MuhlenkampMemorandum

Issue 108 | **Published Fourth Quarter** | **October 2013**

Quarterly Letter

By Ron Muhlenkamp

It's been an interesting summer.

Since 2008, the Federal Reserve (Fed) has been a huge manipulator of the money supply and of interest rates. Beginning with TARP (Troubled Asset Relief Program) in 2008—and continuing through Quantitative Easing II (QE2), Operation Twist, and QE3, the Fed has added over $2 trillion to our money supply (nearly $20,000 per household) and purposely bought U.S. Treasuries and mortgaged-backed securities to keep prices of these securities up and keep interest rates artificially low. The Fed first did this to avoid a financial meltdown in 2008-09 and continued it on the theory that it would help jumpstart the economy after the 2008-09 recession.

We believe that TARP helped avoid a financial meltdown. But we find it hard to find evidence that the subsequent QEs have helped to jumpstart the economy. We do think the QEs help support the bond and stock markets. But we also notice that Mario Draghi, President of the Central European Bank since November 2011, has had at least as much success supporting the European bond market without yet spending a euro.

We were told (and always believed) that the Fed wanted its manipulation to be temporary. Beginning in May 2013, market interest rates on U.S. Treasuries began to move up. By August 2013, the interest rate on the 10-year Treasury had climbed from 1.6% to 2.9 percent. Initially, this upmove in interest rates drove stock prices and price-to-earnings ratios (P/Es) down, as one would expect; (see Chapter 4 of my book). But, by September 2013, stocks had recovered to their levels of May and had actually surpassed them. And the Fed began talking about a "tapering" in its purchases of Treasuries and mortgage-backed securities; (currently at $85 billion per month or about $800 per household per month). In our judgment, the upmove in interest rates (from 1.6% to 2.9%) had brought rates near to where they would be without the Fed's arm on the scale—and the stock market had absorbed this increase very well. This presented the Fed with a great opportunity to "taper off" its manipulation.

On September 18, 2013, the Fed chose not to "taper." For two hours, stock prices went up and some commentators celebrated; then, prices went down for five days as strategists (and I) tried to understand what the Fed's (in)action meant for the markets going forward.

Having broached the topic of tapering in May, and having carefully shifted his tone in June, July, and August to calm investor fears of tapering, why did Ben Bernanke abandon those efforts in September by not executing the action he had so carefully prepared the markets for? My real fear is that the members of the Fed don't want to taper, that they desire to continue to manipulate interest rates, or that they believe their continued manipulation as now essential to the operation of our economy.

If so, it will continue to complicate market evaluations of companies and their securities—with profitability and inflation giving one set of values (refer to my book)—and interest rates giving another. The Fed's legal mandate is to keep inflation in check and to foster employment. Despite this, one of its current goals is to increase inflation. Further, it is hard to find evidence that the Fed has increased employment. (Labor participation is the lowest it's been since the 1970s.) But the Fed seems to have adopted increasing stock prices as a substitute for its mandate and is pointing to higher stock prices to justify keeping its whole arm (not just its thumb) on the scale of interest rates.

We've seen what happens when prices get ahead of the economy reality. The bubbles in the dot-com's in 2000 and the housing market in 2007 were such effects. We fear that the apparent Fed desire to continue to manipulate interest rates may engender more bubbles.

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

Let's Get Real

by Kathy Baum, ChFC®, Client Service Regional Manager

This article was originally published in INCommunity Magazine; *August 2013.*

As summer comes to a close, I'll miss lively conversations with family and friends about graduations, vacations, neighborhood houses for sale…and the Federal Reserve. Yes—"The Fed" and what's happening with interest rates. With an increase in nationwide house sales, there are signs the economy may be improving. Locally, many of us watch this activity and think about our own properties and mortgages.

In comparing/monitoring mortgage interest rates, you've probably noticed a recent uptick: the 30-year fixed mortgage rate is at 4.5%, a two-year high.* On August 9th, 2013, the interest rate on Stafford subsidized student loans increased from 3.4% to 3.86 percent. Our savings accounts, however, are still earning less than 1 percent! What's going on?

Earlier this summer, Federal Reserve Chairman Ben Bernanke announced plans to curb quantitative easing (QE) as the economy improves. The Fed's QE programs began during the 2008-09 recession in order to help stimulate the economy. As part of the current QE program, the Fed has been buying $85 billion a month in bonds and mortgage-backed assets to keep borrowing costs—interest rates—low.

In anticipation of higher interest rates, we begin to think about inflation and the impact on our money. We know inflation can increase the price of a house or a car. As consumers and investors, we need to think of inflation not in terms of prices moving higher, but as the value of our money shrinking—our loss of purchasing power!

At Muhlenkamp and Company, when we initially work with a client, we review their savings and spending—and we listen to what they want their money to do for them. Most often, their primary objective is to make their money work as hard for them as they have worked for it. When talking about investing for the long term, we discuss taxes, interest rates, and inflation. What is the impact? In order to do this, we have to get real. In terms of the client's financial situation, where are they now and where do they want to be?

One of the first steps in this process is to understand the difference between a nominal interest rate and a real interest rate:

- A nominal interest rate is the rate of interest on an investment prior to taking any adjustment for inflation. The nominal interest rate is the interest rate stated on the loan or the yield on an investment.
- The real interest rate is the nominal rate, minus inflation. It reflects your true purchasing power!

Here's an example:
If you are earning 3% per year on a CD (certificate of deposit) and inflation is currently at 2%, then the real interest rate you are receiving is 1 percent. The real value of your savings is increasing by 1% per year when purchasing power is taken into consideration.

Given the task of maintaining purchasing power, an investor faces three investment choices: short-term debt, long-term debt, and equities.

1. Short-term debt: From the borrower's perspective, short-term debt finances such items as installment and credit card purchases, corporate inventories, and government working capital. From the saver's perspective, short-term debt includes savings accounts, Treasury bills, CDs, and money market funds. Anyone who has a 3% CD, for example, and is paying 18% on a credit card balance is participating on both sides of the short-term debt market, and paying dearly for the privilege.

Historically, rates available to savers on these investments have roughly equaled inflation. That is, with no effort and little risk, you've made no real money—after inflation.

2. Long-term debt: From a borrower's perspective, long-term debt finances homes, factories, and government spending. From an investor's perspective, long-term debt takes the form of corporate bonds, mortgage pools, and Treasury and municipal bonds. Differences in interest rates among these securities reflect creditworthiness, time-to-maturity, and taxation (municipals).

Historically, long-term debt of good quality has returned about 2%-3% annually over inflation. In the 1970s, it returned substantially less; in the 1980s, substantially more. Currently, it's substantially less.

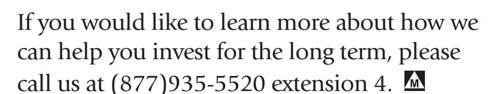
3. Equities: Equity investments represent ownership and are normally long term. Equity ownership can be real estate, tangible assets, or business enterprise. It can be sole ownership, partnerships, or shares of stock in a corporation. Most investors hold real estate through sole ownership of their homes, and corporate enterprise through shares of stock. Corporate shares are usually more liquid than real estate—that is, they can be bought and sold much more readily. This advantage is partly offset by the short-term volatility of share prices.

The key is to focus on the long-term nature of equity investing and not to get caught up in the short-term price fluctuations. Long-term studies of total returns from owning common stocks of corporations demonstrate returns of 5%-7% annually over inflation. Some of this return comes as dividends and some as capital gains.

You want your money to work as hard for you as you have for it. To do so, it is essential to understand what your *real* interest rate is yielding on your investments. You need to know if your assets are gaining in value and, ultimately, increase your purchasing power.

One of Muhlenkamp & Company's maxims is *Only those returns in excess of inflation can be spent if purchasing power is to be maintained over long periods of time.* In today's investment climate, we believe this can best be achieved through viewing equity investments as long-term investments, with a horizon of at least 3-5 years.

If you would like to learn more about how we can help you invest for the long term, please call us at (877)935-5520 extension 4.



* 30-year fixed mortgage rate as of 9/4/13.

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IRA Maxims

by Tony Muhlenkamp, Vice President

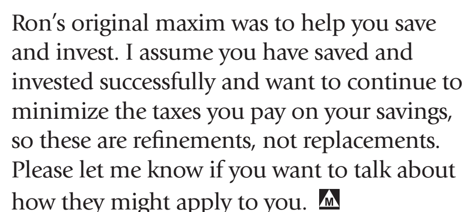
Sue Friday's article in *'Memorandum* #107 called to mind Ron's article *Basic Financial Maxims I Want My Kids to Know* from July 1991. His maxim regarding IRAs is:

Fund your IRA every year—early if possible. Invest in an equity or total-return mutual fund. Equity returns compounded over long periods can be truly amazing.

Maxims are intended to be timeless and to apply over a variety of circumstances; this maxim satisfies those conditions. It remains as true today as it was in 1991. Tax laws, regulations, and life expectancies, however, have changed since 1991, creating additions and refinements to the original maxim that I think are useful. They are:

1. **Fund your Roth IRA every year you are eligible.** Roth IRAs did not exist in 1991, and tax-free equity returns compounded over long periods are even more compelling than tax-deferred equity returns.
2. **Be careful converting Traditional IRAs to Roth IRAs.** I am skeptical of converting the entire IRA all at once, but have seen great success converting IRAs gradually over time. It serves to keep you in the lowest possible tax bracket for the longest possible period.
3. **Consider using IRA Beneficiary Designations to save on taxes beyond your lifetime.** Naming children, grandchildren, and charities as IRA beneficiaries can "stretch out" the tax-deferred compounding of your savings. Or, you may avoid income taxes on your gains entirely by making a charitable bequest of your IRA.
4. **Stop funding your Traditional IRA when you expect to have a million dollars or more in your tax-deferred accounts at age 65.** Tax-deferred accounts are subject to Required Minimum Distributions (RMDs) starting at age 70½; having balances over a million dollars could cause your RMDs to push you into the maximum tax brackets. This could result in paying taxes at a higher rate than when you made the contribution—you have essentially deferred the taxes into a higher rate, which makes no sense. The whole tax advantage to an IRA is deferring taxes to a lower rate. While I am suggesting you stop funding IRAs, you should keep maximizing your contributions to 401(k) and other employer plans to take advantage of pre-tax contributions, employer matching, and tax deferral. And you should keep funding a Roth IRA as long as you are eligible, because the Roth has no RMD and because distributions from the Roth are tax free (under current rules).
5. **Consider taking IRA distributions before your Required Beginning Date, and exceeding the RMD once you turn 70½.** Especially if your balances are over a million dollars, postponing and minimizing your distributions will mean putting yourself into higher and higher tax brackets as you get older. So do some planning and look at all your sources of income starting at age 59½ to see if it makes sense to start taking taxable distributions. The goal is to approach—but not enter—the next highest income tax bracket. Starting early and acting often gives you flexibility for minimizing taxes over a 30-year period.

Ron's original maxim was to help you save and invest. I assume you have saved and invested successfully and want to continue to minimize the taxes you pay on your savings, so these are refinements, not replacements. Please let me know if you want to talk about how they might apply to you.



Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax adviser or legal counsel for advice and information concerning their particular situation.

Basic Financial Maxims I Want My Kids to Know

By Ron Muhlenkamp

Ron's "Maxims" were first published in Muhlenkamp Memorandum*; Issue 19, July 1991. A sampling is provided below. For the complete list, visit our website.*

Don't confuse income and wealth. Income can end with a dismissal notice or a change in interest rates.

Don't confuse wealth with the current price of an asset. People get carried away with prices—up and down.

Don't count on Social Security. The benefits you receive will be a small fraction of what your grandparents now receive.

People think of inflation as prices going up. It's not. It's the value of money going down.

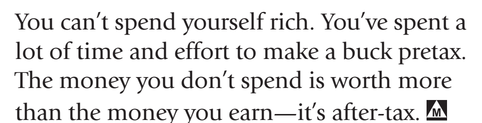
There are no guarantees, there are only guarantors. The phrase "It's guaranteed" requires the response: "By whom?"

Only the Ten Commandments were written in stone. All other laws are at the whim of politicians who will change them in response to current pressures.

When you change the rules a little, you change the game a lot.

Convenience is usually expensive. Ignorance is deadly.

You can't spend yourself rich. You've spent a lot of time and effort to make a buck pretax. The money you don't spend is worth more than the money you earn—it's after-tax.



Glossary

Capital Gain is the amount by which the selling price of an asset exceeds the purchase price; the gain is unrealized until the asset is sold, at which time the gain is realized (and taxed).

Central Bank is the entity responsible for overseeing the monetary system for a nation (or group of nations). The central banking system in the U.S. is known as the Federal

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The "FRIDAY FOCUS" on Retirement

by Susen Friday, AIF® Client Service Regional Manager

Long-time participant in the DCIO (Defined Contribution Investment Only) market, former secretary and active member of the Women in Pensions Network(WIPN), member of the American Society of Pension Professionals and Actuaries(ASPPA) and former plan administrator, Susen also holds an Accredited Investment Fiduciary (AIF) designation.

Throughout 2013, Susen's expertise and experience in the retirement field is being showcased in the Muhlenkamp Memorandum, *referred to as the* "FRIDAY FOCUS" on Retirement.

Past articles include:
'Memorandum #105: *History of Pensions*
'Memorandum #106: *Pension Plans—Types and Characteristics*
'Memorandum #107: *A Primer on IRAs*

Unfortunately, only 51.8% of all employees in the U.S. are covered by any type of employer-sponsored retirement plan.[1] What does this suggest? It tells me that 48.2% of U.S. employees either have no plan or are relying on IRAs at a time when the state of Social Security is vulnerable and age longevity is increasing. It portends a senior demographic facing increasing difficulty in making ends meet.

As mentioned in previous articles in this series, employers increasingly favor the 401(k) model when choosing a retirement plan to provide for their employees. Employers are also more keenly aware that the choices they make regarding those plans can be instrumental in affecting their employees' retirement readiness. Some of the challenges plan sponsors (aka employers) face include enhancing employee participation, along with ever-increasing fiduciary responsibilities and compliance-related issues. Fiduciary responsibilities and compliance-related issues are a consideration in all aspects of managing a qualified retirement plan.

Enhancing Employee Participation

Believe it or not, one of the biggest hurdles that employers have is encouraging employees to save by participating in the plan! Some employees feel they cannot afford to participate because of other financial demands. (Perhaps it is because we are a consumer-driven society, and some are not in the habit of saving.) Others may simply be intimidated by the plan itself.

Over the years, employers have encouraged participation in many ways, including hosting enrollment sessions to better educate employees, along with sponsoring various enrollment incentives. With the passage of the Pension Protection Act in 2006, plan sponsors had an Automatic Enrollment option they could adopt to automatically bring employees into the plan.

The study of behavioral finance tells us that people often suffer from inertia where financial decisions are concerned. With that in mind, if an employee has to actively enroll in a retirement plan, there is a good chance they won't. The same principle applies if an employee is automatically enrolled in a retirement plan at a predetermined contribution rate; it is unlikely they will opt out.

In any case, it is doubtful that a participant will be able to retire on the original rate of contribution chosen. In fact, many participants have no idea how much money they will need at retirement. It takes a little work, but there are various websites that can calculate an estimate for one's particular circumstances. (Some plan websites include links to these tools.) Such tools can prove invaluable, providing the participant a tangible goal.

The plan sponsor has several additional tools to encourage employee participation, the first of which is plan design. Some of the plan features that can entice employees to participate in a plan are:

- Providing a match to a higher rate of contribution, thereby encouraging participants to save more in order to qualify for the full benefit of the match.
- Incorporating a profit sharing feature.
- In addition to automatic enrollment, plan sponsors can now offer automatic escalation. By adopting this feature, participants will have the percentage of their contribution increased, usually on an annual basis, by a set amount.

Beyond plan design, the plan sponsor can encourage plan participation through the thoughtful selection of investment options that are made available to the participants. Because there are so many options to consider (mutual funds, Exchanged Traded Funds (ETFs), collective trusts, etc.), the plan sponsor must carry out due diligence, many times with the help of an adviser who specializes in qualified plans. Additionally, plan sponsors can offer educational services of good investment practices, either through its plan website or by making financial advisers available to the participants.

If a participant does not want to actively make investment decisions, the plan may offer a menu of target date funds; i.e. actively managed funds that adjust a portfolio over time according to a fixed retirement date. Beware: Target date funds are not alike; research is required. Remember, retirement funds need to last throughout one's entire retirement, often for many years.

An employer-sponsored retirement plan is also beneficial to the employer. The employer and other "highly compensated employees"[2] (HCEs) are more likely to contribute to the plan at a higher rate than non-highly compensated employees. The Employment Retirement Income Security Act of 1974 (ERISA) states that unless a plan satisfies one of several safe harbors, the plan must be nondiscriminatory in providing benefits. Each year, retirement plans must undergo testing to verify that HCEs did not

[1] *National Institute on Retirement Security, The Retirement Savings Crisis, June 2013*
[2] *Highly Compensated Employees (HCEs) are defined by the IRS for 2013 as either 5% owners or those with compensation equal to or greater than $115,000.*

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benefit more than non-highly compensated employees. If the plan does not pass the test, contributions must be returned to the HCEs to bring the plan into compliance. As a result, HCEs are unable to declare as large of a deduction on their tax returns. Qualified plans with a high rate of employee participation are less likely to fail their testing.

In sum, employers with a well-administered retirement plan have an important tool to attract and retain knowledgeable employees—and those employees have an easy way to save for retirement! Further, all employees have the opportunity to contribute at higher rates as participation increases.

Inreasing Fiduciary Responsibilities
Plan sponsors are the fiduciaries of the retirement plans. According to Investopedia, a fiduciary is "one who has been legally appointed and authorized to hold assets in trust for another person. The fiduciary manages the assets for the benefit of the other person rather than for his or her own profit."

Often times, fiduciary duties are outsourced to an adviser who specializes in qualified plans. Legally, however, the plan sponsor is ultimately responsible for the plan.

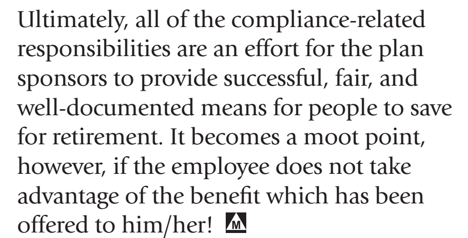
A fiduciary is expected to base decisions on the "prudent man rule." The rule states that "fiduciaries must act as a prudent man or woman would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital, and, in general, avoid speculative investments." As such, the fiduciary decision-making process involves the following steps:

1. Organize and analyze the information available;
2. Formalize the expectations;
3. Implement the decision or practice; and
4. Monitor the process and exercise due diligence.

In the retirement industry, this process has been expanded to include the hiring of advisers, record keepers, and vendors.

Increasing Compliance-Related Responsibilities
As discussed in previous articles in this series, retirement plans are dynamic entities, affected by ongoing legislation and overseen by both the Department of Labor and the Internal Revenue Service. By all means, it is a challenge for plan sponsors to monitor their plans to ensure they are compliant with an ever-changing set of rules.

Currently, the major compliance issue affecting qualified retirement plans is the Department of Labor 408(b)(2) regulation, ensuring that pension plan fiduciaries have sufficient information to determine the reasonableness of compensation and fees paid to service providers and to evaluate potential conflicts of interest that may affect the performance of those service providers. All fees or compensation paid by the retirement plan must be reported annually on the plan's IRS Form 5500.



Ultimately, all of the compliance-related responsibilities are an effort for the plan sponsors to provide successful, fair, and well-documented means for people to save for retirement. It becomes a moot point, however, if the employee does not take advantage of the benefit which has been offered to him/her!

Mark Your Calendar

Muhlenkamp & Company Investment Seminar

Thursday, November 7, 2013
Regional Learning Alliance
850 Cranberry Woods Drive
Cranberry Township, PA 16066

Ron Muhlenkamp will present *Natural Gas: An Energy Game Changer,* and an update on *The Big Squeeze.*

LIVE PRESENTATIONS at 2:00 p.m. and 7:00 p.m. ET

WEBCAST – If you can't join us in person, live video webcasts of both sessions will be broadcast via the Internet. (Log-in instructions will be provided after registration is completed.)

To register, please visit our website, or call our Client Service Department at (877)935-5520 extension 4. RSVP by November 4, 2013.

AAII Long Island Chapter

November 13, 2013
Bertuccie's Restaurant
861 Walt Whitman Road
Melville, New York 11747

Ron Muhlenkamp will present *The Big Squeeze: How taxes are squeezing your income; how interest rates are squeezing your assets*

To register for one of the limited open seats, please call our Client Service Department at (877)935-5520 extension 4.

2013 AAII Investor Conference

Friday, November 15 –
Sunday, November 17, 2013
Loews Royal Pacific Resort
Orlando, Florida

Tony Muhlenkamp will be a guest speaker, hosting a workshop on *The Big Squeeze: How taxes are squeezing your income; how interest rates are squeezing your assets*

To register, please call our Client Service Department at (877)935-5520 extension 4.

The World MoneyShow Orlando

January 30 - February 2, 2014
Gaylord Palms Resort, Orlando, Florida

Ron Muhlenkamp will be a keynote speaker, and will host number of workshops that are free to the public. Presentation details will be announced later this year at www.moneyshow.com

To register, please call our Client Service Department at (877)935-5520 extension 4.

The Sun City Anthem Financial Club

May 14, 2014
Anthem Center
Delaware Room
2450 Hampton Road
Henderson, NV 89052

Ron Muhlenkamp will be a guest speaker.

To register, please call our Client Service Department at (877)935-5520 extension 4.

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Announcements

Roth Conversions

If you are considering a Roth conversion before the end of the year, you may want to read the articles by Tony Muhlenkamp in *Muhlenkamp Memorandum*, Issues 92 and 93. These articles are available on our website at www.muhlenkamp.com, or you can call our Client Service department at (877) 935-5520 extension 4 and request a printed copy.

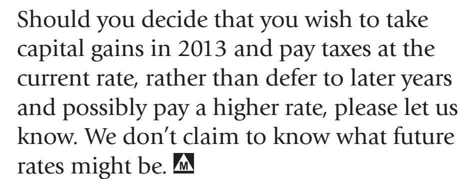
Request for Email Address

To ensure you receive all of the correspondence that Muhlenkamp & Company publishes and distributes, please share your email address with us. From time to time, we publish information that gets distributed by email only. If you would like to be added to our email list, please visit our website at www.muhlenkamp.com. On the 'home page,' you'll find a link where directions are provided or give us a call at (877) 935-5520 extension 4. You can be assured that your contact information will not be released to any third party.

Year-End Tax Planning

To our Clients with privately managed accounts:
If you reported a tax-loss carryforward on your 2012 income tax return, please let us know the amount so that we can incorporate this fact into our tax planning for your account during 2013.

Should you decide that you wish to take capital gains in 2013 and pay taxes at the current rate, rather than defer to later years and possibly pay a higher rate, please let us know. We don't claim to know what future rates might be.



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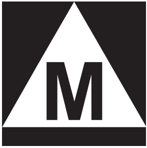

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Intelligent Investment Management

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- The "FRIDAY FOCUS" on Retirement

"Natural Gas: An Energy Game Changer"

Ron will also provide an update on "*The Big Squeeze*"

Muhlenkamp & Company, Inc.
Semi-Annual Investment Seminar
Thursday, November 7, 2013
2:00 p.m. ET and 7:00 p.m. ET sessions
Live video webcasts will be broadcast for both sessions.

The Regional Learning Alliance at Cranberry Woods
850 Cranberry Woods Drive
Cranberry Township, PA 16066

RSVP: By Monday, November 4, 2013
To register, please call our Client Service Department (877)935-5520 extension 4, or visit www.muhlenkamp.com