

MuhlenkampMemorandum

Launched on April 15, 2002, the **MuhlenkampMinute** features commentary by Muhlenkamp employees on various topical subjects.

MuhlenkampMinute
Sound Bites for Investing
(877) 935-5520 ext. 5
www.muhlenkamp.com



The **MuhlenkampMinute** is available via recorded message by calling our toll-free telephone number: (877) 935-5520 ext. 5 or by visiting our website: www.muhlenkamp.com.

The current **MuhlenkampMinute** addresses "What's Up With El Paso?" and will be available through July 15.

The transcript of our first **MuhlenkampMinute**, entitled "How Calpine and Enron are Different," is featured in this quarter's **Investor Education**. The Minute was written and recorded by Ken Dupre, Financial Analyst.

Editor's Correction (7/29/02):

As of 6/30/02, the Fund held the companies discussed in the **Investor Education** article in the following percentages of total assets: Calpine, 2.47%; Enron, 0.00%.

Investor Education

A *New York Times* article on December 10, 2001 was titled "Is it a Enron Twin, or Just a Look-Alike?" The article suggested that both Enron and Calpine trade energy, use off-balance sheet financing, and are suffering from a liquidity crunch.

We disagree.

While Enron began as a pipeline and power producer, it shed those assets. Enron's demise is largely attributed to its activities as a trader and questionable accounting practices. In contrast, Calpine is a fully integrated power company whose business is based on owning geothermal and natural gas power plants. Calpine's new state-of-the-art power plants are 30% more fuel efficient and give Calpine a distinct advantage over the competition.

Calpine's key business strategy is to contract 65% of a new plant's power for several years. So while margins on power have been near break-even as of late, Calpine still expects to make \$1.4 billion of cash flow in 2002.

Calpine's trading and marketing operations are supplemental to power production and are expected to contribute less than 15% to their bottom line. Further, the use of financial swaps with contracted power allows Calpine to lock in profitable power margins.

Calpine has \$12.7 billion of debt, but has \$21 billion of assets to back up the debt. Their use of Special Purpose Entities, a type of off-balance sheet financing, is limited—and not guaranteed or backed by Calpine stock. Enron's use of Special Purpose Entities backed by Enron stock is a questionable accounting practice that helped precipitate the current crisis.

We believe Calpine's management has been open and accessible. To see only the negatives and make an inaccurate direct comparison between Calpine and Enron is a mistake. We consider Calpine a good long-term holding.

In response to this MuhlenkampMinute, we received email from shareholders requesting more information. Following is the essence of Ken Dupre's response.

While Calpine (CPN) may be a weak stock in a weak industry, the market is notorious for overreacting (creating wonderful buying opportunities).

While the overall industry is suffering from overcapacity, the electric-producing industry will continue to grow. The interesting thing is that in the electric industry, the difference between overcapacity and under-capacity is less than a 10% swing. As the economy picks up and demand starts revving up, I expect power margins to come back to very profitable levels. This could easily push CPN to \$25 and above. At \$10, CPN is a great value. I am very comfortable that CPN will be around for the long run. The last thing I want to do is sell a leader, while at the bottom, in a depressed industry. ☐

– Ken Dupre

As of 6/30/02, the Fund held the companies discussed above in the following percentages of total assets: Calpine, 3.1%; Enron, 0.00%.

The information above represents the opinion of Ken Dupre, Financial Analyst, and is subject to change at any time. Also, it is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Mutual fund investing involves risk; loss of principal is possible.

For a list of current holdings, please see the Fund Holdings section on our website: www.muhlenkamp.com.

MuhlenkampMemorandum

Of Personal Interest

In past issues of the **MuhlenkampMemorandum** I have suggested that people save for college in two steps instead of one. The one-step method of saving for college is to use a 529 College Savings Plan (529 Plan). My two-step method is to use the Coverdell Education Savings Accounts (CESA) and the Uniform Gifts to Minors Accounts (UGMA).

Using my two-step method is more complicated, but I think the increased flexibility makes it worthwhile. By increased flexibility I mean the ability to make the best investments you can, to change investments at your discretion, to spend money on things other than college that may be equally worthwhile (such as starting a new business, travel, charitable work, etc.) and to decide when and how to give money to your child. Done properly, you can still enjoy most of the tax savings offered by the 529 Plans.

However, people have voiced several objections to my method because:

1. People with adjusted gross income over \$190,000 (\$95,000 if you are a single tax filer) cannot make the maximum contribution to a CESA.
2. Contributions to a CESA are limited to \$2,000 per year, which isn't going to be enough to pay for college in 5, 10, 15 or 20 years (depending on the school and the age of the child).
3. The child will control a UGMA at the age of majority (18 or 21, depending on the state), and instead of using the money for college the child may spend it on something that the parent doesn't approve of.
4. There must be a 529 Plan somewhere with investments that I like.

These are valid objections, and for many people it is simple (and thereby compelling) to overcome these objections just by using the 529 Plans. However, using the 529 Plans means giving up the flexibility that I think is so important. Instead, there are ways around these objections so that you can still use the CESA and UGMA, but they require some thought. With thanks to my estate attorney Larry Kuremsky for his clear and concise answers to my questions on gift taxes, my responses to the above objections follow.

“You can...decide when and how to give money to your child...and still enjoy most of the tax savings offered by the 529 Plans.”

Response to Objection #1.

Anyone whose adjusted gross income is below the cap can contribute to a CESA for your child. In fact, your child can contribute to his own CESA. Earned income is not a requirement for contributing to a CESA, so your child can make the contribution even though he isn't working.

Make sure you DO NOT move money from your child's UGMA to his

CESA. Here's why:

- UGMA money belongs to the child at the age of majority; CESA money doesn't belong to the child until age 30.
- UGMA money is an irrevocable gift to the minor; CESA money is a gift to the minor that can be revoked and given to a different child by naming a new child beneficiary of the CESA account.

So essentially, moving money from a UGMA to a CESA can be (and probably will be) construed as taking money from the minor. Don't do that.

Now, regarding moving money from a UGMA to a 529 College Savings Plan, some states allow you to do that. In some cases they require you make an irrevocable beneficiary designation, as opposed to the revocable beneficiary designation you normally make with 529 Plans. In my opinion, any time you move money out of a UGMA into an account with a different designation you are leaving yourself open to questions from the IRS, or even the Orphans' Court. Be very, very careful if you plan to move money from your child's UGMA.

Also be careful of “step transactions.” This term covers those series of transactions that are taken to complete a transaction that would normally be prohibited or taxed. For example, suppose you and your wife want to give your child \$100,000 but you don't want to pay gift tax on

continued on next page

Muhlenkamp Fund Average Annual Returns As Of 06/30/02

One Year
-6.08%

Three Year
7.63%

Five Year
11.26%

Ten Year
15.53%

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. A program of regular investing cannot assure a profit or protect against a loss in a declining market.

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\$78,000 (the total gift of \$100,000 less the \$22,000 representing the \$11,000 “free gift” each of you can give each year); so you give seven friends each \$11,000 and ask them to give the \$11,000 to your child. This series of transactions to friends is viewed as “step transactions” and they are AGAINST THE LAW. If this comes to the attention of the IRS you will be treated as having given \$100,000 to your child. Don’t make gifts to people intending to use them as a way around gift tax laws or contribution eligibility requirements. Keep it straight.

“As an investor, I start with two questions: what is the best investment I can find, and how can I make that investment in such a way as to minimize or eliminate having to pay taxes?”

Response to Objection #2.

Depending on the school and your child’s age, saving \$2,000 per year in a CESA may not be enough to pay for college. However, it is a good start, and should be where you save the FIRST \$2,000 per year that you are putting aside for college. Anything you want to save above \$2,000 per year can go into a UGMA for the child. A married couple can put \$20,000 per year into a UGMA account for a child after having put \$2,000 into a CESA for the same child. If you have a few years before your child starts college, you should be able to save enough money in the UGMA for almost any college program.

Response to Objection #3.

If you are worried about the child not using the money wisely when he has unrestricted access to the UGMA, limit what you put into the UGMA. Instead, invest as much as you can into your own personal account, and then transfer (subject to the gift tax rules) existing securities, in kind, to the child

when it is time to pay for tuition. The child then sells the securities and will pay taxes on the gains, but at his lower capital gains rate, not at yours. If the child isn’t enrolled in college, or won’t spend the money wisely, you simply don’t give him anything.

Using a personal account adds more steps to my previous two-step method, and makes it more complicated than it was initially. However, the flexibility benefits make spending the additional time, thought, and energy well worthwhile.

Response to Objection #4.

If you find a 529 Plan that offers investments you like, and if you would invest your money in the funds that are offered using the set allocations between funds, and you would invest this way without the tax benefits, then, by all means, use the 529 Plan. So far, I have reviewed five different state plans in detail, and I haven’t found a set of investment options that I think are as good as the investments I can make outside the 529 Plan. Moreover, I have found that all the investment options available are based on Modern Portfolio Theory and Asset Allocation between asset classes, market capitalization, and investment style. I think this makes it very unlikely for me to make as much money inside the 529 Plan as I will outside the 529 Plan. The options are all based on flawed (yet conventional) assumptions.

As an investor, I start with two questions: what is the best investment I can find, and how can I make that investment in such a way as to minimize or eliminate having to pay taxes? My observation is that people who start by trying to avoid taxes wind up with bad investments that either make them no money or lose their money. My best example of that is the real estate limited partnerships that were sold as tax shelters in the 1980s. People who bought those paid no taxes, but they made no money. In fact, it took most people ten to fifteen years to

get their money back. I’m not predicting that scenario for 529 Plans, but I do predict that five and ten years from now, people will be disappointed in their investment returns; the ingredients are already baked in. 529 Plans are assumed to be good investments and are being sold as tax shelters. I think investing to save taxes rather than investing to make money is unwise.

More information on 529 Plans, CESAs, and UGMAs is available at:

- www.muhlenkamp.com (see Memorandums #58, #60, and #62)
- <http://www.savingforcollege.com/>
- http://www.nasdr.com/529_saving.asp
- <http://university.smartmoney.com/departments/collegeplanning/taxwisesavings/>

You will note that I don’t agree with all the recommendations made at these third-party websites, but they do have good information. The challenge is to distinguish the facts from the opinions, but that is true no matter what you are reading. Please call me if I can help. ☐

– Anthony Muhlenkamp

The above discussion is based on Anthony Muhlenkamp’s opinion, given the current laws and specifications of these savings plans. 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. 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.

The Muhlenkamp Fund is not responsible for, nor guarantees the accuracy of, the information contained on the third-party websites listed above.

InvestmentInsights

Muhlenkamp Memorandum Issue 63

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The Barney Factor and A Methodical Search for Dancing Customers

Startled, I quickly realize that it is not my clock sounding its alarm at 5:30 a.m. but my 2-year-old daughter, Ava Rose. She is demanding that I waken from my slumber and take her downstairs to watch her favorite television program, Barney. "Rosie" is enchanted with the purple dinosaur. Motivated by the spectacle, she begins to dance. Watching her, it occurs to me that day after day I study new product and service offerings trying to find those



that both enchant and motivate prospective customers.

Customer enchantment is just one element of the product equation. I refer to this as The Barney Factor—that which arrests attention, infatuates, enthralls. Motivating a customer to buy, however, is altogether different. What facilitates buying? What secures customer

lock-in? What is the right price? Like Rosie, what makes a customer dance? Successful products strike a critical balance between these components. After all, there are many great products with a high Barney Factor, but with no buyers or available market.

As an equity analyst for Muhlenkamp & Company, Inc., my duty is to be vigilant in observing the multitude of relationships that can affect the delicate balance struck between The Barney Factor and the motivated buyer. I filter and weigh the various dimensions of each relationship to a given company and attempt to quantify the financial consequences. Ultimately, I derive a fair value for the company as it relates to the

"Day after day, my objective is to order and synthesize real-time information, turning it into knowledge."

market price and act on it. Over time, I monitor pertinent relationships to assure that the desired financial returns are maintained.

By 6:40 a.m. my wife is making breakfast as my other two daughters ready themselves for school. Rosie, in the spirit of The Barney Factor, is still dancing. Quick kisses, a cup of coffee, and I am off. The 30-minute drive to Wexford is a great time to refine my "feel" for the market. By this, I mean understanding the mood of the investor as it relates to external influences. Being able to measure and weigh the potential for significant external relationships to dramatically alter investor mood is

essential. It is critical to realize when stock price trends diverge from fundamentals and reality. One can never be certain of the duration of the divergence. Therefore, it is important to "feel" when investors are ready to shift their focus back into reality and act accordingly.

Upon arriving at my office, I open my browser to actively monitor indicators such as commodity price trends, foreign market activity, new economic news, treasury bond activity, analyst commentary, regulatory and political activity, international events, and much, much more. Day after day, my objective is to order and synthesize real-time information, turning it into knowledge.

It is now 9:30 a.m. and the markets have opened. Through e-mail, I review every news message that hits all major wires on specific companies that serve as a barometer of global economic, business, technological, and social trends. I internalize the daily news flow with observable activity in price and volume of the stocks that I follow. These activities, while being cognizant of the mood of the investor, strengthen my "feel" for the explosive potential in stock price movement as it relates to value.

My day is now in full swing. I see from a news release that a competitor of a holding in our portfolio has reported mixed results relative to the expectations of analysts. Initially concerned, I am heartened by the outlook for business conditions and



Muhlenkamp & Company, Inc.
Intelligent Investment Management

continued on back

The Barney Factor...

continued from front

forward guidance. The trickiest time to pick an entry point into a stock is during a period of inflection in which economic growth is changing from a downward to an upward trend. Each day produces either very bad news (reflecting past conditions) or relatively good news (more accurately reflecting the current state of recovery). Earnings with mixed results are typical during a period of inflection.

It is now 11:30 a.m. and I have a scheduled conference call with management of a company whose progress I track. This call takes place once every quarter; in addition, I make brief calls to specific company officials in between. My objective during a conference call is to assure that their product/service offering still has, well, The Barney Factor and, if so, to ascertain if their customers are still dancing. This has become a difficult task since the fair disclosure rules were adopted in 2000. Relying on these rules, management reiterates what they have discussed publicly and will provide little to no additional information regarding business conditions intra-quarter. Therefore, keen listening is essential to getting a feel for the demeanor of management as they answer a direct question. This is aided by having conducted many conversations with the same manager over time. My conclusions draw upon the manager's intonation, voice inflection and the credibility that has been defined from past experience. Nevertheless, I must exercise caution when weighing my conclusions into the financial impact of any relationship discovered through this channel.

As I begin to search the landscape for new ideas, my starting point is the chart book, *Daily Graphs*. This resource charts thousands of stock price patterns on thousands of companies. It may appear technical and dry to the average reader. To me, however, the price chart is a

graphical representation of human emotion—greed, hope, fear, expectations, and many other human attributes. By understanding the power of each price point, the chart becomes alive with information to interpret. Developing an interpretative style for price patterns requires diligence, practice, and patience. I further examine indicators such as price-to-earnings ratio, return on equity capital, price-to-book ratio, distribution, earning growth rate, short interest, earnings estimates, insider activity, cash flow, and many others.

I evaluate a company fundamentally using Ron's proprietary model. Once I have

“To me...the price chart is a graphical representation of human emotion—greed, hope, fear, expectations, and many other human attributes.”

found a candidate, I perform continuous research to fully grasp every technological and fundamental aspect of the company. This includes its product/service offering and the industry in which it participates. It takes a long time for me to gain conviction (sometimes years) and recommend a stock. Hastily recommending a stock can be very costly.

It is now 4:00 p.m., the time for my weekly meeting with Ron and the investment team. Both fun and challenging, I must defend my work with succinct argument, addressing both my evaluation parameters and forecasts because Ron, Ken and Rich (the other members of the team) approach these matters from different perspectives. After 90 minutes, the meeting ends and I begin my journey homeward. My job doesn't end, however, because I have left the office.

Arriving home, I am greeted with hugs and stories of events at school and play. After putting the kids to bed, I visit my window to the world (my computer)

from the comfort of my den. As I take a look at how the Asian markets have opened, I think about what I have learned during my 11 years—a very short period—as an analyst. Consider the Tulip Bubble in Holland around year 1630; or ponder the “new technologies” in the U.S. during the 1870s as the railroads were built across the country. The stock prices of the innovators were bid to extreme highs and subsequently fell. The mantra during the price frenzy was “This time it is different!” I remember hearing this sentiment expressed during the “Internet Bubble.”

My conclusion is that technologies do change but mankind does not. I have also learned to “Never say Never!” I marvel at how Ron has synthesized his understanding of the markets from his 35 years of hands-on experience, encompassing the disparate economic periods of the 1960s, '70s, '80s and '90s. I am humbled by the millions of Americans whose past and present lives were spent building and protecting the economy I enjoy so much today.

Tired, I remind myself that I need to arise with Rosie so that she can experience The Barney Factor. I think that I will dance along with her this time; but then again, maybe, just maybe this time, she will sleep in. ☹



– Jack Kunkle

Jack joined Muhlenkamp & Company, Inc. as an Equity Analyst and the Chief Technology Officer in 1992.

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