially nonfriendly) pension funds and mutual funds so they try to maintain their positions of power and influence with various "Poison pills" and so-called "shareholder rights plans". Managers sometimes literally buy-off unfriendly holders through greenmail payments or the more subtle share repurchase. Some do both. When General Motors paid \$700 million in hush money to H. Ross Perot because Perot refused to keep quiet about GM's loss of market share, the firm was besieged by its other larger shareholders, including the Comptroller of the New York City Pension Funds. It seems these other shareholders were not happy with H. Ross being the only beneficiary of the firm's largess so they made noises about replacing Roger Smith as Chairman. A share repurchase was announced shortly thereafter. Other firms undermine the shareholder's say in management by creating separate classes of stock, one with the great majority of voting power, the other with very little. The trouble with this strategy is that the New York Stock Exchange has something called the "one share-one vote" rule, and firms opting for this strategy face delisting of their securities. Opposition to these and other corporate tactics is increasing as institutional shareholders come to recognize their collective power.

WHAT'S DEDUCTIBLE?

Previously in the fourth quarter of each year we asked our clients if they wished to prepay our investment management fee in order to claim it as a deductible expense on their tax returns. This year we won't be asking because the Tax Reform Act of 1986 changed the rules. In 1987, investment advisory fees are deductible only to the extent they, together with other income producing expenses and certain employee business expenses, exceed 2% of your adjusted gross income. In general, this floor works in the same way as the floor established for medical expenses.

Numerous other provisions that will affect investors are scattered throughout the new tax law. For those of you doing some year-end tax planning, here are some of the more significant ones:

- Convention Expenses – Deductions for convention expenses unrelated to the trade or business of a taxpayer are eliminated. For the typical individual, this means no more deductions for investment or tax shelter seminars.
- Life Insurance – Annual increases in a life insurance policy's cash value remain free of current income tax. Policies with an investment feature, including certain types of universal life and single premium life, are proving increasingly popular because of this provision.
- Personal Interest – Credit card interest and interest on personal loans is disallowed after January 1, 1987. Fortunately for heavy credit users the disallowance is phased in over the period 1987 to 1991.
- Dividend exclusion – The \$100 (\$200 on a joint return) exclusion for dividends received is eliminated.
- Income Averaging – After December 31, 1986, income averaging is repealed.