MuhlenkampMemorandum

Issue 115 | **Published Third Quarter** | **July 2015**

Quarterly Letter

By Ron Muhlenkamp, Portfolio Manager and Jeff Muhlenkamp, Investment Analyst and Co-Manager


Economic news and domestic equity markets have been pretty quiet since we last wrote to you in April. On the domestic economic front the revised numbers for 1st Quarter Gross Domestic Product (GDP) came in at -0.7%, significantly worse than most expected. A number of other economic indicators in April and May also came in somewhat lower than expected. Collectively, these weak economic figures are likely the reason the Federal Reserve did not raise short-term interest rates in June, contrary to what it was indicating in March.

While short-term interest rates in the U.S. have remained low, long-term interest rates have begun to move higher with the yield on U.S. 10-year treasuries moving from roughly 2% at the beginning of the year to 2.4% in early June. Bond prices move opposite the direction of yields, so higher yields mean the price of those bonds has come down. The dollar, which had been very strong relative to most all other currencies, weakened as it became clear the Fed was not raising short-term rates in June. The price of crude oil, which had dropped precipitously from $110 per barrel to a low of $44 per barrel in March, strengthened and is now at about $60 per barrel. Margin debt in stocks, which had plateaued for most of 2015, is once again rising; (refer to page 2 to learn more).

Outside the U.S., things have gotten interesting. Greece is on the edge of bankruptcy and its banking system is shut down, yet European and U.S. equity markets haven't reacted much, at least not as of this writing. In late May and early June, long-duration European government bond yields rose violently while short-duration bonds remained at negative nominal yields in many countries, an aberration we highlighted at our May 5 seminar. It is not clear what this rapid steepening of the yield curve means; so far, even European equity markets have mostly ignored it. It does have our attention and we continue to work to better understand what is happening and the implications for our investments, if any. In the Far East, the Shanghai stock market, which had been on a tear, rising 150% since January 2014, has dramatically reversed and lost almost 30% in three weeks. In early June, the Chinese government took a number of measures to try to stop the decline in their stock markets. Time will tell.

In general, our performance year to date has been slightly better than the broader U.S. markets.* Airlines, which did very well for us as the price of crude oil declined, have given back some of their gains as crude oil prices have risen and doubts have been raised about pricing discipline in the airline industry. Otherwise, our performance has been driven by individual company performance, not sector trends. We've invested a little bit in the broader European markets on a currency hedged basis** as we believe bond buying by the European Central Bank will drive up European equity markets even though it won't do much for European economies.

Looking forward, we expect the U.S. economy to grow at approximately 2% as it has for the past several years. We do not see signs that a recession is imminent. We remain of the opinion that higher interest rates would be beneficial for the economy, though we have no opinion regarding when the Federal Reserve might start raising short-term rates. We have harvested a number of the investments we made in years past, and have put a little new money to work in the few companies we think it is profitable to do so.

With our best wishes for your continued success,

Ron Muhlenkamp and Jeff Muhlenkamp

The comments made in this newsletter are opinions and are not intended to be investment advice or a forecast of future events.

**The S&P 500 Index is a widely recognized index of common stock prices. The S&P 500 Index is weighted by market value and its performance is thought to be representative of the stock market as a whole. One cannot invest directly in an index.*

Announcements

Susen Friday Retires
After 13 years with the Company, Susen Friday, Client Service Regional Manager, retired from Muhlenkamp & Company at the end of June. We wish her the best in future endeavors.

Susen extends her thanks and good wishes to all those with whom she has worked over the years. Any assistance you may now require can be readily provided by our Client Service team, available at (877) 935-5520 extension 4.

Semi-Annual Conference Call
Please join us for our next conference call:

Thursday, August 27, 2015
4:15 pm – 5:00 pm ET
Toll-free number: (866) 297-6395
Conference code: 39031232

Agenda includes:
- Economic observations
- Market commentary
- Investment outlook
- Review of a few companies in our Top 10 holdings
- Question and answer session

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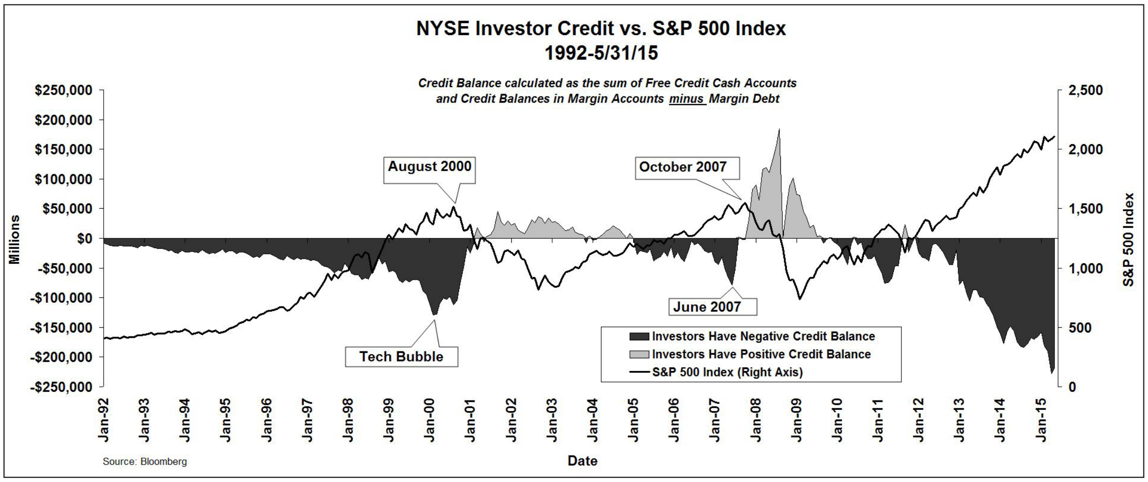
Currency hedging is the act of entering into a financial contract in order to protect against changes in currency exchange rates.

Muhlenkamp & Company, Inc.
Intelligent Investment Management

Seminar Study

After the Great Recession of 2008-09, Ron Muhlenkamp was asked what he would do differently—what he learned from the downturn. A primary observation was that "forced selling" drove the market more than expected. These thoughts now influence Ron's considerations as an investment manager and are relevant to his references to margin debt. Ron addressed this topic at our May 5 investment seminar, and revisits the topic below.



What is margin debt and why is it important?

This chart tracks NYSE (New York Stock Exchange) Investor Credit versus the S&P 500 Index. The line associated with the right axis shows the performance of S&P 500 Index; the solid black areas represent the amounts investors borrow on margin; shaded gray areas represent the net cash investors have in their accounts. As you can see, after the markets moved up as they did in the 1990s, by August 2000, a lot of people had borrowed a lot of money to buy tech stocks—and they did so "on margin."

Here's what's interesting about borrowing on margin:

Most of you have a mortgage on your home. If you have a fixed-rate mortgage and interest rates change, the bank can't change your rate—and the bank cannot "call it" (require you to pay the balance) early. In a margin account, if your assets drop in price, you must put up more money, or sell some assets. So, borrowing on margin presents a problem if asset prices start to fall. In fact, decreasing prices can cascade, just because people have to sell more assets.

After people accumulate net cash in accounts for a year or two, it tends to be a great time to buy stocks. This occurred in 2003 and 2009.

As you can see from this chart, borrowing on margin increased into 2007, which doesn't look like a great amount relative to other periods. On November 15, 2007, however, there was a change in the accounting rules (FAS 157, "mark-to-market"), which had the effect of forcing banks and insurance companies to sell assets when stock and bond prices declined. The pain continued until mark-to-market enforcement was relieved in March 2009.

This kind of "forced selling" resembles what can occur during a margin call. The reason this is a concern is because forced selling can create a vicious cycle; i.e. asset prices fall, triggering sales, which puts downward pressure on prices, which can trigger more sales.

We are now back to huge amounts of borrowing on margin. We think it's being heavily driven by low interest rates and has more to do with hedge funds (and companies) borrowing to buy stocks. If interest rates go up a little bit, borrowing on margin gets more expensive. And, if asset prices come down, that big margin can drive the decline mechanically. Normally, markets fall because people get fearful. This chart shows markets can fall, despite an absence of fear. We can get a 5-10% drop in the market at any time, but there is a number…maybe it's 12%, 15%, perhaps, 20%—I don't know at which point margin calls may start to kick in and the selling cascades. The trouble is, this was true three years ago, and two years ago. No one knows whether, or at what level, the next trigger will occur.

Ron summarized his thoughts about our seminar topic when answering the following questions:

Why do you think it's currently a "stock picker's market" and how does that impact your investment decisions?

Think of a "stock picker's market" this way: If the market were a new car, you'd be paying the sticker price to buy it today—no incentives and no dealer reductions. We keep looking for bargains (companies "on sale"), but we're not finding many.

Here's why…

We're seeing a decline in companies' growth rates in revenues and earnings per share (EPS) for the broad market (1st quarter 2015 versus 2014). When revenues flatten, companies can usually squeeze out extra earnings for a quarter or two, but it's a limited amount. Add to this mix, a strong U.S. dollar, which hurts companies' profits when sales in foreign currencies are translated back into dollars for accounting purposes. For these reasons, market momentum may reverse.

There are also reasons to believe upward momentum may continue. Savers and investors in both Japan and Europe are being punished with historically low, even negative, interest rates and are looking elsewhere for better returns. If their money comes to the U.S. markets, it could well continue to drive prices up for a time.

There is no clear market direction right now; we are watching closely to see what develops. That's why we think it's a "stock picker's market."

To learn more, please visit our website to view a video archive of the May 5 investment seminar.

Letter from the President

By Tony Muhlenkamp

Passive investing is a way of investing that "doesn't entail any forecasting …the idea is to minimize investing fees and to avoid the adverse consequences of failing to correctly anticipate the future."[1] I think of it as a way of implementing the conclusions of the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT).

EMH is described by Burton Malkiel as "Following the tenets of the EMH—that is, buying and holding a portfolio of broad-based low-cost market index funds—is still the best game in town. Although the market may not always be rational in the short run, it always is over the long haul."[2]

"MPT is a theory of finance that attempts to maximize portfolio expected return for a given amount of portfolio risk, or equivalently minimize risk for a given level of expected return, by carefully choosing the proportions of various assets … (it) has the aim of selecting a collection of investment assets that has collectively lower risk than any individual asset."[3]

And both models make sense in theory and can work well in combination. I think a purely passive investment strategy is to keep living expenses for one year in the bank, allocate the rest of your money 50% to the Vanguard Total Stock Market Index and 50% to the Vanguard Total Bond Market Index, and then, rebalance every thirteen months. It's simple, it's rational, and it's consistent.

I just don't know anyone that can do it.

Start with the fact that there are thousands of index funds to choose from. The mere act of choosing WHICH index funds is a "forecast" of sorts, as is deciding how much to invest in each of the index funds you own. Then there's rebalancing, which is taking money from what has gone up recently and adding to what has gone down. Failure to rebalance is "forecasting"(as is holding more money in the bank; as is moving money more often than the once a year needed to rebalance). Anything other than 50/50 is "active" versus "passive" management.

Jared Dillian has a nice take on the problems with passive investing in his article "Ahoy Polloi."[4]

So why is passive investing so hard to practice? As Dillian says, "everyone chickens out."

I've been reading a history of behavioral economics by Richard Thaler[5] at the same time I'm reading histories of capitalist and conservative thought by Jerry Z Muller.[6] Thaler's book is a personal account of events he experienced and witnessed, while Muller is surveying a broad field of thinkers from the last couple of hundred years. Both men illustrate that assuming all people are all rational all the time is a bad idea when creating economic and political models to govern policy making. Thaler refers to this all rational all the time person as "Homo Economicus."

I think assuming all people are all rational all the time is a bad idea when creating investment models as well. The Efficient Market Hypothesis and Modern Portfolio Theory need the same Homo Economicus investor for their models to work. I agree markets are rational in the long haul, but people are emotional ALL THE TIME. I think they are rational in working for their own best interests, but they can be unsure and emotional about what ACTUALLY furthers their own best interest. So, even if the index funds do well over time and in any given year, the index fund investor is still subject to moving money in and out at the wrong times, or not having ENOUGH money in the index when it does well. Having an index fund that does 12% in a year does no good if 90% of your money is in cash earning 0%.

A company called DALBAR publishes a report titled "Quantitative Analysis of Investor Behavior" that "has been measuring the effects of investor decisions to buy, sell and switch into and out of mutual funds over both short- and long-term time frames." The results consistently show that the average investor earns less—in many cases, much less—than mutual fund performance reports would suggest."[7] They are trying to quantify the effect that I'm describing. Their technique has come under criticism lately and I don't think their conclusions are definitive, but I do think the conclusions are illustrative. We can see the same phenomenon at work when we look at the "Capital Share Transactions" in a mutual fund annual report and put those cash flows alongside the performance table showing returns by calendar year. Money seems to always follow performance, which means the INVESTOR is not getting the same performance as the INVESTMENT.

In the last five years more than $1 trillion have moved into equity products that track indexes, and $266 billion have been redeemed from funds run by stock pickers. So there is a lot of money being used to buy indices that had done well lately, without regard to the underlying company fundamentals or economic realities.

We are always concerned when people chase performance (investing in what has done well recently), as this typically results in buying high and selling low. We've seen it before and we expect to see it again, so we are working to take advantage of this trend. We believe there are opportunities for the active manager with a focused discipline to do well in a market being driven by passive investors.

[1] https://en.wikipedia.org/wiki/Passive_management

[2] http://www.forbes.com/sites/quora/2014/06/13/what-does-the-efficient-market-hypothesis-have-to-say-about-asset-bubbles/2/

[3] https://en.wikipedia.org/wiki/Modern_portfolio_theory

[4] http://www.mauldineconomics.com/the-10th-man/ahoy-polloi

[5] http://www.amazon.com/Misbehaving-Behavioral-Economics-Richard-Thaler/dp/0393080943/ref=sr_1_1?ie=UTF8&qid=1435931026&sr=8-1&keywords=misbehaving

[6] http://www.amazon.com/s/ref=nb_sb_ss_c_0_14?url=search-alias%3Dstripbooks&field-keywords=jerry+z+muller&sprefix=jerry+z+muller%2Caps%2C174

[7] http://www.qaib.com/public/freelook.aspx?activeMenu=GLB-1

An index fund is a type of mutual fund with a portfolio constructed to match or track the components of a market index (e.g. S&P 500).

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A Stock Picker's Market

May 5, 2015 Investment Seminar

Video Archive Now Available

The financial headlines tell us the stock market is hitting new highs, but they don't tell us much about what is going on beneath the surface. At our May 5 investment seminar, Ron and Jeff Muhlenkamp examined some of the cross currents in the global markets and economies and how that gets reflected in our stock picking.

Available on our website (or by requesting a DVD), you can view a video archive of the seminar to learn more. We hope you'll take time to "tune in" and view the video. If you have any questions or concerns, please give us a call at (877) 935-5520 extension 4 or send us an email at services@muhlenkamp.com.