

MuhlenkampMemorandum

Issue 67

Published Third Quarter

July 2003


On June 30, 2003 the Net Asset Value of the Muhlenkamp Fund was \$52.01, up 21.26% year to date.
Click here to see the current Net Asset Value of the Muhlenkamp Fund.

Quarterly Letter

Folks, our patience (yours and mine) is paying off.

Since it became clear that the war in Iraq would not be a disaster, the public has become a bit more confident on the U.S. economy and a bit more willing to invest in that economy.

As we stated in recent newsletters, we continue to believe that the economy is recovering from a "normal cyclical recession," albeit slowly. We believe the strength and timing of the recovery have been delayed by the hangover from the stock market fad (bubble) and by the events of 9/11/01 and the litany of concerns that pummeled the American psyche since, culminating with the war in Iraq.

We believe (and pray) that the litany of concerns is now over and that the bad news going forward will be at a more normal pace. We believe that the nature and timing of the recent cuts in federal income tax rates will strengthen the economic recovery. We've been investing your money (and ours) in good companies that are likely to benefit as the economy strengthens and are reasonably priced, in our opinion. This has been a gradual process, which we expect to continue. The key is not to be distracted by the daily market volatility, which we also expect to continue. Patience remains key. 

— Ron Muhlenkamp

Announcements

San Francisco Money Show

October 16-18, 2003

San Francisco Marriott, San Francisco, CA
with speakers Ron Muhlenkamp & Anthony Muhlenkamp
Exhibit booth #408

NAPFA Northeast/Mid-Atlantic Conference

October 22-25, 2003

Philadelphia Marriott Downtown, Philadelphia, PA
with speaker Anthony Muhlenkamp

Annual Winter Investment Seminar

December 4, 2003

Four Points Sheraton Pittsburgh North, Mars, PA
with Ron Muhlenkamp
2:00 p.m. and 7:00 p.m.

For more information, or to register for an event, call us toll free at (877) 935-5520 extension 4, visit the **Contact Us** section of our web site, or click here to send us e-mail.

Investment Seminar Follow-up

During the month of June, Muhlenkamp & Company hosted investment seminars in Pittsburgh, Los Angeles and San Diego. Ron Muhlenkamp delivered the same presentation, *Why the Market Went Down*, on each occasion. To ensure all shareholders and clients have an opportunity to benefit from what took place, we are making available a CD-ROM containing the slides and commentary, along with audience-asked questions and our responses. Contact Shareholders Services at (877)935-5520 extension 4 for your copy of the CD and/or copy of the original 1979 essay. These materials are also available on our web site: www.muhlenkamp.com.

Reminder: Annual IRA Maintenance Fee

The fee is \$12.50 per account (capped at \$25.00 per Social Security number) and is due by October 15th. If you would like to pay the fee by check rather than having it deducted from your account, please make the check payable to US Bancorp and return it to:

Muhlenkamp Fund

US Bancorp Fund Services, LLC

PO Box 701

Milwaukee WI 53201-0701



Muhlenkamp & Company, Inc.
Intelligent Investment Management

MuhlenkampMemorandum

Investor Education

Capital Gains and Income

There are two events that can trigger a tax liability for shareholders of a mutual fund: when the fund manager distributes ordinary dividends and capital gains to shareholders; and when the shareholder initiates a redemption, thereby realizing a capital gain or loss.

We prefer the latter, as it is consistent with the Muhlenkamp Fund's objective to maximize total return. The Fund Manager's preference is to allow shareholders to initiate their own taxable events, permitting them to pay taxes or to take a loss when it is most fiscally suitable (a particular concern for shareholders with non-retirement accounts). For instance, our Manager tries to offset gains with losses when

"... our Fund Manager ... favors unrealized appreciation, as the deferment of taxes is still a goal."

selling securities that are held in the Fund, while trying to maximize unrealized appreciation. With a goal of creating value on an after-tax basis, the Manager monitors several issues, including economic trends and tax regulation, to determine the appropriateness of investing for dividends and interest.

To understand how dividends and interest were handled in the past, refer to our Statement of Operations found in our semiannual and annual reports. The Statement of Operations is effectively the Fund's income statement and reveals details on how the Manager has administered income and capital gains throughout the year. In the December 2002 Annual Report, this statement can be found on page 6. *

Under the heading "Investment Income," notice that the Fund took in \$6,660,626 in dividend and interest income combined for 2002. This income is reduced by \$7,279,585 in expenses that were incurred for the year, resulting in a \$618,959 net investment loss. If there had been a net gain, the Fund would have been required to make a distribution to shareholders thereby creating a tax liability. Shareholders would have owed ordinary income taxes, which could have been up to 39 percent at the Federal level depending on their marginal tax bracket. Moreover, taxes would have been owed despite the fact that 2002 was a down year.

In contrast, long-term capital gains (assets held one year or longer) were taxed at a maximum rate of 20 percent. It was advantageous to obtain the majority of earnings in the form of long-term capital gains. Shareholders realize capital gains two ways:

- First, if the shareholder sells the Fund at a net gain and
- Second, if there is an overall net gain on securities that are sold within the year, the Fund Manager must make an end-of-year distribution.

The timing of capital gains distributions made by the Manager may not be financially practical for Fund owners, since it creates a tax obligation. Therefore, in order to reduce untimely tax consequences to shareholders, the Manager tries to defer capital gains distributions.

With the recent passing of President Bush's Tax Plan, the maximum tax implication of realizing long-term capital gains and receiving dividends is now equal at 15 percent. Interest is still taxed

at ordinary income rates. From a tax perspective, our Fund Manager still favors unrealized appreciation, as the deferment of taxes is still a goal. Second to unrealized appreciation, there is now a bias towards investing for dividends, given the choice between investing for dividends and investing for interest (assuming equal returns). With a focus of creating value on an after-tax basis in mind, the Manager may periodically shift the Fund's emphasis between investing for dividends, interest, and unrealized appreciation depending on the current investment environment and changes in tax laws.

In light of recent legislative changes, it remains our goal to grow our shareholders' assets through unrealized capital appreciation, by increasing the Fund's Net Asset Value (NAV). This is achieved when there is a net increase in the prices of securities held in the Fund. By focusing on increasing unrealized capital gains, our shareholders are placed in control of the timing of taxes owed on gains and the realization of losses. ☐

— Tori Soudan

Tori Soudan works in Shareholder Services. She joined Muhlenkamp and Company Inc. in April 2002.

** To request a copy of our 2002 Annual Report, contact our Shareholder Services Department at (877) 935-5520 extension 4 or you may download a copy from our website: www.muhlenkamp.com.*

For additional information on the tax treatment of distributions and redemptions, refer to IRS Publication 564. The information above should not be considered tax advice. Please consult a tax advisor for your particular situation.

MuhlenkampMemorandum

...of Personal Interest

The Importance of IRA Beneficiary Designations Part II

In Memorandum 66, we began our discussion of "The Importance of IRA Beneficiary Designations". We conclude that discussion in this edition of our quarterly newsletter.

What IRA Beneficiary Designations implement the estate plan?

Continuing the example: my wife and I have designated each other as primary beneficiary for each of our six IRAs (two Traditional, two Roth, one SEP and one SIMPLE IRA) and my retirement plans (one Pension Plan and one Profit Sharing Plan). We also designated our daughter contingent beneficiary for each of these accounts but, because she is a minor, we have asked my brother to be the custodian for her Inherited IRA account. The contingent beneficiary designation reads "Brother Muhlenkamp custodian for Daughter Muhlenkamp under Pennsylvania UTMA". If I die while our daughter is a minor my wife will:

- Rollover my Traditional IRA, Pension and Profit Sharing Plans to her Traditional IRA and my Roth IRA to her Roth IRA.
- File a new Beneficiary Designation Form, naming our daughter the primary beneficiary and nieces and nephews the contingent beneficiaries, using the same designation as we used when we named my daughter the contingent beneficiary.

If my wife also dies while our daughter is still a minor, then my brother (who is our executor and trustee/custodian of our daughter's accounts) will:

- Open an Inherited IRA for my daughter and transfer my wife's IRA (which includes the rollover from my IRA, Pension and Profit Sharing Plans) to my daughter's Inherited IRA.

"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."

- Open an Inherited Roth IRA and transfer my wife's Roth IRA to my daughter's Inherited Roth IRA.

The Inherited IRAs will be registered as "Brother Muhlenkamp custodian for Daughter Muhlenkamp under Pennsylvania UTMA as beneficiary of Wife Muhlenkamp IRA (or Roth IRA). Brother Muhlenkamp will sign the application, but he will use Daughter Muhlenkamp's Social Security Number for the account.

What about distributions and income taxes?

So far, no income taxes are due on the balance in our IRAs. By December 31 of the year following my death, and for each year after, my brother has to take

a Required Minimum Distribution (RMD) from the Inherited IRAs and either spend the money on my daughter or deposit the distribution proceeds into her non-IRA UTMA account. That distribution will be taxed in each year that it is received (the distribution from the Inherited Roth IRA is still exempt from income tax). The amount of the distribution is calculated by dividing the market value of the account as of December 31 of the prior year by the life expectancy of my daughter for that calendar year. As she gets older, the distributions get larger and the taxes are higher, but she isn't forced to take out more than the required minimum. My brother can take out more than the minimum if he needs to, but my preference is for him to spend the testamentary trust money first, only taking the Required Minimum Distributions from the Inherited IRA. However, he has the discretion to pull money from wherever he can and needs to, using his best judgment given the tax laws, investment climate, and my daughter's personal situation at the time.

Who controls the Inherited IRAs?

When my daughter turns 18, my brother is relieved of his custodial duties for the Inherited IRAs and my daughter takes control of the Inherited IRAs, renaming them the "Daughter Muhlenkamp beneficiary of the Wife Muhlenkamp IRA" but keeping her Social Security Number on the account. She can then take as much money out of her Inherited IRA as she wants. For many people, this is a scary idea and one reason they shy away from naming minor beneficiaries of IRAs, even using the UGMA. My wife and I have decided that we would rather my daughter have the money than the U.S. Government. She's likely to be more responsible with it than they are (no matter how irresponsible she turns out to be). This is why my brother has discretion over how much to take out of the Inherited IRAs before she turns 18. He may decide

continued on next page

MuhlenkampMemorandum

to empty out her Inherited IRAs before using funds from the trust and spend the money on her if he doesn't think she will use it wisely when she turns 18.

I don't intend to imply that everyone should follow the plan I outlined above. I am trying to illustrate how the designated beneficiary for your IRA can and should be incorporated into your own estate plan. Start by making sure you have designated beneficiaries on file, then ask what happens to your IRA if you die, if your spouse dies, if you have more kids, etc. Who gets the money? Will they have to pay income tax? Will they have to pay estate tax? How much? Why? Can you avoid, defer or eliminate the tax? As you ask these questions, write down your answers and make the necessary changes to accomplish your goals. Do some reading, consult some experts, and every couple years check to make sure that the situation, the laws, or the taxes haven't changed and rendered your earlier decisions obsolete, or even dangerous. ☹

— Anthony Muhlenkamp

The above discussion is based on Anthony Muhlenkamp's specific situation and investment objectives. It is not intended to be investment advice or estate planning advice. Please consult your investment professional and/or tax adviser for advice concerning your particular circumstances and for any updates to the tax law.

For more information about the Muhlenkamp Fund, including risks, fees and expenses, please call (800) 860-3863 to obtain a prospectus. Please read the prospectus carefully before you invest. Mutual fund investing involves risk; principal loss is possible.

The Muhlenkamp Fund is distributed by Quasar Distributors, LLC.

Muhlenkamp Fund Average Annual Returns As Of 06/30/03

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

	Year to Date	Past Year	Past 3 Years	Past 5 Years	Past 10 Years
Return Before Taxes	21.26%	2.36%	5.63%	5.60%	13.19%
Return After Taxes on Distributions*	21.26%	2.36%	5.28%	5.29%	12.83%
Return After Taxes on Distributions and Sale of Fund Shares*	13.82%	1.53%	4.71%	4.71%	11.70%

**After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on your situation and may differ from those shown. Furthermore, the after-tax returns shown are not relevant to those who hold their shares through tax-deferred arrangements such as 401(k) plans or IRAs. Remember, the Fund's past performance, before and after taxes, is not necessarily an indication of how the Fund will perform in the future. Past performance does not guarantee future results.*

For more complete information about the Muhlenkamp Fund, including risks, fees and expenses, please call (800) 860-3863 to obtain a prospectus. Please read the prospectus carefully before you invest. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. A program of regular investing cannot assure a profit or protect against a loss in a declining market.

The Muhlenkamp Fund is distributed by Quasar Distributors, LLC.

Footnotes

¹ See <http://fairmark.com/custacct/cust101.htm> for a brief overview of UGMA and UTMA custodial accounts.

Resources

1. The current "IRA Disclosure Statement and Custodial Agreement" from your IRA Custodians.
2. IRS Publication 590, *Individual Retirement Arrangements*, Department of the Treasury, Internal Revenue Service, 2002. <http://www.irs.gov/formspubs/index.html>.
3. Natalie Choate, *Life and Death Planning for Retirement Benefits*, Fifth Edition, 2003. <http://www.ataxplan.com/index.html>.
4. James Lange, "MRD Defenses", "Lange's Cascading Beneficiaries Plan", <http://www.rothira-advisor.com/index.htm>. (The "Cascading Beneficiaries" article is very interesting, but be careful when using a trust as a beneficiary. It is easy to foul up.)
5. Donald R. Levy, Steven G. Lockwood, and Gary S. Lesser, *Individual Retirement Account Answer Book, Ninth Edition*, 2003. <http://www.aspenpublishers.com>

InvestmentInsights

Muhlenkamp Memorandum Issue 67

Published Third Quarter

July 2003

Tax Cuts and Their Effect on the Economy

Understanding how people work

My observation is that there are five speeds at which people work:

- Neutral: reward is not worth the effort, so why put in the overtime/extra effort?
- 1st gear: "unwilling labor" — individuals work because they are forced.
- 2nd gear: public sector jobs — individuals work with a sense of security, yet know there are few opportunities for advancement.
- 3rd gear: private business — workers are hired, rewarded, or fired for their value and productivity.
- 4th gear: entrepreneurs — individuals work to transform dreams into reality. They are industrious and lead by example. Through this creative process, entrepreneurs provide the largest source of job growth.

High taxes have two big negative effects on productivity: encouraging those who are working in 4th gear to switch to neutral because the incremental after-tax income is not worth the effort; and encouraging people to work in an unregulated, illegal, underground economy.

If the goal of government is to grow the economy and increase the wealth of its citizens, motivating people to work at their highest gear possible is key.

What does the evidence suggest?

The UK Turnaround

A decade ago the unemployment rates in the United Kingdom and in the Euro-zone were equal at the rate of 10%. No more. Present day: UK = 3.1%; Euro-zone = 8.7%. In addition, the standard of living in the UK is rising faster than that of its neighbors. Since 1991, real per capita incomes have risen 29% versus 20% in the Euro-zone.¹ Why?

The UK has persistently pursued pro-growth and pro-competitive economic reforms with respect to budget restraint, privatization, and pension reforms. Further, liberalization of a host of rules and regulations in the labor markets, foreign trade, etc., have yielded superior job conditions and prospects. The Euro-zone is slower to adopt the reforms that the realities of global competition increasingly require. With what we see, they are likely to stay that way.



Kennedy's Cuts

In 1962, President Kennedy sponsored legislation to cut income tax rates by 20% and corporate taxes by 10% "to increase incentives and the availability of investment capital." After these tax cuts became law, the economic growth rate expanded from 4.3% to

6.6% and the economy created more than 1 million jobs over the following four years. Kennedy's explanation?

Our practical problem is not between a tax-cut deficit and a budgetary surplus. It is between two kinds of deficits: a chronic deficit of inertia, as the unwanted result of inadequate revenues and a restricted economy, or a temporary deficit of transition, resulting from a tax cut designed to boost the economy, increase tax revenue and achieve – and what I believe can be done – a future budget surplus.²

Past Tax cuts

There were three times in the last 100 years when marginal tax rates were dropped significantly: in the beginning of the 1920s (Coolidge), the 1960s (Kennedy), and the 1980s (Reagan). After the drops in tax rates, "real" (inflation adjusted) income for taxpayers grew at a 6%, 5% and 4% rate respectively. During these periods real tax revenues climbed 33%, 33% and 28% respectively. All three times



Muhlenkamp & Company, Inc.
Intelligent Investment Management

InvestmentInsights

demonstrate that a decrease in tax rates leads to an increase in “real” incomes *and* a real increase in tax revenues.

Who will benefit the most from a tax cut?

According to *Webster’s*, “tax base” is defined as “the wealth within a jurisdiction that is liable to taxation.”

In 1979 the top 20% of tax filers paid 67% of all income taxes. In 1999 the top 20% paid 79% of all income taxes; the top 40% paid 94% of all income taxes. That leaves the bottom 60% paying only 6% of income taxes. If there were any cut in income taxes (and the top 40% are the ones paying the lion’s share), by definition, the majority of the tax cut would go to the top 40%.

Yes, the remaining 60% will see a reduction of taxes through a decrease in tax rates, child tax credit, and elimination of the marriage penalty, but the greater benefit will be realized by the 40% who pay 94% of all income taxes.

“Do you want to live in a society that encourages people to dream, create and contribute — or one that encourages people to put in their time and just get by?”

Are taxes too high?

From 1998 to 2001, tax revenues as a percentage of GDP (Gross Domestic Product) ranged from 19.9% to 20.8%. This is the highest tax burden for four collective years in our history. Compare this against the following 2-year periods:

- WWII (1944-45) — 20% tax burden
- Vietnam War (1970-71) — 19.5% tax burden and
- A recession (1981-82) — 19% tax burden.

At our investment seminars we regularly ask: “Suppose you work a 5-day work week. All wages earned on Monday are taxed at 10%; all wages earned on Tuesday are taxed at 20%; all wages earned on Wednesday are taxed at 30%; all wages earned on Thursday are taxed at 40%; all wages earned on Friday are taxed at 50%. How many of you would work on Friday?” In the past six years exactly 8 hands have gone up — among several thousand people.

Consider the implications. What if the top wage earners decide not to work? With the top 40% of income tax payers paying 94% of all income taxes, does it not make sense to encourage your top taxpayers to work more? If you had a partner who paid you 35% of all he/she earned, wouldn’t your best interest be in having him/her earn as much as possible? Might you even lower the tax rate to keep them working fulltime?

Tax cuts, where will the money go?

Regardless of your tax bracket, there are four possibilities for tax cut money. The first possibility is to spend it. This directly helps the economy. The second and third possibilities are to pay down debt or save it. These actions free up capital for banks to loan, so businesses or other people can spend. Paying down debt or saving the money would also help neutralize upward pressure on interest rates due to any increase in government borrowing.

The last possibility for tax cut money is investing for the future productivity growth. This takes the form of investing in companies through IPOs, bonds, stocks, start-ups, etc. This type of investing leads to two major

employment benefits: investing in new jobs directly and investing in capital improvements. Note that investors will do this to the extent that they believe the returns on capital are greater than that available on treasury bonds.

So the basic choice is *spend* now for a bolstered economy or *invest* now to increase future economic growth. The key is realizing that the money does not disappear or just sit: people will spend it; the bank will loan it to someone who will spend it; or it gets invested into more, higher paying jobs.

What do intuition and psychology have to tell us?

People feel that they have more opportunity to become rich in the U.S. than in any other country in the world. In our capitalistic democracy, the more productive you are the more you tend to get paid.

Do you want a tax system that encourages people to be productive or one that promotes complacency (Euro-zone)? Without proper incentives, there are few reasons to work harder or smarter. Do you want to live in a society that encourages people to dream, create and contribute — or one that encourages people to put in their time and just get by? ☒

— Ken Dupre, CFA
Investment Analyst

Footnotes

¹ Straszheim Global Advisors

² *Investors Business Daily*, June 6, 2003