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INTELLIGENT INVESTMENT MANAGEMENT

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Special Interim Edition

Company is publishing this special edition of the Memorandum to point out some of the pitfalls in the current environment. Your regular quarterly edition will arrive as usual in July.

THE BOMB SET TO GO OFF - AGAIN

... our clients about a time bomb that was set ... could destroy their incomes. We see a need to ... g today.

... you were a 52-year-old widow attempting to ... stment income. Your house was paid for and ... 0 in investable assets. At the then prevailing ... %, these assets generated \$9,000 per year. In ... as worth 3.72 times what it is today, so you ... rather nicely on this income (3.72 X \$9,000 ... n today's dollars). Then came inflation, and ... erest rates. By 1981, inflation was 10% and ... e 14%. You will notice from the table below ... est rates rose more than the Consumer Price ... period, your "income" more than kept pace ... purchasing power of your "income" went up. ... pretty comfortable - and the time bomb was

... hat one of two things could happen:

... o could go off slowly. Inflation could stay at ... rates could stay at 14%. But each year your ... lose 10% of its purchasing power, thereby ... n only 7 years.

... o could go off quickly. Inflation and interest ... e significantly. "Income" would drop with ... result is a rapid loss of purchasing power of

... the time bomb went off quickly. As inflation ... st rates. Fourteen percent CDs are no more. ... the "income" from their assets have seen ... their purchasing power shrink rapidly since ... now scrambling for the highest payouts

Today, we are set up to repeat the process. Those assuming that interest rates will stay at 8% are implicitly assuming inflation of 5% - in which case their purchasing power will shrink 27% in only 5 years. If in fact we get inflation down to 1 or 2%, interest rates of 5% are much more likely and "income" will be cut rapidly once again.

These scenarios are shown in the table as 1994A and 1994B. One of them will happen; it's already built in.

In a period of only 27 years, people will have lost 2/3 of the purchasing power of their "income". They've done this while following the rule: "Spend only the income don't touch the principal" which was designed to protect assets and avoid profligacy. They've been snookered because they think in terms of principal and income, rather than purchasing power. When inflation was 10%, the principal had to grow by 10% per year merely to offset inflation. Only the additional 4% interest was spendable if the purchasing power of the principal was to be maintained. Today, at 5% inflation, the principal must grow at 5% just to offset inflation. Whether in the form of income or appreciation, only those returns in excess of inflation represent gains in purchasing power.

The crime of inflation is that it depletes the value (purchasing power) of money, both assets and "income". Our federal government sets standards for weights and measures so that no merchant can cheat you on a pound of bread or a gallon of gas, but it sets no standard on the purchasing power of money, allowing itself to cheat you out of the value of your savings. Contrary to popular opinion, only governments can create inflation because only governments can print money.

The irony of the above example is that the very rules which people were taught in order to be conservative have become a trap. Today, people are trying to maintain their "income" by buying investments with high payouts. Often these payouts are greater than prevailing interest rates because part of each payout is principal.

**THERE'S A TIME BOMB SET TO GO OFF – AGAIN
(continued)**

People buying Ginnie Maes and high-coupon government bonds are getting some of their principal back with each "interest" payment. They rapidly deplete their assets; yet many are unaware of it until maturity, when they receive less than their initial investment.

"Spend your income, don't touch the principal" is a superb discipline when inflation is zero. But it becomes a snare when inflation soars. People really believed that if they didn't touch their principal, it would stay intact. So they invested only for "income". Only now are they discovering that investing for income can destroy the purchasing power of assets. And without assets, there is no income.

Effect of "Spend Income - Don't Touch Principal"

Age	Year	Principal	Interest Rate	Income	Inflation	CPI	Value of \$	Purchsing Power of Income
52	1967	\$200,000	4.5%	\$ 9,000	1%	100	3.72	\$33,500
66	1981	\$200,000	14%	\$28,000	10%	281	1.32	\$37,000
74	1989	\$200,000	8%	\$16,000	5%	372	1.00	\$16,000
79	1994 a	\$200,000	8%	\$16,000	5%	475	.78	\$12,500
	1994 b	\$200,000	5%	\$10,000	1%	390	.95	\$ 9,500