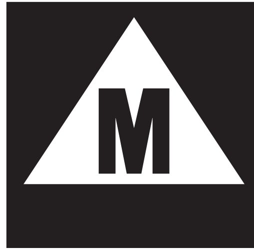

MUHLENKAMP & COMPANY, INC.

INTELLIGENT INVESTMENT MANAGEMENT

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Issue 57 First Quarter 2001

On December 29, 2000 the Net Asset Value of the Muhlenkamp Fund was $48.98, up 25.30% year to date.
Click here to see the current Net Asset Value of the Muhlenkamp fund.

THE 23RD ANNUAL FLORIDA MONEY SHOW

Ron Muhlenkamp will present an investment seminar titled "Understanding the Current Investment Climate" at the 23rd Annual Florida Money Show at the Walt Disney World Contemporary Resort on Thursday, February 22, 2001. Admission to the conference is free by calling 800-970-4355 and referencing the Muhlenkamp Fund. For more information, visit the website at: www.intershow.com/floridamoneyshow/Attendee/index.shtml.

THE BEACON JOURNAL INVESTMENT STRATEGIES CONFERENCE & EXPO

The Muhlenkamp Fund will be hosting an exhibit booth at The Beacon Journal Investment Strategies Conference and Expo at the Hilton Quaker Square in Akron on Saturday, March 3, 2001. Admission to the conference is $10.00. You can purchase tickets in advance by calling 216-619-7469 or by visiting the website at: www.cleveland.com.

INVESTMENT STRATEGIES CONFERENCE AND EXPO

The Muhlenkamp Fund will be hosting an exhibit booth at the Investment Strategies Conference & Expo at the Cleveland Convention Center on Saturday, April 7, 2001. Admission to the conference is $10.00. You can purchase tickets in advance by calling 216-619-7469 or by visiting the website at: www.cleveland.com.

FUND YOUR IRA FOR 2000

You have until April 15, 2001 to fund your Traditional or Roth IRA or a combination of the two for the 2000 tax year. Call us at 800-860-3863 for a prospectus and an application or download the information from our website at www.muhlenkamp.com.

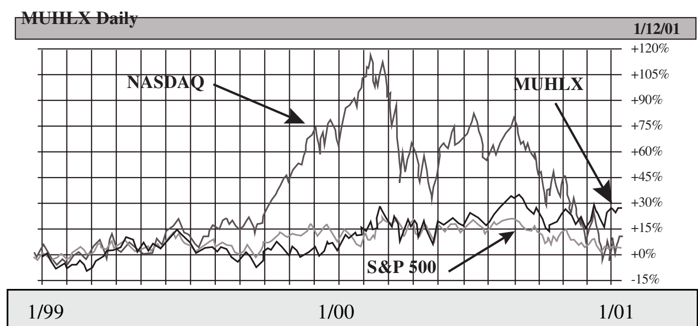
QUARTERLY LETTER

Be careful what you ask for!

Inflation remains under control.

The economy is slowing rapidly. For two years, professional economists have feared that the economy was growing too fast and would engender higher inflation (even though this theory was disproved 20 years ago). In response to these fears the Federal Reserve raised short-term interest rates from 4.75% to 6.50% in the period from mid-1999 through May 2000. The express purpose in raising rates was to slow the economy. They (and we) are now getting what they asked for.

The split in the stock market continues. One part, which we call the "hype" stocks, continues to dominate the media and public attention. Beginning with internet-based brokerage stocks in late 1998 a segment of the public discovered the "game of the stock market." Encouraged by Wall Street and the media, the focus of the game expanded to other Internet stocks, followed by telecom and biotech. By March 2000, the fad ran out of money and of new ideas – it has since collapsed. The plot of the NASDAQ in the chart below illustrates the ride.



Meanwhile, the rest of the market acted as it usually does when interest rates are rising. In 1999, more stocks were down than up, even though corporate earnings were strong.

The Muhlenkamp Memorandum is a quarterly information service of Muhlenkamp & Company, Inc. ©2001

In January 2000, long-term Treasury Rates peaked, and have since fallen from 6.7% to 5.4%. As rates have come down, many stocks are doing well, led by financials and homebuilders. This pattern is similar to that of 1994-1995 and to that of prior slowdowns.

Of interest, the last two increases in short-term rates by the Fed occurred after long-term Treasury Rates had already begun their decline, much as the Fed raised rates in February of 1995 after long-term rates peaked in November 1994.

Currently, the interesting question is whether the Fed is successful in engineering a soft landing and avoiding a hard landing or recession. The Greenspan Fed managed this feat in 1994-1995 after failing in 1990. We believe the Gulf War in 1990 damaged consumer confidence and turned a slowdown into a recession. We believe the uncertainty surrounding the Presidential election in 2000 damaged consumer confidence but not enough to give us a recession. Nevertheless, the question remains.

By lowering short-term rates by ½% on January 3, 2001 the Fed signaled that it will do what it can to make the landing soft. We note that the Fed has ample room to lower rates further. Current short-term rates are well above their normal level relative to inflation. And the strength of the dollar eliminates it as a constraint on Fed policy.

Furthermore, the new administration is pushing for a meaningful cut in taxes which would help the economy. Some fear that the proposed $1.3 trillion cut over 10 years is too big, but it's ¼ of the projected budget surplus and, relative to GDP, ½ the Kennedy tax cut of the early 1960s.

So we're expecting a soft landing, but recognize that it's not yet assured. We do think it's a good time to buy selected stocks.

Ron Muhlenkamp

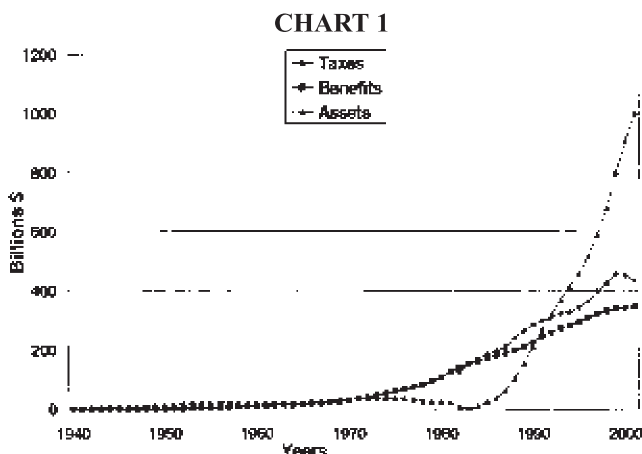
Social Security Revisited

Six months ago we updated our Essay on Social Security. In the essay, we looked at Social Security from the point of view of the individual, specifically, "How much did I pay into it?" and "What can I expect to get out of it?" Our essay resulted in a number of comments and questions. In order to address these questions, we need to review Social Security in the aggregate, i.e. what does the whole program look like?

In chart 1 we've plotted the following for each year since 1940:

1. The number of dollars workers paid into the program in taxes.
2. The number of dollars retirees received from the program in benefits.
3. The resulting assets in the "trust fund."

CHART 1



As you can see, the program currently looks pretty good. There is close to a trillion dollars in the trust fund, roughly 2 ½ years worth of benefits. This looks impressive until you realize that most people receive benefits for 20 years, not 2 ½.

Most of you know that we don't like to make projections, but in the case of Social Security, it's pretty easy.

The benefits to be paid out each year will equal the number of retiree's multiplied by the benefits promised to them.

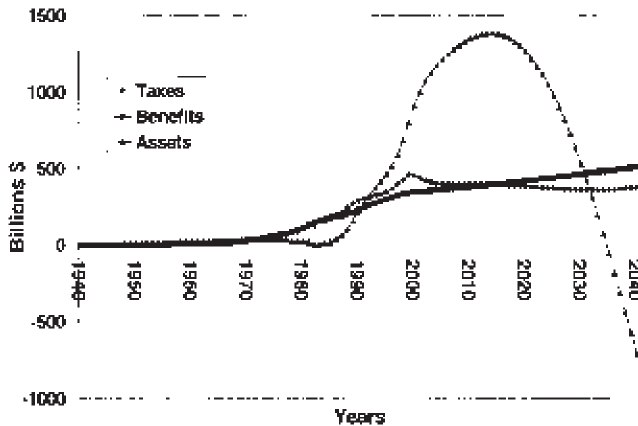
The taxes paid in each year will equal the number of eligible workers multiplied by the employment rate multiplied by the withholding rate on their salaries up to a stated level.

Since nearly all the future retirees are already in the workforce and nearly all the eligible workers for the next twenty years have already been born, its fairly easy to project the taxes, benefits and assets for the next 20-40 years. In fact, our projections look just like the projections of the Social Security Administration (SSA). The projections are included in chart 2.

Chart 2 shows why today's retirees over the age of 65 don't have a problem; there will be sizable assets in the program for the next 30 years.

But chart 2 also shows why the children of today's retirees, 30-

CHART 2



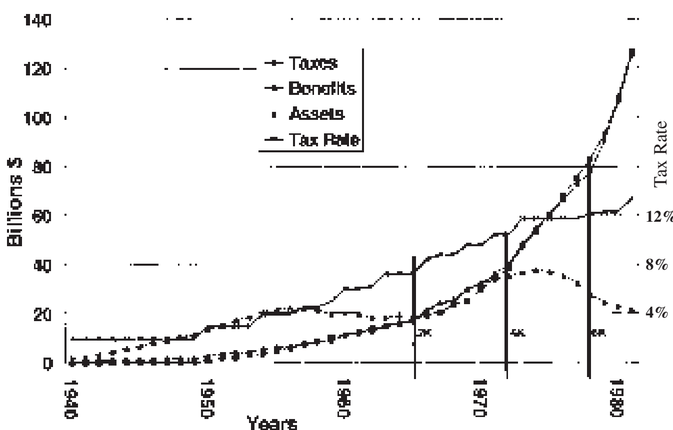
40 year-olds, do have a problem; the program runs out of money in 2034.

Why has the program worked so far? When the Social Security Program was initiated in 1937, the average life expectancy in the U.S. was less than 65 years. Eligibility for benefits was set at age 65 in the expectation that fewer than ½ of the workers would collect Social Security (because they wouldn't live long enough). Furthermore, when the program started, there were a lot of workers paying into the program and few receiving benefits.

In 1945, the ratio of workers to retirees was over 40 to 1; in 1950, over 16 to 1; and in 1960, the ratio was 5 to 1. Today, the worker/retiree ratio is a little over 3 to 1.

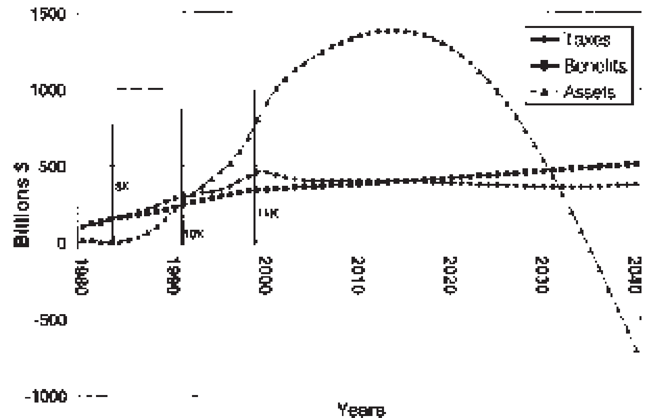
As the worker/retiree ratio fell, the SSA found it necessary to raise the tax rate from 2% in 1937-1949 (1% employee + 1% employer) to 6% by 1960 to 12.4% in 1990. The 12.4% rate remains today.

CHART 3



Furthermore, the SSA found it necessary to raise the level of wages on which the tax is paid from $3,000 in 1937 ($34,000 in 1999 dollars) to $72,000 in 1999. On charts 3 and 4 we've plotted the applicable tax rate. We've also marked the years when the combination of tax rate and rate base first pushed the top payer over the levels of 2, 4, 6, 8, 10, & 11 thousand dollars (all numbers inflation adjusted). Note that chart 4 is a continuation of chart 3, simply with a change in scale.

CHART 4



Also, starting in 1984, the SSA started cutting the value of retiree benefits. In 1984 they started taxing benefits; they started taxing 50% of the benefit and now tax 85% of the benefit. More recently, they've been raising the retirement age.

I was born in 1944; the age for me to qualify for full Social Security benefits is 66 years, not 65. If you were born in 1960, the age at which you will qualify for full benefits is 67 years, not 65.

Social Security benefits are calculated as a percentage of your qualifying pay prior to retirement. Currently benefits are calculated at 90% of the first $6,000 in wages plus 32% of wages from $6,000-$40,000 plus 10% above $40,000. Since the average wage earner today earns roughly $30,000 per year, the average retiree is promised benefits a little over ⅓ their pay.

As long as there are over three workers per retiree, the system is stable. Three people each paying 12% in can support one person taking 36% out. (Note that in 1960, 5 people each paying 6% in could support one person taking 30% out.) The problem is that the ratio of worker/retiree will decline to just two to one by 2030.

At that point, the two workers would each have to pay 18% of their pay (nearly a 50% increase) into Social Security in order for one retiree to receive 36%. Some people believe this is a viable solution. I don't. In the 1970s, I saw what happens when people are pushed into ever-higher tax brackets. At some point, they quit work. Even if the employees want to work, if the employer quits, the employees are out of work.

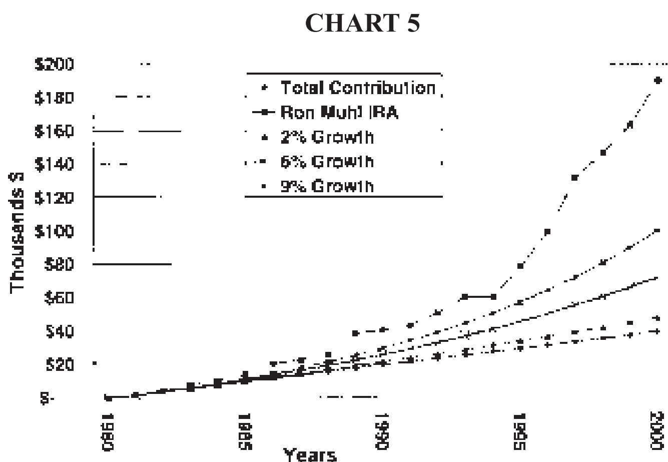
A second solution is to cut benefits. (In fact, I've suggested cutting the benefits of millionaires, but there aren't enough millionaires to solve the problem.) Many retirees believe that their benefits can't be cut. They believe they're "entitled" to the promised benefits. But the Supreme Court (Fleming vs. Nestor, 1960) has ruled that we're not "entitled" to the promised benefits. Some retirees were recently shocked when Medicare tripled the amount (from $10 to $30) that they co-pay for prescribed drugs. Folks, the rules on Social Security are set by the same people who make the rules on Medicare. If they believe it is necessary, they will cut your benefits.

But there is a third way to make Social Security viable for the next generation.

If a part of the taxes used to build the trust fund for the next 30 years could be invested to earn a reasonable rate of return, we could alleviate the problem. Some have suggested allowing people to invest part of their Social Security taxes in a Personal Social Security account. To me a Personal Social Security account sounds a lot like an IRA (call it a PSA). So I took a look at my IRA to see how it has done.

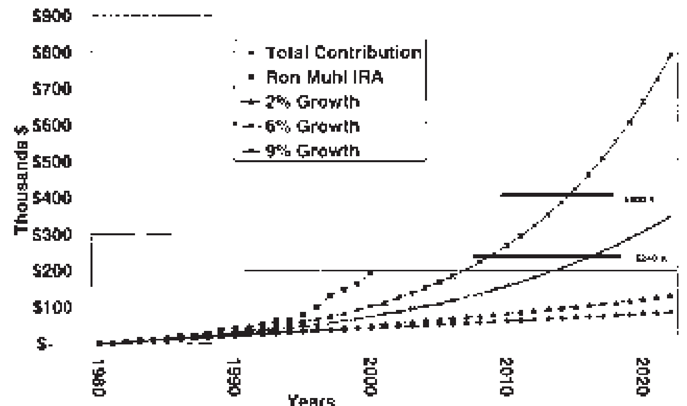
Chart 5 is a plot of my personal IRA from 1980 through 2000. The bottom line is the total dollars I've paid in over the years. Twenty years multiplied by $2,000/year = $40,000 total. The middle lines are calculated: they show the assets I'd have if I'd earned 2, 6, or 9% per year. The top line is what my account has actually done. Chart 6 simply extends chart 5 out another 23 years to show a typical working lifespan of 43 years.

CHART 5



The SSA recently sent me a statement which said my promised benefit upon retirement is $20,000/year. The IRS says my life expectancy at age 66 is 20 years. So the SSA expects to pay me $400,000 over my retirement years. We've marked that on chart 6.

CHART 6



Alternatively, an annuity which promised $20,000 for 20 years, would cost $240,000 at the start, if we assume an interest rate of 6%. We've marked that on chart 6.

You'll note that at $2,000/year, the return has to be greater than 6% to reach $400,000 in 43 years but that it reaches $240,000 in 37 years. It looks like I'll reach it in less than 30 years. The amazing thing is that the $2,000/year I put in my IRA is just 40% of what I've paid into Social Security in the same period of time. It's less than ⅓ of what I've paid into Social Security to date. So just by earning a reasonable return on my investment (its been invested only in the Windsor Fund and the Muhlenkamp Fund from day one), I will be able to fund an amount equal to my promised Social Security benefits with only 30-40% of the money. This makes 60-70% of my Social Security taxes available to someone else.

From the above data I reach several conclusions:

1. The 65+ year olds don't have a problem, their children do.
2. Using Private Security Accounts for a part of the taxes can alleviate the problem.
3. We have a fairly short period of time (the next 10-15 years while the assets in the trust fund are building) to implement the PSA. After 15 years the window closes.
4. Politically, it will probably not happen soon enough unless those over 65 push for it.

We welcome your comments and questions.

Ron Muhlenkamp

MUHLENKAMP FUND AVERAGE ANNUAL RETURNS AS OF 12/31/2000

Click here to see the current performance information for the Muhlenkamp Fund

One Year	Three Year	Five Year	Ten Year
25.30%	*12.94%*	*20.08%*	*19.87%*

Please read the prospectus carefully before you invest. Past performance does not guarantee future results. Fund shares when redeemed may be worth more or less than their original cost.