

THE MUHLENKAMP MEMORANDUM

QUARTERLY LETTER (*Continued*)

about how much to throttle back spending, not whether or not to spend less. The Federal Reserve has room to lower interest rates and their most recent two moves have been downward.

- Japan appears to be backing away from the brink of financial disaster in a rational fashion and Germany appears to be loosening up a bit. Other European governments are trying to come to grips with the welfare state. They have a long, hard way to go (*compare the budget arguments in France to those in the U.S.*), but the first step is to identify the problem. The politics in Russia seem to be backsliding toward the hard-liners, but no more so than we expected.

Thus, the intermediate trends are quite positive.

THE SHORT - TERM PICTURE:

- You have been seeing the short-term factors discussed on the news and on the front pages of your local newspapers. Some are disasters waiting to happen. I believe our troops in Bosnia are likely to be targets for the young locals. (*What would happen if we asked soldiers of a foreign nation to police our streets?*) After being ignored by the U.S. news media, the Vince Foster/Whitewater affair has suddenly become news and has plenty of potential for political disaster.

- The budget debate is currently stalemated in Washington, but that very fact is helping to stir debate in the country. There are important philosophical and fiscal issues at stake, and the prolonged debate may well be a plus. I believe less government spending is a move in the right direction, but the Republican agenda may have gotten ahead of broad public opinion.

The value of prolonged debate was illustrated by the recent year-long discussion we had on healthcare. I believe the debate served to give us not only a good outcome, but one in which all interested parties felt they had input. In a democracy, the “input” part may often be nearly as important as the “outcome” part. Frankly, the longer I watch free markets and the American democratic experiment at work, the more impressed I become with the capacity of both for healthy self-correction and positive outcomes. In the 1980’s we worked off inflationary excesses with about as little pain as possible; and in the 1990’s, we may be working off governmental excesses with as little pain as possible.

- And of course, there is always the unforeseeable. The point is that we always face short-term psychological crosscurrents, and thus we always face the possibility of a 5-10% “correction” in stock and bond prices. We are probably in one now.

Thus, the short term trends are choppy, but essentially neutral.

CONCLUSION

We conclude that stock and bond prices are fair, the long and intermediate term trends are positive, and the short term trends are neutral.

Thus, we remain positive.

ADDITIONAL COMMENTS

We recently went through a dialogue with the Securities and Exchange Commission concerning the format and filing procedures for our mutual fund prospectus. If I were to view the experience in a vacuum, I would be very discouraged. It was a veritable case study of regulators following form and procedure, oblivious to common sense.

But when I look around, I see the Justice Department suing Hooters for not hiring male waiters along with the young females — and the public laughs at the Justice Department. At the same time, Philip K. Howard’s book, “The Death of Common Sense,” is on the best seller list. The book is a pretty good description of what we went through and how government regulation evolved to its current state. I suggest you read Mr. Howard’s book.

In our case, the public’s response to our experience was, “Oh — The Government!” My point is that much governmental regulation has lost the respect of the American people and is therefore subject to being changed.

The lag times are much longer than we would like, just as they were for inflation and the federal budget, but I am gaining increased confidence that when U.S. economic and political trends reach absurd extremes, the public reverses the trends back toward sensible levels.

A quote from *This Week with David Brinkley*, December 5, 1993. Sam Donaldson: “No one in this town [Washington DC] tells the truth.” David Brinkley: “That’s the truth. No one in this town tells the truth.”

THE MUHLENKAMP MEMORANDUM

ESSAY

THE FUNDAMENTALS OF LIFE INSURANCE - WHY IT IS SUCH A POOR INVESTMENT

Since Muhlenkamp Memorandum #35 we have been discussing financial planning in our essays. As professional investors our perspective and conclusions differ from the conventional wisdom in several areas. One important area of difference is life insurance, which plays an important part in many financial plans. The following is a discussion of life insurance from an investment perspective.

Any whole life policy has two parts. The first part is pure insurance, just like a term policy. The second part is a savings account (*the insurance company calls it cash value*). The savings account is designed to equal the death benefit of the policy at the end of the insured's life expectancy. As the savings account grows, the amount of pure insurance declines. (See Figure 1)

The insurance company estimates the interest rate it will earn during the life of the policy to determine the amount of the premium required to fund the savings account. They then add on the insurance premium which is required to offset the risk that the insured dies early. The sum of the two is the annual premium. Thus, the policy "illustration" is based on the premium and the assumed interest rate. If future interest rates match the estimated rate, the cash value of the policy will match the illustration.

But if future interest rates do not match the estimated rate, the insurance company will "adjust" premiums or the value of the policy to reflect the actual rates. When estimating future interest rates, most insurance companies use a rate similar to what they are currently earning.

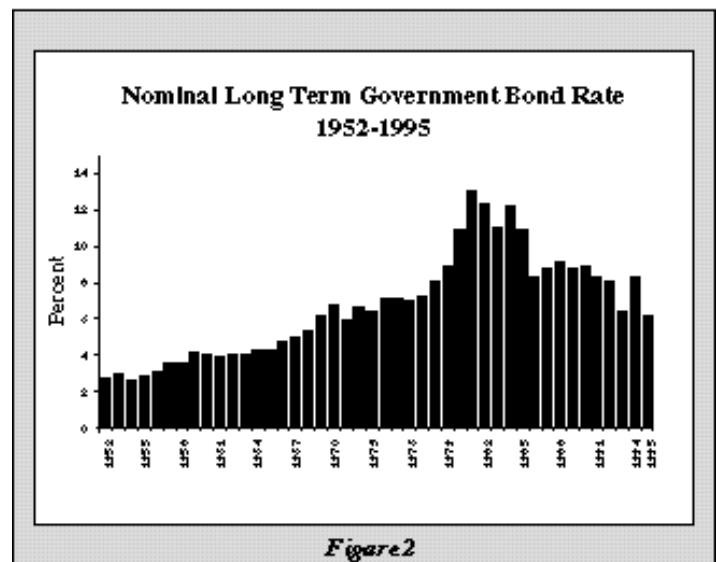
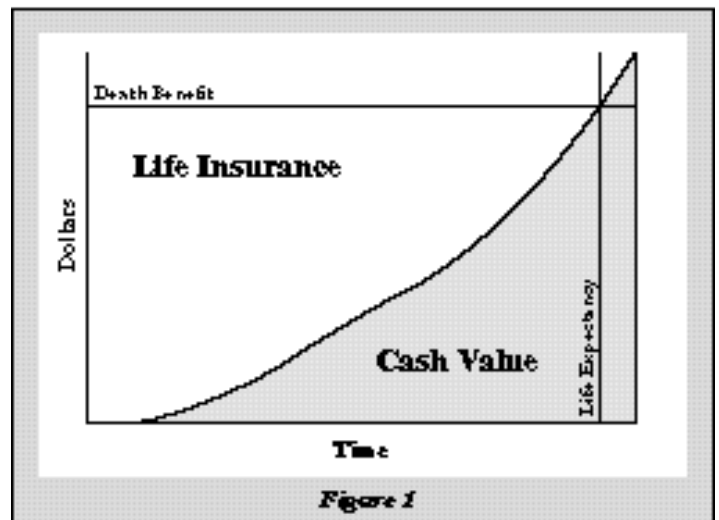
This rate reflects securities which they have bought and still hold. Since companies don't replace their entire holdings each year, their response to changing interest rates tends to be gradual and to reflect market changes with a lag. As rates moved up in the '70's, this lag was reinforced by company's reluctance to sell bonds at a loss. As rates have moved down since 1981, the lag has been determined largely by "call" protection.

The bonds and the mortgages which insurance companies own are callable. Callable means that the companies issuing these securities can "call" or refinance them when interest rates drop. As interest rates fell over the past 15 years, many of us benefited by refinancing our mortgages.

But this benefit was at the expense of the holders of these mortgages, including insurance companies. Much of the mortgage refinancing has been completed. But the bond refinancing is still going on. This is because most bonds have 5 or 10 years of "call protection", therefore the call response lags the market by 5-10 years.

How do these changes in interest rates get reflected in individual policies? In the 1970's interest rates rose, exceeding rates which had been estimated in the 1960's (see Figure 2). As a result of this, the death benefits on two policies which I bought in 1964 and 1970 were upped by 40% in the early 1980's. This sounds impressive until you recall that the consumer price index doubled during that period.

But since 1984, interest rates have fallen well below the levels which insurance companies estimated in the early 1980's. If you



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ESSAY (Continued)

bought a whole life policy 10 - 15 years ago, you have probably received a statement in the past 2 - 3 years saying that the insurance company needs more money, or they will decrease your death benefit. But this statement only reflects the decline in interest rates which occurred from the early 1980's to the late '80's. The decline in rates that has occurred since the late '80's means that 3-5 years hence (*due to the call lag*), you will get another statement saying that the insurance company needs more money *again*. The people who have bought policies since 1985 will also receive statements asking for more money. And we believe there is a 50% probability of a third "adjustment" 5-10 years down the road. We estimate that the decline in the value of the policy will approximate 20% each time, for a ***cumulative 40-60% decline***.

The problem is that old and obsolete interest rates are still being used in policy illustrations. We recently reviewed a policy proposal in which the cash value illustration was based on interest rates credited to the policyholder of 8%. Yet a footnote stated that the actual rate credited will be 2% less than the company earns on its investment portfolio. The illustrated numbers were obsolete the day they were printed. In any other business, such illustrations would be considered fraud.

Policies are sold on the basis of "illustrated" growth in the cash value. In recent years, disclosure has improved and these tables usually include a footnote which states that in fact the interest earned will be 2-3% less than what the company earns on its investment portfolio. So the company is telling you up front that your assets with them will earn 2-3% less than the company earns ***with your money***. Since the bonds and mortgages they invest in normally earn about 1% more than Treasury bonds, you can expect to earn about 1-2% per year less than if you had simply bought long-term Treasury bonds.

The conclusion of all this is that any money set aside to accumulate in an insurance policy or a fixed annuity will earn returns of 2-3% a year less than corporate bonds. This means it will earn 1-2% a year less than Treasury bonds. It also means it is likely to earn about 1% more than passbook savings and 4-5% a year less than common stocks. It ***cannot*** do better. When insurance commissions are figured in, the results become significantly worse.

If you are 35 years old, have little or no assets and have people dependent on you, buy life insurance to cover the risk of early demise. We strongly recommend term insurance. But if you are 55 years old and have assets sufficient to care for your dependents, you don't need life insurance. Under these circumstances, buying "cash value" life insurance merely prevents earning a decent return on your money. We call that a poor investment.

A second area where we disagree with the conventional wisdom is in the use of irrevocable trusts (*the following comments do not ap-*

ply to revocable trusts). The use of irrevocable trusts is driven by three factors:

1) IRS Regulations that gifts to charities or heirs be irrevocable to qualify for charitable deductions or for exclusion from the donor's estate.

2) The donors' belief that they can only spend "income" during their lifetime. Therefore, they believe they must keep their assets in their name.

3) A third factor that sometimes comes into play is a desire to control assets from the grave, either to protect irresponsible heirs from themselves, or to benefit from the donor's superior investment acumen.

Our objection to irrevocable trusts is that they are irrevocable. The trust may not be able to adapt to changes in the world or in people. We've seen trusts that irrevocably stipulated:

- Trustees who became senile or died.
- Bank administrations whose trust departments become incompetent or were so careful to "protect principal" that inflation destroyed the assets. (*See Muhlenkamp Memorandum # 35 - line B on the chart.*)
- Charities whose later administrators adopted policies counter to the donor's intent. Henry Ford II resigned as trustee of the Ford Foundation (*which his grandfather's will created*) in disgust.
- Investments that become obsolete. I had a college classmate whose wealthy grandfather, observing the need for good public transportation, stipulated that his assets should always be invested in streetcar companies. His grandson was as broke as I was.

Meanwhile the IRS discounts the value of any charitable gift to its "present value" in calculating any tax deduction. We've seen present values as low as 5% of the intended gift. The donor and the charity would have been better served with a present gift of 5% of the expected future gift. This would allow the remaining 95% to be invested (or gifted or spent) in concert with a changing world.

OUR CONCLUSION: *The only way to protect your assets for use by your heirs is to educate your heirs.*