



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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Upon sitting down to write this letter, I realized I don't have much new to say. I've reread past letters for inspiration, but this simply confirmed that current markets and topics are a continuum of the past. For those of you who don't keep old letters (we try to make them worth keeping), a brief recap:

In 1980, when the Consumer Price Index rose 13.4%, we told our clients that if Reagan could control inflation, as he appeared to be doing, we could have a good decade in both the economy and the financial markets.

Since 1982, inflation has averaged less than 4% per year. A booming economy has created more than 19 million jobs. Unemployment fell from 10.5% to 5.3%. Real interest rates averaged more than 5% while falling in nominal terms from 15 to 9%, giving savers their best returns in two generations. Stock prices compounded at 16% per year, including the market crash of 1987.

All this was due to controlling inflation and offsetting inflationary distortions and disincentives of the 1970s. We risk giving back these gains only if we allow inflation to get out of hand once again, which is why the Federal Reserve and the markets fear inflation so much. This, in turn, is why higher inflation is unlikely. The Fed is not printing money fast enough to allow it, and the markets overreact to any hint that it might be worsening. In short, after under reacting to inflation from 1965 to 1980 we now overreact, making it less likely in the future.

The last time the US went from high inflation to low inflation was the decade of the 1950s. Comparing the 1980s to the 1950s does not mean the 1990s will be like the 1960s, but they can be. The big current negatives in the US are debt and the high level of government spending. The big positives are the broader adoption of free-market economics worldwide and the outbreak of peace. Each, in turn, is worth further discussion.

In 1946, the United States had all the money, all the productive capacity (the only major power not bombed or invaded!) and much of the brains in the world. In the 1950s, we spent faster than we earned, eating up our savings. In the 1960s, we continued to spend faster than we earned, borrowing the difference. In the 1970s, we reneged on our debts and obligations by inflating our money, paying off our parents (war bonds, savings, etc.) in cheaper dollars and buying oil the same way. But the Arabs caught on quickly (much faster than our parents) and raised the price of oil, forcing us to pay for our profligacy. In short, we went from cash rich to deep in debt in 30 years. Sounds like many families, doesn't it?

Meanwhile, Federal spending grew from 19% to 24% of GNP. Every dollar spent by government is a dollar removed from the free market. The strength of a free market is the continual striving for new products and services and the production of old products and services at lower cost. Things which people consider useful enough to pay for, free markets will provide. It is left to government to provide products, which are useless, or to subsidize high costs. People are willing to pay farmers for food; only government will pay them not to grow food. People are happy to switch from tin-plate beverage cans to aluminum based on price; only government thinks it can protect the steel industry from its own inertia. (I believe the steel industry lost more market share and jobs to aluminum than to the Japanese.) People are happy to ship by UPS or fax machine; only government sees mail service as a monopoly.

Government is political and has great incentive to preserve the status quo. The beneficiaries of the status quo are easily identified and quite vocal and generous. The beneficiaries of a new idea or product are unknown (and unknowing). How many people wanted a fax machine five years ago? Or knew that replacing 400 lbs of steel with 100 lbs of aluminum would improve the fuel mileage of their new car? The fraction of 1% of the population that produces milk is very vocal in its demands for, and generous in its support of, higher milk prices. The costs are spread throughout the population, and are small for any given family. So we set milk prices politically, and now subsidize dairy farmers to the tune of \$1400 per cow per year. And, of course, we pay bureaucrats to make sure all this continues.

When I studied economics (two courses) in the mid 1960s, economists measured the growth in US GNP at 4%/year and estimated the growth in Russian GNP at 6%/year. They extrapolated these numbers indefinitely and concluded that the Russian economy should surpass ours by the year 2000. At the same time, Khrushchev said, "We will bury you" economically. In the 1970s it became apparent that the USSR was not growing at 6%/year, but was still believed to be growing. The US, in turn, suffered stagflation. Stagflation was a surprise to many Keynesian economists, who believed (and still believe) that growth causes inflation. Stagflation was not a surprise to classical economists, who taught that inflation, through disincentives, and misallocation of resources, saps the morale of people and the vitality of an economy. Suffice it to say that the US economy in the 1970s was hardly viewed as a textbook success by other nations. This began to change in 1980; however, when Ronald Reagan was elected president.

In his book "Revolution", Martin Anderson said Ronald Reagan's great advantage is that he studied classical economics in the 1930s, and is not hindered by Keynesian theories. Some people in the US

still argue the merits of free markets and "Reaganomics," but the rest of the world has few doubts and is rapidly following suit. If the experiences of the US since 1930, Japan since 1945 and, Korea since 1952 are any indication, the world is about to witness an era of unprecedented economic growth and prosperity. The common threads that I find in the above examples are peoples in the modern industrial age with recent memories of hard times, security in their homes, and the opportunity to benefit themselves and their children through free enterprise.

If the Chinese, for example, are allowed by their government to benefit from their own efforts, they will do so to the benefit of us all.

#### Finally - World Peace

A friend of mine recently attended a conference attended by George Schultz (now Secretary of State), Harold Brown (Carter's Secretary of Defense) and addressed by Senator Robert Packwood. The focus was Russia Glasnost and military de-escalation, and whether these shifts are temporary or will endure. The above gentlemen see two major changes that convince them that Glasnost will last.

First, the Soviet Union sees improvement in other nation's economies, including the Chinese, and fears it will be unable to maintain "superpower" status unless it improves its own economic base. This thesis, summarized in Paul Kennedy's book "The Rise and Fall of the Great Powers" argues that military strength must be founded on economic strength to be enduring. Reagan's foreign policy successes are directly attributable to his economic successes. The old boy had his priorities right after all!

The second argument is that Gorbachev the first Russian leader since Khrushchev young enough to still be around when the payoffs of a

major change are realized. Seventy-two-year-old leaders seldom make drastic changes in any organization.

So where are we today? Inflation comes from growing money faster than goods and services. No country has ever had rapid money growth without inflation. Inflation usually lags behind money growth by 12-24 months. Since early 1987, money growth in the US has been 4-6% by nearly all measures. Real GNP growth has been positive, so inflation above 5% is unlikely, at least in the next year or two. The economy is slowing to the Fed-targeted 2.5% growth rate. Presumably, when the 2.5% level is reached, short-term interest rates should move no higher and may start down.

Long-term Treasury rates remain at a high 9% vs. inflation of less than 5%, partly due to high debt levels. A stable dollar indicates these rates are attractive to foreign investors.

A recent rise in short rates, accompanied by a modest decline in long rates, indicates that long bond buyers may be anticipating a turn in short rates. We're doing the same and have begun buying long bonds.

The elections are over, we opted for the fewest changes possible and Bush seems to be making a good start. Corporate earnings are about to be reported. We expect individual stocks to respond to both unexpectedly good and unexpectedly poor reports. By way of perspective, in the 1960's after inflation was stable for a decade, Wall Street believed that stocks rose and fell on earnings alone. We continue to monitor earnings, look for good companies, set prices at which we'll buy and urge our Congressmen and our children to spend less money.

#### **It's a...Mutual Fund**

At exactly 2.30 P.M. on November 17, 1988, after a long gestation mid hard labor, Muhlenkamp Fund was born. On that date, the Securities, and Exchange Commission declared our no-load, total-return mutual fund effective. We would like to thank all of our initial shareholders for waiting patiently for the effective date, and invite anyone with funds to invest or an interest in the happenings at Muhlenkamp to call us at (724) 935-5520 for a prospectus. It took a while to produce, but it's a beauty and we're proud of it!

During the gestation period, we answered many questions about our new fund. For all the people unfamiliar with mutual funds, Muhlenkamp A Company, or managed investing in general, we decided to put the questions and answers on paper:

#### **Why did you bring out a Mutual Fund?**

We manage assets for people in the stock and bond markets. In those markets, to be reasonably diversified requires about \$200,000. Not everyone has \$200,000! Those who don't can best participate by pooling their assets with those of other people in a fund. Over the years, a number of people have asked us to invest sums of \$5,000 - \$50,000 for them, but we didn't have the appropriate vehicle so we usually sent them to someone else. Since we

would like to make these people our clients, we decided to start our own fund.

#### **Will this be a Stock Fund or a Bond Fund?**

Muhlenkamp Fund is a Total Return Fund. Most of the time, the focus will be on common stocks. But should interest rates rise high enough to make bonds more attractive than stocks, as occurred in the recent past, we have the flexibility to own bonds. Should we be unable to find stocks or bonds which meet our investment criteria, we will hold cash equivalents such as T-Bills, Certificates of Depositor commercial paper. The mix of stocks, bonds, and cash, equivalents will change as we perceive changes in the attractiveness among them.

#### **Is that to be diversified?**

Partly. But more important is the value received. Remember that behind each of these pieces of paper is a company. Someone who owns General Motors stock, General Motors bonds and General Motors commercial paper is less diversified than someone who owns stock in General Motors, PNC Financial and Phillip Morris. Day-to-day, these stocks may act alike, but over time each will reflect the success of the underlying company. Far too much emphasis is placed on the day-to-day prices of "stocks" instead of the longer-term values of companies.

#### **Would you ever own Gold or Real Estate?**

Not directly. But we might own shares of companies that produce or trade gold or shares of Real Estate Investment Trusts.

#### **But some people have turned sour on Mutual Funds!**

Don't confuse the vehicle with the underlying investment. A mutual fund is a vehicle that allows a number of people to pool their assets. The underlying investment can be common stocks, bonds, real estate, commodities, etc. Historically, the public embraces each area after the prices have run up, and rejects them after the prices have declined.