

The Muhlenkamp Memorandum



For stocks I begin with the Value Line database, looking for companies with good balance sheets and a good Return on Equity Capital. The ROE should be 15% or better; an ROE of 10 or less is not worth their being in business. I don't like to state rules of thumb because they are subject to change with inflation and interest rates, but today I would like the P/E (Price to Earning Ratio) to be less than the ROE and the expected Growth Rate. Next, call the company to get their financial statements. Check the numbers and the footnotes in the Annual Report (it is audited) to be sure the Value Line numbers are accurate

At this point you will have identified up to a half dozen car models that satisfy your criteria. Now its time to shop the newspaper, because you would like to buy from a private individual. You would rather avoid a dealer because dealers dress up the cars they sell and know how to disguise problems. But the main reason you want to buy privately is because you would like to judge the current owner as well as the car. The degree of care the car has received can enhance or negate the record which you got from Consumer Reports. There are no used cars I would buy sight unseen; but there are people (very few) whose used car I would buy sight unseen. In such cases, I am buying based on my knowledge of the owner. Once you have identified a model that fits your criteria and a car that appears in good shape, be willing to pay your mechanic to check it over (it is cheap insurance).

Similarly, with stocks you would like to talk to the management of the companies you are interested in buying. For the individual, this is not always practical, but you can often get a reading on management from the annual report. The letter to shareholders should give you a summary of what management sees in their markets and what they are trying to accomplish. The best management will spell out the company's goals in specific terms. The proxy material will tell you how much stock management owns and whether they are compensated in ways that encourage them to work for the shareholders. In nearly all cases, the quality of the company management is more important than the characteristics of the industry they are in. Finally, check with the company's customers. If the customers are happy, the company is doing something right.

With both used cars and company stocks, you will find that junk is junk; there are many models and many companies you do not want to own at any price--so don't! Good is good, you will find some that you would like to own at a fair price. And there are a few gems that are worth paying a premium for (Warren Buffett has suggested that you should expect to find fewer than 20 gems in a stock picking lifetime). With both cars and stocks, look for the gems, but expect to compromise, particularly on the non-essentials. If you accept only perfect gems you will miss a lot of good stocks and do a lot of walking.

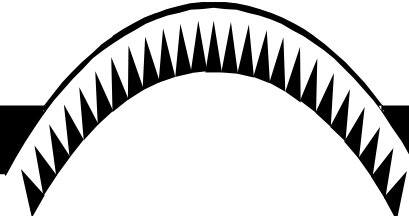
Finally, be aware that no matter how much effort you put into it, on occasion, you will get a lemon. When this happens, sell it and go on to the next vehicle. Selling a lemon may be a blow to your ego, but its a lot less painful than keeping it. You will find that commissions for selling a stock are low. You will also find out that selling a lemon car you paid \$3,000 for is a lot less painful than the new lemon your neighbor paid \$20,000 for.

How long will all this take? My daughter-in-law knows nothing about the mechanics of cars and knew nothing about shopping for them. Using the above advice, she spent 4 hours in the library and 5 or 6 hours shopping; and she bought a good used car for \$4500. On stocks, I spend 40+ hours per week.

Out of curiosity, I decided to check my own record. In 32 years, I have bought and sold 24 cars. The total of the purchase prices minus the sales prices is less than \$20,000. If you adjusted this for inflation it might be \$30,000. So our annual depreciation cost has been less than \$1,000 and we've been a two car family since 1970. Today a more realistic depreciation would be \$1,000 per car per year.

In the meantime, I have been fully funding my IRA since the law became effective in 1981. So I have contributed \$29,500 (in 1981 you could only contribute \$1500). I have not done anything fancy or heroic, just put the money in two good No-Load Total Return Mutual Funds (Windsor Fund and Muhlenkamp Fund). As of March 31st of this year the market value is over \$76,000. A glance at the table to the right shows that it has been compounding at better than 12% per year and I am on track for a prosperous retirement.

We've seen some articles making the case that not everyone should fund their IRA. We agree. When you become confident that your tax deferred assets (Pension Plan, Profit Sharing Plan, and IRA) will exceed \$1 Million by the time you reach 60, its makes sense to cease funding your IRA (and to take a full measure of comfort in what you have accomplished).



\$2000 PER YEAR COMPOUNDED @

<u>YEAR</u>	<u>10%</u>	<u>12%</u>
5	\$ 12,210	\$ 12,706
10	31,875	35,097
15	63,545	74,559
20	114,550	144,105
25	196,694	266,668
30	328,988	482,665
35	542,049	863,327
40	885,185	1,534,183

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We are also interested in hearing if you would like us to develop a home page on the World Wide Web.

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