
THE MUHLENKAMP MEMORANDUM

This discipline should temper our decline in a correction but is not designed to neutralize it. Frankly, we don't always get corrections when we want them. So, we limit the dollars we bet on short-term moves. As long as the long-term and intermediate-term fundamentals are favorable (as they are), we are willing to live through short-term psychological corrections. We choose this because we find the long and intermediate term disciplines more reliable than short-term market timing. Of course, corrections can get out of hand. The same "momentum players" who like to drive high prices higher also like to drive low prices lower. In our judgment, the current price correction has been healthy – so far.

The trigger for the price correction in bonds and in stocks was the U.S. Federal Reserve's action in raising short-term interest rates on March 25, 1997 from 5 ¼ to 5 ½%.

Why Did the Fed Raise Short-Term Rates?

Recent Fed actions coincide with the debate in economic theory over the root causes of inflation. In each newsletter over the past year, we have related this debate to you; and it continues to command center stage in the stock and bond markets. Six months ago, we wrote:

"The debate is, "Does Economic Growth Cause Inflation?". Keynesian economic theory says growth causes inflation. Classical economic theory says that only the printing of money causes inflation. If you took economic courses 30 - 40 years ago, the odds are very high that you were taught the Keynesian theory (that growth causes inflation). I took these courses and that is what I was taught (I'm 53). Most of the people who are now "chief economists" were also taught this theory. Economic history of the last 30 years has proven that growth doesn't cause inflation. Specifically, the changes in policy by Paul Volcker and Ronald Reagan in 1979-1982 proved that money growth, not GDP [Growth Domestic Product] growth, causes inflation. But the evidence has not caused many economists to change their minds.

More recent refinement of the theory states that growth greater than 2 ½% per year will result in increased inflation after a time lag of about 18 months. We have now had GDP growth exceeding 2 ½% for 18 months (which is why the issue is front and center). So the Keynesians have been expecting increased inflation and have predicted higher interest rates as a result. Specifically Morgan Stanley's chief economist has been predicting long-term U.S. Treasury Rates of 8 ½% by yearend 1997. Conversely, at Donaldson, Lufkin and Jenrette, their chief economist (based partly on a belief that growth doesn't cause infla-

tion **and** partly on his forecast of a recession in 1997) is predicting long-term Treasury Rates of 4 ½% by yearend 1997. Folks, that is a huge difference! If rates go to 8 ½%, a 6% 30-year Treasury which was priced at \$1,000.00 on 12/31/95 would be priced at \$740.00 at yearend 1997. If rates go to 4 ½%, the same 30-year Treasury would be priced at \$1,230.00. Similarly, the S&P 500 which was priced at 620 on 12/31/95 would be likely to sink to 550 or soar to 850 by yearend 1997. So the outcome is far more than academic.

An interesting sidebar is that these predictions were both made in early 1996 with a horizon of nearly two years. Two years is a short time in economics but a long time in the stock and bond markets. Two years is ample time for the markets to swing one way based on hope or fear, and then to swing the other way based on reality.

During the first half of 1996, the yield on long-term Treasuries rose from 6% to 7 ¼%. The price fell from \$1000 to \$850. We believe this move was based on a fear of inflation in concert with the Keynesian theory. Evidence for this includes a 2% drop in bond prices and stock prices on July 5 when the government reported GDP growth for the second quarter of 4.6%.

Through the first nine months of 1996, the reported economic numbers have been mixed enough that neither economist saw a need to change his forecast – until now. The first change occurred on October 4, when in response to lower employment numbers (and an uptick in the unemployment rate), the economist at Morgan Stanley shifted his GDP growth prediction to 2% in the third quarter and 4% in the fourth quarter (from 3% in each quarter) and lowered his interest rate ranges for 1996 from 8%+ to 7 ¼%+. That day, the bond market jumped over 1% and the stock market rose 1%. The numbers for the remaining months of 1996 will be key to determining which theory is accepted. We believe the classical theory (growth does **not** cause inflation) will be affirmed once again, that interest rates will decline and that the stock market will do well with a focus on individual stocks – stay tuned."

Since we wrote the above in October, GDP growth has been greater than forecast with the 4th quarter up nearly 4%, but without an increase in reported inflation. Nevertheless, the strong GDP numbers renewed the fears of inflation resulting in renewed pressure on the Federal Reserve to raise short-term interest rates. The Fed raised rates by ¼% on March 25, 1997. The Fed labeled the move "preemptive".

The strong 4th quarter also resulted in DLJ's economist extending his projections out three to six months but he did not change his

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conclusion. Morgan Stanley's economist has also extended his prediction. So now both economists have extended their time periods, but neither has changed their (diametrically opposed) forecasts. The strength in GDP and the fears of increased inflation have also moved the rates on long-term treasuries to a range of 7.10 - 7.15%, up from less than 7% at yearend, but still below the 7 1/4% reached (3 times) in 1996.

Normally we don't worry much about a difference in interest rates of 1/4 to 1/2%; and frankly, we don't think current changes of this magnitude will have much effect on the economy. But, in the current environment of well-balanced growth and fair stock prices, many market participants have focused on Fed actions and long-term interest rates as bellwethers for the next short-term move in the markets. In short, today the perceived signal may be more important than the reality.

Since WWII, each recession in the U.S. economy has been preceded by an increase from the Fed in short-term interest rates (although not all increases have been followed by recession), and each major decline in stock prices has also been preceded by an increase from the Fed in short-term interest rates. We believe we must respect this history and the Keynesian theories (and the amount of money responding to the theory) until we see further evidence (and they see evidence) that inflation is not increasing.

Two things that we are watching closely are long-term interest rates and the public's purchase of housing. Long-term interest rates directly reflect the fears of inflation. The reason the Fed raised short-term rates is to quell inflation and inflation fears which should ultimately drive long-term rates down. When the Fed raised rates in March by 1/4%, rates on long-term bonds, which are determined in an open market, went up by roughly 1/8%.

The people who buy houses make their decisions partly based on the mortgage interest rates (which usually move parallel to other long-term interest rates). Since 1990, our observation has been that when mortgage rates exceed 8% (as they have just done), the public reduces its home purchases. Should it do so once again, long-term rates won't go much higher.

Meantime, we continue our normal course of identifying companies we would like to own, setting prices at which we like to buy their stocks, and investing some of our cash when those prices are met.

The Effect of Currency on Foreign Investments

Over the past two years, we have warned you about the effect of currencies on investments in foreign countries. During that time, the Japanese market has been quite strong. You may very well have bought a Japanese stock at 75 (yen) which has since appreciat-

ed to 105 (yen); but since the dollar has also appreciated from 75 yen to 105 yen, your 40% stock appreciation combined with a 40% dollar appreciation resulted in a net profit of zero. That's right -- a 40% stock appreciation combined with a 40% dollar appreciation netted zero!

The April 17, 1997, Wall Street Journal, Section C, page 1, has an article and a table showing the effect on an American investor when the dollar is appreciating. Although the table only shows the brief period since yearend, the principle is the same, and there is also a nearby chart of the U.S. dollar versus 19 other currencies.

Recent conversations with travelers to/from Europe and Asia convince us that the dollar remains undervalued (although a lot less so than two years ago). The rate hike by our Fed helps move it up. So, we still see a significant risk of dollar appreciation and continue to warn you to be careful of foreign investments.

Contact Your Congressman!

The topics of tax rates and tax reform are "on the table" in Washington, D.C. These topics include:

- Reducing or abolishing the Capital Gains Tax
- Reducing or abolishing the Federal Estate Tax
- Adopting Steve Forbes' 17% Flat Tax

We are in favor of all three. If you also are in favor of these reforms, we encourage you to call or write your elected officials. Their respective addresses and phone numbers follow:

President Bill Clinton
The White House
Washington, DC 20500
Phone: (202) 456-1111
e-mail: president@whitehouse.com

Senator _____
United States Senate
Washington, DC 20515
Phone: (800) 972-3524
e-mail: <http://www.senate.gov>

Representative _____
U.S. House of Representatives
Washington, DC 20515
Phone: (800) 962-3524
e-mail: <http://www.house.gov>

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THE BUSINESS OF INVESTING

As mentioned earlier in this newsletter, the “Business of Investing” differs greatly from the “Game of the Stock Market”. Ron Muhlenkamp first wrote the following essay detailing the differences at the end of 1994. With recent market events, we believe it is worth another look.

I entered this business in 1968. At that time, I had never owned a stock or bond, and I had never taken any courses on Wall Street finance. (I had taken courses in corporate finance.) So, I began my studies with a clean slate.

I soon learned there are an unlimited number of people with ideas on how to invest money, and that all these ideas sound good at the time. Some of these people are paid to sell newspapers and magazines, some are paid to entertain on radio or television, some are paid commissions to sell financial products, and some are actually paid to manage other people's money. Only this last group publish the actual results of their advice. The others tell me when they have been right, but I have to research what they wrote three-five years ago to get a complete picture. I also noticed that the gurus and the managers who were heroes in any one year seldom repeated; those who had good long-term records tended to stay on top, but were seldom heroes in any one year.

Since my goals are good, reliable, long-term returns, I decided to study the philosophies of the people with good long-term records. I found that they all own corporate stocks, but their approach is to look at companies as businesses. And I learned that, over time, stock prices do reflect the values of the underlying business. I also learned these values and the resulting stock prices have increased by 9-10% per year, indicating that if a person just buys good companies and holds them long enough, their returns would be 9-10%.

By contrast, long-term returns on bonds have been 4-5% and CD's have been 2-3%. So I have concluded that, as a long-term investor, my “normal” position is to be 100% invested in corporate stocks.

All the problems with investing in stocks are in the short-term, where changes in stock prices often seem unrelated to long-term values. Short-term prices are determined by whatever hopes and fears are currently driving the American public to buy and sell stocks. These hopes and fears are fanned by the media, the brokerage community, and various pundits with a short-term agenda. But it is also true that much of the public insists on this short-term agenda and revels in the drama of it. I call it the “Game of the Stock Market”, as opposed to the “Business of Investing”; and it is very entertaining. The game focuses on the most dramatic and volatile aspects of price movements. Even the language is borrowed from gambling, focusing on “winners” and “losers”. The game can also be quite profitable, but requires an iron stomach and an “against the crowd” discipline which few people have.

For most people the “Game of the Stock Market” is a distraction which prevents them from making money in the “Business of Investing.” Periodic setbacks and a focus on the game results in their selling stocks when they should be buying and vice versa. We focus on the long-term “Business of Investing” because we have found it to be more profitable and more reliable.

OTHER SOURCES OF INFORMATION ON MUHLENKAMP:

“Ten Top Funds for Small Investors”, *Money Magazine*, May 1997, page 51.

“Mutual Funds You Can Live With”, *Consumer Reports*, May 1997, page 19.

“Top Performing Stock Mutual Funds: 1 Year”, *Kiplinger's Personal Finance Magazine*, May 1997, page 34.

“20 Show Stopping Funds”, *Individual Investor*, April 1997, page 48.

“In the Money”, *Financial Planning*, April 1997, page 102.

“Top-Performing Funds: Flexible Portfolios”, *The Wall Street Journal*, April 4, 1997, page R18.

“It's Refund Season -- Time to Plant Investments”, *The Christian Science Monitor*, March 25, 1997, page 8