dramatically wrong:

1. To protect our gold supply, we raised interest rates.
2. To balance our federal budget, we raised taxes.
3. To protect our manufacturers, we raised tariffs.

When you think about what these actions did to the American consumer, it's no surprise that we suffered a depression. Today, we are lowering interest rates and lowering taxes, so we see no danger of a depression.

Inflation results from a too rapid growth in the money supply. Currently, the Federal Reserve is not allowing the money supply to grow fast enough to give us an increase in inflation. Moreover, remember that the Fed raised interest rates starting in 1999 for the express purpose of slowing the economy to limit fears of inflation. They did this because they, and we, view inflation as a greater risk to prosperity than recession. I repeat, the Fed did this on purpose. Today we see low probability of the risk of depression or increased inflation. We also see a low probability of the third big risk to the economy, which is war.

Conclusion: The big picture looks good.

Slowdowns/recessions also serve the economic purpose of curbing prior excesses. In most recessions the parts of the economy exhibiting the greatest decline are the very parts that exhibited the greatest recent excesses. In the current cycle, that area is investment in technology. In the 1982 recession, it was investment in real estate.

We believe that the negatives this time around are largely those of perception. The perception was that the strength of consumer spending on technology was ever upward. Wall Street and the media abetted this perception, focusing on tech stocks and implying both a long-term trend and imputing a greater importance to this sector than was warranted economically. Again, the pattern was similar to real estate in the late 1970s. If, in fact, computer and telecom equipment are capital goods, we'd expect that they'd magnify and lag the economy's cyclical peak and decline. They are doing just that.

There is a remaining risk. Our observation has been that if people are going to change their minds about spending and saving (thereby giving us a change in the investment climate) they are most likely to do it in the middle of a slowdown or recession. In the past, such a change in mindset followed a lengthy period of time when their prior mindset caused economic pain.

We see no signs of economic pain caused by the public's current mindset. And, in fact, those areas of consumer spending which are normally most vulnerable to a slowdown, housing and autos, have remained surprisingly strong in the current slowdown. The fact that most consumers are about to receive a tax refund/tax cut can only be a plus.

Conclusion

The intermediate picture looks like a "normal" slowdown or recession. We won't really know which until it no longer matters in an investment sense. We are investing your money (and ours) accordingly.

We do expect continued short-term market volatility. We also expect continued declines in the remaining overpriced tech stocks; these declines will be aided by tax-loss selling beginning in a few months. We also expect the media to continue to focus on these volatile stocks, allowing us to make good money on the ones they're ignoring.

Ron Muhlenkamp

Some Criteria to Consider When Selecting a Mutual Fund

In my article on 529 plans (Muhlenkamp Memorandum #58) I talked about evaluating investment options, here I would like to build on those ideas as a bridge to the process described in the article, "How to Choose a Money Manager" (to follow).

The whole process of evaluating investments (whether it be mutual funds, annuities, 529 plans, individual securities, etc.) boils down to answering the questions, "Do I want these people to invest my money for me," and "How do I know?"

Over the last couple years I have been thinking about how to answer those questions, and I have come up with the following process.

I start by setting some criteria for judging my investments. My criteria are:

1. **Performance for five and ten years averaging 15% a year or better**. This is the performance I would have been happy with the last five and ten years. Admittedly it is the result of hindsight, but it is a useful starting point.
2. **Three-year earnings growth of 15% or better for the mutual fund portfolio.** This indicates to me that the fund is investing in companies that are doing a reasonable job of selling their product. I would like to be able to screen for return-on-equity greater than 15% as well, but the *Morningstar Principia* product that I use doesn't publish that statistic.

3. **Manager tenure of ten years or longer.** I want to make sure the person responsible for the performance track record is still running the fund.

Over the last several quarters, I have searched *Morningstar Principia* for mutual funds that meet these criteria with the following results (you can probably do the same reporting with *Morningstar Online*):

Quarter Ending	# Of funds 5,10 yr performance > 15% Manager Tenure > 10 years 3 Yr Earn Grth > 15 %	# Of funds p/e < 1.2 x 3 Yr Earn Growth
03/31/1999	36	9
06/30/1999	47	14
09/30/1999	54	10
12/31/1999	38	8
03/31/2000	42	11
06/30/2000	31	7
09/30/2000	83	17
03/31/2001	19	11

The third column of the table comes from my belief that it is possible to turn a good company into a bad investment if you pay too much for it. Therefore, I run a manual screen and compare the actual P/E of the fund to a cutoff P/E of 1.2 times the earnings growth. Any fund that has a P/E higher than that, I suspect of paying up for earnings. I don't want that.

By running the same report over time I get a sense of which funds stay on the list. Those that stay on the list from quarter to quarter are more appealing than those that don't. I discard load funds because I have enough choices that I don't feel compelled to pay a load. I discard specialty or sector funds because I want a diversified fund and a manager that will look everywhere for good investments.

Now that I have identified good funds to investigate and good money managers to learn more about, I request a prospectus and annual report and take a look at the performance for each of the last ten calendar years. Then I look at how volatile the performance is, and can I live with that kind of volatility? Are the five and ten- year performance the result of one or two good years, or are they consistent over any three-year period? I am looking for solid returns on a rolling three-year average.

Then I put the fund and the manager through the process described in the article, "How to Choose a Money Manager." I read everything I can find written by the manager and about the manager (making sure I understand the distinction). Letters to shareholders are good places to start. I might even call the fund company and see what they can tell me about their current work. By the time I have done this I have found one or two funds that I am comfortable with (actually, in my case I have found just one fund that I use).

I am not suggesting your criteria should be the same as mine in terms of performance, earnings growth, etc. You could use tax-adjusted returns for five and ten years instead of before-tax returns. You could increase your earnings growth requirements from 15% to 20%. Whatever you use, you should use *something,* and you should have a rationale for why you are using that particular criterion. Write your criteria and your reasons down so that five years from now you remember why you picked a certain fund. Your criteria should reflect what performance you need from your investments according to your financial plan. For my part, I don't expect or require 15% a year going forward. My plan only calls for returns of 8% (or 5% over inflation). I just think I am more likely to get that from someone who has done 15% the last ten years than from someone who has done 8%. Then every year I calculate a three-year rolling average of the funds performance and make sure that it meets or exceeds my requirements.

Over ten years or longer, the average performance for all these managers clusters together. Whether growth or value, large or small cap, doesn't really matter over time. What matters over time is whether or not I can stick with the manager even when the performance is disappointing. None of these funds make money every year. To make money over time you need a way to get through the down and disappointing years. That is the "sleep factor" referred to in the article, and what this process provides me.

Anthony Muhlenkamp

How to Choose a Money Manager

Choosing a professional money manager has much in common with choosing professionals in other fields. As in selecting a lawyer or accountant, it is difficult to judge basic competence and integrity without a lengthy professional history or personal relationship. Therefore an investor must rely on references from existing clients or other professionals.

Money manager referrals can usually be obtained from members of the brokerage community, or from accountants and lawyers, preferably those serving the manager's present clientele.

Beyond the determination of basic integrity and competence, the investor's real need in choosing a money manager is to find a manager with a consistent investment philosophy that the investor is comfortable with. Consistency and comfort are the keys.

There are a number of profitable investment philosophies. Some of the better known are fundamental value, contrarian (which is simply