

MuhlenkampMethods

For the Intelligent Investor

Answers to questions you may not even know you have.

Reflecting over 40 Years—Lessons Learned and Changes Observed

by Ron Muhlenkamp, originally published October 2017



To celebrate the anniversary of Muhlenkamp & Company, I was asked to put on paper what I have learned over the last 40+ years in the industry and comment on any changes I've seen over that period. This essay is my attempt at meeting this request. About ten years ago we wrote a book, *Ron's Road to Wealth—Insights for the Curious Investor*, in which we did a similar thing, though in more detail than what we have here.

Lessons I've Learned

Free economies work; managed economies don't. Let's look at real instances: The obvious examples are to compare East Germany to West Germany during the time before their reunification in 1990. Look at North Korea versus South Korea, both were in shambles in 1950, but South Korea is a thriving economy today. Also, look at Cuba which is stuck in the 1950s. Venezuela has gone from prosperous to destitute in a decade. My observation is that if people are lacking food, clothing, and shelter, they will do almost anything to acquire these basic needs. Once these needs are covered, economics is all about incentives. So the question becomes, how do you get people to produce more? And the answer has been proven time and time again: you allow them to benefit from their own efforts; in other words, you pay them. The beauty of a free market is the incentives are built in. In a free market, you only get paid if you serve your fellow man in a way that he's willing to pay you since you can't force anyone to buy your product. It doesn't matter what I think my services are worth, it only matters what my services or product are worth to someone else.

In a free economy, the consumer is king. In a free economy we, the consumer, can influence price, production, and distribution by exercising our free will (spending our dollars). Sellers have incentive to improve their product or service to meet the needs and requests of the consumers (the "kings"). These continuous improvements to product and services are one reason why free economies thrive relative to managed economies.

Prosperity must be produced before it is consumed. You can't spend your way to prosperity, you can only produce your way to prosperity. Folks, that's true on a personal level, that's true on the local level, and that's true on a national level. Nevertheless, we have economists who encourage us to spend money (many times money we don't have). Debt can kill prosperity. So for an economy to thrive in the long term, it must be productive and live within its means (same goes for personal finances). As we discussed earlier, allowing the worker to benefit from their own effort creates the incentive to produce.



Muhlenkamp & Company, Inc.
Intelligent Investment Management

5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

Copyright ©2020 Muhlenkamp & Company, Inc. All Rights Reserved.

People have three working speeds. Low speed is when you can't be fired and can't earn a bonus—typically, that's working for government. They can't fire you, but you can't earn a bonus either. Medium speed is when you can be fired, but you can also earn a bonus or a premium—typically, that's working for private enterprise. High speed is when people work for themselves—that's when they pull out all the stops (and likely when they experience the most satisfaction in their work). I'm not the only one to notice this: the best-run private companies are those who find a way of compensating their employees in ways that encourage the employee to act as if she's working for herself. The best work comes from people who are working for themselves and can keep the fruits of their labor.

People have four spending modes. One mode is when people spend their own money on themselves. The second mode is when they spend their own money (money they've earned) on someone else—which is typically gifts or charity. Most of us will spend more money on a gift for our friend than we'd spend on ourselves, which I think is kind of fascinating. A third mode is when we spend other people's money on ourselves, and I would encourage you to check the Senate office buildings to see what happens in that regard. And then, the fourth mode is when we spend other people's money on other people—which is what politics is all about. Frankly, I think the major problem with politicians is they're all on O-P-M (they are dealing with Other People's Money). I've found that the best decisions are made when spending your own money on yourself or others.

Notice that these five lessons tie together: free market economies perform better than managed economies because more people are working for themselves than for government and more people are spending their money, not other people's money. It's all about incentives, and the incentives in a market economy create much better decisions than in a managed or planned economy.

Ownership equals responsibility. I've learned that people take better care of property they own than property they rent. And they take better care of property they rent than property held in common (see the former Soviet Union). People take better care of their pets than strays. You can debate the morality of ownership of animals or land all you like, but the practical effect is that establishing ownership generally results in people working harder to care for that which they have acquired the title to, and that's a good (productive) thing.

You must live by Mother Nature's rules. Ignoring reality usually turns out badly. I grew up as a farm kid, you either lived by Mother Nature's rules or you don't prosper as a farmer. When I got into engineering, I found out that you either live by Mother Nature's rules or your engineering doesn't work. The feedback is generally rapid and hard to ignore. There are some endeavors, however, where you can ignore the difference between what actually works and what doesn't for a *long* time. When I got to business school, we were taught that if you can convince the hundred people in the room of something, they can make it happen. That might work (for a while) in marketing, in politics, and in economics, however it does not work in production, in farming, nor in engineering. Mother Nature's rules will overwhelm whatever good logic you think you brought to the game.

People have a nearly unlimited capacity to believe what they want to believe. I've known folks who have been wrong for 40 years, but they're still making a good living because our country is so prosperous and they are "protected" (to use a Peggy Noonan term). "Protected" means that if they are wrong, they don't starve, lose food, clothing, or shelter. They can be wrong



for 40 years and still keep their job, particularly if they're an economist or a tenured professor. They could probably be wrong for 40 years as a weather person too. We all laugh at the weatherman, but their record is better than some economists.

Just because everybody knows something doesn't make it true. In fact, in investing, if everybody knows something, that alone makes it false, or at least an unprofitable investment. It is almost poetic—the public adopts a rule of thumb based on one time period and one set of circumstances, but it continues to use this rule of thumb after the circumstances have changed.

How you deal with your mistakes matters. When I watch some uneducated people make a mistake, they say, "Gee, I made a mistake." They change what they do and they go on with life. When I see some educated people make a mistake (especially those "protected" folks), what I tend to hear is, "Well, I would've been right if only." That's how you get economists who are wrong for 40 years but never change their minds or their methods. That's how you get politicians who spend more and more money on programs that have never produced the desired outcomes. They can't admit they were wrong, and they are protected from the results of their failures, so they never have to.

People assume that others act as they themselves do. As a result, honest people have a hard time believing anyone would lie to them, actively deceive them, or misrepresent something to them. They assume everyone else is honest too. I had a client who was so honest that he couldn't conceive of telling someone a lie. And his difficulty was, as a result, he couldn't conceive of anyone telling him a lie. He got a sales pitch one day and asked, "Is that true?" and I said, "No, that's a sales pitch..." and he said, "Oh, it didn't quite make sense, but I didn't think he would lie to me."

People have different approaches to issues. I've observed a difference in what I call the "rural mentality" versus the "urban mentality" and I think this major difference is reflected in our politics. The rural mentality is if you have a problem, you fix it. The urban mentality is if you have a problem, you call somebody else to fix it. Since politicians are quick to promise to solve your problems if you vote for them (and pay their taxes), an urban mentality lends itself to bigger government responsible for more things in our society, whereas a rural mentality does not.

To my mind, Houston's response to Hurricane Harvey reflected the "rural mentality." The media's astonishment at the volunteers reflected an urban mentality (though I witnessed a similar response in New York City on 9/11). I would encourage you to think about your local fire company. If it's a volunteer company, it's reflecting what I call the rural mentality. If it's a paid company, it's reflecting what I would call the urban mentality.

And yes, before you jump all over me, these lessons are not hard and fast, but I find them useful ways of thinking about things. If you don't find them useful, discard them. If you do find them useful, then I've done you some good. Life is not a dress rehearsal, you only get one shot at it. I hope my lessons will help you out or, at least, spur some good conversations.

Changes over the Years

The biggest change that I've seen in the last 40 years is that communication has gotten faster. As a result, we have more short-term cycles within the same long-term cycles. And that the long-term business cycle used to be four to five years, but



we've had three experiences in my lifetime: in the '60s and the '80s and the last 10 years when the business cycle got extended. But we continue to get more and more short-term cycles.

The trouble with instant communication is there are no longer any filters. You and I and anyone else can put an opinion out there, frankly, with no consequences. It used to be that a reporter or editor would do some checking of their work, but the incentive now is to be fast, not accurate or balanced. I'm finding I have to wait two or three days to get the story from both sides of an argument and I have to do more of that work myself. So, I say, "Who makes sense and who doesn't?" I've also found that more bias has crept in, and I have to do more work to ferret out the bias in almost all the information I receive.

In order to determine if an article or statement is truly neutral, I change the nouns (or pronouns). For example, every place that says "he," I write "she," and every place that says "she," I write "he." And then I read it again to see if it sounds sexist from either reading. If it's truly neutral, it will not. The fact that I have to do this indicates how rare it is for what is written to be factual and not editorial. Also, many words have become loaded terms (to some people they have much more or a different meaning than what is in the dictionary).

Another change I've noticed is our educated have become more arrogant. I always knew that Harvard was arrogant. MIT has gotten just as bad...a great disappointment to me. That's a bad thing, because arrogant people don't learn from their mistakes (see the discussion on that above).

The things I've just talked about all tie together.

The end result is that even though we KNOW what works best economically we are pursuing the same old failed solutions touted by our academics and politicians only with increasing vigor. They won't change, and we haven't fired them (yet?). This is pretty frustrating for me to watch. We're doing our very best to strangle the golden goose that is the free market.

A Final Thought

My grandchildren are now ages 9 through 20. I've started asking them what money is for. They all think money is to buy things and I agree with that, up to a point. But once food, clothing, and shelter, and a few other things are covered, I believe that money is to build things—which looks a little bit different. I would encourage you to think about money and how much the purpose is to buy things. At what point does the purpose become to build things?

Thank you to our clients and friends for an interesting 40 years!

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

