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# THE MUHLENKAMP MEMORANDUM

*Quarterly Letter (continued)*

believe that is true, but the statement was premature. The economy continues to expand at a healthy rate and the data indicate that inflation is under control. But the reality has not yet alleviated the fear of inflation. We find it interesting that the stock market bears have been able to keep their fear, despite a reversal of the cause from "too little" growth to "too much" growth. The abiding fear is that too much growth causes inflation, even though Reagan and Volcker disproved this theory twenty years ago.

Nevertheless, for six months, we have been dealing with the fear of rising inflation despite very little data to support it. My observation remains that people can hold a fear for six to nine months. Unless confirmed by data, the fear then dissipates. We expect the fear to dissipate between now and yearend. We find it interesting that long-term Treasury Bonds, which should be the best market barometer of inflation fears, bottomed in late June, in early August, in mid-September, and again in October; each time at yields of 6.1 - 6.4%. Another reason we expect volatile unsettled markets through yearend is the normal yearend tax-selling and tax-swapping activity in the marketplace.

Part of our frustration is due to the fact that we have been right in our assessment of the economy. Furthermore, most of our companies are meeting our expectations and a number of "security blanket" stocks have lost part of their premiums. Further still, a number of our stocks have been bought, usually for cash, by competition or by management. Many of our companies are buying in their own stock. So businessmen are seeing the same values in our companies that we are.

	<u>ROE</u>	<u>EPS Growth 5-year</u>	<u>EPS Growth 1-year</u>	<u>Sales Growth</u>	<u>P/E Growth</u>
<b>S&amp;P Top 15</b>	30	23	15	10	41
<b>Muhlenkamp Top 15</b>	21	25	24	15	14
<b>Average Company</b>	15	--	0	--	16

We have updated our table from April on our top holdings. Since April, the only difference is that our P/Es are lower now than they were then. So the values are even greater. But, so far, the public investors are not interested. The public is playing a "momentum" game focusing on those stocks that have had the greatest price move lately. But the rotation among groups is rapid and the declines can be as dramatic as the advances. In April, the top group was internet stocks, many of which have lost 30-50% since then. Today, the top groups are media and telecoms which, like the internet stocks, are being bid up on the basis of hope for future profitability. Not all of these hopes can be realized. Even those companies who win the battle for the customer will be unlikely to earn enough profit or cash flow to justify current prices. This is why we don't own them. Instead, we own companies that

demonstrate good profitability today, and whose stocks are modestly priced based on their current profitability. Over the years we have found this a much more reliable way to earn good returns. Today we're finding more values and better values than we've found at any time since late 1994. Our expectation is that other investors will begin looking for these values as their fear of rising inflation dissipates between now and yearend. - Ron Muhlenkamp

## PROSPERITY by Ron Muhlenkamp

What does prosperity mean to you?

When I ask this question, people respond in terms of a better lifestyle, home, car or vacation; a secure retirement; funding college education; etc. But these responses describe how we consume prosperity. I believe we can't consume prosperity unless we produce prosperity. So I want to discuss how we produce prosperity. In this regard, the last thirty years (which is the period of time that I've been paying attention) have been fascinating.

In the 1970's, we had stagflation. Stagflation is a combination of low growth (stagnation) and high inflation. According to the economic theories I was taught in the late 1960's, this wasn't supposed to happen. Inflation was supposed to be a result of too much growth. Low growth was supposed to result in lower inflation or deflation. So stagflation wasn't supposed to happen -- but it did.

In the 1980's and '90's, we have had accelerating growth and declining inflation, along with huge federal budget deficits. When Reagan proposed the tax cuts which resulted in the budget deficits, conventional economic wisdom argued that the increased federal borrowing would result in higher interest rates, a "crowding out" of commercial borrowers, and a declining economy. It didn't happen, interest rates have fallen and the economy has expanded for nearly twenty years. What went right?

In the 1970's, we had 10% inflation and a progressive Federal income tax rate structure with a top tax bracket of 70%. Ten percent inflation meant that each individual needed 10% more money each year just to maintain his/her standard of living. The progressive tax rate meant that if you received a 10% raise (pretax), your taxes went up 20%. (The numbers are straight from the tax tables of 1979.) A 70% tax rate meant that after a certain level it didn't pay to work (and produce).

One day in 1980, I was visiting a couple of clients who are doctors. They had set up Pension and Profit Sharing Plans but also had a plethora of other plans including salary deferral etc., each designed to minimize or defer their tax bill. I finally asked them how much of their time they spent being doctors and how much of their time they spent deferring taxes. They said they spent about a day per week deferring taxes. So here you have

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two highly intelligent, highly trained individuals who spent four days a week doing something useful and one day a week producing nothing, simply because of their high tax bracket.

The 70% tax bracket fed a tax shelter industry, which funneled money into areas that were tax-favored rather than economically productive. And we got a glut of boxcars, barges, and "see-thru" (empty) office buildings. Meanwhile, my friends who were farmers concluded that the way to get ahead was not to grow more food, but to borrow more money and buy more land. My suburban friends spent some of their working hours planning how to borrow more money and buy a bigger house. At about this time a friend of mine who taught at Duquesne University, sketched the following scenario based on a five day work week:

Monday, you pay 10% in taxes on your earnings,  
Tuesday, you pay 20% in taxes on your earnings,  
Wednesday, you pay 30% in taxes on your earnings,  
Thursday, you pay 40% in taxes on your earnings,  
Friday, you pay 50% in taxes on your earnings.

How many of you would come to work on Friday? Over the years, I have asked this question to groups of people aggregating several thousand. I used to get 2-5% of hands going up. In the last three years, I've gotten zero hands up. People are telling me that, at a 50% tax bracket, they will quit work. And you don't have to be an adult to come to this conclusion.

In the early '80's, when my daughters were in their early teens, I hired them to key-punch for me. I paid them \$5.00 an hour when they could make \$2.50 an hour babysitting. After watching their money go to early-teen things that I considered frivolous, I suggested that henceforth, they should not spend half of what they earned working for me. But the next time I asked them to work, they were unavailable; and the next. I finally had to remove the restriction in order to get the work done. My early-teen daughters were unwilling to work under a 50% tax rate (as perceived by them) even though the net to them was as great as they could earn elsewhere.

I believe that the reason we had high unemployment in the 1970's is simply that it didn't pay to work. Certainly there were people looking for jobs, nearly all of whom would not have been in the 50%+ tax brackets. It would have paid them to work, but it didn't pay a businessman to hire them. Aside from the income taxes, there was a raft of other penalties. When I hired my first full-time employee in 1981, I had to fill out seven different forms and pay seven different taxes. My friends running small businesses told me I was crazy to hire employees instead of temporaries. Yet, few politicians seem to understand that taxing the *employer* is not conducive to creating jobs. The exception was Ronald Reagan.

In 1983, Ronald Reagan lowered the top tax rate to 28%. It paid businessmen to earn the incremental dollar so they started hiring. Unemployment has fallen ever since. George Bush and Bill Clinton have raised the top tax rate to 39.6%. Depending on the state and local rates, most people are faced with an

additional 3 to 8%. So we are once again flirting with the 50% rate at which people tell me they will quit working.

Meanwhile there is another dynamic that has changed in the last 30 years. If you work in a union shop, seniority (length of tenure) gives you preference on certain things. Thirty years ago seniority gave a worker preference in working overtime (which pays 1.5 or 2 times the hourly rate). Today seniority still gives preference, but it is viewed as the right to *not* work overtime. My father worked all the overtime he could. When I worked in a union shop (a couple summers), I worked all the overtime I could. It was a chance to earn more money. Recently I had a conversation with a man who has a tool and die shop in Vandergrift, PA. I asked him if he has trouble getting employees. He said it isn't too bad. He pays less than Allegheny Ludlum (the big local mill) but people want to work for him because there is no compulsory overtime. Let me repeat. He can *pay less* because he has no compulsory overtime (which would allow employees to earn 1.5 or 2 times the normal rate). Given similar choices, people have reversed their preference! What is going on?

I believe that many people no longer work just for money. While this may seem to contradict my earlier argument, I think the answer is a bit more subtle.

My parents and their peers, who lived through the depression, were willing to work long hours and live cheaply to make things better for their children. People in Japan who survived the war were willing to work long hours and live cheaply to make things better for their children. When my son, Tony, was in Korea, he wrote home to say, "Dad, these people work 60 hours a week and live in rabbit hutches." My observation is that people who have been truly poor (without food, clothing and shelter) or who fear being truly poor, will do almost anything to avoid it. But those who have always had the basics, and take them for granted, have much different incentives.

Once you are able to take food, clothing, and shelter for granted (or believe you can), the willingness to work additional hours becomes a direct tradeoff between leisure time and additional goods or services. And it involves not just the hours of work, but also all the other facets of working, from a sense of challenge and satisfaction to the social and human aspects. Working becomes not just a means to feed and clothe yourself and your family but to foster a sense of purpose and self-esteem. I know a lot of people who find purpose and self-esteem in their work. I don't know any who have found it in the party circuit.

One of the interesting aspects of the current U.S. economy is that many of the goods and services we now consume were unheard of just a generation ago. We use the word "need" to describe goods and services our parents viewed as luxuries and our grandparents never dreamed of. It has become apparent that there is no limit to the goods and services desired by the consumer, which means that there is no limit to GDP/capita from a demand or consumer perspective. The only limit to GDP/capita is what that same consumer is willing to produce.

