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## THE MUHLENKAMP MEMORANDUM

Memorandum #40). For 1997, we expect a continued economic expansion, but the increases in corporate earnings are likely to be considerably less than in 1996, limiting the increase in corporate values.

### Short-Term Picture:

Since mid-July, the bond market has improved and the major stock market averages are up 14-20%. So we have received 18 months worth of returns in 6 months. This fact alone makes us a bit nervous. Logically, the markets could move sideways while the economy catches up; but markets seldom move sideways. It would disappoint too many commentators who crave the dramatic. In short, we expect choppy markets for the next few months, probably with a downward bias.

*But our bigger point is that the focus on the market is the wrong focus.* When aggregate values are fair, the focus needs to be on individual companies where values are good. This focus has served us well in the 1990-1996 period and we will continue to pursue it.

## THOUGHTS ON THE FUTURE

*I have been asked by a local paper to write a short essay on the future.*

**THE FUTURE IS GOOD!** The future is good because large parts of the world population are adopting freer markets. In Asia, in Eastern Europe, and in much of South America, the move from state controlled economies to free-market economies is now irreversible.

In a free market, the consumer is king. Each individual can choose whether to buy, what to buy, and at what price. No producer can make a consumer buy its product. Instead, producers must compete for the consumer's business. This competition can take many forms, but it is all aimed at serving the needs and desires of the consumer. Because of this, the true value of free markets comes to fruition.

The true value of a free market is that it provides incentives for each person to serve his/her fellow man. If you serve the needs of your fellow citizen, he will pay you. If you don't serve his needs, he won't pay you. Thus, the way to better yourself economically is to provide goods and services that other people desire. In fact, you can get rich by providing others with what they want. Further, you can only get rich by providing what others want. Whether by pro-

viding new or imaginative goods and services (from microwave ovens to the Internet) or existing goods and services at cheaper prices (read Sam Walton's autobiography), the standard for an individual's economic success is the degree to which he/she serves the needs and wants of others. As a consumer, I will pay only those who provide what I want. As a producer, I will be paid only by those to whom I provide a service that they want.

To criticize some consumers because their choice of incentive is different from mine is shortsighted. Every business transaction in a free market has a dual outcome. The buyer gets the product he/she chooses and the seller gets paid for the product or service. The buyer sets the agenda because the product must be chosen before it is bought, otherwise it will rot on the shelf. Thus, consumers have the ultimate say in what is produced; and only those goods and services of value to consumers will be rewarding to producers.

These consumer driven, free-market rules know no boundaries of geography or politics. No American was forced to buy a Sony or a Toyota. We did so willingly, because we perceived a better value for ourselves. In a free market, no one is forced to buy an airplane from Boeing, a soft drink from Coca Cola, or a computer chip from Intel. They do so willingly because they perceive a better value to themselves. As the number of people participating in free markets expands, we will each have access to the greater values produced by all of us.

Much of the focus on free markets has been on the dislocation to the producer/worker as a result of the constant changes driven by the consumer. This focus has two major faults. It ignores the fact that all workers are consumers, and it focuses on the transition rather than the result. The transition can be traumatic, but it is temporary. In the U.S., we have accomplished exemplary results. Each generation's living standard has improved over the prior one; this will continue. What we must improve upon are the methods and the attitudes which we use to help people through the transition.

A second focus has been on the failure to fulfill all our desires at once. But this is simply a matter of priorities. In 1954 Abraham Maslow published a treatise positing a hierarchy of human needs. After the basic needs of food, shelter and safety, he also listed the needs for love, esteem and self-actualization. He went on to state that, "As each need is satisfied, the next higher level dominates conscious function." In the U.S. today, it is not difficult for each of us to provide for the basic needs of food, clothing and shelter. They are available to anyone willing and able to work. And in concert with Maslow's hierarchy, the discourse on human needs for much of the population has shifted to higher order needs such

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as love and self-esteem. Human concern for the environment, for example, will always be subordinate to food, clothing and shelter. Only after these needs are met (and taken for granted) will secondary needs be addressed. That is why the air and water in the U.S. is cleaner today than in the past; and is cleaner than in most developing countries. The very prosperity of the U.S. has moved clean air and water to a dominant position in the public's conscious. Economic prosperity doesn't solve all problems but it does provide the means to solve many of them.

Our remaining problem is that we haven't learned to live with our prosperity. Our economic well being has progressed faster than our social theories on how to deal with the discretionary time and money. Our attitudes toward work were appropriate to a time when work was drudgery. In most occupations, we've rid ourselves of the drudgery, but not the attitude. We've lost sight of the fact that useful work is also a way of serving our fellow man, and it is also a primary source of self-esteem. All too often, we teach our young - if it is useful, call it work and avoid it; if it's useless, call it play and pursue it. Then we complain that they have no self-esteem. I know many people who have found happiness in their work. I know none who have found happiness or self-esteem on the party circuit. *Properly understood, the pursuits of economic prosperity and human fulfillment are complementary.*

### QUESTIONS FROM OUR CLIENTS AND SHAREHOLDERS AND OUR RESPONSES.

#### *Is this a good time to buy a house?*

This is an average time to buy a house. If you do normal maintenance, the house should retain it's value and the price should increase with inflation, which is currently about 3%. Mortgage rates are 7 1/2 - 8%. So the cost of financing the mortgage, after taxes and inflation, is about 2 1/2-3%. So buy a house to live in and expect the average cost to be 2 1/2-3%. Don't buy a house because you expect to make money on it.

Note: In the '70's, the cost of a mortgage after taxes and inflation was negative; we were actually paid to borrow money. Those days are over. In the '80's, 11% mortgages and 4% inflation resulted in a cost of financing of 3 1/2-4%.

#### *What magazines and newspapers should an investor read?*

Those in the library five years old. Magazines and newspapers

can be a useful source of current facts. The problem is most of them confuse the facts with opinion, and the opinion focuses on the current fads. Magazines and newspapers are in the publishing business. Their readership grows in direct proportion to the degree to which they reflect current public opinion. So their articles make great sense within the context of current public opinion. The next time you find an article that makes great sense, go to the library and see what the publication (and preferably the author) said five years ago. Then check to see how well the advice worked out.

#### *Why are 14% average annual returns not likely going forward?*

Corporations earn about 14% returns on their own equity capital (14% ROE). When inflation was 10% and interest rates were 12% (as they were in the early '80's), this 14% return was only worth the equity capital (or book value) base on which it was earned. So price-to-book value ratios averaged about 1, and price/earnings ratios averaged 7. Since then, inflation has fallen to 3% and interest rates have fallen to 7%. This caused the price-to-book value ratio to climb to 2 or more and price earnings ratios to climb to 17 (and gave us the dramatic markets of 1981-1993). This expansion of P/BV and P/Es is now over. So we can only expect returns approximating earnings growth. Going forward, this should be about 8 - 10% a year on average.

#### *Can the DOW go to 10,000?*

Sure, at a rate of about 7% per year (9% total return - 2% in dividends).

#### *What do you think of international investing?*

The U.S. dollar is undervalued and it is likely to move up against many foreign currencies. This represents a sizable currency risk to U.S. investors, which is not mentioned by most of the people recommending international investing. We don't currently find foreign securities which are attractive enough to offset this currency risk.

#### *Should we expect a correction in the near future?*

Yes, but corrections may continue to take the form they have taken over the past 3-5 years. Various groups and sectors have corrected at different times so that there was no clear or dramatic correction visible in the major averages.

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## THINGS TO DO IN 1997:

### Fund Your IRA.

You have until April 15, 1997 to make a contribution (up to \$2,000) for the 1996 tax year. All or a portion of your contribution may be tax deductible. In any event, your contributions will grow tax-deferred until you need the money in your retirement years. If you have money available, consider funding your IRA at the beginning of each year. Spousal contributions in 1997 have been increased to \$2,000. Call us for more information.

### Call Your Congressman.

This Congress should provide the best opportunity in many years to cut the maximum tax rate on capital gains (now 28%) and/or index gains for inflation. We urge you to call or write your Congressman and get him focused on this goal.

### Double-Check Your Portfolio.

Are your current investments providing the returns you require? If not, this may be a good time to get a second opinion. We are not financial planners *per se*; however, we may be able to provide you with useful guidelines regarding your investments. Call us for more information.

## OTHER SOURCES OF INFORMATION ON MUHLENKAMP:

“America’s Hottest and Coldest Funds”, *Mutual Funds Magazine*, February 1997, page 40.

“Top Performing Growth & Income Funds”, *Kiplinger’s Personal Finance Magazine*, February 1997, page 34.

★★★★ Muhlenkamp Fund Five Star Rating, MORNINGSTAR Principia for Mutual Funds, December 31, 1996.

“The U.S. Triumph of Workers’ Capitalism”, Guest Editorial by Ron Muhlenkamp, *Investor’s Business Daily*, December 27, 1996, page A2.

“Against the Grain”, *Pittsburgh Post Gazette*, December 8, 1996, page C4.

“These Seven Soloists Are Playing Sweet Music”, *The New York Times*, December 1, 1996, page F7.