

MuhlenkampMemorandum

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On December 31, 2003 the Net Asset Value of the Muhlenkamp Fund was \$63.51, up 48.07% year to date.

Quarterly Letter

The economy continues to expand.

In the past 12 months GDP (Gross Domestic Product) grew by 4% after growing by 3% in 2002. Capital spending and payroll employment, both of which lag the economy, have bottomed and are now trending up. The unemployment rate has declined from 6.4% to 5.9% in the past six months. So, in my opinion, the economy is firmly on a recovery track.

We are, of course, still hearing negatives. Some people seem to think that all economic data must exceed the old highs before they'll admit that things are improving. That's like saying that daily temperatures must match those of last July before concluding that winter is over. Such a stance makes no sense economically and will cause many investors to miss the largest part of a market upswing.

There are negatives, of course. There always are. The biggest negative is that our politicians continue to spend money like... politicians (thereby outspending teenagers and drunken sailors).

At our recent seminar, we received a number of questions about the federal budget deficit, inflation, and the trade deficit with China. These topics are also getting major play in the media. It's as if we learned nothing about these topics from the inflation of the 1970s, the budget deficits of the 1980s, or the trade deficit with Japan in the 1970s. (We have included a number of these questions and our response in an insert in this *Muhlenkamp Memorandum*.)

It appears prices of most stocks and bonds have returned to near fair values after suffering from the triple whammy of recession, psychological hangover from the fad (or bubble) prices, and the psychological damage from the 18-month litany of ills from 9/11/01 through the Iraqi War. We believe this triple whammy has now worked its way through the markets, although some lingering effects are bound to crop up from time to time.

Thus, the markets remain volatile. While not unscathed, we have come through this period in good shape. The challenge now is to differentiate among those companies that are best serving their customers in a fashion that provides net income and cash flow. We are spending our time and effort accordingly. ■

—Ron Muhlenkamp



Muhlenkamp & Company, Inc.
Intelligent Investment Management

MuhlenkampMinute

The following is a transcript of the Muhlenkamp Minute recorded November 20, 2003 by Ron Muhlenkamp on the topic of Late Trading/Market Timing.

In the past few weeks, there has been a lot of media attention focused on legal investigations into parts of the mutual fund industry. These investigations include allegations of late trading and market timing activities.

Late trading involves allowing certain investors to enter orders to buy or sell shares after the 4:00 p.m. ET market-closing deadline, and still obtain the 4:00 p.m. ET closing price. **This is illegal.**

Our policy and our custodian's policy do not permit late trading.

Market timing refers to the purchase and sale of mutual fund shares over a short time frame, attempting to profit from short-term swings in the market. While *not* illegal, if done successfully in large amounts, market timing can disrupt the management of the funds, and possibly benefit the short-term traders at the expense of the funds' long-term holders.

We discourage market timing using our Fund. Currently, we levy no financial penalties on those who redeem shares shortly after purchasing them, partly because shareholders sometimes find it necessary to redeem shares sooner than planned. We do, however, closely monitor cash flows both into and out of the Fund.

On a couple of occasions, we've identified people who did purchase and subsequently, soon, did redeem a sizeable number of shares in the Fund in an apparent effort to time the market. While these transactions did not have a negative effect on the price of the Fund, we have informed the parties that we will no longer accept their money. We will continue this practice in the interest of our shareholders.

This is Ron Muhlenkamp, and this is your Muhlenkamp Minute.

Mutual fund investing involves risk; loss of principal is possible. Please refer to the prospectus for more complete information about the Muhlenkamp Fund, including risks, fees and expenses. Read it carefully before you invest or send money.

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Investor Education

The USA PATRIOT Act and Its Effect on Financial Institutions and Investors

Congress created the USA PATRIOT Act of 2001 "To deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and for other purposes." The acronym stands for **Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism**. The Act has ten titles which include, for example, "Protecting the Border," "Improved Intelligence," "Enhanced Surveillance Procedures" and "Enhancing Domestic Security Against Terrorism." As investors, the title that affects us directly is Title III, which is the "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001." The U.S. Treasury Department and the Securities and Exchange Commission (SEC) issued regulations based on this part of the USA PATRIOT Act. All financial institutions were to begin compliance with these new regulations on October 1, 2003.

Included in the Treasury & SEC regulations are guidelines to establish a Customer Identification Program (CIP) to be used in account opening and maintenance procedures. Using CIPs, investment companies should be able to determine with reasonable belief that they know the true identity of each "customer." The CIP should include steps to reject and return the investment if the applicant's identity is unable to be verified. Also included in the regulations are guidelines to establish procedures to identify money laundering and terrorist financing. By identifying these illicit activities, investment companies can obstruct and possibly help to intercept terrorists or individuals engaged in money laundering activities.

Muhlenkamp & Company, Inc. has designated an Anti-Money Laundering

(AML) compliance officer to adopt and implement procedures necessary to enforce the new regulations within the Company. However, since Muhlenkamp & Co. acts only as investment advisor to its Fund, the Fund's transfer agent, U.S. Bancorp Fund Services, LLC, processes applications and transactions for all of our direct shareholders according to the established AML rules. The Anti-Money Laundering Program for our privately-managed accounts and indirect fund shareholders is practiced by the affiliated financial intermediaries that house each account.

All financial institutions had to appoint a compliance officer and establish their own Customer Identification Program. Upon receiving a completed account application, the applicant's name must be checked against lists provided by Federal government agencies of known or suspected terrorists. Financial institutions also have to make sure that the information on the new account application is legitimate. This is done by running a crosscheck of the applicant's identity information against a database designed for this purpose. Some of the information that is checked includes the applicant's first and last name, social security number, street address, and date of birth. Everything should agree with the database information; if not, the applicant's identity must be further researched. If unable to verify the applicant's true identity, the financial institution must reject the application and return the investment. Also, financial institutions must monitor existing accounts for suspicious activity that might suggest money laundering.

How will all the new regulations affect you? If you are opening a new account, you may spend a few more minutes filling out your account application. Our mutual fund account application now requires a permanent street address rather than just your mailing address. It also requests your driver's license number to do an additional

crosscheck of your identity information if something is not consistent with the initial data check. In case you are wondering, it is not used to check your driving record: we do not have access to those records and do not need them for our purposes. Another effect of the new regulations is additional expenses for the investment institutions that house your accounts. These expenses are a result of the extra procedures, database searches, and additional monitoring done in order to comply with the new regulations. The costs may be passed on to you in higher fees.

Although the enactment of the PATRIOT ACT resulted in the request for additional personal information, the release of this information to nonaffiliated third parties is guarded by Title V of the Gramm-Leach-Bliley Act. The SEC created provisions under this Act that require companies to adopt and practice a privacy policy that restricts the use and sharing of nonpublic personal information. The provisions also require companies to adopt procedures and implement safeguards to protect the records of its customers from unauthorized access. This Act is still in effect and we still follow all of the guidelines included in The Muhlenkamp & Company, Inc. Privacy Policy and the Wexford Trust Muhlenkamp Fund Privacy Policy. These policies explain that "we do not disclose any nonpublic personal information about our current or former clients/shareholders to nonaffiliated third parties, except as permitted by law." Copies of these policies can be requested by calling (877) 935-5520 ext. 4 or viewed on our web site, www.muhlenkamp.com. 

—Michelle Orphall

Sources:

The USA PATRIOT Act is available on the website of the Electronic Privacy Information Center: <http://www.epic.org/privacy/terrorism/hr3162.html>

Federal Register/Vol. 67, No.141/Tuesday, July 23, 2002/Proposed Rules (Pages 48318-48328)

Customer Identification Programs for Mutual Funds

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... of Personal Interest

Fraud

In a courtroom, witnesses must raise their right hand and swear to tell the truth, the whole truth and nothing but the truth.

Ironically, there is no oath or written law that can guarantee honesty. The investing public has been forced to face this fact since the well-known corporate fraud cases and the more recent mutual fund investigations became public. The scandals have raised the question of whether or not the investment industry has just been diagnosed with a terminal disease or if the incidents are mere symptoms of a rare illness. I would argue the latter. A small minority of people will always be willing to sacrifice their integrity in exchange for personal gain. The increased awareness of this fact does not signal a downfall of the entire industry.

Regarding the mutual fund scandals, Ron Muhlenkamp, Portfolio Manager of the Muhlenkamp Fund, is not willing to spread the illness. In the November version of the **Muhlenkamp Minute**¹, Ron stated that late trading is not tolerated in the Fund and market timing is strongly discouraged.

In relation to the corporate scandals, as “purchasing agent” for shareholders of the Fund, the rare illness is one that Ron also tries not to catch.

“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.” —Ron Muhlenkamp, **Muhlenkamp Memorandum #62**.

Ron suggests that he cannot guarantee immunity to any scandal, but instead attempts to diversify the risk away by owning a number of holdings.

A recent study conducted by the Federal Bureau of Investigation approximates the arrest rate of individuals involved in such misconduct, categorized by the agency as “white-collar” criminals, at 5,317 per 100,000 inhabitants. This translates to approximately 5 percent of the population — much like Ron’s estimate.

Of the dishonest few, the most destructive are by and large the least likely suspects. They are usually found among the most charismatic, entrusted, educated and seasoned professionals. A 2002 report issued by the Association of Certified Fraud Examiners (ACFE) concludes that one of the best indicators of the financial

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scale of a fraud scheme is the employment rank of the perpetrator. While managers and executives accounted for only 42 percent of the acts, the total financial damages they created were approximately 4 times greater than that of lower-ranking employees.

The ACFE study also reveals a direct correlation between the age of the perpetrator and median losses incurred: the older the perpetrator, the higher the price tag of the crime. Median losses by employees older than 60 years of age were 27 times higher than that of employees 26 years of age or younger. However, it is important to note that older professionals generally hold the highest-ranking positions. By virtue of their rank, they

tend to have greater access and control over an organization’s assets.

The ACFE study indicates that college educated people and males also tend to commit more costly fraudulent crimes for the same reason. Ron states, “The last person I want to deal with is a smart crook.” He thinks that intelligent criminals are undeniably the most dangerous. On the other hand, in order to trust an individual’s opinion, Ron maintains that the individual must be knowledgeable and demonstrate good judgment, but it is absolutely essential that they possess integrity.

The financial scale of the crime is usually greatest in fraudulent cases where employees and managers act in unison. According to the ACFE study, in such cases the median costs are eight times greater than cases in which lower-ranked employees act alone. When managers collaborate with their employees, the system of control and oversight in a company breaks down, allowing fraud to thrive.

Surprisingly, these white-collar criminals are not only educated and the most mature, but they typically have no prior criminal convictions. Only seven percent of perpetrators were known to have a criminal history and three percent were charged for previous fraud-related offenses. By the time an offender is exposed, the crime has already taken place.


Whether a perpetrator has a criminal history or not, they all have one thing in common — a clear motive. Some thieves act in pursuit of easy profits while thinking they can get away with it. Others are tempted by some hidden incentive to commit the crime, or they simply find an opportunity to test their egos. In addition, white-collar criminals tend to feel little or no guilt for committing fraudulent crimes since they do not carry the same social stigma as violent crimes.

The fact is no fraud scheme can be committed without an opportunity. There

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Fraud continued from inside

will always be opportunities, or loopholes, that certain people will find and choose to test. As with the recent passing of the Sarbanes–Oxley Act, regulators continue to try and tighten the system. At the same time, fraudsters are also becoming more sophisticated; therefore, there will always be an element of fraudulent activity that can never be fully regulated away.

Further, there is no identified evidence that suggests that participants of any particular profession have a stronger inclination to commit fraud. The real flaw lies not within the nature of an industry, nor as a result of an oversight in the formation of any rulebook. The true imperfection lies within the core of the character of the perpetrator — it is revealed by their personal choice to be dishonest. 

—Tori Soudan

Sources:

U.S. Department of Justice. *The Measurement of White-Collar Crime Using Uniform Crime Reporting (UCR) Data*. Retrieved December 3, 2003 from <http://www.fbi.gov>

Association of Certified Fraud Examiners. *2002 Report to the Nation: Occupational Fraud and Abuse*. Retrieved November 6, 2003 from <http://www.cfenet.com>

Footnotes:

¹ A proprietary communication tool, the Muhlenkamp Minute provides opinions on current events and selected topics. To listen to the most recent recording, call (877) 935–5520 ext. 5, or visit our web site at www.muhlenkamp.com.

Average Annual Returns as of 12/31/03

	Year to Date	Past Year	Past 3 Years	Past 5 Years	Past 10 Years
Muhlenkamp Fund					
Return Before Taxes	48.07%	48.07%	9.04%	12.60%	14.85%
Return After Taxes on Distributions*	48.07%	48.07%	9.04%	12.29%	14.52%
Return After Taxes on Distributions and Sale of Fund Shares*	31.25%	31.25%	7.78%	10.90%	13.26%
S&P 500**	28.67%	28.67%	-4.04%	-0.57%	11.05%

*After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on your situation and may differ from those shown. Furthermore, the after-tax returns shown are not relevant to those who hold their shares through tax-deferred arrangements such as 401(k) plans or IRAs. Remember, the Fund's past performance, before and after taxes, is not necessarily an indication of how the Fund will perform in the future. **Past performance does not guarantee future results.**

**The S&P 500 is a widely recognized, unmanaged index of common stock prices. The figures for the S&P 500 reflect all dividends reinvested but do not reflect any deductions for fees, expenses or taxes.

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.

The Muhlenkamp Fund is distributed by Quasar Distributors, LLC.

Announcements

Muhlenkamp & Company, Inc. wishes our readers a peaceful and Happy New Year.

2003 Distributions

There were no taxable distributions from the Muhlenkamp Fund during calendar year 2003. Consequently, only shareholder accounts where shares were redeemed during calendar year 2003 will receive an IRS Form 1099.

2003/2004 IRA Contributions

You have until your tax deadline, April 15, 2004 for most individuals, to fund your IRAs — including Roths, Traditionals, and Educations IRAs (Coverdell Education Savings Accounts). Check with your tax advisor for more information and contribution limits.

And it's not too early to begin funding your 2004 IRA. Equity returns compounded over long periods can be truly amazing.

The Florida Money Show

Join Ron and Anthony Muhlenkamp February 2 – 5, 2004 at the Gaylord Palms Resort in Orlando, FL. Stop by one of the workshops and visit us at Exhibit Booth #422.

St. Vincent's Continued Learning

A four-part workshop on *Investments and Finances*, featuring Anthony Muhlenkamp, will be held at St. Vincent's Amphitheatre from 6:30 p.m. until 8:00 p.m. on the following dates at St. Vincent's College in Latrobe, PA. The workshop is facilitated by adjunct faculty, Ken Dupre.

Tuesday, March 23, 2004
Tuesday, March 30, 2004
Tuesday, April 6, 2004
Tuesday, April 20, 2004

Investing: Where to Look, What to Pay

At our winter seminar on December 4, 2003, Ron Muhlenkamp presented *Investing: Where to Look, What to Pay* to an audience of clients, shareholders and prospective investors. Afterwards, Ron Muhlenkamp entertained questions from the audience. The following is a sampling of the Question & Response session.

Federal Budget Deficit

As the federal deficit increases, won't it cause inflation?

Folks, we went through that argument in the 1980s. When Reagan said that he was going to cut taxes in the early 1980s all the economists hit the fan. They said that if you cut taxes you'll have deficits, the government will have to borrow a whole lot of money — and that will drive up interest rates, squeeze out private borrowers, and the economy will tank. In fact, the economy boomed.

Thirty years ago, textbooks used to talk about inflation being cost-push and demand-pull. What Paul Volcker proved is that inflation is monetary. The economics I was taught was all nonsense. The last 30 years has proved it. But if you are a tenured professor, or an economist, or have a PhD, it's kind of hard to agree with that.

In mid-1991, Connie (my wife) and I were at a reunion at MIT. I caught up with an old classmate, who is the chief economist at DRI, (Data Resources, Inc.). They own Standard & Poor's and other things. At the time, treasury bonds were at 9%, and he argued that with the deficit, interest rates had to go up. I said, "With the incentives that are going on and with inflation coming down, interest rates will come down." In June of '91, treasury interest rates were at 9%, and by year-end of '93, they were at 6%.

Let's bring it home. Connie and I have been married 40 years. We've had deficit spending 18 of the 40 years. Five years when I was in school, eight years when the kids were in school, three years when we bought houses, two years when I started the company. I don't regret borrowing money for any of those purposes. But I will not borrow money to buy a new car. I will not borrow money to take a vacation. Every now and then I will borrow money for an investment, but I will not borrow money for things I think will depreciate. In your own lives, it's not whether you borrow money — it's what you use it for.

Ronald Reagan borrowed money to get the economy moving again. It boomed. We had 20 years of prosperity. And he borrowed money to end the cold war. Most economists will agree that when you are in a recession, you should borrow money; there should be a deficit. You should have surpluses when you are in boom times. And I think we'll probably get there in a few years. The problem isn't whether you borrow money — it's what you do with it. That's true for you personally. That's true for our government. The deficit itself is not the key. We went through this argument 20 years ago! And the economists still haven't learned. They're making the same arguments that they made in the early 1980s.

What are your thoughts on the deficit in relation to taxes?

The timing of the tax cut was useful in that we are in the aftermath of a recession — which is when you should have some deficit spending. But I've argued that we needed the cut in tax rates to keep people working three, five, ten years from now. Obviously there are folks that want a job and want to work, but you also need someone who is willing to hire them. Who's more likely to hire your kids: somebody in the top tax

bracket, or someone in the bottom tax bracket? The answer: those in the top tax bracket. They're only going to hire them if they see the rates low enough that it pays them to do so.

We wrote an essay about three years ago called *Prosperity* in which we argued that, in the U.S. today, in both the spending level and in the earnings level, at the margin, things are discretionary. Some of you have been through the thought process. Suppose you work a 5-day week. What you earn on Monday, you pay 10% in taxes. What you earn on Tuesday, you pay 20%. What you earn on Wednesday, you pay 30%, and on Thursday you pay 40%. Whatever you earn on Friday you pay 50% in taxes. How many of you would come to work on Friday?

As you get more prosperous, the rate at which you will continue working comes down, which is why I believe this recent cut in taxes was necessary. If you are hungry, if you are starving, you'll work at a 95% rate, right? That's called slavery; but even slaves will work to get fed. But as you get more prosperous that number comes down.

What effect will budget deficits have on interest rates and capital spending?

Long-term rates reflect inflation. Long-term rates should be, and historically are, 3% above inflation. Long-term rates, we think, are fair today.

Short-term rates swing all over the place. Right now, short-term rates are below where they should be. If inflation is 1½%, short-term rates should be 1½–2%. The reason they are so low is that for the past three years the Fed has been trying to goose the economy up. Before that short-term rates were high.

You've got to watch the interplay between the two. You can't just read one and not the other. Capital spending always lags the consumer. As you've seen in the last

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continued from front

3-6 months, capital spending is now picking up.

Trade Deficit

What are your thoughts on the trade deficit?

The reason we have a trade deficit is that our population is quite prosperous and we're buying all this stuff. And we're buying it at the cheapest price we can get. So while we're buying goods from China and Japan, they're buying our Treasury bonds. So we have a trade deficit and a T-bond surplus, if you will. I had a question from a shareholder a couple of days ago asking "But isn't the trade deficit terrible and isn't it terrible that the dollar is falling?" Folks, our producers want the dollar to fall so that they can sell things cheaper overseas. Frankly, our consumers would like a stronger dollar. There is no free lunch. How do you find the balance? Right now we're seeing the dollar coming down a little and that will help our trade deficit. And, incidentally, all the stuff we're hearing about China, we heard the same stuff about Japan, thirty years ago.

When Tony (Muhlenkamp) was in Korea he wrote home to say "Dad, these people work sixty hours a week and live in rabbit hutches!" My father was willing to work an unlimited number of hours and to live cheaply to make things better for his kids. I don't have quite that same drive. My kids have always been well fed. But if you've been through the depression in this country or the war in Japan or the war in Korea, that population is willing to work unlimited hours and to live cheaply and thirty years later, the young folks living in Japan have always taken food, clothing and shelter for granted and they are not willing to work those hours. So Japan today has the same problems that we do. So now we say, isn't China out-competing us? As a consumer you welcome people who are willing to work hard and cheaply. They are selling you goods that are cheap.

Employment

You say we are willing to work longer hours to earn more — but businesses are taking jobs off shore! How can we create new, good-paying jobs?

There is no unemployment among the Amish. My grandfather was a farmer, which means he farmed with horses. He was never unemployed and he didn't have time to worry about it. My father worked in a foundry for twenty years to pay for a farm. He never told me that if I lived clean and worked hard I too could work in a foundry. I don't want my grandfather's job and I don't want my father's job.

A month ago I was on an airplane sitting next to a guy who works for Oracle and he was worried about software jobs going to India. I said: "How is that any different from thirty years ago when we worried about steel jobs going to Japan?" He said: "I don't work in the steel industry." What we would like to have is our job disappears the day we retire. It doesn't quite work that way.

We're producing more goods and we're doing it with fewer people. We produce the same tons of steel that we did in 1960. We do it with about a sixth of the people. How many of you have kids that want to work in the steel mill? So, whose kids do you want to work in the steel mill? Now the guys that are there, they'd like their job to disappear the day they retire. We do a terrible job of the transition. We do a good job of creating jobs, and if you look at the turnover as opposed to the net gain in employment or unemployment, what we do is a terrible job of is the transition. I don't have an answer for that. But when you tell me that you've got children that want to work in a steel mill, then I'll change my opinion.

Presidential Election

With 2004 being a presidential election year, is there any significant impact on the stock market?

Historically that's been a good year. We think things are in place. This time around we actually cut taxes at the bottom of the

recession. We think the economy looks pretty good next year. For politics, it's still "the economy, stupid."

Frankly, I think Bush is playing more politics than he has to. I think things are going to look pretty good for him. If we listed how many presidents we've had (forty-eight), how many of you could tell me which ones were two-term presidents and which ones were one-term presidents? It seems to me that a guy gets elected president and he's kind of relaxed and he wants to do good things. But the people around him... If Bush ends up being a one-term president, then he's in the history books. But all his aides, if he's a one-term president, what are they going to do a year and a half from now? So, I think you get all these folks around the president whose incentive is to do whatever... (And Republicans aren't much better than the Democrats because they think they get elected to spend our money and to promise us stuff.)

You've heard me say this before: I don't think it's Republicans versus Democrats, I think it's politicians against taxpayers. And all the guys around the president think, "Gee, if we just put on steel tariffs then we can get Pennsylvania's vote." Well, if we're that dumb, folks, then we're going to get the kind of politicians that we deserve. It looks to me as if the folks around the president play politics more than does the president.

To ensure investors have an opportunity to benefit from what took place, a CD-ROM containing the slides and commentary, along with audience-asked questions and our responses, is available by request. Contact Shareholder Services at (877) 935-5520 extension 4 for your copy of the CD or visit our web site at www.muhlenkamp.com.

Opinions expressed are those of Ron Muhlenkamp and are subject to change, are not guaranteed, and should not be considered a recommendation to buy or sell any security. Please consult your investment professional and/or tax advisor for advice concerning your particular circumstances and for any tax advice. Neither the Fund nor any of its representatives may give legal or tax advice.