MuhlenkampMemorandum

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Quarterly Letter

By Ron Muhlenkamp

Sometimes, I'm tempted to write "same as last time." This is one of those times.

Three months ago, in *'Memorandum #110*, we wrote:

Most of the economic and market trends we've been discussing for the past few years remain in place.

Russia's action in the Ukraine/Crimea may have long-term implications, particularly for Europe, but the near-term economic implications are modest. It remains to be seen whether this gets added to our long-term worry list or not.

Japan's version of "Quantitative Easing," after helping its market last year, is now running out of gas. A few days ago, Japan raised its consumption tax; the last time they did that, it triggered a recession. We remain baffled by the logic Japan is following; i.e. attempting to spur growth via government spending, which requires an increase in taxes and borrowing to achieve. We are not optimistic about the outcome.

Various countries in Europe continue to flirt with recession or default. Sovereign bond rates remain very low, and the European Central Bank's commitment to do "whatever it takes" has not been tested. Very little has changed in Europe.

The Chinese economy and other "emerging" countries continue to slow. China continues to try to unwind a credit binge in a controlled manner, which is working so far. Dramatic currency shifts in Turkey and other emerging markets, which started when the Fed started "tapering," have subsided. It isn't clear if continued tapering will create other dislocations and shifts going forward.

In the U.S., we continue on a slow growth path. Our government continues to squeeze employers, resulting in only modest gains in employment. The U.S. Federal Reserve is proceeding with tapering of its buying of U.S. Treasury and mortgage bonds. The bond market responded to the change in direction last summer by upping interest rates in long bonds. Since then, long rates have fluctuated in a range consistent with contained inflation and continued slow growth in the economy. Short rates remain near zero, driving individual and pension investors elsewhere.

Stocks rose last year to a level consistent with current earnings levels and very modest inflation. Company earnings have actually been aided by management reluctance to build plants or hire people in the face of slow economic growth and added regulations. (Have you noticed that corporate annual reports are twice as thick as they used to be, but with no additional information?) Currently, we see no relief from these pressures.

A few new items:

In Europe, Banco Espirito Santo, the largest bank in Portugal, has defaulted on interest payments on its bonds. Europe has not solved its problems.

In the U.S., for at least the fourth consecutive year, estimates of real GDP (Gross Domestic Product) growth, which exceeded 3% prior to the beginning of the year, have been reduced to 2% or less by midyear (now). The U.S. continues on a slow path.

During the second quarter, stock prices rose nicely to levels that we consider full value, so we've begun selective pruning of our holdings.

We do consider it healthy that individual stocks are now responding to both good and bad news.

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.

Be Careful Dealing with Creative Sources of Yield: A Redux

By Celeste Zingarelli

In February 2013, Ron attended a Money Show in Orlando where a topic that generated a lot of interest was "How can I get more income from my investments?" In response to what he heard from other speakers, Ron wrote an essay, *Be Careful Dealing with Creative Sources of Yield*; (refer to *Muhlenkamp Memorandum #106*).

As the Fed prolongs its policy of keeping interest rates at very low levels, investors continue their quest for finding more ways to generate income. And Wall Street, being a great marketing machine, is happy to oblige. As a result, we believe Ron's warning remains valid. This article examines definitions, expectations, and valuations when searching for sources of greater income.

Definitions

"Yield" is generally understood as the interest or dividend payment earned on a security over and above the return of principal. Historically, investors seeking yield (or income) would focus on bonds or low-growth, high-dividend stocks. In today's ultra-low rate environment, that focus has changed a bit.

Recently, one of our shareholders asked us to examine a mutual fund offering a double-digit distribution. Let's say the distribution is 10 cents on every dollar. Reading the fine print, we learned that 3 cents of the "payout" was earned in dividends. The remaining 7 cents of the payout is not income over and above the principal; i.e. it is not a return *on* your money, it is a return *of* your money! This is akin to investing $100 in a mutual fund, getting back $10 at the end of the year—$7 of which is a return of your capital—and paying a 1% management fee for the privilege.

Be careful when yield and payout are used interchangeably, as if they were the same thing. We are not required to pay taxes on a return of our principal, we are only required to pay taxes on the money earned in excess of our investment. So be especially careful when a product is labelled "tax favored," as much of the payment may be a return of your capital. This applies to many royalty trusts and master limited partnerships (MLPs) as well.

Expectations

Historically, investors would hold a bond until maturity, as the interest payments provided a consistent income stream. With the recent onslaught of energy-related investment opportunities, investors looking for something similar should be guarded. For example, consider a royalty trust that owns the rights on a group of oil or gas wells. Investors receive pro rata shares of the proceeds from what is produced, but nearly all oil and gas fields produce at a declining rate. So, a 10% payout in the first year could diminish to 1% by the twentieth year.

Investors should also be wary of what we call "no-cushion stocks."

Historically, the stocks of electric, gas, and water companies ("utilities") are noted for their dividends. Recent *Value Line®* reports indicate electric utilities now average a yield of 3.6%, a P/E (price-to-earnings ratio) of 17, and a payout (dividend as a percent of earnings) of 60 percent. We believe the high payout limits their flexibility in making capital expenditures and future dividend increases. We prefer companies with a 3% yield, representing 30% of the earnings (for a 10 P/E). Such a company has much more flexibility to finance itself and to raise its dividend in the future.

Valuations

With a slew of retirees all in the same boat, investors stampeded into "income" securities—and Wall Street responded. From 2010 through 2013, high-dividend mutual funds and ETFs took in more than $112 billion in new money. By the end of last year, these funds reached a total of $394 billion in assets—more than triple their size in 2008.[1] The monies flowing into higher-yielding securities have driven their prices up, creating a "crowded trade." There is an inverse relationship between price and yield. So, when the prices of these securities increase, their yields decrease.

At Muhlenkamp & Company, we believe you can turn a good company into a bad investment by paying too much for it. Because price always matters, we are concerned that some investors are paying too high a price for a security (utility stock, junk bond, MLP, etc.) in exchange for a hoped-for income stream, thereby subjecting themselves to the risk of a price decline.

In summary, Ron's first investment maxim is borrowed from Milton Freeman: *There is no free lunch*. His second maxim is: *There is no free income, either!* Be sure to read the fine print! Be sure to check the numbers! Be sure to check the underlying assumptions! In short, be sure to understand what you are buying. And, if you have questions or concerns, be sure to give us a call. We are happy to assist you.

[1] *The Wall Street Journal;* May 31-June 1, 2014

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Ask Muhlenkamp

The following correspondence took place between a shareholder and Ron during the second quarter. A meaningful exchange, we found it useful—and hope that you do, too. Please feel free to send us a note, indicating your ideas, comments, and suggestions. We appreciate hearing from you!

Dear Ron,
I read all the articles (and opinions) in your newsletters and I feel compelled to ask you to wage a campaign to get rid of all regulations and government laws in our lives. You continue to mention government regulations and "squeezes." What a world we would have! Consider how corporations and their employees could foul our water, air and soil without any oversight. Let us not forget the crumbling roads and bridges that would eventually be the result of this. Think about riding over the Fort Duquesne Bridge to downtown. The water there is only eighteen feet deep. Surely we can all handle that.

Along with the so-called Tea Party group whose members don't turn down their Social Security and Medicare, I am continually amazed at how people want others to pay for everything. It is EASY to look for scapegoats. The negativity of so many people is very sad.

I don't expect a response from you, but I do think you should occasionally hear from some people that don't appreciate your patronizing monologue. And yes, I have had money in your namesake fund for over a decade.

Dear Shareholder,
Thank you for your email.

I have never said I'm against all regulation. I have said recently that, in many cases, current levels of regulation are much greater than they were a few years ago and have become a major drag on economic growth and employment.

Following are:
– **Example 1**
 Some of the current regulations and requirements pertinent to hiring people.
– **Example 2**
 Employment costs at Muhlenkamp & Company for 1996, 2006, and 2014.

Sincerely yours,
Ron

P.S. I am 70 years old and have not taken one dime from Social Security or Medicare.

Example 1: To Hire One Person

Some of the current regulations and requirements pertinent to hiring people

1. **Employers must obtain an Employer Identification Number by completing IRS Form SS-4.**
 In order to hire an employee, you must first get an Employer Identification Number (EIN) to use on tax returns and other documents that are submitted to the IRS. To get an EIN, you must file IRS Form SS-4.

2. **Set up a payroll system to withhold taxes.**
 Employers need to withhold a portion of each employee's income and deposit it with the IRS, and also make Social Security and Medicare tax payments to the IRS. (They may also have to withhold taxes for your state and local municipality.)

3. **Obtain the employee's legal name and Social Security Number and complete IRS Form W-2.**
 Employers must keep records of employment taxes for at least four years.

4. **Have each employee complete IRS Form W-4.**
 On the W-4 form, employees list how many allowances they are claiming for tax purposes. Employees should fill out a new W-4 form each year, if they want to change their allowances.

5. **Fill out Form I-9, Employment Eligibility Verification for each new employee.**
 Employers must verify that each new employee is legally eligible to work in the United States. U.S. Citizenship and Immigration Services requires employers to use this form to verify that every employee is eligible to work in the United States. (You don't have to file this form with the USCIS, but you must keep it in your files for three years.) These forms should be kept in a separate I-9 folder for all employees, not in each employee's personnel file.

6. **File IRS Form 940 each year.**
 Employers must file IRS Form 940 to report federal unemployment tax for any year in which you paid wages of $1,500 or more in any quarter, or for any year in which an employee worked in any 20 or more different weeks of the year.

7. **Register with your state's labor department.**
 Once you hire an employee, you will have to pay state unemployment compensation taxes, so that the state can pay short-term relief to workers who lose their jobs.

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8. **Report each new employee to your state's new hire reporting agency.**
   Employers must report information on all new employees for the purpose of locating parents who owe child support. (Each state has a different new hire reporting agency.)

9. **Provide Insurance Exchange Notice.**
   The Patient Protection and Affordable Care Act (ACA) amended the federal Fair Labor Standards Act (FLSA) to require covered employers to provide current employees and new hires with written notice of the existence of the exchanges and various other information pertaining to health care coverage. (Generally, employers with one or more employees involved in interstate commerce and with $500,000 or more in annual sales are subject to the FLSA.) Employers who are required to provide insurance exchange notices to employees must do so for both full- and part-time employees. Employers are also required to provide the notice to each new employee at the time of hiring, within 14 days of an employee's start date.

10. **Get workers' compensation insurance.**
    Workers' comp insurance is required in the vast majority of states, although some make an exception for very small employers.

11. **Post required notices.**
    Several government agencies require employers to post notices providing information on worker rights. (The Department of Labor's "Poster Advisor" will help you determine which posters you must display.) In addition, you must comply with your state department of labor's poster requirements.

12. **Adopt workplace safety measures.**
    Every employer must comply with the requirements of the Occupational Safety and Health Act (OSHA) by, among other things, providing a workplace free of hazards, training employees to do their jobs safely, notifying government administrators about serious workplace accidents, and keeping detailed safety records.

13. **Create an employee handbook.**
    Although not required, it is a good idea to have a handbook describing your business's employee policies and making it clear that employment is at will unless an employee has signed a written employment contract.

14. **Set up personnel files.**
    For each employee you hire, create a file in which to keep job-related documents, such as job applications, employment offers, IRS Form W-4, performance evaluations, and sign-up forms for employee benefits. Medical records should be kept in a separate, confidential file, in a locked cabinet. (You should store I-9 Forms, which document an employee's immigration status, in a separate file.)

15. **Set up employee benefits.**
    If your business has established employee benefit programs such as a 401(k) plan, you'll need a sign-up procedure so employees can enroll, name dependents, and select options.

16. **Employers should create a job application.**
    Unlike a resume and cover letter, a job application contains questions that require factual responses; e.g. social security number, dates of employment, positions held, names and contact information for direct supervisors, dates of degrees, street address, and phone number. The applicant's signature on the job application allows the employer to verify the truth of all content and gives permission for reference checking, background checking, criminal history checking, and often, reviewing the results of drug testing. (All job applications end with the applicant's signature certifying that all stated is true and granting the potential employer broad permissions to check the applicant's suitability for employment and to check the applicant's veracity.)

Sources:

http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online

http://www.uscis.gov/sites/default/files/files/form/i-9.pdf

http://www.sba.gov/content/hire-your-first-employee

http://www.inc.com/guides/2010/04/improving-hiring-practices.html

http://www.nolo.com/legal-encyclopedia/hiring-first-employee-13-things-29463.html

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Example 2: Employment Costs

Employment costs at Muhlenkamp & Company for 1996, 2006, and 2014

Employment Costs (W-2: Married Filing Jointly; No Dependents)

Employee's Deduction	**January 1996**	**January 2006**	**January 2014**
Gross Wage[1]	$36,000.00	$40,000.00	$45,000.00
FICA			
• Social Security (6.2%)			
• Medicare (1.45%)	2,754.00	3,060.00	3,442.50
Federal Withholding	3,626.00	2,714.00	2861.00
PA State Withholding	1,008.00	1,228.00	1,400.00
PA State Unemployment	10.80	36.00	31.50
Occupational Tax	10.00	10.00	N/A
Local Services Tax	N/A	N/A	52.00
Local Earned Income Tax	360.00	400.00	450.00
Employee's Take-Home Pay	**$28,231.20**	**$32,552.00**	**$36,763.00**

Employer's Costs

Gross Wage[1]	$36,000.00	$40,000.00	$45,000.00
FICA			
• Social Security (6.2%)			
• Medicare (1.45%)	2,754.00	3,060.00	3,442.50
Health Insurance	4,207.32	13,765.20	22,264.00
PA State Unemployment	167.52	266.94	557.76
Federal Unemployment			43.00
Employee's Cost to Company	**$43,128.84**	**$57,092.14**	**$71,307.26**
Pension/Profit Sharing Contribution[2]	9,000.00	10,000.00	11,250.00
Employee's Cost to Company	**$52,128.84**	**$67,092.14**	**$82,557.26**
Employee Cost: Employee Take-Home Pay (Pre-Profit Sharing)	1.53	1.75	1.94
Employee Cost: Employee Take-Home Pay (Post-Profit Sharing)	1.85	2.06	2.25*

The first table shows the W-2 numbers for a person's gross income and take-home pay. This is what "employment" looks like to the employee. The second table shows the amounts paid by the employer for FICA and health insurance, various unemployment taxes, etc., which most employees don't see. In 2014, for the employee to take home $36,763.00, it costs the employer $71,307.26 or $82,557.26 with a pension/profit sharing contribution. This is what "employment" looks like to an employer.

* Specifically, for my son to take home $1.00, it costs me (his employer), $2.25, so he must produce $2.50. The 25 cents is my return for hiring him. (In fact, the average profit-payroll ratio in the U.S. economy is 10%-11%.) If you tax (or regulate) away the 25 cents, none of this happens. (To learn more, read *The Trouble with Government Spending* by Ron Muhlenkamp, available at www.muhlenkamp.com.)

[1] Based on the U.S. median income.

[2] Based on maximum allowable by law: 25% of gross wages.

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Be Careful Dealing with Creative Sources of Yield: A Redux

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Glossary

Bonds are a way for the government or a company to borrow money. Bonds have two parts: the principal and the coupon. The coupon is a fixed amount that is to be paid to the bondholder periodically over the life of the bond (thus providing "income"). The principal is repaid when the bond matures. Bonds are traded in an open market, just like stocks. Bond prices reflect many things, including changes in interest rates. The price of a bond changes as follows:

- If the current market interest rate is higher than the bond coupon, the bond will sell for less than the face (par) value of the bond.
- If the current market interest rate is less than the bond coupon, the bond will sell for more than face (par) value.
- If the current market interest rate equals the coupon value, the bond will trade at face (par) value.

Dividend is a distribution of a company's earnings to its shareholders, as decided by the board of directors.

P/E (price-to-earnings ratio) is the current price of a stock divided by the (trailing) 12 months earnings per share.

Royalty trusts are a 'pass through' vehicle available to get income from the corporation to the individual with only one level of taxation (the individual income tax). As a result, royalty trusts do not own the properties that are producing, they simply collect royalties and distribute them. Royalty trusts trade on the basis of income; therefore, it is important to check not only today's yield, but, more importantly, what the yield will be or is projected to be in the future. The price of oil and gas drive the payouts, so as oil and gas prices fall and rise, the payouts change from month to month.

In general:

- Royalty trusts have no employees;
- Royalty trusts generally own no land or any other asset except for the right to receive a percentage of either revenues or profits from a production asset that someone else owns; and
- Royalty trusts generally have a finite life, either measured in time (years), or volumes (i.e. a certain amount of oil or gas), or, in some cases, they terminate upon deaths of certain named individuals.

Announcements

Request for Email Address

To ensure you receive all of the correspondence that we publish, please share your email address with us. Occasionally, Muhlenkamp & Company publishes information that gets distributed by email only. To be added to our email list, visit our website at www.muhlenkamp.com, or call us at (877) 935-5520 extension 4. Your contact information will not be released to any third party.

IRA Beneficiary Designation

If you haven't named a beneficiary to your IRA, following are a few reasons to do so:

- Upon your death, it allows the remainder of your IRA to be distributed according to your wishes;
- It provides an opportunity for your beneficiary to preserve the tax-deferred (tax-free in the case of a Roth IRA) compounding of investment gains for years after your death; and
- It avoids the public and costly process of probate for the assets in your IRA.

If you would like to name or verify beneficiaries listed on your account(s), please contact our Client Service Department at (877) 935-5520 extension 4.

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. Muhlenkamp & Company may not give legal or tax advice.

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Intelligent Investment Management

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At our June 3, 2014 investment seminar, Ron Muhlenkamp presented:

The Second Great Economic Experiment… How's It Going?

Here's a snapshot of what was presented:

In the 1970s, the U.S. economy experienced stagflation—a perfect storm of high inflation, high unemployment, and slow economic growth. Economists maintained this condition was common to a mature economy. Paul Volcker and Ronald Reagan proved it was a matter of bad policies. Ron refers to this as "the first great economic experiment in my adult lifetime." In 2008-09, we began "the second great economic experiment." It's now five years in the making and where are we?

Ron compares and contrasts these economic experiments, so that investors have a greater appreciation of what is at stake.

A video archive is available on our website. A DVD is also available that you may view on your PC or TV. If you'd like a copy, please give us a call.