



MUHLENKAMP AND COMPANY, INC.

INTELLIGENT INVESTMENT MANAGEMENT

12300 Perry Highway • Wexford, PA 15090 • (724) 935-5520 • (800) 860-3863

e-mail: [click here](#) home page: www.muhlenkamp.com

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Special Interim Edition

Muhlenkamp mid Company is publishing this special edition of the Memorandum to point out some of the pitfalls in the current investment environment. Your regular quarterly edition will arrive as usual in July.

THERE'S A TIME BOMB SET TO GO OFF - AGAIN

In 1981 we warned our clients about a time bomb that was set to go off which would destroy their incomes. We see a need to repeat that warning today.

Suppose in 1967 you were a 52-year-old widow attempting to live off your investment income. Your house was paid for and you had \$200,000 in investable assets. At the then prevailing interest rate of 4.5%, these assets generated \$9,000 per year. In 1967 the dollar was worth 3.72 times what it is today, so you were able to live rather nicely on this income ($3.72 \times \$9,000$ equals \$33,500 in today's dollars). Then came inflation, and with it higher interest rates. By 1981, inflation was 10% and interest rates were 14%. You will notice from the table below that because interest rates rose more than the Consumer Price Index during this period, your "income" more than kept pace with the CPI; the purchasing power of your "income" went up. You were feeling pretty comfortable - and the time bomb was set to go off.

We said in 1981 that one of two things could happen:

1) The time bomb could go off slowly. Inflation could stay at 10% and interest rates could stay at 14%. But each year your "income" would lose 10% of its purchasing power, thereby cutting it in half in only 7 years.

2) The time bomb could go off quickly. Inflation and interest rates could decline significantly. "Income" would drop with interest rates. The result is a rapid loss of purchasing power of your income.

We all know that the time bomb went off quickly. As inflation fell, so did interest rates. Fourteen percent CDs are no more. People living off the "income" from their assets have seen their income and their purchasing power shrink rapidly since 1981. They are now scrambling for the highest payouts available.

Today, we are set up to repeat the process. Those assuming that interest rates will stay at 8% are implicitly assuming inflation of 5% - in which case their purchasing power will shrink 27% in only 5 years. If in fact we get inflation down to 1 or 2%, interest rates of 5% are much more likely and "income" will be cut rapidly once again.

These scenarios are shown in the table as 1994A and 1994B. One of them will happen; it's already built in.

In a period of only 27 years, people will have lost 2/3 of the purchasing power of their "income". They've done this while following the rule: "Spend only the income don't touch the principal" which was designed to protect assets and avoid profligacy. They've been snookered because they think in terms of principal and income, rather than purchasing power. When inflation was 10%, the principal had to grow by 10% per year merely to offset inflation. Only the additional 4% interest was spendable if the purchasing power of the principal was to be maintained. Today, at 5% inflation, the principal must grow at 5% just to offset inflation. Whether in the form of income or appreciation, only those returns in excess of inflation represent gains in purchasing power.

The crime of inflation is that it depletes the value (purchasing power) of money, both assets and "income". Our federal government sets standards for weights and measures so that no merchant can cheat you on a pound of bread or a gallon of gas, but it sets no standard on the purchasing power of money, allowing itself to cheat you out of the value of your savings. Contrary to popular opinion, only governments can create inflation because only governments can print money.

The irony of the above example is that the very rules which people were taught in order to be conservative have become a trap. Today, people are trying to maintain their "income" by buying investments with high payouts. Often these payouts are greater than prevailing interest rates because part of each payout is principal.

**THERE'S A TIME BOMB SET TO GO OFF – AGAIN
(continued)**

People buying Ginnie Maes and high-coupon government bonds are getting some of their principal back with each "interest" payment. They rapidly deplete their assets; yet many are unaware of it until maturity, when they receive less than their initial investment.

"Spend your income, don't touch the principal" is a superb discipline when inflation is zero. But it becomes a snare when inflation soars. People really believed that if they didn't touch their principal, it would stay intact. So they invested only for "income". Only now are they discovering that investing for income can destroy the purchasing power of assets. And without assets, there is no income.

Effect of "Spend Income - Don't Touch Principal"

Age	Year	Principal	Interest Rate	Income	Inflation	CPI	Value of \$	Purchsing Power of Income
52	1967	\$200,000	4.5%	\$ 9,000	1%	100	3.72	\$33,500
66	1981	\$200,000	14%	\$28,000	10%	281	1.32	\$37,000
74	1989	\$200,000	8%	\$16,000	5%	372	1.00	\$16,000
79	1994 a	\$200,000	8%	\$16,000	5%	475	.78	\$12,500
	1994 b	\$200,000	5%	\$10,000	1%	390	.95	\$ 9,500