

THE MUHLENKAMP MEMORANDUM

Quarterly letter (continued)

Freemarkets is a Pittsburgh company that conducts auctions, on the internet, for businesses purchasing parts and supplies from other businesses. Thus, it can be useful in helping a purchasing agent to do his/her job. By September 1999, it had conducted auctions for a total of 21 companies with two, United Technologies and General Motors, accounting for 58% of its revenues. UTX owns 5% of the company and could reasonably be expected to continue as a customer. But GM, at the time of the offering, had invested a sizeable sum in a competitor.

In 1998, Freemarkets had \$8 million in revenues. By the fourth quarter of 1999, its revenues were approaching \$5 million/quarter. In December 1999, the company sold 3.6 million shares to the public, out of a total 34 million shares. The stock had been filed to come to market at \$14/share; but due to high demand it came at \$48/share, and it jumped to \$350/share in three weeks. At this point the market valued the company at \$12 billion (\$350 times 34 million shares). This for a company doing \$20 million annual rate in revenues and without anything proprietary. On January 3, 2000, GM announced they were canceling their contract with Freemarkets and would henceforth do their business with the competitor in whom they had made their investment. In 12 days the stock fell from \$350 to \$172.

The second instance occurred when an analyst for a major Wall Street firm wrote that Qualcomm, which was priced at \$500, should go to \$1000/share. (The stock split 4/1 the next day.) The media immediately picked up on the \$1000 price and the stock jumped to \$660 (up 30%) in a day and to \$750, (up 50%) in a week. The analyst's argument for the \$1000 price (\$250 post split) was that in the year 2010, he expects the worldwide public to buy 3 billion cellphones for an average price of \$180 a piece. He further believes that Qualcomm should then sell for 60 times the resulting earnings. Folks, there are roughly 6 billion people in the world, one-half of whom don't earn \$180/year. To predict that 3 billion of them would pay \$180 for a cellphone in a given year is crazy. I suspect that a number of Qualcomm stockholders realized this when they saw on paper the assumptions that were required to justify the price of the stock. Since early January, it has fallen from \$187 to \$140 (post split).

It is always hard to say how far a fad can run or when it will stop, but they do work both ways. In Muhlenkamp Memorandum #52, we named 6 internet stocks (America-On-Line, Amazon, Ameritrade, E-Bay, E-Trade and Mindspring)

which were down 30-50% from their April 1999 highs. Despite the tech rally in the fourth quarter (in which 2 of the 6 hit new highs), the six stocks are now down 35-65% from their highs.

Meanwhile, some of the seven "security blanket" stocks (Abbott Labs, American Home Products, Clorox, Coca Cola, Disney, Gillette and Pfizer) we named in Memorandum #52 have partially recovered, but the group remains down 15-40% from their highs. Of the six cyclical stocks we named (Alcoa, Caterpillar, DuPont, Goodyear, International Paper and 3M), three recently hit new highs. In fact, in recent weeks, aluminum, copper and steel stocks have been among the strong performers.

We suspect the market is beginning to pick up on the trend begun in the second quarter of 1999. We said then that, as the fear of recession disappeared, the market's focus would shift from "Security Blankets" and internet stocks to a broader list of companies with good earnings and reasonable prices. We were right -- for three months. Then the Fed and the institutional market shifted to a fear of increased inflation based on strong growth in GDP driving up interest rates - both short-term rates and long-term rates. The retail public ignored these fears. Reflecting a continued strong consumer confidence, it continued to play the "game of the stock market", merely rotating its focus from internet stocks to other technology stocks, primarily in telecommunications.

A number of trend following (momentum playing) professionals extended the game to the point exemplified by the two examples given earlier. These examples and the price action since year-end indicates that the "game" may have peaked although it could once again rotate to a new group.

Meanwhile, similar to Q-2/99, we are seeing strength in name cyclical stocks, indicating that some people are willing to bet on the strength in the economy. Since early December, we're also seeing strength in utilities (normally a proxy for bonds) although we haven't yet seen strength in the bond market itself. This indicates that bond investors are not yet willing to bet that inflation remains low. Since we now have nine months of data showing a strong economy and low inflation, our expectation is that the fears of inflation will soon subside, allowing interest rates and P/E's to stabilize and stock prices to reflect their earning gains of 1999 and 2000. If we are right, the strength should spread to the broad range of companies and stocks that are doing very well in this economy. This broadening of strength should also close the huge valuation gap between the largest companies (and stocks) and the small and midsize companies.

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Quarterly letter (continued)

We continue to invest in good companies at cheap prices as indicated by the following table. We also continue to be bought out of a number of our holdings through mergers and management buyouts.

These buyouts confirm the values we see in our companies. It also validates that companies, at least, value themselves and their competitors much the way we do. We use these valuation methods because they have been proven reliable in all kinds of markets over a long period of time (over 50 years). Whether or not we're in a new economy is debatable, but ultimately, stock prices will reflect company values; and company values are determined by earnings and

	<u>ROE</u>	<u>EPS Growth 5-year</u>	<u>EPS Growth 1-year</u>	<u>Sales Growth</u>	<u>P/E Growth</u>
S&P Top 15	25	21	20	16	48
Muhlenkamp Top 15	23	26	31	14	22
Average Company	15	--	10	--	15

cash flows. So despite periodic excursions into the "growth" stocks of a given time, values in companies and stocks ultimately provide good returns.

One more point. Some of you have suggested that we should own (have owned?) more technology stocks. Our portfolio is

nearly 20% in technology stocks but we're focused on those companies that benefit from a **greater number** of integrated circuits used in technology, and in companies with a history of good profitability. We have not invested in companies that are one of many competitors in new markets or in those with no near-term prospects of turning a profit. -Ron Muhlenkamp

OLD TAX RETURN VERSUS PROPOSED TAX RETURN

Below we have printed the tax return you would have to file should Steve Forbes be elected president and get his programs enacted.

When you have completed your tax return for 1999, you might want to fill out the form to determine the difference in dollars, time and frustration between his proposal and our current system.

I have been a fan of Mr. Forbes' flat tax proposal since he first proposed it, for the reasons I gave in last quarter's essay on "Prosperity." But even I was surprised when I heard Steve's response to presidential candidate Gary Bauer in a recent debate. Mr. Bauer took Steve to task for dropping the mortgage interest deduction and the charitable gift deduction in his flat tax proposal. Steve replied, "We'll give you the choice, file either the flat tax form or the old 1040 forms

complete with the mortgage deduction and the charitable deduction. The taxpayer can file whichever one he/she chooses."

Now I've known for a long time that Steve's program would allow you to do this, and that individual choice and responsibility is at the core of all his programs; yet, I was surprised when I heard a presidential candidate say that an individual taxpayer could calculate his taxes in multiple ways and choose the lesser tax rather than the greater tax, as is now often required.

That Steve Forbes should be the only one of six Republican candidates (all of whom favor some tax cuts) who would allow the taxpayer this choice speaks volumes about how far we are from understanding what makes a free economy work. And it means that I must find better ways of explaining the ideas

in my essay on "Prosperity." - Ron Muhlenkamp

The Steve Forbes Flat Tax Form

1999

Individual Wage Tax

First name and initial _____ Last name _____ Social Security Number _____

First name of spouse (if applicable) _____ Last name _____ Spouse's Social Security Number _____

Present home address (Number and Street including apartment number or rural route) _____

City, Town or Post Office, State and Zip Code _____

Your Occupation _____ Spouse's Occupation _____

1. Wages	1.
2. Number of adults in family	2.
3. Number of children in family	3.
4. Deductions for adults (multiply line 2 by \$13,000)	4.
5. Deductions for children (multiply line 3 by \$5,000)	5.
6. Total deductions (line 4 plus line 5)	6.
7. Taxable income (line 1 minus line 6)	7.
8. Tax (multiply line 7 by 17%)	8.

