

# MuhlenkampMemorandum

Issue 74

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On March 31, 2005, the Net Asset Value of the Muhlenkamp Fund was \$76.94, down \$2.03 year-to-date.  
*Click here to see the current Net Asset Value of the Muhlenkamp Fund.*

## Quarterly Letter

The economy continues to expand.

Inflation remains under control at about 2%.


The Fed continues to raise short-term interest rates toward the 3%+ range, which we consider fair. The long-term treasury rates (the 30-year) are just below the 5% range, which we consider fair.

We believe stocks are priced to return 8%-9%, which we consider fair.

Folks, fair is fair.

Our companies continue to do well.

Meanwhile, a whole lot of people, with a lot of money, are watching and speculating on the day-to-day news and rumors so the market will remain quite volatile.

Welcome to "normal." 

— 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. Copies of past newsletters are available on our website at [www.muhlenkamp.com](http://www.muhlenkamp.com).*

## Announcements

### Social Security: Behind the Numbers

Ron's essays on Social Security, published in last quarter's *Muhlenkamp Memorandum*, prompted a strong response from readers. Visit our website at [www.muhlenkamp.com](http://www.muhlenkamp.com) for a sampling of comments received via email, along with Ron's response. While there, join in the debate!

## Mark Your Calendars

### Las Vegas Money Show

May 9-12, 2005  
Paris and Bally's Resorts

*Come and visit us at exhibit booth #411*

### Money Show Workshops

Tony Muhlenkamp  
Director, Muhlenkamp & Company, Inc.  
Tuesday, May 10  
3:15 p.m. – 4:00 p.m.  
"Back to Basics"

### And

Thursday, May 12  
7:45 a.m. – 8:30 a.m.  
"How to Choose a Money Manager"

Ken Dupre, CFA  
Investment Analyst, Muhlenkamp & Company, Inc.  
Wednesday, May 11  
10:30 a.m. – 11:15 a.m.  
"Optimizing Investment Performance: Helping Investors to Become Better Investors"

### Muhlenkamp & Company Semi-Annual Seminar

June 2, 2005  
Click here to join us on-line via a live webcast

### Or

Click here to join us on-site at the Heinz History Center  
Senator John Heinz Pittsburgh Regional History Center  
Sebastian Mueller Education Center (5th floor)  
1212 Smallman Street  
Pittsburgh, PA 15222  
Sessions at 2:00 p.m. and 7:00 p.m.

To RSVP for either the on-site or on-line offering, please call (877) 935-5520 extension 4, or visit our website at [www.muhlenkamp.com](http://www.muhlenkamp.com)

### FPA Retreat

May 14-17, 2005  
Westin Innisbrook, FL

### NAPFA Annual Conference

May 18-23, 2005  
Tampa, FL

### Morningstar Annual Conference

June 20-22, 2005  
Hyatt Regency, Chicago, IL

*Come and visit us at exhibit booth #43*



**Muhlenkamp & Company, Inc.**  
Intelligent Investment Management

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## Optimizing Investment Performance: Helping Investors to Become Better Investors

Do you need to be a better investor?

- Does your portfolio consistently underperform?
- Was the bear market more painful than you can stand?
- Do you invest emotionally?

If you answered yes to any of these questions, it's probably because you have a tough time distinguishing between emotional and intelligent investing. *Webster's Dictionary* defines these terms as:

**Emotional** – Markedly aroused or agitated in feelings or sensibilities.

**Intelligent** – Reflecting good judgment or sound thought.

One of the best ways to improve investor performance is to distinguish between emotional and intelligent investing. While this may seem obvious, investing emotionally has consistently been the costliest mistake made by investors. (The irony is most investors would choose steady and boring over inconsistent and exciting when it comes to investing.)

So why *do* people invest emotionally? I think it's because the basic blocking and tackling (the homework) of investing lacks excitement. People enjoy bragging about their successes and showing family and friends how smart they are. Often times, they want to feel like they are contributing, so they micro-manage the professional they hired. The key is resisting our natural tendency to invest emotionally. To do this effectively the investor needs to follow three simple steps:

1. Understand your emotions;
2. Practice investor honesty; and
3. Exercise discipline.

### Understanding Emotions

Information sources can affect your emotions. Remember, television and the print media are in the business of selling advertising. The best way to promote viewership and readership is to appeal to emotions like hype, hope, greed and fear.

Think back to the highs of the "dotcom" and "telecom" bubble in 1999 and early 2000. Do you remember these headlines?

*It's a new economy*

*The internet is exploding*

*Don't worry about price, just buy great companies!*

*The DJIA is going to 30,000*

During the market bottom in early 2003 media stories focused on:

*Rampant terrorism*

*Shock and awe in Iraq*

*Record highs for unemployment*

*The DJIA is going to 5,000*

Members of the media know that the more dire or euphoric the story, the more people are willing to listen.

So I ask: "Did the media help you invest emotionally or intelligently?"

Let me personalize this for you. What worried you during the market high?

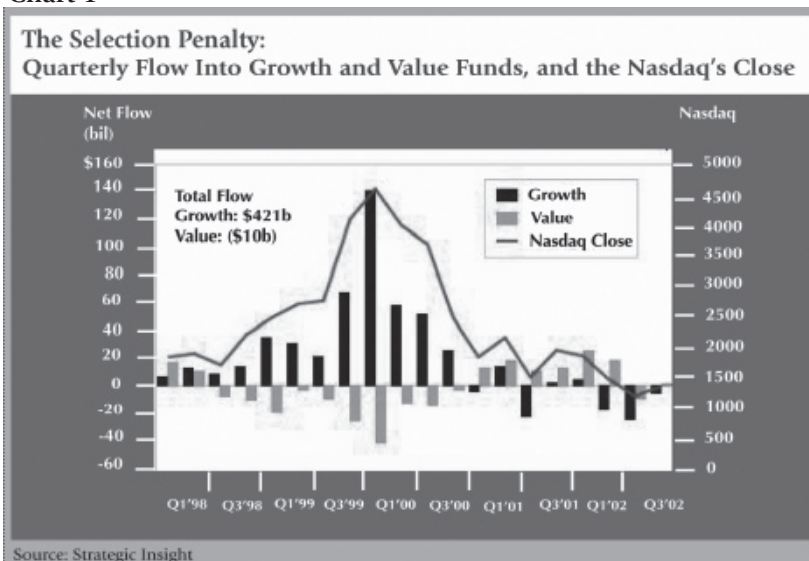
One of the most common responses is "keeping up with your neighbor."

During market lows, the most common response is "losing your shirt." Doesn't "keeping up with your neighbor" sound greedy? Doesn't "losing your shirt" sound fearful? If you want to decrease your investment emotions, avoid mainstream media.

Now let's take a look at the anecdotal evidence. A study conducted by Dalbar Inc., a Boston research firm, found that from 1984 to 2002 the S&P 500 averaged 12% annual returns and the average equity fund investor had 3% annual returns. The burning question is:

**How did the S&P 500 generate 10% annual returns, while the average equity fund investor realizes only 3% annual returns?**

Chart 1



Reprinted with permission from Strategic Insight. Past performance is no guarantee of future results. Index performance is not indicative of fund performance.

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The answer is poor timing and selection caused by investing emotionally!

To better understand how poor timing reduces investment returns, the preceding graph speaks volumes:

In Chart 1, according to *Strategic Insight*, a New York City research firm, leading up to the peak of the NASDAQ in March 2000 over \$200 billion went into growth funds (the “new economy” stocks), while more than \$60 billion was redeemed from value funds (the “old economy” stocks). If we fast-forward to the market low, people were selling growth and buying value. The message is clear: investors bought greed and sold fear. Investors not only had bad timing as demonstrated by investing in the market at the wrong time... investors also had poor selection by putting their money in the wrong stocks at the wrong time! They bought expensive new economy stocks and sold discounted old economy stocks at the high and were selling both at the low.

If investors understood basic financial valuations, they would have avoided this very expensive lesson. In my opinion, the main reason investors fail to follow these simple steps is because few investors are honest with themselves.

## Practicing Investor Honesty

I define “investor honesty” as acknowledging one’s shortcomings in knowledge, performance and effort.

*The easiest thing of all is to deceive one’s self; for what a man wishes he generally believes to be true. — Demosthenes*

Awareness of your shortcomings should pave the way to better performance. Most investors want high returns, but are unwilling to do basic financial

homework. Following is an “investor honesty” quiz on the fundamentals of finance:

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*“...the message is clear: investors bought greed and sold fear...”*

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- What’s your definition for risk?
- What does ROE stand for, how is it calculated, and what does it mean?
- How much time do you spend to be a better investor?

## Investor Honesty Quiz: Risk

Wall Street defines risk as *volatility*. Most investors define risk as *probability of loss*. At Muhlenkamp & Company, we define risk as the *probability of losing purchasing power*. The key is adjusting expected returns for taxes and inflation!

Table 1 <sup>1</sup>

Available Returns (%)			
	Nominal	After-Tax	Real After-Tax
Short-Term Debt	2	1.3	-.7
Long-Term Debt	5	3.2	1.2
Equity	8	6.8	4.8

*Source: Muhlenkamp & Company, Inc. Past performance is no guarantee of future results. Index performance is not indicative of fund performance.*

Table 1 shows the three basic investment options investors have and their current expected returns. (Short-term debt is cash and money market accounts, long-term debt is corporate bonds and equity is stocks.)

When you look at your investment options on an after-tax, after-inflation

basis, investors will find their only real investment option for long-term growth is stocks. Cash will lose you approximately 1% a year in purchasing power. Bonds will generate approximately 1%. Stocks are expected to grow your purchasing power by approximately 5% a year.

## Investor Honesty Quiz: ROE

The second question on our investor honesty quiz is about ROE. ROE (return on shareholder equity) is a fundamental investment term that few investors really understand. It is calculated by taking the earnings a company has and dividing by the shareholder equity (book value). Thus, ROE is the return a company earns from its book value.

As an analyst, I use ROE as a proxy for returns on future projects in which a company invests. If management has the best interest of shareholders in

mind, they use this number as their minimum hurdle rate for investing. If they have no projects that meet this criterion, they should invest in themselves by buying back company stock. As such, ROE is a proxy for future earnings growth.

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## **Investor Honesty Quiz: Time**

How much time do you spend to be a better investor? This question begs referring to *Webster's Dictionary* to define gambling vs. investing.

**Gamble** – To take a chance.

**Invest** – To commit (money) in order to earn a financial return.

If your goal is to invest instead of gambling with chance, I recommend you take the time to pick high quality managers, learn basic fundamental analysis and resist the temptation to invest emotionally. To do this takes a disciplined approach.


## **Exercising Discipline**

The key to being more disciplined is keeping a financial journal. I recommend just two hours every quarter; a half-hour every quarter tracking performance, a half-hour every quarter writing your reasons for

investments and your current thoughts on the investment climate, and one hour every quarter writing down investment lessons learned.

What will a financial journal do for you? It will help you identify and be more aware of your emotions. It will help protect you from selective memory by tracking your actual performance — and increase the rate of your investment learning.

To conclude, if you want to be an intelligent investor, remember:

- Markets are rational in the long term — so, buy and hold high-quality managers.
- Adjust expected returns for taxes and inflation.
- Be honest and disciplined. Learn and *do* the basic financial homework! 

*This article was written by Ken Dupre, an equity analyst at Muhlenkamp & Company.*

*Ken Dupre's opinions are subject to change, cannot be guaranteed and should not be considered investment advice.*

*The Dow Jones Industrial Average (DJIA) is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividends.*

*The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded only over-the-counter and not on an exchange. You cannot invest directly in an index.*

## <sup>1</sup> Table 1 - Available Returns (Percentage)

1. Nominal rates for short- and long-term debt were found at [www.federalreserve.gov](http://www.federalreserve.gov):

- Short-Term (1-month Treasury Bill) quoted at 2.05% in Jan '05; \*
- Long-Term (30-year Treasury Bond) quoted at 5.12% in Jan '05.\*

\*Rounding

2. The after-tax returns for short- and long-term debt are based on interest gains being taxed at 35%.

3. The real, after-tax returns assume inflation at the time of 2.0%, which can be corroborated at [www.bea.gov](http://www.bea.gov).

4. The nominal return for equities at 8% is founded in an essay published by Ron Muhlenkamp, *How Much Money Are You Willing to Lose for a Theory?*

5. The after-tax returns for equities are based on a long-term capital gains tax rate of 15%.

6. The real, after-tax returns for equities assume inflation at the time of 2.0%, which can be corroborated at [www.bea.gov](http://www.bea.gov).

Quantitative Analysis of Investor Behavior (QAIB) uses data from the Investment Company Institute (ICI), Standard & Poor's and Barclays Capital Index Products to compare mutual fund investor behavior with an appropriate set of benchmarks. Covering the period from 1984 to 2002, the study utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. These behaviors are then used to simulate the "average investor." Based on this behavior, the analysis calculates the "average investor return" on both a cumulative and annualized basis. These results are then compared to respective indices. The average investor refers to the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor. This approach allows the entire universe of mutual fund investors to be used as the statistical sample, ensuring ultimate reliability. For Average Investor Return Performance, QAIB calculates investor returns as the change in assets, after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms (above) two percentages are calculated:

- Total investor return rate for the period
- Annualized investor return rate

Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges for the period. Annualized return rate is calculated as the uniform rate that can be compounded annually for the period under consideration to produce the investor return dollars.

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## Average Annual Returns as of 3/31/05\*\*\*

	Year to Date	One Year	Past 3 Years	Past 5 Years	Past 10 Years	Since Inception 11/1/1988
<b>Muhlenkamp Fund</b>						
Return Before Taxes	-2.57%	14.91%	10.66%	11.74%	17.34%	14.62%
Return After Taxes on Distributions*	-2.57%	14.88%	10.65%	11.51%	17.06%	14.25%
Return After Taxes on Distributions and Sale of Fund Shares*	-1.67%	9.72%	9.19%	10.16%	15.66%	13.31%
S&P 500**	-2.15%	6.69%	2.75%	-3.16%	10.79%	11.68%

*Performance data quoted represents past performance and 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. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be found on our website at [www.muhlenkamp.com](http://www.muhlenkamp.com).*

**\*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.**

**\*\*The S&P 500 is a widely recognized, unmanaged index of common stock prices. The figures for the S&P 500 reflect all dividends reinvested but do not reflect any deductions for fees, expenses or taxes.**

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

**Information contained in this newsletter does not constitute an offer to sell, or a solicitation of an offer to buy shares of the Muhlenkamp Fund, nor shall any shares be offered or sold to any person in any jurisdiction in which such offer, solicitation, purchase, or sale would be unlawful under the securities laws of such jurisdiction.**

**Mutual fund investing involves risk. Principal loss is possible.**

*The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The Prospectus contains this and other important information about the investment company, and it may be obtained by calling (800) 860-3863, or visiting [www.muhlenkamp.com](http://www.muhlenkamp.com). Read it carefully before investing.*

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