The Muhlenkamp Memorandum

Muhlenkamp & Company, Inc.
Intelligent Investment Management
12300 Perry Highway ✆ Wexford, PA 15090
(412) 935-5520 ✆ (800) 860-3863 ✆ FAX (412) 935-4720

Issue 33, First Quarter 1995

Quarterly Letter

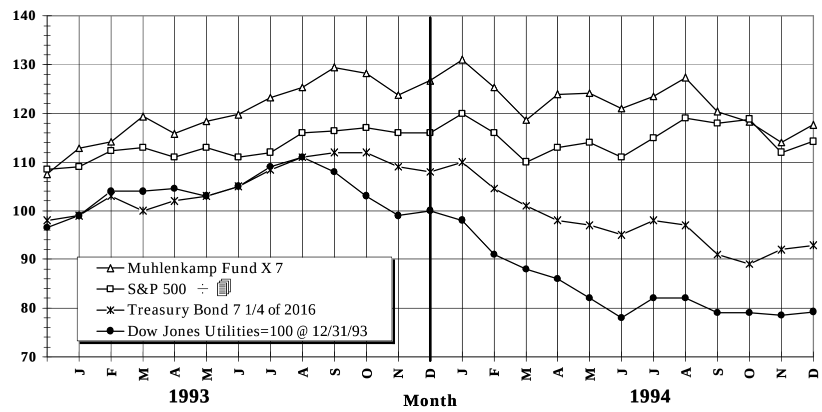
On December 30, 1994 the Net Asset Value of The Muhlenkamp Fund was 16.21 after a 27.6 ¢ per share long term capital gain dividend and 7 ¢ per share ordinary income dividend. For the year the fund was down 7.3%. ***Click here*** to see the current Net Asset Value for the Muhlenkamp Fund.

We are hearing from our clients some confusion about the Stock and Bond Markets in 1994. A typical comment is, ñWhen I read the company reports, they are doing well- why are my stocks down?ò In fact, if you look at anything other than stock and bond prices, 1994 was a very good year. Gains in Gross Domestic Product have been near ideal, inflation has remained in check, and employment has expanded nicely. Bosnia is still a mess, but Haiti did not prove disastrous and Somalia seems behind us. The health care bill was defeated, GATT was passed, and the new Congress is talking seriously about cutting spending. Sounds like a very good year. Yet since September 1993, bond prices are down over 20%, utility prices are down over 25% and most other stock prices are down 5-10% (see chart).

We believe that stock prices are down because bond prices are down. Bond prices are down because of a number of factors:

① Bonds had reached full value
② Uncertainty by our trading partners on the terms of trade
③ Declining value of the dollar
④ An increase in commodity prices
⑤ The Fed raised short term interest rates
⑥ Strong growth in the GDP
⑦ A number of investors owned bonds on margin (borrowed money).

Chart



Many of these factors operated in concert, reinforcing each other, so it is difficult to assign individual cause and effect weights to each one, and we will not attempt to do so. But, we will discuss each in turn, including our reading of where we are today.

① In The Muhlenkamp Memorandum #28, (fourth quarter 1993) we discussed why we believed bonds had reached full value at a 6% interest rate (3 % over inflation) and concluded that ñthe time to be heavily invested in long bonds has just come to an end.ò Since that time interest rates on long-term bonds have risen to 8% , while inflation remains below 3%. This 5% difference makes long bonds attractive once again.

❖ **(If you have a copy of *The Wall Street Journal*, the charts on page C-1 help illustrate the following discussion.)**

② & ③ Uncertainty over the terms of trade and the declining value of the dollar are inextricably linked and must be discussed together. Most Americans know that we have had large trade deficits and large budget deficits for over a decade. A trade deficit means that we buy more goods from other countries than they buy from us. We pay for the difference by sending them dollars. A federal budget deficit means that our federal government spends more on programs than it takes in from tax revenue and must borrow the difference by selling Treasury Bonds. What most Americans do not know is that many of the dollars which we sent to foreign countries to fund our trade deficit were used by people in those countries to buy our Treasury Bonds, thus helping to fund our budget deficit. In mid-February 1994 the Clinton administration started bashing the Japanese on the terms of trade, creating great uncertainty among our trading partners on what the US trade policy was likely to be. These partners quit buying our Treasury Bonds, sending bond prices down and interest rates up. Overnight the dollar fell 4% versus the yen. The dollar continued to fall in value relative to the yen and the D-mark until November, when the GATT Treaty was ratified by the US Congress and US trade policy was clarified. We believe the decline in the dollar between February and November 1994 contributed to the decline in the bond market over the same period. Both declines seem to have ended in November.

④ ⑤ & ⑥ The US Federal Reserve Board has the task of setting US Monetary Policy to foster healthy economic growth without inflation. Its primary tools include expansion and contraction of the money supply, and the setting of short-term interest rates. What makes its job interesting (some say difficult or impossible) is that its actions tend to affect the economy (GDP) with a time lag of 6-12 months and to affect inflation with a time lag of 18-24 months. The power of the Fed is such that every recession we have had since World War II has been instigated by the Fed as a means of countering inflation. Since long-term rates are heavily influenced by inflation (although the lags can be very long), often the Fed raises short-term rates as a means of preventing increases in long-term rates. In determining its targets for short-term rates it looks at a number of factors, but the major factors are inflation, growth in GDP, employment levels, and the strength of the dollar. In February 1994, short-term rates were less than inflation, indicating that rates were lower than could be justified. Also, while inflation in the Consumer Price Index and the Producer Price Index remained at roughly 3%, commodity prices (CRB Index) were moving up at a more rapid rate. Also, GDP was growing faster than desired; and unemployment was decreasing. The dollar was flat to increasing in value.

So the Fed raised short-term rates a notch. Over the course of 1994 the Fed raised short-term rates 6 notches. During that time the CPI and PPI have remained below 3% and the CRB index has been flat since mid-year.

(Continued on Next Page) ☞

Quarterly Letter *(Continued)*

Growth in GDP and employment levels remain stronger than the Fed desired, leading to fears of future inflation (One conclusion of the Keynesian theory of Economics is that strong growth in GDP causes inflation. I was taught this 30 years ago only to watch it be disproved by the facts of the last 30 years. But, the facts have not managed to kill the theory. So strong growth in the GDP still engenders fears of future inflation). And the dollar had been falling. As the Fed raised short-term rates throughout most of the year, long-term rates also went up, causing speculation that "the market" did not believe the Fed was serious about controlling inflation. But when the Fed raised short-term rates in mid-November, long-term rates fell. We believe this change in market reaction is significant.

⑦ A number of the investors who owned bonds on margin received margin calls and have been sold out. The Hedge Funds whose bonds were called made the news in February and March. Orange County, California made the news in December. The difference is that when margin calls resulted in the sale of bonds in February, the long-term bond market fell; when margin calls resulted in the sale of bonds in December, the bond market absorbed it without falling. We believe this change in market reaction is significant also.

So where are we today?

Position: We are looking at a "20% off" sale. Bond prices and stock P/E's are 20% lower than they were a year ago. After warning our clients about bonds being fully priced a year ago, we decreased our ownership of bonds but continued to hold a number of stocks which others view as interest rate sensitive. Consequently, in 1994 we gave back much of the premium returns (over the S&P 500) which we earned in 1993. But the companies have done well and we fully expect their stock prices to reflect it. Meanwhile, the US economy remains strong and foreign economies are picking up. US politicians are moving toward spending less money, a topic we have been discussing for years. Our Federal deficit will not be solved until we come to grips with Social Security, but we welcome every bit of progress we see, and we currently see progress on cutting spending. Some Congresspeople are now saying that they're seeing greater support for cutting spending than for lowering taxes. This sounds too good to be true, and we're skeptical; but we should get a good reading on the mood of the new Congress by monitoring it's actions over the next couple of months.

Trends: During most of 1994, the trend was toward a lower dollar and lower bond prices, which caused lower P/Es on stocks. The trends to a lower dollar and lower bond prices appear to have reversed in November. We believe the passage of GATT helps ratify a firming in the dollar. We believe that the decline in long-term rates when the Fed raised short-term rates in November signaled a turn in the bond market. We believe the absorption of the Orange County news by the bond market ratified the change in trend. We conclude that U.S. long-bonds are now compelling buys and that many stocks are even better buys.

ESSAY

A client has asked me to summarize my investment philosophy. With the recent crosscurrents in the bond and stock markets, it seems a particularly good time to do so.

I entered this business in 1968. At that time, I had never owned a stock or bond, and I had never taken any courses on Wall Street finance. (I had taken courses in corporate finance.) So, I began my studies with a clean slate.

I soon learned that there are an unlimited number of people with ideas on how to invest your money, and that all the ideas sound good at the time. Some of these people are paid to sell newspapers and magazines, some are paid to entertain on radio or television, some are paid commissions to sell financial products, and some are actually paid to manage other people's money. Only this last group publish the actual results of their advice. The others tell me when they have been right, but I have to research what they wrote three-five years ago to get a complete picture. I also noticed that the gurus and the managers who were heroes in any one year seldom repeated; those who had good long-term records tended to stay on top, but were seldom heroes in any one year.

Since my goals are good, reliable, long-term returns, I decided to study the philosophies of the people with good long-term records. I found that they all own corporate stocks, but their approach is to look at companies as businesses. And I learned that, over time, stock prices do reflect the values of the underlying business. I also learned these values and the resulting stock prices have increased by 9-10% per year, indicating that if a person just buys good companies and holds them long enough, their returns would be 9-10%. By contrast, long-term returns on bonds have been 4-5% and CD's have been 2-3%. So I have concluded that, as a long-term investor, my "normal" position is to be 100% invested in corporate stocks.

All the problems with investing in stocks are in the short-term, where changes in stock prices often seem unrelated to long-term values. Short-term prices are determined by whatever hopes and fears are currently driving the American public to buy and sell stocks. These hopes and fears are fanned by the media, the brokerage community, and various pundits with a short-term agenda. But it is also true that much of the public insists on this short-term agenda and revels in the drama of it. I call it "The Game of the Stock Market" (as opposed to "The Business of Investing); and it is very entertaining. The game focuses on the most dramatic and volatile aspects of price movements. Even the language is borrowed from gambling, focusing on "winners" and "losers". The game can also be quite profitable, but requires an iron stomach and an "against the crowd" discipline which few people have. Identifying a top or a bottom does no good unless you have the intestinal fortitude to act decisively on it. Professionals face the same problem. In mid 1987, Elaine Garzarelli became justly famous when she identified a short-term market top and avoided the decline in October of that year. But she then failed to buy in a timely fashion, even though her research told her to do so. Consequently, her advantage was dissipated as the market recovered to new highs in 1988 and 1989.

For most people "The Game of the Stock Market" is a distraction which prevents them from making money in "The Business of Investing." Periodic setbacks and a focus on the game results in their selling stocks when they should be buying and vice versa. We focus on the long-term "Business of Investing" because we have found it to be more profitable and more reliable.

Ron Muhlenkamp

End