



**MUHLENKAMP & COMPANY, INC.**  
**INTELLIGENT INVESTMENT MANAGEMENT**

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On September 30, 2001 the Net Asset Value of the Muhlenkamp Fund was \$43.05, down 12.11% year to date.  
[Click here to see the current Net Asset Value of the Muhlenkamp Fund.](#)

**A REMINDER  
TO OUR SHAREHOLDERS**

As a reminder to our shareholders, our address for checks and account correspondence is as follows:

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

Please do not send checks and account correspondence to our Wexford address, as we can no longer process these requests at this location. The requests will be forwarded to Milwaukee, possibly causing a delay in processing.

**NEWSLETTER AND UPDATES  
VIA E-MAIL**

[Click here](#) to provide us with your contact information in order to subscribe to our e-mail list.

**QUARTERLY LETTER**

It strikes me that the American people have just suffered a death in the "family.,, We've just come through a period of shock and mourning. During this time, our neighbors have taken up the slack, pitching in to support us both emotionally and physically, doing with us and for us the things that needed to be done to get us through a rough time.

Frankly, since leaving the farm 40 years ago, I didn't expect to see that again. On a farm, animals and crops need to be tended on their own schedule, regardless of human troubles, including death and disability. So neighbors pitch in, tending the animals and the crops when a family is unable to do so. In suburbia, where I now live, physical support of a bereaved family is much less because the need is much less, usually limited to cooking food and possibly providing shelter. In the past few weeks, we've seen the entire U.S. act as one neighborhood. The response was immediate, voluntary and universal.

Suddenly, the things that concerned us a few weeks ago became irrelevant. The need to rescue our neighbors and support their families, both physically and emotionally, took precedence. It affected all of us.

When my wife, Connie, and I tuned into Jay Leno's show on September 19th, he announced that he was going to start telling jokes again. Apparently, for a week, he didn't feel like telling jokes. In truth, I don't know, because we didn't feel like watching. I'm told that David Letterman did a monologue that was highly patriotic. This from a comedian who built a career on comedy that is often (New York?) cynical. Both men are successful because they're good at reflecting the mood of the American public. They're just now easing their way back into the normal working pattern. I suspect the rest of the country will be easing its way back to normal working patterns, each of us on our own timetable.

# THE MUHLENKAMP MEMORANDUM

So how does all of this get reflected in the investment markets?

## Long-Term

The response of the American public to the mass murder of September 11th has been superb. The response of most of the world has been sympathetic. As a consequence, we continue to believe the long-term picture for the U.S. economy is positive.

## Intermediate-Term

We believe the recent events will turn the slowdown in the U.S. economy into a recession. We also believe the bottom, which we thought in early September had been reached, is now delayed by a few months. If asked for a pattern, we could use the Gulf War of 1990-91, which we believe turned a "soft landing," into a recession. One difference is the fear built up gradually in 1990-91 as war became more and more likely.

The fear then dissipated quickly. (The market recovered during the air war, before the ground war ever started.) This time, the worst news was concentrated in a of couple hours. We expect the psychological recovery to be gradual. We do expect interest rates to continue to decline, probably allowing many homeowners to refinance their mortgages, thereby lowering their monthly payments and increasing their disposable income.

In the 1960s and 1970s, I came to consider recession as a normal part of the business cycle. I learned that the media always played up the negative news and the fears of another depression. But I also observed that people acted in ways that made recession self-correcting. Partly from the fear of layoffs, people worked harder, spent less and saved more. For the 2-5% of the working population that lost their jobs, building up savings was necessary. However, after four to six months of increased savings, the 90-95% of people who didn't get laid off resumed their normal patterns of spending. We expect that this recession will self-correct in a similar manner.

## Short-Term

The Federal Reserve is providing liquidity to the system as promised. I believe it was necessary to close the markets temporarily. As a result, the bond markets were closed for two days – the stock market for four days. I believe it was necessary to open the market on September 17th. After all, many people periodically convert (sell) some of their invested assets to spending money on a regular basis. At Muhlenkamp, we send funds to many of our investors for this purpose, typically on the 1st and/or the 15th of the month. Partly for this reason, we expected the stock market to decline for the first few days after it opened. Also because we knew that some companies, including insurance companies, would need to raise funds.

As the week progressed, we observed several interesting patterns: In the first couple days, we saw a move toward large, name brand stocks which many commentators label a flight to quality. (We call it a flight to security blankets.) Later, these stocks also declined.

Despite large volumes traded in the large institutional stocks, there wasn't much depth (ability to trade large volume without sizeable price changes) in most stocks. I've been told there wasn't much depth in the bond markets either. This included the Treasury market, normally the most liquid (and the deepest) market in the world. The loss of 700 employees of Cantor Fitzgerald, the largest bond-trading firm in the world, most likely had an effect. In conversation with traders, some sounded like their normal aggressive selves, others, particularly in the New York City area, told me their "heart isn't in it., I suspect that the loss of traders and of heart by those remaining had a major effect on the depth of the market. So we had selling by those who needed to raise cash, selling by those who were fearful and, most likely, selling by some who trade on short-term momentum.

We did see an interesting pattern among our investors. In the first few days of market activity, our direct shareholders bought more shares. Our indirect shareholders, those who work through a broker or financial planner, redeemed shares for the first six days. Since then, they too have bought more shares.

Market action over the first several days indicated that financial professionals sought security blankets much more than the public. This may be because financial professionals were more likely to have known people who were trapped in the WTC than the public.

Unlike selling, buying usually requires a measure of hope and/or confidence. But even confident buyers are in no hurry when it looks like prices will be lower tomorrow. This is true at any auction, not just for stocks. So, the value buyers waited until their stocks were truly irresistible as they were at the end of September.

I learned a long time ago that when prices are irresistible, quit resisting and buy. While another "shoe,, can always drop, it would be pretty hard for it to be more painful than the one of September 11th.

In summary, we think the mass murders of September 11th made the slowdown/recession deeper and longer, so that the proper strategy today is similar to the one of six to nine months ago. That strategy is to invest in those companies that will benefit from lower interest rates and from the rebound in the U.S. economy. We are following that strategy.

Ron Muhlenkamp

# THE MUHLENKAMP MEMORANDUM

## SECTION 529 COLLEGE SAVINGS PLAN UPDATE

I wrote an article on 529 Plans in Muhlenkamp Memorandum #58. I've since learned some new facts about the plans.

Corrections (with thanks to Bill McDonnell at Parker Hunter):

1. Early withdrawals from Roth IRAs for education purposes are penalty-free (although the withdrawn earnings are subject to ordinary income tax).
2. The age of majority for UGMA/UTMA accounts in Pennsylvania is 21, not 18.
3. You can exercise some control over your investments by switching plans between states (limited to once every twelve months for the same beneficiary), or by changing beneficiaries within the same state plan.

New facts:

1. Distributions from 529 plans for qualified educational expenses made after December 31, 2001 are free from federal income tax.
2. Many states offer participants who are also residents state income tax deductions for contributions and state income tax-free distributions for college.

In my first article I glossed over the benefits and advantages of 529 plans because there are a number of articles and resources extolling the virtues of 529 plans. One such article is in the August 2001 issue of *Mutual Funds* magazine. I still advise people to be careful when considering using one of these plans.

Here's why:

The case for using 529 plans assumes that the investments available within the plan will make money. The other assumption is that the investments inside the plan are as good or better than the investments outside the plan. If both these assumptions are true, then using the 529 plans is a terrific idea because of the tax-free distributions for college.

So test the assumption. Determine if the 529 plan is a good investment by ignoring the tax advantages and evaluating the 529 plan as a mutual fund. What return do you expect to earn over what period of time? How will your money be invested? What is the performance track record? What are the fees and costs of investing in the 529? What is the investment discipline and philosophy of the manager? What is the experience of the manager? How will you know if the 529 plan changes managers? If you aren't satisfied, how do you get your money out?

I have only reviewed 529 plans from four different states in detail. Either I couldn't answer these questions, or I didn't like the answers I found. There are general rules that are true for all 529 plans, but the details differ from state to state, and not all states offer the plan. Each state has a prepackaged product that they offer, so you should be prepared to review and compare plans from different states, not just the state where you reside. If you find a 529 plan that you think is a good investment (in terms of the returns you expect to earn) then by all means use it. I just think you have to be able to answer the questions, "Do I want these people to invest my money for me?," and "How do I know?,"

Anthony Muhlenkamp

## SPECIFIC SHARE IDENTIFICATION METHOD AND TAX-EFFICIENCY

You can manage your non-IRA investments tax efficiently by using the specific-share identification method when you sell shares of a stock or mutual fund. If you bought all of your shares of a particular investment at one time and/or you are selling all of your holdings in the same year, you don't have an option. If you bought your shares, however, at various times and you are only selling a portion of your holdings, the method that you choose to calculate your cost basis on the shares that you are selling can make a difference in the amount of tax you must pay in the current year.

The specific-share identification method allows you to have more control over the amount of taxes you pay. Because this accounting method allows you to "specify," the shares you are selling, you can choose high-cost shares or low-cost shares. You

only pay capital gains tax on the difference between what you bought your shares for (your cost basis) and what you sell them for. This can be beneficial when you know that your tax bracket will be changing. For example: upcoming retirement, future layoff, change in salary, etc. It can also be beneficial if you are "gifting," shares to someone in a lower tax bracket such as a grandparent to a grandchild or "gifting," shares to a charity. You would sell the shares that would result in the lowest taxable gain when you were in the higher tax bracket and defer the higher taxable gain when the tax bracket was lower.

Another way that the specific-share identification method can minimize taxes is when you can offset a capital gain with a capital loss. If you know that you have a significant loss for the year, and you are planning on selling an asset in which you would

## THE MUHLENKAMP MEMORANDUM

realize a gain, you would choose the shares that had the lowest cost basis and thus offset the large taxable gain with a deductible loss.

One thing to remember is that if you sell shares that you owned for only one year or less, the resulting gain is taxed at the short-term tax rate which is your ordinary income tax rate. Capital gains resulting from shares held longer than one year are taxed at a lower long-term tax rate. So when using the specific-share identification method, also consider the holding period when you are considering which shares to sell.

While the specific-share identification method gives you the most flexibility and the most advantageous way to minimize your taxes, there are three other methods that can be used to calculate cost basis. They are average cost single category, average cost double category, and first-in, first-out (FIFO).

Average cost single category method is what most mutual fund companies provide to you if they calculate the cost basis for you. It is simply an average of all shares that you owned at the time you sold your shares. (It saves you from doing the math, but you don't have the maximum tax benefits that the specific-share identification method has.) Once you start using this method, you must continue using it for all accounts in the same fund unless you receive prior approval from the IRS to begin using another method. This does not stop you from using a different method for calculating your cost basis for other funds in your portfolio.

Average cost double category method divides the shares that you owned into two categories: short-term and long-term. Short-term includes all shares held one year or less and long-term includes all shares held longer than one year. The average of each category is used to determine the basis of the shares in each category.

First-in, first-out method (FIFO), as its name implies, assumes that the shares sold were the first shares purchased. If you do not specify which method you are using to calculate your cost basis, the IRS assumes that you are using this method.

The first step to take in using the specific-share identification method is to keep good records. It is very important to keep your confirmation statements because they include the information that you need to calculate your cost basis. Some mutual fund companies charge a fee to issue statements from past years. This can get expensive and they might not be able to send the statements to you by the time that you need them for tax purposes. (If the year-end statements you receive include all transaction detail from the entire year, it is not necessary to keep each statement that you receive throughout the year.)

Since the IRS assumes that you are using the FIFO method, unless you specify otherwise, you must indicate at the time of the sale that you are using the specific-share identification method. This should be put in writing on your redemption request, although some mutual fund companies allow you to specify your method verbally on their recorded phone lines. A written confirmation from your mutual fund company should indicate the specific shares that you sold and this confirmation should be kept with your records. Unless you notify the IRS that you are changing your current method of calculating cost basis for a particular investment, you should continue to use your current method until you have sold all shares of that particular investment.

For more information on calculating your cost basis, refer to IRS Publication 564 (Mutual Fund Distributions). It can be obtained by calling the IRS at 1-800-TAX-FORMS or you can download the publication from the IRS website at [www.irs.gov](http://www.irs.gov).

If you decide to manage your investments tax efficiently by choosing the specific-share identification method, you might also be interested in investing in mutual funds that do the same. Check out the latest Muhlenkamp Fund prospectus which now includes information on after-tax returns. See how it compares to the other mutual funds that you own or are considering owning. Although past performance does not indicate how funds will perform in the future, it will give you an idea of how fund managers consider tax implications when managing their mutual fund portfolios.

Michelle Orphall

### MUHLENKAMP FUND AVERAGE ANNUAL RETURNS AS OF 9/30/2001

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

One Year  
**-8.57%**

Three Year  
**11.33%**

Five Year  
**13.56%**

Ten Year  
**14.76%**

For more complete information about the Muhlenkamp Fund, including risks, fees and expenses, please call 1-800-860-3863 to obtain a prospectus.

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.

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