

# MuhlenkampMemorandum

Issue 62

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On March 31, 2002 the Net Asset Value of the Muhlenkamp Fund was \$56.86, up 6.18% year to date.

[Click here to see the current Net Asset Value of the Muhlenkamp Fund.](#)

## Quarterly Letter

The economy has turned and is beginning to expand rather than contract. As is normal in transitions, the crosscurrents are many. Some data have turned plus; others remain minus, so forecasters can argue either side. As a friend of mine observed in a similar transition nearly thirty years ago, "If you look for remaining signs of winter, you can find them long after spring has begun. If you look for signs of spring, you can find them long before winter is over."

We've been expecting economic spring; but frankly, it seems to be coming quicker than even we expected. Stock price moves in early March indicate that many investors are even more surprised than we are. The increase in prices for many cyclical stocks from homebuilders to auto parts to hand tools to farm equipment has been truly dramatic. Suddenly, investors believe that the recession is over.

We believe that the recession is over. But we also know that the data will remain mixed for some time, giving ample fuel to fears of a double-dip and/or of rising inflation and interest rates. As a result stock prices will remain quite volatile. But the bottom line is – Economic Spring is here. Enjoy it.

There are also fears of a spread of "Enron-itis" – an epidemic of disclosures of corporate theft and accounting dishonesty. These fears are fed by some people who believe that all businessmen are dishonest. We're about to relearn the lesson that most businesses and businesspeople are accurately portrayed in their financial statements. Granted you may have to read the footnotes to get a good picture, but knowledge seldom comes without some effort.

As the Enron saga demonstrates, some managers do lie to us. (I figure about 3-5% – much like the general population.) And we have no recourse against management lying – except to limit the amount we invest in any one company. That is the purpose of diversification: to limit our risks in areas where we have no other protection. It is interesting to me that businesspeople comprise the only profession whose results are audited and widely disseminated. What would happen if we audited the professional results of doctors, lawyers, economists, professors, congressmen, etc.?

### A couple of observations:

In all the recrimination about the events of 9/11/01 and the demands for greater airport security, little has been said about the key issue of allowing the hijackings to occur in the first place.



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The hijackers complied with airport security, only carrying weapons that were allowed. The hijackers succeeded because they exploited a dumb policy. The policy of the Federal Aviation Administration (FAA) was not to resist hijackings.

The policy has since been reversed, but I've seen no statement from the FAA changing the policy. Airline passengers and crews have reversed the policy. The passengers of UAL Flight 93, which crashed in Southwest Pennsylvania, first reversed it. It took these passengers but a few minutes to reverse the policy, and airline crews but a few hours. Folks, we airline passengers are safer today than we were on 9/10/01, but it's mostly due to this change in a dumb policy, a change brought about by passengers and crews.

A recent *Wall Street Journal* article stated that the government and the American Medical Association (AMA) are moving closer to allowing payment for organs used in transplants. The whole idea of economic incentive (money) as an inducement to donate organs has been anathema for much of the medical profession, but particularly to the United Network for Organ Sharing (UNOS), the non-profit group that coordinates transplants for the federal government. The article states that 79,000 people are awaiting organs for transplants. But there are a limited number of organs available, and over 5,000 people die each year while waiting for organs.

The AMA could solve the shortage with the stroke of a pen (i.e., a change in policy). If they stated that henceforth priority for donated organs would go to those who had volunteered to donate their own organs (and signed a donor card) and that priority would then be given to whoever signed their card at the earliest date, they would have a surplus of available organs in less than three years. The ideal organ donors are healthy people who die unexpectedly. We kill over 40,000 of these people on our highways every year. Yet, healthy people have no personal incentive to sign a donor card. So they don't.

The only downside to my suggestion is that some doctors at UNOS would no longer get to play God, deciding who lives and who dies. My suspicion is they won't want to relinquish their role. ☒

– Ron Muhlenkamp

## ANNOUNCEMENTS

### MuhlenkampMinute


The MuhlenkampMinute features commentary by Ron Muhlenkamp and Company on various topical subjects, starting with *How and Why Calpine and Enron Are Different*. The 60-second broadcasts are updated on the 15th of every month. Call (877) 935-5520 ext. 5 or visit our website at [www.muhlenkamp.com](http://www.muhlenkamp.com). Take a minute and tune in!

# MuhlenkampMemorandum

## Investor Education

There are several ways that you can save money for a child's education. Following is a chart, comparing three different types of accounts along with some commonly asked questions.

For more information refer to:

- IRS Publication 970 on Tax Benefits for Higher Education. Available on the IRS website [www.irs.gov](http://www.irs.gov) or by calling (800) 829-3676.
- Qualified Tuition Program (529 Plans) information can usually be obtained through the state (doesn't need to be your state of residence) or from the educational institution offering the plan. For state programs, information is usually available through the state treasurer's office. Most states have information on their web site. Also see [www.savingforcollege.com](http://www.savingforcollege.com).
- Muhlenkamp & Company, Inc. web site [www.muhlenkamp.com](http://www.muhlenkamp.com). See our website for a more detailed Education Savings Account Comparison Chart and articles expressing our reservations regarding 529 Plans. 

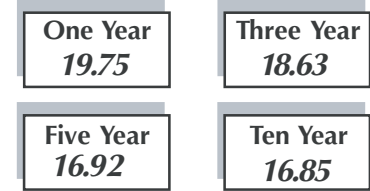
– Michelle Orphall

*Michelle Orphall joined Muhlenkamp and Company Inc. in 1997.*

The following information is based on the IRS rules effective 1/1/02.

### MUHLENKAMP FUND Average Annual Returns As of 3/31/02

Click here to see current performance information for the Muhlenkamp Fund



For more complete information about the Muhlenkamp Fund, including risks, fees and expenses, please call (800) 860-3863 to obtain a prospectus. Please read the prospectus carefully before you invest. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost. Please consult your tax advisor for advice concerning your particular situation and for any updates to the tax law. A program of regular investing cannot assure a profit or protect against a loss in a declining market. The Muhlenkamp Fund is distributed by Quasar Distributors, LLC.

	<b>Custodian Accounts</b>	<b>Coverdell Educational Savings Accounts (CESA)</b>	<b>Qualified Tuition Programs (QTPs) -Also referred to as 529 Plans.</b>
<b>What is it?</b>	The Uniform Gifts to Minors Act (UGMA) and the Uniform Transfers to Minors Act (UTMA) are custodial accounts, or a "poor man's trust," allowing assets to be registered in a minor's name with a custodian to manage the assets until the minor reaches the age of majority.	Formerly known as Educational IRAs or Education Savings Accounts. They are custodial accounts or trusts, usually maintained by a bank or financial organization, for the exclusive purpose of paying qualified education expenses of the designated beneficiary.	Qualified Tuition Programs are savings programs created under Section 529 of the Internal Revenue Code, which allow you to either prepay a student's tuition, or to contribute to an account established for paying a student's education expenses. These plans are established and maintained by a state or agency of the state and by some educational institutions.
<b>How can the money be used?</b>	If used before the minor reaches the age of majority, the funds can be used in any way the custodian deems proper for the support, education, maintenance, general use or benefit of the minor. The account, however, may not be used to discharge the liabilities normally associated with raising the child, such as for payment of food, shelter, and so on. Upon the minor reaching the age of majority, he or she controls the funds and can use them as he or she wishes.	For qualified educational expenses incurred for enrollment or attendance at any eligible educational institution for elementary, secondary, and postsecondary education. Qualified elementary and secondary expenses include: tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with enrollment or attendance as a student at the school. Also, some computer and internet equipment expenses, room and board, uniforms, transportation, and supplementary items may be covered. Qualified post-secondary expenses include: tuition, fees, books, supplies, equipment and, in some situations, the cost of room and board.	For qualified higher educational expenses incurred for enrollment or attendance at any eligible postsecondary educational institution. Qualified expenses include: tuition, fees, books, supplies and equipment required for enrollment or attendance at an eligible educational institution. Also included are expenses for special needs services, in the case of a special needs beneficiary, which are incurred in connection with such enrollment or attendance. Room and board costs may also be included up to certain limits. Generally, an eligible educational institution includes most public and private colleges and universities, graduate school, two-year community and junior colleges, and vocational and technical schools.

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	<b>Custodian Accounts</b>	<b>Coverdell Educational Savings Accounts (CESA)</b>	<b>Qualified Tuition Programs (QTPs) -Also referred to as 529 Plans.</b>
<b>Can I make contributions to multiple plans in the same year for the same beneficiary?</b>	Yes, making contributions to a custodian account does not restrict you from making contributions elsewhere (unless the amount exceeds \$11,000/ year, then you would incur the gift tax).	Yes, you are now allowed to make contributions to both a Coverdell Education Savings account and a Qualified Tuition Program, as well as to a Uniform Gifts to Minor Account.	Yes, you are now allowed to make contributions to both a Qualified Tuition Program and a Coverdell Education Savings Account, as well as to a Uniform Gifts to Minor Account.
<b>Are there maximum contribution limits?</b>	No, the minor or any other contributor can add any amount to the account at any time. No lifetime limits.	Yes, the total of all contributions made to one or multiple CESAs for one designated beneficiary cannot exceed \$2,000 per tax year. Contribution amounts over \$2,000 per tax year are considered excess contributions and, if not removed by June 1st of the following year, will be subject to a penalty tax of 6%.	Yes, depending on the individual QTP as to what the limit is. Board members of the QTPs are required to set the maximums so that total contributions to a QTP for an individual beneficiary are not more than the amount necessary to provide for the qualified higher education expenses of that beneficiary.
<b>Is there a deadline for making a contribution each year?</b>	Not applicable unless you are making maximum tax-free gifts each year (\$11,000/year), then make sure the investment check is cashed on or before Dec. 31 <sup>st</sup> of the year in which you made the gift.	Yes, you have until the due date of your tax return, not including extensions, to make contributions for that year; (beginning with contributions for tax year 2002).	No, there isn't a deadline each year as to when you make contributions. The earlier you invest, however, the longer the assets have to grow.
<b>What are the benefits regarding federal taxes?</b>	Usually taxed at the minor's tax rate, however, there are some instances when taxed at the parent's rate; i.e., Kiddie Tax.	Growth of assets, dividends, and interest income are non-taxable. Qualified withdrawals of contributions and earnings are exempt from federal income tax to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified education expense for the tax year.	Withdrawals from QTPs established and maintained by a state are free of federal income tax if the assets are used for qualified higher education expenses. If the QTP is established and maintained by an educational institution, any earnings distributed from the plan before January 1, 2004 must be included in income.
<b>When are distributions required to be made?</b>	No time requirements. Once the minor reaches the age of majority, the account registration should be changed to remove the custodian's name and the UGMA or UTMA registration.	Distributions are required to be made within 30 days of when the beneficiary turns age 30, unless the child is deemed to be a "special needs" child, as defined by IRS regulations. If the beneficiary dies, assets must be withdrawn within 30 days after the date of death.	No time requirements.
<b>What if the beneficiary decides not to go to college?</b>	Not applicable.	The responsible individual may designate another beneficiary as long as the new beneficiary is under age 30 and is an eligible family member of the existing beneficiary. Another option is to withdraw the funds and pay income taxes and a 10% additional tax on any earnings.	You may change the beneficiary of the account to an eligible family member who can use the assets for a qualified educational expense. Another option is to withdraw the funds; but then you would have to pay income taxes and a 10% additional tax on any earnings.

# MuhlenkampMemorandum

## ...of Personal Interest

Recently, Tony Muhlenkamp received an email from a shareholder requesting investment advice for a newborn daughter. With permission from the shareholder, reprinted below is the correspondence.

**To:** Muhlenkamp Fund  
**Subject:** Education Funds

I am a Muhlenkamp investor and would like information on what to do with education funds for my newborn daughter. I had read a couple of articles posted on your web page, written by Anthony Muhlenkamp, suggesting that Education IRAs and 529 Plan accounts are not the best approach. I was unclear, however, as to what approach he would advocate. He said he was planning something for his own children and I was wondering if he could elaborate on the plan he has implemented or, if possible, advise me on my problem since my situation may need a different type of solution.

The specifics of my situation follow: My daughter is 3 months old. I am in the third year of my career and currently have little money to invest, but will have more in the future. We do not plan to pay for her entire schooling, but would like to pay for one year's worth at a state-type school. Our plan was to invest \$500 a year at first, and then invest more as we have more to give. I would like to create a plan that I can use for the long term.

Thanks,  
MUHLX Shareholder

### Dear MUHLX Shareholder,

My savings for college are part of a larger whole. My wife and I are doing the following for our long-term goals of retirement and college for our three-year-old daughter.

In general, we are trying to make more, spend less and invest the difference. We have multiple accounts to take advantage of current tax law, which treats Simple IRAs, Roth IRAs, UGMAs and CESAs (formerly called Education IRAs) differently. Our savings plan in order of priority is:

1. My wife makes the maximum contribution to her Simple IRA every year; (she is self-employed).

2. My company contributes to my pension plan, but if we had a 401(k) I would make the maximum contributions.

3. Then we save \$3,000 each year into my wife's IRA, her Roth if eligible, or her Traditional if we aren't eligible for a Roth. (The Roth IRA gives us tax-free compounding; the Traditional IRA gives us tax-deferred compounding.)

4. Then we save \$3,000 into my IRA, my Roth if eligible, or my Traditional if we aren't eligible for a Roth.

5. Starting in 2002, we put \$2,000 into a CESA for our daughter. Prior to 2002, we could only put \$500 into an Education IRA each year so we didn't bother. Now we bother. We can add money to it until she turns 18 years old, and we can keep it in until she is 30 years old. If she hasn't spent it on college by then, we can pull it out and pay taxes and penalties, or name a new minor beneficiary who will use it on college.

I am not a fan of 529 plans; refer to our website for details.

6. When my daughter starts earning money, we will then save \$3,000 (or whatever she earns) into a Roth IRA for her.

7. Anything that we have left goes into our joint investment account.

My daughter has her own UGMA account. I have let all her aunts, uncles, grandparents and godparents know that for every dollar they give her, I will add one of my own. This money gets invested instead of being used to buy more stuff. I plan to use this to teach her about investing as she gets older and to encourage her to save on her own. This account gets turned over to her at age 21 and, at that point, she can spend it as she will. Until then, my wife and I control it.

I will take distributions for college from our accounts in the following order because of the tax consequences:

1. We pay no taxes on the CESA gains.

2. We pay 10% capital gains tax on the gains in the UGMA.

3. We pay 15% income tax on the gains in her Roth IRA, but no penalties if used for education.

4. We pay 20% capital gains tax on the money withdrawn from our joint account.

5. We pay 31% income tax on money withdrawn from our IRA or Roth IRA accounts.

6. We pay 10% penalty and 31% income tax on money withdrawn from our Pension Plans.

Clearly, we will spend my daughter's money (CESA, UGMA, Roth IRA) on her college first. Then we can decide how much of our money we want to spend. I like having multiple accounts in case she would rather start her own business or travel instead of going to college. The CESA is the only dedicated college account; the others are flexible in how they can be used.


When my wife and I retire, we plan to pull money from our accounts in the following order, still being mindful of the tax consequences:

1. Our joint account.

2. At age 70, we take the Required Minimum Distribution from our Traditional IRA.

3. Use our Roth IRAs as a last resort.

Remember, any money in our IRAs when we die will be left to our daughter and can compound tax-deferred (tax-free for the Roth) over her lifetime. That is powerful. Dad reminds me, however, that I may not want to fund our IRAs forever. His rule of thumb is that if I have \$1,000,000 in my tax-deferred retirement accounts by age 60, then I should probably stop funding my IRA each year. If I have that much at age 60, then my mandatory distributions at age 70 will probably keep me in the highest tax bracket and I will simply be converting capital gains on my investment to ordinary income raising my tax bill in retirement instead of lowering it.

I suspect this is more answer than you bargained for, but I hope it helps. Let me know if you have questions. 

Regards,

Anthony Muhlenkamp

*The above discussion is based on Anthony Muhlenkamp's specific situation and investment objectives. It is not intended to be a forecast of future events, guarantee of future results, nor investment advice. Please consult your investment professional and/or tax advisor for advice concerning your particular circumstances and for any updates to the tax law. IRA withdrawals prior to the age of 59 1/2 may be subject to a 10% penalty. A program of regular investing cannot assure a profit or protect against a loss in a declining market. Mutual fund investing involves risk; principal loss is possible.*

# Investment Insights

Muhlenkamp Memorandum Issue 62

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## Why "Hot Stock Tips" Are A Bad Idea



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*"While 'Hot Tips' can make you some money, they can also be very costly..."*

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To be a successful investor you need to know three things:

- Why you own the stock;
- What price to sell; and
- What price to buy.

The fundamental reason why "Hot Tips" are a bad idea is they encourage you to ignore these key questions. Without answers to these questions it becomes very difficult to profit from an investment idea. For example, you get a "Hot Tip" on IBM and buy at \$120 could you answer the following:

- Does it matter if the tipper bought at \$90?
- If IBM goes to \$150 do you sell?
- If IBM goes to \$60 do you sell or buy more?
- If IBM is still at \$120 six months later, what should you do?

Now if the tipper happened to tell you at what price to buy and what price to sell, will he be in contact to give you updates? Will you know what to do if three months later IBM comes out with a new technology, or if a competitor comes out with a superior technology? The only way to make consistently good decisions over time is to know why you own IBM.

The biggest lure to "Hot Tips" is greed. They sound like such an easy way to make a quick buck. While "Hot Tips" can make you some money, they can also be very costly. This reminds me of a Neural-networks class I took during my graduate studies at Carnegie-Mellon University. The course was a study in

using computers to grind through financial data with sophisticated statistical algorithms (formulas) to determine future price movements in stocks. There was an algorithm that was able to correctly determine tomorrow's future direction of the market 80% of the time. When put into action over a period of time the trading strategy was a consistent money loser. The problem was when the algorithm was wrong it was very, very wrong. The losses from being wrong 20% of the time were greater than the gains from being right 80% of the time. Do you know anyone who has consistently outperformed the markets using "Hot Stock Tips"?

Investing is both an art and a science. Investing is the art of making a decision with subjective information and the science of doing your homework. Most people enjoy the art of the decision, but are unwilling to do the necessary homework. My graduate and CFA (Chartered Financial Analyst) studies focused on the science of doing the necessary homework and utilizing different valuation techniques. Before I recommend a company, I have studied its financials, talked to management, looked at competitors, and learned about the key dynamics of its industry. I am able to expedite and streamline this very time consuming process, because I research companies for a living. I believe that being thorough with the science of investing gives me a distinct advantage, over the investing public, at the art of investing.

The most efficient part of the market is reflecting historic financials into the current prices of stocks. The most inefficient part is reflecting future expectations into the current prices of stocks. This is why many non-investment career professionals



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*continued on back*

## Hot Tips... Bad Idea

*continued from front*

seem to have an advantage in picking the better companies in their industry. Where I am able to level the playing field is by having a better understanding of valuations. If there is one idea that has been ringing loud and clear in the market since March of 2000, it is that valuations do matter and are very important.

There are many different valuation techniques. The most frequently used techniques include: Price to Earnings; Price to Book; Price to Free Cash Flow; and EV (Enterprise Value) to EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). These valuation techniques can be used in historical comparisons or projected onto future expectations. Because each company tends to have its own story, background, capital structure, and accounting, I find that often I have to employ several valuation techniques to find one that makes the most sense. From this I am able to determine what I think is the value of the company and compare my analysis to the market price. Depending on whether the security is undervalued or overvalued, I make my recommendation accordingly.

While up to this point it all sounds like science, the art of investing has already started. Once you move from historical information to projecting future economic and business activities, the whole process turns very subjective. The art of making a decision with less than perfect information is where real skill is recognized and rewarded. It is because of the high rewards that so many very bright and highly credentialed professionals have been attracted to the investment industry.

And now that I have covered the ground work, to the right are the top 10 reasons I feel "Hot Stock Tips" are a bad idea.

*– Ken Dupre*

*Ken Dupre joined Muhlenkamp & Company Inc. as an Investment Analyst in 1997.*

### Top 10 Reasons why "Hot Stock Tips" are a bad idea:

- 10) Biases – Does the tipper really have your best interest at heart? It's never long before you discover that some people clearly have their own agenda. They either tell you all the great things about a company or all the negatives. (Need I mention the propensity to distort or misrepresent the facts?)
- 9) The grapevine – Most "Hot Tips" come from the grapevine. The grapevine is a place of nebulous information. You're never sure exactly where the information came from and, as it was passed along, how many different iterations the information has suffered. The irony of the grapevine is that it sounds as if the information is always first-hand and verbatim from an expert source.
- 8) Quality of advice – Do you really trust the tipper to know what they are doing? The way people hand out advice you would think everyone has multiple degrees (e.g., John Doe J.D., M.D., C.P.A., C.F.A., P.E.).
- 7) Accuracy - Is the information accurate? Do you remember on 8/25/00 a news posting that "Emulex's CEO had resigned, that its recently reported fourth quarter results were to be restated, and that Emulex was under investigation by the Securities and Exchange Commission..."? The stock dropped over 60% before trading was halted. None of it was true.
- 6) Timing – Imagine you hear a "Hot Tip" that a new technology is going to make a big impact on the future of a company. If the stock is already up 30% in two days do you still buy? With today's market volatility, old "Hot Tips" are more often costly than profitable.
- 5) Taxes – Most people who trade on "Hot Tips" do it to make a quick buck. If you have enough money to invest in tips you are probably paying 40% short-term capital gains taxes.
- 4) Investment discipline – Think about whether the "Hot Tip" fits your investment philosophy and goals.
- 3) Ethics – For the sake of argument assume you just received some insider information. If you trade on the insider information and the SEC tracks you down, there could be civil as well as criminal penalties. Are your morals up for sale?
- 2) Gambling – If you can't answer, why you own the stock, what price to buy, and what price to sell, I would argue you're gambling.

And the #1 reason why "Hot Stock Tips" are a bad idea -

- 1) Availability of High-Quality Mutual Funds — Why gamble when you can invest in a high-quality mutual fund that outperforms the S&P 500 on a 1,3,5 and 10 year basis; is highly tax efficient; has low turnover; and is run by an investment manager with over 30 years of experience? You have worked hard for your money; let your money work hard for you!