

MuhlenkampMemorandum

Issue 90

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On March 31, 2009, the Net Asset Value of the Muhlenkamp Fund was \$34.02, down \$4.58 year-to-date.

Quarterly Letter

by Ron Muhlenkamp



We believe that, long term, stock and bond prices reflect economic values. But for shorter periods of time, prices are set by market supply and demand, much like any other auction. Our puzzle the past six months has been seeing great companies selling at cheap prices, and then watching them continue to get cheaper. In trying to determine why, we've taken a look at a number of factors, including the sizeable amounts of forced selling that took place in 2008 and extended into 2009. We're also looking at factors that signal a change.

Hedge Funds: Their Impact on the Markets

We believe that deleveraging by hedge funds¹ and redemptions at both hedge funds and open-end mutual funds were at the center of the forced selling. The difficulty is getting good numbers on hedge funds, but the following is the best that we've been able to put together:

- At the end of '07, there appears to have been about \$1.7 trillion or \$1.8 trillion invested in hedge funds. The extent to which they were leveraged — particularly in stock funds — we don't know.
- During '08, hedge funds were told to deleverage, primarily by their primary dealers or investment bankers. It looks like they had to cut their leverage in half; for instance, from four-to-one to two-to-one.

- During '08, there were redemptions of approximately \$400 billion out of hedge funds. This was concentrated in the latter part of the year, particularly in October and November. Redemptions continued into January and February of '09 to the tune of about a \$120 billion.

What do these numbers mean?

Hedge funds deleveraged by about half in '08. (Mandates went out fairly early in '08, so we believe the deleveraging is probably over.) Many hedge funds have the requirement that to withdraw funds, the investor must provide ninety days notice. We think hedge funds got those messages in September (to take effect in December) and did a lot of selling in October. In October, almost everything went down in price: bonds, stocks — foreign and domestic — and real estate, (as represented by Barclays Capital Aggregate Index, MSCI EAFE Index, S&P 500 Index, and S&P/Case Shiller Home

continued on page 2

¹ *Hedge fund is an investment fund open to a limited range of investors that is permitted by regulators to undertake a wider range of investment and trading activities than other investment funds and pays a performance fee to its investment manager.*

Mark Your Calendar

Muhlenkamp & Company Investment Seminar

May 7, 2009
Pittsburgh Marriott North,
Cranberry Township, PA

*The Sign Posts of Change:
Economics, Rules, Markets*

2:00 p.m. and 7:00 p.m. sessions
2:00 p.m. ET webcast

To register, please call our Client Service Department at (877)935-5520 extension 4 or visit www.muhlenkamp.com. RSVP by May 1.

Las Vegas Money Show

May 11 – 14, 2009
Mandalay Bay Resort & Casino,
Las Vegas, NV

Ron Muhlenkamp will deliver the following free workshops:

- *Back to Basics: How to Make Money in the Current Investment Climate*
- *Bailouts, Your Dollars & the Whole Credit Mess*
- *Recessions: What Do They Look Like?*
- *Where to from Here?*

To register, please call (800)970-4355 or visit moneyshow.com and reference priority code #012877.

If you would like to talk with us at the show, please stop by our exhibit booth, #205.

Morningstar Investment Conference

May 27 – 29, 2009
McCormick Place, Chicago, IL

Please stop by our exhibit booth #20.

continued on page 5



Muhlenkamp & Company, Inc.
Intelligent Investment Management

MuhlenkampMemorandum

Quarterly Letter

continued from page 1

Price Index, respectively)². We think of this period as an “estate sale” at which assets will be sold regardless of price, due to the forced selling.

We believe there was a second round of forced selling as pension fund trustees read their financial reports after year-end '08. These statements brought home how much the prices of their assets were bid down during October and November. Upon receiving these reports in January and February of '09, we suspect some of them said, “Just get me out.” Whatever the reason, it looks like there was an additional \$120 billion in redemptions in January and February of '09.

Worth noting, some hedge funds postponed the date at which investors could redeem. As those postponements are coming to a close, we are hearing that as of year-end, hedge funds are sitting on a fair amount of cash. Some firms monitor hedge funds, and it looks like they went from a fully invested position in late '07 to a sizeable cash position in late '08.

Bottom line: Our judgment is that the deleveraging is over and that most of the forced selling is over.

Forced Selling compounded by Mark-to-Market Accounting

While forced selling was taking place, there was no forced buying. There may have been as much as \$1 trillion of forced selling in '08, but there was not enough buying to offset it. For those who did buy in '08, further price declines made it painful, so buying was quickly discouraged. Further, any buying by banks and insurance companies was discouraged by “mark-to-market” accounting, FASB #157.³

We describe mark-to-market accounting in our booklet, *Bailouts, Your Dollars, & the Whole Credit Mess*, which is available on

our website. Following is an example of its impact:

If you're an insurance company, most of your assets are bonds and mortgages. Buying new bonds and mortgages in '08 was problematic because if the bid price dropped at all, mark-to-market accounting lowered your asset base. Specifically, it lowered your regulatory capital, thereby limiting the amount of business you could do.


As of mid-March '09, mark-to-market accounting is being neutralized. FASB hasn't suspended it, nor rescinded it, but it has clarified the regulation in ways that look like the continued markdowns of mark-to-market accounting may be over.

A Turn of Events: From Forced Selling to Forced Buying

We find it interesting that, as of mid-March '09, we're seeing forced buying. The various programs coming out of the federal government are beginning to spend money by buying mortgage-backed securities and Treasury bonds. The latest initiative, TALF, (Term Asset-Backed Securities Loan Facility), states that it will buy securitized non-mortgage-backed type debt, including credit card debt and auto loans.

We believe that the forced selling of 2008 cut across all asset classes. When you are getting redemptions, you have to sell something. (You would like to sell what you want to; but if you can't, you have to sell something.) In contrast, the forced buying is in a somewhat limited range, primarily in debt-type securities. Both TARP (Troubled Asset Relief Program) and TALF are buying primarily debt-type securities. This, in conjunction with an alleviation of mark-to-market accounting, enables the bolstering of balance sheets amongst banks and insurance companies. Presumably, the impact will be reflected in

their common stocks, which leads to the bounce we had since early March. While much of the bounce was ascribed to Treasury Secretary Geithner's new plans, including PPIP (Private-Public Partnership Investment Program), I think the change in mark-to-market accounting was more important to that bounce than Geithner's plan.

In summary, I think that the combination of forced selling ending, and forced buying beginning, along with the alleviation of mark-to-market accounting changed the game in terms of short-term supply and demand. As a result, we're putting our cash to work. 

The comments made by Ron Muhlenkamp in this article are his opinion and are not intended to be investment advice or a forecast of future events. Copies of past newsletters are available at www.muhlenkamp.com.

² *Barclays Capital Aggregate Index represents the universe of U.S. investment-grade bonds.*

MSCI EAFE Index represents foreign stocks. It is maintained by Morgan Stanley Capital International/Barra; the EAFE acronym stands for Europe, Australasia, and Far East.

S&P 500 Index represents the prices of 500 common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either the New York Stock Exchange or NASDAQ.

S&P/Case Shiller Home Price Index represents quarterly nominal house prices for the United States.

³ *Mark-to-market, FASB #157, is an accounting method of assigning a value to a financial instrument based on the current market price for the instrument or similar instruments.*

MuhlenkampMemorandum

Conversations with Ron

Every week, Ron Muhlenkamp conducts a Friday morning meeting with staff. Following are excerpts of our weekly conversations:

What are the major lessons learned over the past year?

1. Watch for changes in things that have been stable.
2. Pay more attention to my own maxims, specifically, "If you change the rules a little, you change the game a lot."

First, the change in the velocity of money...whether you call it securitization¹ or the shadow banking system, money that was created outside of the Federal Reserve by Wall Street bankers, such as Morgan Stanley and Goldman Sachs, overwhelmed what the Fed was doing.

For forty years, I found it useful to monitor the Fed as a warning sign for bear markets and recessions. That did not work in the last four years. When the Fed starting squeezing interest rates in 2004-05, the shadow banking system continued creating, or leveraging, money at a much faster rate, thus increasing the rate or "velocity" at which money was used in our economy. Strictly speaking, the Fed did not lose control of the money supply, but it did lose control of the velocity with which the money supply was being multiplied. Velocity kept growing until about July of '07 and, then, fell off a cliff.

The change in velocity is still negative. At some point, it will likely return to neutral and then go positive, but it probably won't ever get back to what we thought was normal five years ago. The very fact that much of the securitization has now gone away means that it should no longer accelerate to the down side.

Second, changing the rules... Mark-to-market accounting came into effect in

What is the velocity of money?

Irving Fisher, an American economist, developed the equation:

$$\Delta MV = \Delta PQ.$$

Let M = money;
V = the velocity of circulation of money;
P = price;
Q = quantity of real output (goods).

This equation says the "change in money x (times) velocity = change in price x (times) quantity."

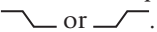
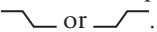
Historically, if money grows faster than the quantity of goods, the price of goods goes up to reflect the change. That's called inflation. The assumption has always been that velocity is stable – mostly, because it's difficult to predict. In fact, for most of the past thirty to forty years, velocity has been relatively stable. But during 2004-07, it grew rapidly and, in the last year, it has collapsed.

For forty years, I found it useful to monitor the Fed. That did not work in the last four years.

November 2007, requiring that the assets held by a bank or insurance company be "marked" to the prices of similar assets which have been selling (or not selling) in the open marketplace. Historically, other ways to value assets, including using amortized or appraised values, have been used. I am not going to argue about which of the methods makes more sense. My point is when you shift from one accounting method to another, there is an adjustment period that has to occur. I refer to this as a "step function."

Could you clarify what you mean by "step function?"

A step function is a change from one level to another in a brief period

of time. It's like stepping on or off a curb;  or .

When the public lowers their spending by 5% (thereby raising their savings by 5%) in a six-month period, it doesn't necessarily mean that they're likely to lower spending by an additional 5% in the next six-month period.

We're seeing step function patterns in a number of areas, including consumer spending, consumer savings, retail sales and truck tonnage.

Speaking of the consumer, how do you think he is faring?

We're seeing signs that the consumer, having stepped down his spending, is

continued on page 4

¹ Securitization is the process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors.

MuhlenkampMemorandum

Conversations with Ron

continued from page 3

now leveling off — and we think there is the potential for consumer spending to grow from this new level. We don't think consumer spending will snap back quickly to where it was four years ago, but having taken a step down, (whether at restaurants, or going on nearby vacations, or with housing or autos), we think it has probably set a new norm and should grow from here.

Gasoline, having run up to \$4 per gallon is now at \$2, no higher than it was two years ago. Grain prices, having run up, have come back down. You've probably noticed that mortgage rates, (the average mortgage is about 6%), are now below 5 percent. Some of you have recently rolled your mortgage down from 6% to 4½% and 4⅝ percent. Well, that's just as good as lowering the amount of your mortgage by 20% or 25 percent.

So the direct consumer costs for food, clothing, and housing are no higher than they were a couple of years ago. Obviously, if you lose your job that cancels out everything I've just said. But, for the 90% of people who don't lose their jobs, their direct costs and cash flows² are in pretty good shape.

You've talked about the consumer, what about the taxpayer? Will the taxpayer benefit in terms of TARP or TALF or PPIP?

Bond prices fell off a cliff in October '08; that is, as yields went up, bond prices dropped dramatically. Since then, bonds have looked interesting to us. Frankly, they look like good investments to us for the first time since 1984. (The bonds we bought in 1984 were sold in 1993, so it's the first time in fifteen years that bonds have looked attractive to us.)

If the government is buying such bonds, then, the government will likely make

...when you shift from one accounting method to another, there is an adjustment period that has to occur.

money on them. You've heard me say many times that when you borrow money, it's not whether you borrow money, it's what you spend it on. If you spend it on bridges that go nowhere, then that's a loss. But if you spend it on things that actually return value to you, whether it's a bridge that's going somewhere, (which is what government should normally be doing), or if you're buying bonds that actually pay off, you can make money.

You may recall that the federal government once lent money to Chrysler, some thirty years ago. Because Chrysler stayed in business, and managed to make some decent products, the government made money on those bonds.


There are a whole lot of people who fear that with all of the money the government is putting into the economy, we're going to have inflation down the road. Well, at least, the Fed and the Treasury are aware of this. Nevertheless, two or three years down the road, as the economy recovers and as velocity becomes positive, the government will have to soak up that extra money. What it is trying to do now is to avoid deflation, or to avoid a more serious recession. Could that give us inflation down the road? Absolutely. But first, you get the alligators and then, drain the swamp.

Historically, financial stocks lead the market into a decline / slowdown and, in turn, lead the economy out of the recession. Do you believe that will happen, given the stake(s) of the Federal government?

I've studied the recessions since World War II. For most recessions you could take your cue from the Fed. Each time we've had a recession it was triggered, on purpose, by the Fed to slow the economy down, usually because it feared inflation was getting too high.

When the Fed squeezes the economy, it squeezes through the banks, which means that banks tend to be among the first stocks to go down. When the Fed concludes that inflation is under control, it starts releasing the pressure on banks, making them early rebounders. This time, we've made it tougher on banks. The Fed (and FASB 157) changed the rules (repeatedly) as well as the interest rates. This has driven many stock prices to bankruptcy levels. They're likely to get sizeable bounces off these levels, but it will be hard to determine new fair values until the rules are stable.

What are your thoughts on today's buying opportunities?

The public and companies are responding normally and appropriately to the recession. We continue to see great companies selling at cheap prices. The Fed and the Treasury are now aiding the banks and printing money. While velocity is still negative, in March, we saw major changes. Forced selling has matured; mark-to-market accounting has been alleviated; forced buying has begun. We're putting our cash back to work. 

² *Cash flow is a revenue or expense stream that changes a cash account over a given period.*

As of 3/31/09, the Fund held 0.0% of Morgan Stanley, Goldman Sachs, and Chrysler.

Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Current and future portfolio holdings are subject to risk.

MuhlenkampMemorandum

Mark Your Calendar

continued from page 1

NAPFA National Conference

June 3 – 6, 2009

Gaylord National Resort & Convention Center,
National Harbor, MD

Please stop by our exhibit booth.

AAII – Millburn Chapter

June 9, 2009

Millburn Public Library, Millburn, NJ

7:00 p.m.

Tony Muhlenkamp will deliver:

Bailouts, Your Dollars & the Whole Credit Mess

For more information, please call our Client Service
Department at (877)935-5520 extension 4.

AAII – Long Island Chapter

June 16, 2009

East Norwich Inn, East Norwich, NY

7:30 p.m.

Tony Muhlenkamp will deliver:

Bailouts, Your Dollars & the Whole Credit Mess

For more information, please call our Client Service
Department at (877)935-5520 extension 4.

Better Investing National Convention

June 28, 2009

Westin Peachtree Plaza, Atlanta, GA

4:00 p.m. – 5:00 p.m.

Tony Muhlenkamp will deliver:

Bailouts, Your Dollars & the Whole Credit Mess

Admission is free, but registration is required.

To register for the event, please visit
betterinvestingnationalconvention.eventbrite.com.

Average Annual Returns as of 3/31/09

	Three Month	Year to Date	One Year	Past 3 Years	Past 5 Years	Past 10 Years	Past 15 Years	Since Inception 11/1/1988
Muhlenkamp Fund								
Return Before Taxes	-11.87%	-11.87%	-41.54%	-21.42%	-8.87%	2.15%	7.02%	8.35%
Return After Taxes on Distributions*	-11.87%	-11.87%	-41.49%	-22.16%	-9.41%	1.71%	6.60%	7.90%
Return After Taxes on Distributions and Sale of Fund Shares*	-7.71%	-7.71%	-26.90%	-16.95%	-6.92%	2.06%	6.37%	7.60%
S&P 500**	-11.01%	-11.01%	-38.09%	-13.06%	-4.76%	-3.00%	5.91%	7.64%

Expense Ratio: 1.18%

Performance data quoted represents past performance and 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. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be found on our website at www.muhlenkamp.com.

***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.**

****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. One cannot invest directly in an index.**

Information contained in this newsletter does not constitute an offer to sell, or a solicitation of an offer to buy shares of the Muhlenkamp Fund, nor shall any shares be offered or sold to any person in any jurisdiction in which such offer, solicitation, purchase, or sale would be unlawful under the securities laws of such jurisdiction.

Mutual fund investing involves risk. Principal loss is possible. The Fund may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund may also invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The Prospectus contains this and other important information about the investment company, and it may be obtained by calling (800) 860-3863, or visiting www.muhlenkamp.com. Read it carefully before investing.

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MuhlenkampMemorandum

Inside this issue:

- Ron's Quarterly Letter
- Conversations with Ron

The Sign Posts of Change:

Economics ■ Rules ■ Markets *Presented by Ron Muhlenkamp*

Please join Ron Muhlenkamp and Company on Thursday, May 7, 2009.

We are hosting two sessions – one at 2:00 p.m. ET and one at 7:00 p.m. ET, both held at the Pittsburgh Marriott North (Cranberry Ballroom). A live video webcast of the afternoon session will be broadcast via the Internet at 2:00 p.m. ET. (Log-in instructions will be provided after registering for this event.) For those attending in person at the Marriott, light refreshments will be served prior to both sessions. Free parking is available in the Marriott parking lots.

RSVP by May 1, 2009. To register, please call our Client Service Department (877)935-5520 extension 4 or visit www.muhenkamp.com

Attend this meeting and learn...

- What's happening with the economy – both people and companies?
- What are the rules – informal and formal?
- What do people know, but haven't formalized?
- What could people know, but haven't looked for, or asked?
- How does it all get reflected in the markets?

Muhlenkamp & Company, Inc. Semi-Annual Seminar

