



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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### 1988 - A FASCINATING YEAR OF FEAR VS. REALITY

Following the Stock Market Crash of 1987, many experts, economists, and financial seers predicted a Depression. These predictions were amplified by the news media, which always prefers the dramatic to the mundane. Instead the economy just kept rolling along.

So we kept our fear but reversed the cause – the economy was too strong and would result in more inflation. But the economy tapered off.

The Fed, after making money available after October 19, continued to slow monetary growth (we repeat – inflation is monetary, and is not caused by a strong economy).

We feared the trade deficit was too big and the dollar would collapse (after already declining 30-50% in three years), but the trade deficit gradually declined and the dollar stabilized.

We feared the budget deficit was out of control - and it may be - but it is not uncontrollable (holler at your Congressman to spend less), and at least is no longer getting worse.

In the end, what did we get for our year of fear and trembling? We learned that, as Calvin Coolidge put it, most anticipated troubles are intercepted before reaching us. We also learned that the headlines and static of day-to-day market gyrations are not what economic reality is made of. For a truer, bigger picture, we must look longer term.

Consider the period January 1, 1987 to June 30, 1988. For calendar 1987, our average account was down 2%. For the eighteen months, January 1, 1987 to June 30, 1988, our average account was up 13%. In other words, when the worst stock market crash in history is put into the context of twelve months, our result is a minus 2%. When it is put into the context of eighteen months, we did better than if we had held cash or bonds. Don't get me wrong, we wish we'd been smart enough to sell in August (we didn't) and buy in December (we did). But when being only half-right gives good returns, we can hardly complain.

In sum, 1987 presented a great chance to be a "hero" or a "bum." (the papers were full of each). But if 1987 is the once-in-a-generation cost of participating in the reality of long-term superior returns of equity ownership, frankly, we are willing to pay that price.

Turning to the political arena, the most fascinating item we witnessed all year was Michael Dukakis' nomination acceptance speech. He praised Ronald Reagan, by name, twice, and never mentioned Jimmy Carter. He said that he is not challenging the Reagan ideology, but only his competence. That is, he wants to do the same thing, only better! Aside from whether you believe his ideology is the same as Reagan's (it hasn't appeared to be in the past), it's an amazing statement from the leader of the opposition party.

After the Democratic Convention, when Dukakis was ahead in the polls by 17 points, we were told he would be elected (he might), raise taxes (he might), and put us into a recession (it would). The

immediate result; however, would likely be a market rally. Higher taxes would shrink the budget deficit (assuming flat spending) and reduce interest rates -both positives. The negatives would come a year or two later.

When you receive this issue of the Muhlenkamp Memo, we'll be a few days on either side of October 19, 1988. This anniversary will present a great opportunity for the media and the pundits to relive October 19, 1987. (In the Pittsburgh area on October 19, 1988, Muhlenkamp and Company is sponsoring "Adam Smith's Look at October 19, 1987" on WQED. We have no idea what he'll say, but he's usually fairly objective.) Suffice it to say that conditions are quite different from a year ago, and we see little or no chance of a repeat any time soon. So many people are prepared for another collapse that the real surprise will likely be on the upside. Count the number of optimists versus pessimists you've heard in the last year.

From an investment perspective, not much has changed from three months ago. We still see inflation at 4-5%. We see the economy gradually slowing. The dollar has been fairly stable. Short-term interest rates ran up and appear to have stabilized. Long-term rates have been stable at a level almost competitive with the average stock, so company earnings must do well for individual stocks to do well. Corporate earnings have been superb, but gains are slowing. The election is only a few weeks away and will answer some questions. The next move will likely be up, triggered by lower interest rates and favoring companies with good balance sheets and good earnings.

\* This thesis came from a speaker at an investment conference. I have found that conference speakers tend to be negative. I don't know why, but it may be that you must be different to be paid to speak, and since Wall Street is normally bullish and free, maybe you must be negative to command a fee.

## **AN INSURANCE PRIMER**

The purpose of insurance is to protect against financial disaster. Any loss that is non-financial cannot be remedied by insurance. Life insurance doesn't replace life, only the financial loss that goes with the death of the wage earner. Any loss that is not disastrous is a poor insurance bet.

With auto insurance, for example, you can insure for:

- Liability for Injury
- Liability for Property Damage
- Collision (Loss of Vehicle)
- Comprehensive (Fire, Theft, etc.)

In this day of lawsuits, the first two can be catastrophic and need to be insured against. The third and fourth are seldom catastrophic. A vehicle to provide transportation can be purchased for less than \$2,000 and few people carry items worth as much as comprehensive insurance costs them. Since claims on this type of insurance average less than 50% of premiums, the average person pays twice as much for the insurance (to cover the loss) as he would pay for the loss.

Loss of home or health can be financially disastrous, so there is a need for insurance. To minimize premiums, choose a deductible just below the level you deem disastrous, and shop around.

## **A DOCTOR OF ECONOMICS**

There is no less sympathetic figure on today's media scene than Maria DeSillers. By refusing to pay a quarter million dollars to Pittsburgh's Children's Hospital for care her son received in 1986, and allegedly spending funds donated for that care on herself, she put herself under a cloud of hate and derision. Especially egregious in society's eye was her self-dealing. But what of her "crime" of non-payment? How would you react to a 50-page-computerized invoice longer than a semi-trailer? Her dilemma, and her larger-than-life hospital bill, is symptomatic of American health care inflation.

Economists define inflation as "an increase in the volume of money and credit relative to available goods, resulting in a substantial and continuing rise in the general price level." Substantial health care expenditures will be 14% of U.S. GNP in 1990, versus less than 5% in 1940. Continuing? Health care cost increases have outpaced the Consumer Price Index in each of the last 27 years. An increase in the volume of money and credit relative to available goods. Federal health care spending has increased 30 fold since 1965, the year before Medicare was enacted.

Meanwhile, the ranks of health care workers have merely tripled. Obviously not all federal money goes for people costs, but in the great majority does; these numbers indicate that growth in staffing simply cannot keep up with government-led demand. The result is an ongoing upward spiral of Social Security (Medicare) taxes and medical rates. As the tax payer falls further and further behind, politicians cry "political suicide" at the mere mention of cuts in the growth in health-care spending for old people. If current trends continue, Medicare will be bankrupt by the year 2000.

As a "solution" our leaders offered price controls. Like the Dutch boy with his finger in the dike, Congress fixed hospital rates in 1983 on every procedure from angioplasty to X-rays. This held back hospital charges (many rural hospitals now face bankruptcy), but the pressure of ever rising Medicare spending burst out elsewhere in the form of higher doctor fees. Payments for physician's services under Medicare have risen at an 18% to 20% annual clip as the number of procedures per patient soars. Physicians argue that multiple tests and exams are a shield against malpractice claims. Others, including Harvard medical economist William Hsiao, who currently is helping Congress study price controls for physicians, say doctors order unnecessary tests because they pay well.

But the issue is- not whether tests are necessary or not, or whether we should have price controls for physicians. The issue is: Can we afford as a nation the current rate of growth in spending on health care? Judging from the rate of medical cost inflation, and the actuarial flimsiness of Medicare, we cannot. Significantly, the people and institutions that pay private medical bills are beginning to realize this, and there are important implications for the future of U.S. health care.

Medical benefits account for over half the cost of the typical corporate benefit program. In the past year, this cost has increased 25 to 60 percent, depending upon location, industry and plan design. In other words, the typical corporate health insurance premium has increased 25 to 60 percent in one year. After several years of moderate increases, this is a huge jump. Why, if federal health care costs have been rising rapidly for years, has the bill taken so long to get to the private payer?

The answer has to do with the way the private sector pays for health care. A long chain exists between the consumer of the care and the final payer of the bill. It stretches from patient to doctor to insurance company to corporate plan sponsor. The key link in understanding the delay is the insurance company. As health care cost increases began to accelerate in the early 1980s, group health coverage became a losing proposition for many carriers. The hope that pricing leverage and profitability would return to the industry as financially weak carriers dropped out kept many firms hanging on for several years without significant rate increases. Eventually their ranks were thinned and rates came up rapidly and seemingly all at once, as is common in the industry. But the overall process took several years. Thus, because insurance companies had absorbed the increases in the short run, much of the 8% to 12% annual jumps which Medicare was experiencing in the early 1980s got rolled into one mighty increase in the private sector. Corporate benefit managers, the people who pay the other half of the health care bill in this country, are now seeing this increase. They do not like what they see.

This rotten result of years of public demand-pull inflation will bring many changes to private-pay health care. Many firms are going beyond Health Maintenance and Preferred Provider organizations to much higher deductibles and benefit cutbacks. Some have eliminated vision, dental- and hearing-care plans, or offered a selection of limited coverage, cafeteria style. Their aim is to economize by making employees aware of the high cost of care and responsible for choosing care wisely. By showing their people the limits to health care spending, private payers will help slow the rate of medical cost inflation. Our national leaders should do the same.