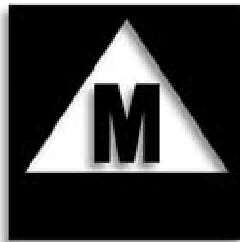

MUHLENKAMP & COMPANY, INC.
INTELLIGENT INVESTMENT MANAGEMENT

(800) 860-3863

e-mail: click here • website: www.muhlenkamp.com

Issue 59 Third Quarter 2001

On June 30, 2001 the Net Asset Value of the Muhlenkamp Fund was $54.10, up 10.45% year to date.
Click here to see the current Net Asset Value of the Muhlenkamp Fund.

A REMINDER TO OUR SHAREHOLDERS

You have the option to pay your annual IRA maintenance fee by check rather than having it deducted from your account. The fee is $10.00 per account, capped at $20.00 per Social Security number. If you would like to pay by check, make your check payable to **Firstar Bank, N.A.** and mail it to:

Muhlenkamp Fund
c/o Firstar Mutual Fund Services, LLC.
P.O. Box 701
Milwaukee, WI 53201-0701

Include the account number(s) you are referencing on the memo line of your check and indicate that the payment is for your "IRA fee."

Please send your check before October 12, 2001. If we have not received your check by this date, we will deduct the fee from your account.

WSB RADIO MANAGING YOUR MONEY SHOW

Tony Muhlenkamp will present a seminar, "Understanding the Current Investment Climate" at the *WSB Radio Managing Your Money Show*. The show will take place on Saturday, September 15th at the Cobb Galleria Centre in Atlanta, Georgia. Tickets to the show are $30.00 and can be purchased in advance by calling 770-804-0440 or visiting the website at: www.wsbradio.com.

WEST COAST SEMINARS

Plan to join Ron Muhlenkamp when he presents his seminar, "Understanding the Current Investment Climate" in Los Angeles and San Francisco. Ron will be in Los Angeles at the Four Points by Sheraton near Los Angeles International Airport on Monday, September 17th and San Francisco at the Sheraton Fisherman's Wharf on Wednesday, September 19th. For more details, visit our website at: www.muhlenkamp.com or call our client service representatives at: 800-860-3863.

QUARTERLY LETTER

The U.S. has reached that stage common to all slowdowns/recessions when the negative economic effects are quite apparent and the positive effects are not yet visible. As often happens at this stage, we are seeing and hearing from those who believe that (for reasons unique to this time and circumstance) the U.S. economy will not rebound in the usual fashion. We see no evidence that this is true. On the contrary, the signs we see indicate a high probability that the consumer is in good shape and will bring the economy back.

I have just re-read our past newsletters, including those written during the 1990-1991 recession and the 1995 slowdown. In doing so, I was reminded that in the 1970s I concluded that people had to live through four or five recessions before they came to view recession as a normal, non-threatening part of the business cycle. But since we've had just one recession (1990-1991) in the past 19 years, a large part of the investing public and the media have limited experience with market actions through a recession.

So let's start with some background. A slowdown/ recession is the primary risk to the economy over the intermediate timeframe. Historically, that time frame was 3-5 years and was viewed as the business cycle. (In our weather analogy, we call it the seasons.) In the 1960s and 1970s, the cycle was regular enough that the stock market ran in a four-year cycle (even when the economy didn't). I have since concluded that the cycle was driven as much by politics as by economics, but in investment matters, the fact is/was more important than the cause.

As investors, our first concern is whether a recession can evolve into a bigger problem such as a depression or hyper-inflation (what we would call a "change in climate").

Milton Friedman maintains that a normal 1930 recession evolved into the Great Depression because we in the U.S. did three things

dramatically wrong:

1. To protect our gold supply, we raised interest rates.
2. To balance our federal budget, we raised taxes.
3. To protect our manufacturers, we raised tariffs.

When you think about what these actions did to the American consumer, it's no surprise that we suffered a depression. Today, we are lowering interest rates and lowering taxes, so we see no danger of a depression.

Inflation results from a too rapid growth in the money supply. Currently, the Federal Reserve is not allowing the money supply to grow fast enough to give us an increase in inflation. Moreover, remember that the Fed raised interest rates starting in 1999 for the express purpose of slowing the economy to limit fears of inflation. They did this because they, and we, view inflation as a greater risk to prosperity than recession. I repeat, the Fed did this on purpose. Today we see low probability of the risk of depression or increased inflation. We also see a low probability of the third big risk to the economy, which is war.

Conclusion: The big picture looks good.

Slowdowns/recessions also serve the economic purpose of curbing prior excesses. In most recessions the parts of the economy exhibiting the greatest decline are the very parts that exhibited the greatest recent excesses. In the current cycle, that area is investment in technology. In the 1982 recession, it was investment in real estate.

We believe that the negatives this time around are largely those of perception. The perception was that the strength of consumer spending on technology was ever upward. Wall Street and the media abetted this perception, focusing on tech stocks and implying both a long-term trend and imputing a greater importance to this sector than was warranted economically. Again, the pattern was similar to real estate in the late 1970s. If, in fact, computer and telecom equipment are capital goods, we'd expect that they'd magnify and lag the economy's cyclical peak and decline. They are doing just that.

There is a remaining risk. Our observation has been that if people are going to change their minds about spending and saving (thereby giving us a change in the investment climate) they are most likely to do it in the middle of a slowdown or recession. In the past, such a change in mindset followed a lengthy period of time when their prior mindset caused economic pain.

We see no signs of economic pain caused by the public's current mindset. And, in fact, those areas of consumer spending which are normally most vulnerable to a slowdown, housing and autos, have remained surprisingly strong in the current slowdown. The fact that most consumers are about to receive a tax refund/tax cut can only be a plus.

Conclusion

The intermediate picture looks like a "normal" slowdown or recession. We won't really know which until it no longer matters in an investment sense. We are investing your money (and ours) accordingly.

We do expect continued short-term market volatility. We also expect continued declines in the remaining overpriced tech stocks; these declines will be aided by tax-loss selling beginning in a few months. We also expect the media to continue to focus on these volatile stocks, allowing us to make good money on the ones they're ignoring.

Ron Muhlenkamp

Some Criteria to Consider When Selecting a Mutual Fund

In my article on 529 plans (Muhlenkamp Memorandum #58) I talked about evaluating investment options, here I would like to build on those ideas as a bridge to the process described in the article, "How to Choose a Money Manager" (to follow).

The whole process of evaluating investments (whether it be mutual funds, annuities, 529 plans, individual securities, etc.) boils down to answering the questions, "Do I want these people to invest my money for me," and "How do I know?"

Over the last couple years I have been thinking about how to answer those questions, and I have come up with the following process.

I start by setting some criteria for judging my investments. My criteria are:

1. **Performance for five and ten years averaging 15% a year or better**. This is the performance I would have been happy with the last five and ten years. Admittedly it is the result of hindsight, but it is a useful starting point.
2. **Three-year earnings growth of 15% or better for the mutual fund portfolio.** This indicates to me that the fund is investing in companies that are doing a reasonable job of selling their product. I would like to be able to screen for return-on-equity greater than 15% as well, but the *Morningstar Principia* product that I use doesn't publish that statistic.

3. **Manager tenure of ten years or longer.** I want to make sure the person responsible for the performance track record is still running the fund.

Over the last several quarters, I have searched *Morningstar Principia* for mutual funds that meet these criteria with the following results (you can probably do the same reporting with *Morningstar Online*):

Quarter Ending	# Of funds 5,10 yr performance > 15% Manager Tenure > 10 years 3 Yr Earn Grth > 15 %	# Of funds p/e < 1.2 x 3 Yr Earn Growth
03/31/1999	36	9
06/30/1999	47	14
09/30/1999	54	10
12/31/1999	38	8
03/31/2000	42	11
06/30/2000	31	7
09/30/2000	83	17
03/31/2001	19	11

The third column of the table comes from my belief that it is possible to turn a good company into a bad investment if you pay too much for it. Therefore, I run a manual screen and compare the actual P/E of the fund to a cutoff P/E of 1.2 times the earnings growth. Any fund that has a P/E higher than that, I suspect of paying up for earnings. I don't want that.

By running the same report over time I get a sense of which funds stay on the list. Those that stay on the list from quarter to quarter are more appealing than those that don't. I discard load funds because I have enough choices that I don't feel compelled to pay a load. I discard specialty or sector funds because I want a diversified fund and a manager that will look everywhere for good investments.

Now that I have identified good funds to investigate and good money managers to learn more about, I request a prospectus and annual report and take a look at the performance for each of the last ten calendar years. Then I look at how volatile the performance is, and can I live with that kind of volatility? Are the five and ten- year performance the result of one or two good years, or are they consistent over any three-year period? I am looking for solid returns on a rolling three-year average.

Then I put the fund and the manager through the process described in the article, "How to Choose a Money Manager." I read everything I can find written by the manager and about the manager (making sure I understand the distinction). Letters to shareholders are good places to start. I might even call the fund company and see what they can tell me about their current work. By the time I have done this I have found one or two funds that I am comfortable with (actually, in my case I have found just one fund that I use).

I am not suggesting your criteria should be the same as mine in terms of performance, earnings growth, etc. You could use tax-adjusted returns for five and ten years instead of before-tax returns. You could increase your earnings growth requirements from 15% to 20%. Whatever you use, you should use *something,* and you should have a rationale for why you are using that particular criterion. Write your criteria and your reasons down so that five years from now you remember why you picked a certain fund. Your criteria should reflect what performance you need from your investments according to your financial plan. For my part, I don't expect or require 15% a year going forward. My plan only calls for returns of 8% (or 5% over inflation). I just think I am more likely to get that from someone who has done 15% the last ten years than from someone who has done 8%. Then every year I calculate a three-year rolling average of the funds performance and make sure that it meets or exceeds my requirements.

Over ten years or longer, the average performance for all these managers clusters together. Whether growth or value, large or small cap, doesn't really matter over time. What matters over time is whether or not I can stick with the manager even when the performance is disappointing. None of these funds make money every year. To make money over time you need a way to get through the down and disappointing years. That is the "sleep factor" referred to in the article, and what this process provides me.

Anthony Muhlenkamp

How to Choose a Money Manager

Choosing a professional money manager has much in common with choosing professionals in other fields. As in selecting a lawyer or accountant, it is difficult to judge basic competence and integrity without a lengthy professional history or personal relationship. Therefore an investor must rely on references from existing clients or other professionals.

Money manager referrals can usually be obtained from members of the brokerage community, or from accountants and lawyers, preferably those serving the manager's present clientele.

Beyond the determination of basic integrity and competence, the investor's real need in choosing a money manager is to find a manager with a consistent investment philosophy that the investor is comfortable with. Consistency and comfort are the keys.

There are a number of profitable investment philosophies. Some of the better known are fundamental value, contrarian (which is simply

acting in opposition to the conventional wisdom), and earnings momentum. Any of these, if consistently applied, can make money.

The difficulty is in the consistency of application. No matter how good the underlying philosophy, there will be periods when it appears not to be working. It is during these periods that it will be very tempting to try a different philosophy, usually just as it ceases to work. Thus, to a great extent, successful investing depends on standing firm in the face of the current emotional fashion. This can only be done if both the investor and the manager are comfortable with, and have conviction in, what they are doing.

We call this the “sleep factor.” People who hire money managers pay them a fee not only to earn a healthy return, but to do so in a fashion that allows the investor to sleep at night. A philosophy or methodology that keeps an investor awake has obvious ill effects on physical and mental health, effects which eventually flow over into the investor’s financial health as well.

People who are uncomfortable will change to become comfortable again, so it is critical that the philosophy and methods used for investing be comfortable to the investor so he can stay with them in the face of adversity.

For this reason, a true “meeting of the minds” must occur between the manager and the investor. The manager must explain his philosophy and methods in terms that the investor understands, and this dialogue must be ongoing; there should be no surprises.

Because there will be periods when the chosen philosophy appears not to be working, there must also be an understanding between the investor and manager of a reasonable period of time for judging whether the manager is in fact doing what he said he would. Is he fulfilling the investor’s expectations? Are the expectations consistent with the philosophy and methods chosen?

A long-term, value oriented philosophy, for example, will not normally outperform the market averages during short-term market upswings. If the investor is unaware of this tendency, he may begin to second-guess his selection of a value manager during a roaring bull market. He may become uncomfortable, and consider changing horses in midstream when all he really needs is a better understanding of the horse he is riding.

Again, this sort of indecision can be especially deadly in the investment business, as this year’s hero (or bum) rarely repeats. To continue the analogy, often the investor leaps upon a horse which is about to go under, just as his original mount gets a second wind. To avoid these disasters, the investor and manager must share investment goals and perspective.

The final factor in the manager selection equation is client reporting. An often-abused area for many managers, the client reporting jungle is proof positive that the biggest computer doesn’t necessarily produce the best reports.

Thirty pages of printout are no good to a person too intimidated by investment jargon to read beyond page one. Designed more to inundate than educate, these elaborate productions often hide poor performance in a tangle of statistics and bond duration equations.

A good and useful report, by contrast, tells the client the value of his portfolio on the day he started with the manager, the change in value over time, and the value today.

It shows the percentage return generated by the portfolio for the given period, and if the client desires, may include a comparison of the client’s return with that of market averages (Dow Jones Industrial Average, S&P 500, etc.), or any other bogey the client selects. It shows the securities held, their market value and their yield. If the account pays taxes, the report also provides realized gain and loss data for use in preparation of tax returns.

Nothing else (unless the client specifically requests it) is required. Simple, straightforward reports are read and understood by clients. Complex, cluttered ones go straight into the (circular) files.

In summary, a successful investment manager needs a consistent investment philosophy, a sense of perspective, and the confidence and discipline to carry it through. The investor, in turn, must understand and be comfortable with the manager’s philosophy. He must know why it works, and when it won’t work, so he too has the confidence to see it through. A wise investor once said that in the money management business the only surprises are bad surprises. He was right.

Ron Muhlenkamp

Muhlenkamp Fund Average Annual Returns as of 6/30/2001

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

One Year	Three Year	Five Year	Ten Year
22.59%	*10.95%*	*20.41%*	*18.68%*

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.