



# MuhlenkampMemorandum

## Quarterly Letter

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Key Questions	Your Response	Our Response
1. What is inflation today?		2%
2. If inflation is __%, what return do you require on a 90-day T-Bill?		2%
3. If inflation is __%, and T-Bills are __%, what return do you require on a 30-year AAA bond?		5%
4. If inflation is __%, and T-Bills are __%, and long-term AAA bonds are __%, what return do you require to put up equity money?		8%
5. Similarly, if you are a corporate treasurer and it costs you 5% to borrow money, what return do you require on that money to be worthwhile expanding your business?		8%
6. If I told you that the average company is doing 12% ROE (return on equity), what would you be willing to pay for that company?		2x book value

Our required equity return of 8% to Key Question #4 is derived as follows:  
2% inflation + 3% long-term debt premium + 3% equity return.

To pay 2x book value should *not* require paying for inflation twice, or the debt premium twice. It *would* require earning the equity premium twice, so that an 11% ROE would be worth approximately 2x book value. Paying 2x book value for 11-12% ROE should return to me the required 8% over time.

Note: Return on Equity (ROE) is just earnings divided by book value (E/B), so paying 2x book value for a 12% ROE equates to being willing to pay 16.7x earnings ( $P/E = P/B \div E/B = 2 \div 0.12 = 16.7$ ) when inflation, interest rates, and ROE are as described in the table.

Today, current inflation and interest rates approximate the numbers in the table, and the average corporate return on equity is 12%. So we should be willing to pay 2x book value or 17x earnings for companies with 12% ROE. (Actually, we like to buy cheap.) If your debt and equity premiums are similar to mine, the justifiable P/E in today's market is 17 – as it was in 1965 (which is the last time we had 2% inflation and 5% long-term interest rates). Of course, if your debt and equity requirements are different from mine, you will be willing to pay a different price for the same company.

The average P/E on the S&P 500 is significantly higher than my fair value of 17, but that is a capitalization-weighted P/E. The unweighted median P/E of the 1700 stocks covered by *Value Line* is 15, which is fair. We believe prices on average are roughly where they should be.

Some people believe that P/Es must go to 6 or 7 before the market bottoms as it did in 1982. We believe it was high inflation that drove average P/Es to 6, as explained in *Why The Market Went Down*. In 1982, inflation of 8% and long-term interest rates of 12% required equity returns of 15% and P/Es of 6x.

Today, we are recovering from a “normal cyclical recession.” We haven't made the governmental policy mistakes that would give us a depression or revived inflation. So we see no economic reason for P/Es to go to 6 or 7, and believe the secular bear market of the 1970s is not about to be repeated.

If you are wondering why the market has come down since March 2000, read my quarterly letter in Issue 63 of the *Muhlenkamp Memorandum* (also available on our website). The great stock market fad, which round-tripped in only three years, was all about hope and hype— two of the most expensive four-letter words I know. ☹

— Ron Muhlenkamp

*The comments made by Ron Muhlenkamp in this article are his opinion and are not intended to be investment advice or a forecast of future events.*

### In the News

Ron Muhlenkamp is featured in the February 2003 Money Manager Interview section of *The Wall Street Transcript*. The 8-page interview text gives a more in-depth look at Muhlenkamp & Company's view of the current investment climate, our investment process, and some of our holdings.

You'll find a copy of the transcript on our website's home page: [www.muhlenkamp.com](http://www.muhlenkamp.com).

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## ...of Personal Interest

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### *The Importance of IRA Beneficiary Designations* Part 1 of 2

In January 2003 we mailed an "IRA Designation or Change of Beneficiary Form" to all our IRA account holders and asked them to complete it and return it to us. Judging from the few responses we received, not everybody recognizes the importance of these forms.

Designating a beneficiary is your opportunity to specify what you want done with your IRA money when you die. Also, designating a beneficiary provides that beneficiary the chance to preserve the tax-deferred (or tax-free in the case of a Roth IRA) compounding of investment gains in your IRA for years after your death. Tax-deferred compounding remains a powerful advantage of the IRA, and doesn't have to end with your death.

Your beneficiary designations should be incorporated into your overall estate plan. Everyone should have some form of estate plan, regardless of your age or how much money you have, so that ALL your money goes where you want it to go. Frankly, once you start planning and adding everything up, you may be surprised to realize how much money is in your estate. If you don't provide direction on what should be done with your money after your death, then someone else will have to decide for you. That will probably be the probate courts. If you don't have a plan for what happens to your money when you die, I suggest you start making one. Designating IRA beneficiaries is a good first step.

#### How do you designate an IRA Beneficiary?

First, if you don't have a beneficiary designated, or you don't know if you do, call the mutual fund, bank or broker where you have your IRA and ask what beneficiary designation is currently on file. Make this call every couple of years to verify that the correct designation remains on file. Mutual funds, banks and brokers make changes to their systems all the time and information can be lost or misfiled,

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*"You should designate a beneficiary for your IRA so your heirs have the opportunity and the flexibility to defer paying income tax on your IRA as long as possible, which should be far longer than your own life expectancy."*

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making it difficult to retrieve when you need it. So ensure that your information is readily available and still correct.

To designate an IRA Beneficiary:

1. File a new IRA Beneficiary Designation Form if you don't have a beneficiary designated; if your original information cannot be retrieved or if something changes in your life such as a new spouse, child, or grandchild that needs to be added to the form; pertinent addresses and phone numbers change; a beneficiary dies; a minor beneficiary reaches maturity, etc.
2. If you need to file a new beneficiary designation, then request a new

IRA Beneficiary Designation Form, fill it out and sign it. MAKE A COPY FOR YOUR FILES, and send the original via registered or certified mail so you have a receipt from your IRA Custodian. When you get the receipt, staple it to your copy of the forms, and keep it in a safe place.

3. Make sure your spouse, lawyer, and executor know where you keep your copies of the beneficiary forms. (This is good advice for all your legal documents such as wills, insurance policies, etc.)

#### What happens if you don't properly designate an IRA Beneficiary?

According to the Muhlenkamp Fund IRA Disclosure Statement and Custodial Agreement, Article VIII, Section 5:

*In the event the Depositor has not designated a beneficiary... the following persons shall take in the order named: (a) The spouse of the Depositor; (b)...then to the Depositor's estate.*

This means that if you die without a designated beneficiary, we will distribute your IRA to your spouse; and if your spouse isn't living (or you don't have a spouse) then we will distribute your IRA to your estate. Unlike the Muhlenkamp Fund, many IRA Custodians (mutual funds, banks and brokers) will skip your spouse and distribute the IRA directly to the Depositor's estate if there is no designated beneficiary. The only way to know for sure is to read the IRA Custodial Agreement you receive from your IRA Custodian.

#### What happens if your IRA is distributed to your estate?

Your estate will probably have to pay income tax on the taxable portion of your IRA before any money can be distributed to your heirs. This means your heirs will probably pay income taxes earlier than they would if you had

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