



## MUHLENKAMP & COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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Issue 44, Fourth Quarter 1997

On October 21, 1997 the Net Asset Value of the Muhlenkamp Fund was \$37.10, up 34.8% year to date.

[Click here to see the current Net Asset Value of the Muhlenkamp Fund.](#)

#### RON MUHLENKAMP TO APPEAR ON *CNBC*

Ron will appear once again on CNBC's morning show "Squawk Box". He will be the guest host on Monday, December 9, from 8-10 a.m.

#### SEMINAR SCHEDULE

Ron Muhlenkamp will present 2 investment seminars in Western Pennsylvania this Fall. Admission is free of charge, and both are open to the public.

On Monday, November 10, at 7:30 p.m., Ron will present "Understanding the Current Investment Climate" at St. Vincent College in Latrobe, Pa. The event will be held in the Science Amphitheater. Reservations are not required.

Plan to join us on Tuesday, December 2, for our 4<sup>th</sup> Annual Christmas Celebration at the Pittsburgh Sheraton North in Cranberry Twp., Pa. Bring a friend or family member to either the 2:00 afternoon session or the 7:00 evening session. Ron will recap the events of 1997 and give his outlook for the future. Seating is limited, so call us to reserve your place today.

#### EXPANDED DISTRIBUTION

Shares of the Muhlenkamp Fund can now be purchased through Charles Schwab's OneSource; Fidelity's FundsNetwork; Jack White & Company's Mutual Fund Network and Waterhouse Securities' Mutual Fund Connection with no transaction fees.

## QUARTERLY LETTER

### ANOTHER GREAT QUARTER -- SELECTIVELY

The Third Quarter was marked by volatility in stock prices. The market did correct - selectively. The DJIA corrected 8%, peak to trough, before finishing the quarter up 3.5%. The S&P 500 corrected 7%, peak to trough, before finishing the quarter up 7%. We corrected 3%, peak to trough, before finishing the quarter up 14%. Thus, those who expected lower prices were teased, only to be frustrated once again.

Economically, the growth in Gross Domestic Product (GDP) continues, as does the gradual decline in inflation. This growth without inflation is frustrating to Keynesian economists who believe that growth, at current levels, necessarily causes increased inflation. These are the same economists who, using the same theory, were unable to explain the high inflation and low GDP growth "stagflation" of the late 1970's. Some of these economists are now saying that current conditions are inexplicable, while others are saying that increased inflation is merely delayed longer than they had expected. To date, I haven't seen evidence that these economists are willing to question their basic economic theory.

Meanwhile, Dick Hokenson, Chief Economist at Donaldson, Lufkin and Jenrette, who had been predicting a recession in late 1997, rescinded his forecast in mid-August. He is now forecasting "positive but more moderate real growth".

**Where do we stand?** — We stand where we stood three months ago. We continue to believe the long-term and the intermediate-term fundamentals are quite favorable. To wit, inflation is not getting worse and the economy is expanding. We believe stocks are fairly priced. Companies continue to add value at an 8-10% annual rate. We are confident that shareholders will realize that 8-10% over time. In the near term, however, prices are likely to continue to be quite volatile with the focus on individual companies and stocks.

*(Continued on Next Page)*

## THE MUHLENKAMP MEMORANDUM

We call this a period of digestion. To date, the current digestion of the prior strong upward move has been appropriate; but we suspect it's not over yet. A friend said he thought the period was more like indigestion, but I suspect that his "mental picture" of normal digestion is less messy than mine. We still don't see a reason for a market down move greater than 10%; however, we do continue to expect high volatility. We think the key to success in this market is in finding good companies at reasonable prices. We are spending our time and effort in this endeavor. □

### COMPETITION FOR THE CONSUMER

We often hear the argument that a company or a country must do certain things "to compete" or "to be competitive". This goal "to be competitive" is stated as the rationale for much of the cost-cutting and downsizing in industry, as well as the privatizing of various tasks previously done by government, both in the U.S. and in other countries. We agree that each of these entities should "be competitive", but we think that much understanding has been lost because the sentence is seldom finished. The complete sentence would state: "We must take these steps to be competitive *for the consumer's business.*" Such a statement makes it explicit that the ultimate beneficiary, and the ultimate driver, of these corporate actions is the consumer. In a free economy, the consumer is KING!

In a free economy, no person or company can make the consumer purchase its product -- only government can do that. Producers can advertise, pitch, cajole and sweet talk; but they cannot force the consumer to purchase their product. Unless the producer offers a product the consumer wants, at a price the consumer is willing to pay, no purchase will take place.

Certainly, there are products the consumer must buy, i.e., food, clothing and shelter; but in a free economy, there is no requirement to buy these products from any one provider. As long as the market is open, multiple producers will compete for the consumer's business. Over time, most producers learn that the best sales gimmick is to provide a quality product at a cheaper price.

Years ago, I was taught that there are "natural monopolies" for some goods, but I no longer believe that. The only monopolies I can find are government sanctioned. In the current decade, we have opened up markets in natural gas and long distance phone service and are currently opening electric power. Each of these markets was once viewed as "natural monopolies". Granted, transitions to freer markets can be confusing. The recent move to deregulate telephone and electric service in the U.S. has resulted in some confusion and complaints because people are now asked to make choices they didn't have to make before. I am told that some people in Russia have similar complaints now that they have choices

in buying food and clothing.

The beauty of a free market is that consumers who don't want to spend their time shopping to save the last nickel still benefit from the actions of their neighbors who do. This competition for the consumer's business drives all producers to produce better products at lower prices. I must admit that I didn't understand much of the above until I read Sam Walton's autobiography. Sam Walton founded Wal-Mart. He perceived his job as that of a purchasing agent for his customers. There is nothing you can buy at Wal-mart that you can't buy somewhere else. The only thing that Wal-mart claims (or advertises) is lower prices. The sole task Sam set for himself was to bring existing products to his customers at a lower price. He did it well enough to become the richest man in the country.

As an investment manager, I am embarrassed to admit that I never bought a share of Wal-Mart. My rationale was: "Retailing is the world's second oldest profession; what can Sam Walton do that K-Mart can't copy in six weeks or Sears copy in six months?" It wasn't until I read Sam's book that I learned that Sam had worked for K-Mart. He left because he thought his ideas for lowering costs and prices had merit, but K-Mart wasn't interested in his ideas. Remember that K-Mart was the leading discount retailer at the time. Yet, Sam Walton and his ideas eclipsed K-Mart in 20 years.

In a free market, the consumer is King. If you serve the consumer by providing a product or service that he/she values, you can get rich. But, of equal importance, you can get rich *only* by providing a product that the consumer values. Many is the inventor who created a new product he thought was great, but the consumer wasn't interested. Many is the engineer who improved an existing product (by his standard) only to be chagrined when the consumer didn't appreciate the improvement.

Several years ago, Intel launched a consumer advertising campaign identifying those computers with "Intel Inside". But when their next new chip, the Pentium, was found to have an arcane flaw, Intel found consumer awareness to be a two-edged sword. Intel found that statistical analyses and other explanations, which had been acceptable to their corporate and engineering customers, were not acceptable to the retail consumer. The retail consumer was a more demanding customer than the professionals! Intel's management finally realized that, if they wanted to sell consumer products, they had to accept the consumer's standard for performance. Andy Grove, the Chairman of Intel, describes this realization as a major "inflection point" for his company. I would describe it as the realization that the consumer sets the rules.

In a free market, every improvement in quality or service becomes the new standard which all competitors are expected to meet. Similarly, each price decline becomes the new standard of competition for the consumer's business. □

## THE MUHLENKAMP MEMORANDUM

### ROTH IRA

*Many of you have asked about the newly passed Roth IRA legislation. It occurred to me that other people might be interested as well. Please call or write if you have any questions. - Anthony Muhlenkamp*

The first thing to know is the Roth IRA isn't available until 1998, and the IRS has not written the rules yet. So I can only tell you what I know so far, with the understanding this could all change. There are still a lot of unanswered questions about rolling over your current IRA to a Roth IRA, and about what will happen to a Roth IRA after you die. So don't be in a hurry to do anything.

**How it is supposed to work.** The Roth IRA differs from traditional IRAs in four ways:

1. You can contribute up to \$2,000 to a Roth IRA. These contributions are phased out for single taxpayers with income between \$95,000 and \$110,000 and married taxpayers with income between \$150,000 and \$160,000. If your income exceeds these upper limits, you cannot contribute to a Roth IRA.
2. You are not allowed to deduct your \$2,000 contribution to a Roth IRA, so it doesn't matter if you or your spouse are covered by retirement plans. You and your spouse can each make a \$2,000 contribution, but you cannot take a tax deduction.
3. You will not pay taxes on any of the distributions you take from a Roth IRA at retirement.
4. You are not required to start taking distributions from your Roth IRA at age 70 ½.

For the rules governing deductible and non-deductible IRAs, call the IRS at 800-829-3676 and request Publication 590. (They may also have a web page). The 1997 version of Publication 590 will be available in early December. They don't have a publication for the Roth IRA yet, but one should be available by mid-year 1998.

**Should you plan on using it?** Yes, as it stands today. The power of tax deferred compounding offered by the current IRA is amazing enough, but the Roth IRA gives you *tax free* compounding. Hiring Muhlenkamp to invest these assets gives you years of investment returns on which you will pay no taxes.

**Should you convert your current IRA to a Roth IRA?** Depends. You can only convert in 1998, and your Adjusted Gross Income for a married couple filing jointly has to be less than \$100,000. You will have to pay ordinary income tax on the conversion. Say you have an IRA worth \$60,000 with a cost basis of zero. In other words, you deducted all your contributions. That \$60,000 is treated as ordinary taxable income, and you will owe taxes on it. Now, you have 4 years to pay the tax, and once it is in the new Roth IRA you won't pay taxes on it ever again. But you will pay tax today.

Whether or not you should depends on some facts and some assumptions. The critical facts are the taxable amount in your IRA and the available cash flow to pay the tax. The critical assumptions are your future tax bracket, when you retire, your life expectancy, your designated IRA beneficiaries, and how the IRS writes the rules. (This all becomes moot if Steve Forbes can get a Flat Tax passed eliminating taxes on investment income and capital gains. In that world, the IRA is redundant.)

**My plans.** I plan to keep my current IRA and make my 1998 and future contributions to a Roth IRA. We will have the forms and applications for establishing a Roth IRA available in January, but I will probably wait until the end of 1998 before doing anything with a Roth. I want to get more answers and better explanations first, and I have to wait until the IRS writes the rules. Even then, there is no guarantee they won't change the rules later. □

### INVEST NOW OR WAIT UNTIL NEXT YEAR?

As we enter the fourth quarter, we expect, once again, to see numerous articles warning mutual fund investors not to invest before yearend. Such investing, particularly in a year of big gains, can result in the investor prepaying taxes on income and capital gains, which they haven't yet received. All too often, the articles fail to mention two key points:

1. Such taxes are specific to the individual fund and are largely determined by how that fund is managed.
2. Mid-December to mid-January is often the strongest period of the year.

In the past, we've often seen investors miss a dollar in appreciation because they wanted to avoid paying taxes on a dime of income. At Muhlenkamp & Company, we have always managed the Muhlenkamp Fund and our private accounts for after tax returns. After all, most of our personal assets are invested in the Muhlenkamp Fund; and we don't want to prepay taxes any more than you do! This is why we look for long-term values and long-term trends, which allow us to minimize turnover and defer taxes. For the year 1997, our income will almost certainly be less than 15 cents per share and our realized gains will most likely be less than 20 cents per share. □

### SEMINAR VIDEO AND ESSAYS

Videotapes of Ron Muhlenkamp's seminar entitled "Understanding the Current Investment Climate" will soon be available for purchase. A bound compendium of essays written by Ron Muhlenkamp is now available for \$10 per book. Please call us if you are interested in purchasing the video and/or the book.

## THE MUHLENKAMP MEMORANDUM

### EXCERPTS FROM RON MUHLENKAMP'S APPEARANCE ON *WALL STREET WEEK WITH LOUIS RUKEYSER*

**RUKEYSER:** You like corrections because they make prices cheaper and you get a chance to buy some bargains.

**MUHLENKAMP:** People have been sending us money, and obviously we like to buy good companies, but we like to buy them cheaper. Plus, as was mentioned by your panelists, it's been a pretty good move since April, and you can't have that kind of move without some digestive period.

**RUKEYSER:** What's your take on where we're likely to go next?

**MUHLENKAMP:** Well, you can get a five or ten percent move in either direction at any time. And I agree with Ed that right now we're fairly priced, which actually makes it easier to go either direction. But the next move over ten percent will be up. Companies are adding value at about a ten percent a year rate. We're back to fair prices. So going forward, you should do nine or ten percent a year in stocks. The caveat of course is you get a five or ten percent correction at any time.

**RUKEYSER:** With close to half your assets still in financial stocks, does that suggest you think interest rates will remain tame?

**MUHLENKAMP:** Yes. Since 1990, the American public has been reluctant to pay over 8.0% on a mortgage. In fact, they won't. And we're hearing this from people in the building industry. So if mortgages don't get over 8.0%, Treasuries aren't going to go over 7.0%. So anything above a 6.7 on a Treasury I think you can buy with impunity.

**RUKEYSER:** But your primary driving force is that you think Americans are more interested in financial investments than financial savings.

**MUHLENKAMP:** Yes. I've had people sit in my office and say, "Ron we've got enough house, we've got enough cars." I've never had anyone say, "We've got enough investments." And that's where the public is putting their incremental money. The money that used to be spent on mortgages is now being spent in stocks and bonds and mutual funds and annuities.

**RUKEYSER:** What's working for you this year?

**MUHLENKAMP:** Well the financials are working great.

**RUKEYSER:** I mean in terms of overall market analysis.

**MUHLENKAMP:** We said at the beginning of the year that we ought to do ten percent plus. The surprise for four years running now has been that GDP has been greater than expected and inflation's been less than expected. Frankly we think that's a trend. We monitor how earnings do versus analysts' expectations. One of the reasons the market's so strong this year is because earnings have been so strong. That was also true in '96. So as long as the companies don't disappoint us, we'll hold them. If the company starts to disappoint, then we run pretty quickly. And as long as GDP is doing better than expected and inflation less than expected, those are positive trends. And I learned a long time ago not to try to predict changes in trend. I look for signs of it, but I don't try to predict it.

*The above transcript from the August 22, 1997 show was reprinted with permission from Wall Street Week With Louis Rukeyser. To obtain a complete transcript of this show, please send \$5 to: Wall Street Week With Louis Rukeyser, 11767 Owings Mills Boulevard, Owings Mills, MD 21117-1499.*

### OTHER SOURCES OF INFORMATION ON MUHLENKAMP:

#1 Flexible Portfolio Fund for the last 1,3 and 5 Years, Lipper Analytical Services, Inc., as of 9/30/97

"Muhlenkamp Sees Return To Pickers' Market", *Investor's Business Daily*, September 29, 1997, page B3.

"Stocks to Consider", *Worth*, October 1997, page 52.

"ROE: A Return To Basics", *Bloomberg Personal*, October 1997, page 24.

## GLOBAL MARKETS ROIL U.S. MARKETS

*Editors Note: Issue 44 of The Muhlenkamp Memorandum went to print before the events of the last several days took place. We wrote the following article to keep our clients and shareholders apprised of the nature of these events.*

The U.S. Securities Markets have just provided the public with a few days of high drama and entertainment. Such occurrences are becoming more commonplace. We suspect the volatility will continue, although not often to the extent we saw in the past few days.

As is often the case, there were fundamental factors at the core of what happened. But the response of the securities markets was greatly magnified by the number of “players” with huge amounts of money, each responding rapidly as the same data were promulgated worldwide.

We believe the following fundamental factors came together in this instance:

1. A number of *currencies*, some of which were pegged to the dollar, became overvalued relative to the dollar and were thus susceptible to devaluation. We’ve been trying to warn our clients about currency risk since early 1995.
2. Several years ago, George Soros correctly concluded that the British pound was overvalued and should be devalued. He put his money where his conclusions were and made a billion dollars when England was forced to devalue the pound. Since then, Soros and a number of other well-heeled investors seem intent on repeating his earlier success. Their efforts have evolved into attacking any currency that appears vulnerable (and some that aren’t) because its respective government has been less than fully disciplined in controlling the money supply. Since most governments are not fully disciplined and are predictable in their responses when attacked, these investors are having a field day.
3. After its run-up to *fair value* this summer, the U.S. stock market became susceptible to a correction. At Muhlenkamp,

we’ve been asking for a correction since the Dow hit 8000 in mid-July.

The response of the markets to these fundamental factors was greatly magnified by several trends which have evolved over the past several years. These include:

***Momentum investors*** who buy after prices move up and sell after prices move down, thus magnifying any move.

***Instant communications*** combined with computerized trading allows large numbers of “players” with huge amounts of money to move these assets rapidly.

***Global markets*** allow for investing throughout the world, but also allow for the use of the same trading techniques throughout the world. This is ironic since economic and market fundamentals differ from country to country, allowing global investors to diversify fundamental risk; yet, the market players are the same, and they use the same trading techniques in the various countries. As a result, the markets may act the same, even though business conditions differ greatly. In our terms, the “Business of Investing” may be different in various countries, but the “Game of the Stock Market” has become globally uniform.

The net effect of all these gyrations is that the market and most stocks are about where you’d expect, if we’d had a normal (whatever that is) orderly correction of the April through August up-move.

At Muhlenkamp, we believe it is possible to observe the fundamental factors which “set up” markets for various moves. We aren’t often able to determine whether such moves will in fact occur, nor when. We are comforted by the fact that it might not be necessary to know whether or when events will happen. Since July 16, when the Dow first hit 8000 (and we started asking for a correction) through October 28, when it closed at 7498, the Dow fell 6.2%. During that same period the Muhlenkamp Fund rose 3.9%.