



## MUHLENKAMP & COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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Issue 45, First Quarter 1998

On December 31, 1997 the Net Asset Value of the Muhlenkamp Fund was \$36.55. The Fund gained 33.3% in 1997.

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

#### RON MUHLENKAMP ON *CNBC* AND *CNNfn*

Ron Muhlenkamp will appear once again on national television on Thursday, February 12. From 8-10 a.m. he will be guest host on CNBC's "Squawk Box", and he will also appear as a guest on *CNNfn* at 2:40 p.m. the same day. Mark your calendars.

#### 403(b) INVESTING

The Muhlenkamp Fund now accepts 403(b) retirement plan investments. Contact your 403(b)-plan administrator to see if you can use the Fund as an investment option. If so, call us for an application.

#### VIDEOS AND ESSAYS

Videotapes of Ron Muhlenkamp's seminar entitled "Understanding the Current Investment Climate" are available for \$15 each. A bound compendium of essays written by Ron Muhlenkamp is also available for \$10 per book. Please call us if you are interested in purchasing the video and/or the book.

#### RON MUHLENKAMP IN CLEVELAND

Ron Muhlenkamp will be a panel speaker at *Money Watch Live '98* in Cleveland on Saturday, February 28. The panel discussion will begin at 3:35 p.m. and cover numerous issues related to investing. Representatives of the Muhlenkamp Fund will also attend this event hosted by *The Plain Dealer*. Call us for more details.

## QUARTERLY LETTER

### ANOTHER GOOD YEAR -- SELECTIVELY

1997 has been a good year. Financially, it's been a very good year. This fact alone has some people nervous.

The three sentences above are a repeat of our opening comments one and two years ago. During 1997, the U. S. economy continued to grow at a healthy rate and inflation continued to decline. This combination resulted in lower long-term interest rates and continued gains in consumer confidence, corporate profits, and stock prices. It has also resulted in confusion among Keynesian economists, some of whom still maintain that it can't happen.

Domestically, we see nothing that would reverse these current trends, although we do expect each of them to moderate. Given no major outside influences, the U.S. economy is likely to continue to grow, but at a slower rate. Inflation is likely to continue a gradual decline and corporate profits are likely to continue to grow, but at a slower rate. Each of these trends are positive for stock prices, which are currently at fair values.

But the real difference is that the Far East has the potential to become a major influence. Since our one page note of October 30, 1997, South Korea has joined the list of Asian countries suffering currency devaluation and liquidity crises. The economies of Thailand, Malaysia, Indonesia and the Philippines are too small to have a major impact on the world economy. But the addition of South Korea to the list, along with the vulnerability of Japan, creates a potential risk to the world and American economies. □

## PROBLEMS IN ASIA

The problems in these Asian countries are not unlike the problems in the United States in 1980. Investment/borrowed money at cheap rates allowed a dramatic misallocation of resources. Although the sources of the problem were different, the results were much the same. In the United States, the source was a period of high inflation and low interest rates which made it profitable to borrow money, -- and buy bigger houses, more farmland, and build more buildings.

In Asia, the source was investment money, much of it debt, from Japan, Europe and the United States seeking to participate in the growth of Asia. The investment of that money was allocated by government or by politically connected businesses. Thus, these moneys were invested politically, instead of in response to economic demand.

In both cases, the most visible results were the construction of "see-through" (empty) office buildings. This is a recurring theme:

The Empire State Building was completed in 1931.

The World Trade Center was completed in 1977.

The tallest buildings in the world have just been completed in Kuala Lumpur, Malaysia. They are empty.

It is apparent that these Asian skyscrapers are an ego trip, with little or no economic justification. I spoke to a Malaysian businessman in November who maintained that, "the Malaysian economy is based on commercial real estate." Folks, you cannot have an economy based on commercial real estate. Commercial real estate is a service business, which must serve other businesses. Building office space only to house real estate agents is unsustainable!

In both the United States and in Asia, short-term deposits were used to finance illiquid investments including real estate. In the United States, when our mothers realized the effect of inflation on their savings, they withdrew their savings from passbook accounts in favor of higher yielding money market funds. Their withdrawals triggered bankruptcy in many savings and loans and some banks. In Asia, the declining Yen (down 20%) and falling stock prices in Thailand (down >50%) exposed the vulnerability. As foreign investors started withdrawing their funds, a number of banks proved vulnerable. Fear has done the rest.

The situation today for the citizens of these countries is that the price of everything imported has gone up dramatically and interest rates have gone up dramatically, so their economies are slowing dramatically. This results in layoffs and gives consumers less purchasing power (stagflation). Part of the IMF's prescription for this problem is an opening of their economies to more competition,

more disclosure, and less government allocation of resources -- all of which is good! BUT, the second part of the IMF prescription is to encourage them to devalue their currency (more inflation), and to balance their budgets, which politicians translate to raising taxes. That didn't work for the United States in the '70's, nor in Japan in the '90's. It won't work in the rest of Asia today.

As a citizen/employee/consumer, how would you respond to being told that; having raised prices on the things you buy and interest rates on the money you borrow, we -- your friendly government -- will now raise your taxes? And, by the way, we expect you to work harder as a result of the above.

Asia needs a Ronald Reagan, but there is no one like him visible today. Ronald Reagan understood that some things are worth borrowing money for (deficit spending), and that sometimes you must lighten the tax load to encourage people to work.

So, what is likely to happen? The most likely outcome is for these countries to muddle through as Japan has done since 1990, but their task will be tougher than Japan's because they don't have Japan's financial reserves. This would actually be positive for the U.S. consumer and those companies buying Asian products. It would be a negative for U.S. companies and workers selling their products to Asia. If they learn from the Paul Volcker and Ronald Reagan model and get it right, they will thrive much as the U.S. has done -- and this would be a positive for the U.S. as well.

If these countries do everything wrong, by overloading their citizens to the extent that they quit producing, and the U.S. compounds the situation by restricting trade, it could trigger a worldwide recession/depression as the U.S. did in 1929/30. In a recent interview in *Forbes* magazine, Milton Friedman described the current odds of such an outcome as trivial. We expect that the various countries will follow somewhat different paths. The path each chooses will determine the attractiveness of investing in each country. □

## IRA UPDATE

by ANTHONY MUHLENKAMP

**Muhlenkamp Fund has the Roth IRA for 1998.** The necessary forms (applications, conversion forms, disclosure and custodial agreements) are available.

**You can still make a 1997 deductible or non-deductible contribution to a traditional IRA.** The deadline for the contribution is April 15, 1998, but avoid the last minute rush and make your 1997 contributions as soon as possible. Make sure you identify a 1997 contribution, otherwise we will record and report it as a 1998 contribution.

## THE MUHLENKAMP MEMORANDUM

**Thoughts about the Roth IRA.** I continue to get Roth IRA questions so I will expand and update my comments from *Muhlenkamp Memorandum #44*. One correction to my earlier comments is that you can convert or rollover a traditional IRA to a Roth IRA in any calendar year, but 1998 is the only year in which you can prorate the taxes over four calendar years. Thanks to Joel Bruckenstein who brought this to my attention.

The rules for Roth IRAs have not yet been written for every situation, and many of the rules that are in place are subject to change. You must continue to pay attention and double-check your assumptions at every step. I tried to write the following in English, but found it difficult. Please read our Roth IRA Custodial and Disclosure Agreement for complete descriptions of the rules and terms that govern the Roth IRA. I also encourage you to read the following paragraphs two or three times. It can be confusing.

There are now two types of IRAs; the traditional IRA and the Roth IRA. You can make deductible or non-deductible contributions to a traditional IRA. You can make non-deductible contributions to a Roth IRA or you can rollover money from a traditional IRA to a Roth IRA. Contributions to a Roth IRA, traditional IRA or combination of the two cannot exceed \$2,000 annually. The rules for taking money out of the Roth IRA depend on how you put money into the Roth IRA.

The rules governing contributions, penalties, taxation and withdrawals are different between traditional and Roth IRAs; but they also differ between deductible and non-deductible traditional IRAs and between regular and rollover Roth IRAs. I said this would be confusing.

Eligibility for Roth IRA contributions phase out for single taxpayers with modified adjusted gross income (MAGI) between \$95,000 and \$110,000 and for married taxpayers between \$150,000 and \$160,000.

Use the traditional IRA if you can deduct your contributions on your tax return, **AND** if you expect your tax bracket at retirement to be lower than your tax bracket in the year you make your contribution. Do not make non-deductible contributions to a traditional IRA if you are eligible to make contributions to a Roth IRA. If you are not eligible to make Roth IRA contributions, then make non-deductible contributions to a traditional IRA.

You are eligible to rollover a traditional IRA to a Roth IRA only if your MAGI is less than \$100,000.

Your decision whether to convert a traditional IRA to a Rollover Roth IRA depends on several factors:

1. Your tax bracket the year of the rollover and the taxable amount of the rollover, how you pay the taxes that result from the rollover, and what after-tax returns you could earn with that

money instead of paying taxes. Generally, if you are under age 59 ½, you do not want to use a portion of the rollover to pay the taxes because a 10% penalty is due on the money that does not get rolled over to the Roth. The taxable amount of the rollover is added to your adjusted gross income for the year and could change your income tax bracket. In 1998 you can spread the additional income and tax equally over four years, but any rollovers completed after January 1, 1999 will be taxed in the year they are made.

2. The time until you take IRA distributions, the amount of the distributions, and your resulting tax bracket at the time. Using IRAs as part of your estate planning requires that you consider these questions for the beneficiaries of your IRA as well as for yourself.
3. Capital gains taxes are 10% for taxpayers in the 15% tax bracket. It may be possible for a person in the 15% tax bracket to make a rollover to a Roth IRA each year and stay in the 15% tax bracket. This way he pays 15% taxes on the rollover, 10% capital gains taxes on private investments, and no taxes on distributions from the Roth IRA. The 5-year waiting period for distributions starts each time you make a rollover to a Roth. If you make more than one rollover, you probably want to make them to a new Roth IRA account each time.

Several items favor making the conversion:

1. The higher your basis in your traditional IRA, which is simply a total of all your non-deductible contributions.
2. The greater the time until you expect to take IRA distributions, and the longer the time you expect to keep assets in the IRA without taking distributions.
3. The higher the tax bracket you expect to be in when you take IRA distributions.

You must sit down, list your assumptions, and compare the results between keeping the traditional IRA and converting to a Rollover Roth IRA before deciding what to do. Just start at the beginning and keep asking yourself, "Then what happens?" and you will be amazed at what you figure out. Mostly it depends on using a compound interest table or a spreadsheet, and being willing to spend some time and energy thinking it through. Please let me know if you reach interesting conclusions.

### Sources of Information.

1. Muhlenkamp Fund IRA and Roth IRA Custodial and Disclosure Agreements.
2. Website [www.rothira.com](http://www.rothira.com)
3. "The New Roth IRA", *Mutual Funds Magazine*, January 1998.
4. Internal Revenue Service Publication 590. Note that they have not updated the Publication for the 1997 traditional IRA or the 1998 Roth IRA. Copies available by calling the IRS at 800-829-3676.
5. *JK Lasser's How to Pay Less Taxes on Your Retirement Savings*, by Seymour Goldberg. ISBN 0-02-860088-6

# THE MUHLENKAMP MEMORANDUM

## TAX-MANAGED INVESTING

The media are discovering tax-managed investing. Some mutual funds are introducing new funds which, they say, will be managed for tax efficiency. We can hardly wait until they discover the wheel.

Folks, the only reason to invest money is to make a decent return after taxes and inflation. That's the only money you can spend in the real world. We have always managed money for returns after-taxes and inflation. After all, our personal money is in the pool with yours. That's one reason we've realized just \$0.36 in capital gains per share in the Muhlenkamp Fund in 9 years. During this time, the Fund has grown from \$10 per share to over \$36 per share. Thus the overwhelming majority of shareholder gains remains tax deferred.

In 1997 your representative in Washington D.C., complicated the process by legislating 3 different standards for long-term capital gains. So we strove (successfully in the mutual fund) to realize no gains for tax purposes, while earning excellent returns on your assets. We will continue to do so.

We would prefer Congress simplify the tax code instead of adding layers of complexity. After calculating your taxes, (or completing your review with your accountant or tax preparer) take a moment to recalculate your taxes (and note the preparation time) using Steve Forbes' proposed "Flat Tax" plan on the form below.

## CALIFORNIA ROAD SHOW

Grant Duffield will be in California most of the month of February meeting with shareholders and others interested in the Muhlenkamp Fund. His schedule includes the following stops:

Feb. 6-11, in Los Angeles

Feb. 7-8, *L.A. Times* Investment Show, L.A. Convention Center

Feb. 12, presenting seminar in Monterey

Feb. 13-17, in the San Francisco Bay area

Feb. 18-20, in Carlsbad

Feb. 21-24, in Palm Desert

Feb. 24, presenting seminar in Palm Desert

Feb. 25-28, in San Diego

Call Grant at extension 12, if you would like to attend one of his seminars or arrange an individual meeting.

## SELLING SHARES

When selling shares of appreciated securities, consider using "specific identification" of shares sold, for tax purposes. By identifying the specific shares you sell, you can choose to raise or lower your realized capital gains in any given year, depending on your tax situation. However, you need to keep accurate records of specific shares sold in case of an audit. Call us to learn more and check with your accountant.

## RON MUHLENKAMP ON AOL

Ron Muhlenkamp will appear once again on America On-Line's Sage Investment Chat. He will be the guest manager on Tuesday, February 17, at 9 p.m. Ron will respond to investment questions from the AOL audience during this time.

## NEW AREA CODE

Please note that our area code has been changed from 412 to 724 effective February 1, 1998.

## IRS FORM 8606

Remember to file Form 8606 with your 1997 Federal Tax Return if you made *non-deductible* contributions to a traditional IRA.

## Ron Muhlenkamp's "READING LIST FOR LIFE AND INVESTMENT FUNDAMENTALS 101"

*This is Part I, "A Reading List for Life"*

### TO UNDERSTAND:

The way things work .....  
Why you'll never understand the other sex .....  
Values .....  
The evolution of moral standards .....  
Why global warming is unlikely .....  
The differences of modern liberals and conservatives....  
How the best and the brightest can be totally wrong ....  
  
Economics .....  
Economics – the short course .....  
Why socialism can't work .....  
Politics .....

### READ:

*The Way Things Work* .....  
*You Just Don't Understand* .....  
*Zen and the Art of Motorcycle Maintenance*....  
*Lila* .....  
*Climate and the Affairs of Man* .....  
*A Conflict of Visions* .....  
*The Best and the Brightest* .....  
*Atlas Shrugged* .....  
*Human Action* .....  
*Economics in One Lesson* .....  
*Socialism* .....

### BY:

David Macaulay  
Deborah Tannen  
Robert M. Pirzig  
Robert M. Pirzig  
Iben Browning  
Thomas Sowell  
David Halberstam  
Ayn Rand  
Ludwig von Mises  
Henry Hazlitt  
Ludwig von Mises  
Will Rogers