

MuhlenkampMemorandum

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Quarterly Letter

Last quarter we said “It seems like every quarter something big happens for us to talk about...” Well, not this quarter. The last three months have been very quiet – economic growth hasn’t changed much, central bank policies haven’t changed much, bond prices haven’t changed much, commodity prices haven’t changed much, etc. The S&P 500 did have its best quarter of the year gaining a little over three percent even as volatility in the U.S. equity markets set new records for all-time lows in August and September. Not much to talk about there.

Instead, we’d like to share an excerpt from an interview between Tom Keene of Bloomberg TV and Federal Reserve Vice Chairman Stanley Fischer where they discussed negative interest rates (rates of return on loans that are less than zero) that aired on Bloomberg TV on 30 August, 2016, immediately after the central bankers’ conference in Jackson Hole: (emphasis ours)

KEENE: *What did you learn about negative rates in the crucible of the markets? What have you learned in the last number of months?*

FISCHER: *Well, we’ve learned that the central banks which are implementing them — there were four or five of them — basically think they’re quite successful and are staying with their approach, possibly with the exception of Japan. They’re thinking it through and they have said they’ll come back to try and make negative rates work better. So we’re in a world where they seem to work. I think one of the most interesting developments I’ve seen in theory is a paper that says, yes, they work up to a certain point and then they become counterproductive.*

KEENE: *Precisely. Yes, that’s a critical point. I mean, we have within the interviews of Bloomberg Surveillance that Francine Lacqua*

and I have had, Olivier Blanchard [who] calls them an outright scam. Granted, he’s not a public official anymore, I understand that. There is a raging debate about the efficacy of negative interest rates for central banks, for governments, and again for banking itself. What about the efficacy of negative rates for savers and the people of these different nations?

FISCHER: *Well, clearly there are different responses to negative rates. If you’re a saver, they’re very difficult to deal with and to accept, although typically they go along with quite decent equity prices. But we consider all that and we have to make trade-offs in economics all the time and the idea is the lower the interest rate the better it is for investors.*

Note: Olivier Blanchard was the Chief Economist for the International Monetary Fund from 2007 until 2015

We find Mr. Fischer’s comments difficult to reconcile with the Federal Reserve’s dual mandate to maintain price stability and promote full employment.

As we’ve stated before, savers, including pensions and insurance companies, are being thrown under the bus in the hopes a low cost of debt will spur growth – we find no evidence very low or negative interest rates have improved economic growth on a sustained basis anywhere they’ve been tried. It is clear now that central bankers fully understand the drawbacks of low and negative interest rates but consider the damage done to savers an acceptable price to pay as central banks incentivize borrowers in the hope it will generate growth.

Have they made a good decision? You are all participants in our economy and likely to benefit if the economy grows more quickly and probably most of you are savers. Is



the poor return on your savings adequate compensation for an economy growing at less than 2% per year and “quite decent equity prices”?

We’d also remind you that as the price of an asset rises, its future return declines. From these prices we think future returns from the stock market in general will be low relative to the past few decades, and future returns from bonds will be very low. We continue to hold a significant amount of cash awaiting lower prices and hence better future returns.

Until next quarter,

Ron Muhlenkamp and Jeff Muhlenkamp 

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

Announcements

Archive Available: September 1, 2016 Conference Call

Ron and Jeff shared their observations on issues facing the economy, the markets, and investors during our September 1, 2016 semiannual conference call. A transcript and audio archive of the call are available on www.muhlenkamp.com in “Our Library.”

Request for Email Address

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Muhlenkamp & Company, Inc.
Intelligent Investment Management

MuhlenkampMemorandum

September 1, 2016 Conference Call: Highlights

Starting with the “big picture” and working their way toward how economic policies ultimately impact the portfolios, the conversation that took place during the September 1 conference call is available for your review. A transcript and audio archive of the conference call can be found on www.muhlenkamp.com in “Our Library.”

Participants’ questions focused on the Fed’s low interest rate policy:

Low Interest Rates

Ron Muhlenkamp: Low interest rates kill retirees. If you had a financial/retirement plan made more than two or three years ago, it’s time to revisit the assumptions. You were probably told that you could spend 4%-5% of your assets because that’s what bonds threw off. That’s a little more than stocks threw off in dividends, and you expected some capital gains along with that. Today, that’s no longer true. As a result, you’re seeing 65-year olds continue to work because what they thought they could earn during retirement—the income on their assets—has been taken away from them.

It’s having the same effect on pension plans. Pension plans in this country exceed \$9 trillion, and most of them assume they can earn 7% or 8% on their investments. Today, they can maybe earn 2% or 3% on corporate bonds¹—they are not going to make up the difference on stocks.

Jeff Muhlenkamp: The way I think of it is, a company’s cost of capital is the investor’s return on capital: When a company like Apple can borrow at 1% for 30 years, somebody else is getting 1% for 30 years—some saver out there somewhere.

If a pension plan can’t make money on its assets, they pass along the difference to the supporting company. So, if you’re a Lockheed-Martin, Boeing, Delta Airlines, Goodyear Tire...and you are still sponsoring pension plans, your contributions continue to go up. If the pension plan happens to be public, like police and fire, then, as a tax payer, you are on the hook for making up that difference—you might expect the taxes that you pay to go up to support the promises that were made.

Low interest rates prohibit returns on assets. Where does the pension money that has been promised come from? Either you break the promise—in which case the retiree gets hosed—or you pass it along to the underlying customer base. Frankly, that’s companies and that’s taxpayers.

Muhlenkamp Marathon Financial Planning Workbook

If you had a financial/retirement plan made more than two or three years ago, it’s time to revisit the assumptions.

—Ron Muhlenkamp

Regardless of where you are in the process, our Muhlenkamp Marathon Financial Planning Workbook can help you work toward gaining financial freedom. It includes worksheets and suggestions for budgets, guidelines for insurance, and useful explanations/examples of the power of compounding interest. It also includes steps for crafting a “Statement of Investment Policy,” essential to laying out and confirming your investment assumptions.

If you or someone you know needs assistance in getting on the right course financially, request this workbook. Visit www.muhlenkamp.com or call (877)935-5520 extension 4.

In response to the punishing effects of low interest rates, participants inquired about alternative investments:

Alternative Investments (Gold, Real Estate Investment Trusts (REITs), Commodities)

Ron Muhlenkamp: To me, gold has always been half religion because there is no dollar return on gold—it just sits there; it doesn’t generate anything. But, if bonds cost you money through negative interest rates, gold actually has an advantage. So, for probably the first time in my career, we own a little gold.

REITs got a pretty good play a couple of years ago when people were searching for yield. Coming out of the Money Show in Florida a few years back, we warned that a lot of securities were being marketed as

‘high yield’ when they were really ‘payout.’ For example, a mortgage REIT means that you are on the receiving end of a mortgage. Most people have a mortgage they are paying off—every month they make a payment: some of it is interest and some of it is principal. If you own a REIT, you are on the receiving end of that, so some of what you receive is principal. It’s your own money coming back—and you will be told that it is tax advantaged (because you don’t pay tax on the amount of your money that you’re getting back). A lot of people got seduced into investing into REITs. One way or another people got a little smarter, and they corrected.

Jeff: Commodities ran for about a decade, as China grew and consumed commodities—both for its own use and to manipulate and sell to other people. My suspicion is that’s done. For four or five years, after prices started going up, commodity producers made great returns and they started putting that money into new mines and new wells and new processing capabilities. That all came online at about the same time, two or three years ago, which means there is now a glut of nearly every commodity...which means the price tanked...which means commodity producers are losing money. At about the same time, China’s economy slowed down, moving from 10% growth to 5% [gross domestic product] growth.

Ron: For most commodities, the prices are driven by actors. For instance, my farmer cousins know a whole lot more about growing hogs, which would be pork bellies, which is just bacon. Smithfield Foods knows a whole lot more about the processing and selling of pork bellies than either the bacon producer or the consumer.

Unless you really know what you’re doing in the commodity in which you are investing, I predict that you will lose your money because you are competing with people who know what the numbers are, not just those who are speculating on it.

I’ve been saying for 40 years that when people start investing in something they know nothing about, when it doesn’t work, they don’t say, “Did I buy at the wrong time or the wrong price?” They say, “I’ll never do that again,” and go farther afield and invest in things they know less about. Alternative investments are the ultimate in that. 

¹ Source: Bloomberg; Moody’s AAA Long-Term Corporate Bond Yield Averages as of 10/3/16

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The Farming Analogy

By Jeff Muhlenkamp



During the September 1 conference call, more than one question focused on the time horizon for investments (long-term versus short-term) and how those decisions are made. The following essay by Jeff Muhlenkamp builds on a concept published by Ron Muhlenkamp in April 1992: Investing and Farming: Know the Climate (available on our website). Jeff's thesis regarding time horizon(s) boils down to investment objectives and expectations. Let us know what you think.

Over the years, Ron has compared farming with investing. He has stated that investing is much like being a farmer—and that the calendar year with its spring, summer, fall, and winter is analogous to the business cycle. A farmer plants his seeds in the spring when conditions for plant growth become favorable and harvests his crop in the fall when the plants have matured and growth ebbs with the coming winter. In a similar fashion, many stocks are best purchased in a recession as conditions for business growth shift from unfavorable to slightly less unfavorable and are sold some years later when they've reached their full value or, perhaps, when business conditions begin to wane.

I'd like to expand on this analogy a little bit. Farmers don't all plant row crops that are planted and harvested over the course of one growing season. Farmers also plant orchards that produce crops every growing season for a number of years. The analogous investment would be in dividend-paying stocks or bonds. The investment vehicle is held over several business cycles and the important part is the annual yield, not the growth. Foresters (tree farmers) manage crops (trees) that are only harvested after a number of growing cycles. It would be unproductive to cut down your oak seedlings every year like you do your wheat crop—that's not the best way to profit from timber. In like fashion, there are some companies (a bit more rare than trees in the plant kingdom) that are best held for multiple business cycles because they can

compound their earnings over an extended period of time. Like the oak, they are most profitably cultivated by allowing them to grow over multiple growing cycles.

I'd like to make a couple of observations based on this extended analogy:

- The farmer has a much better calendar than the investor. The invention of the calendar gave the farmer a pretty reliable guide about when it was time to sow and reap. Absent a calendar, the farmer would have to make that judgement based on his observations of the weather, the behavior of animals, etc. His decisions would be more difficult and, probably, less reliable. The investor has no equivalent to the calendar and must judge where he's at in the business cycle based on the things he can observe. It's harder for him to get it right than a farmer, which isn't to say that it is a slam dunk for farmers every year either. Farmers often struggle with late frosts, wet weather, etc. that can delay planting or harvesting and reduce the harvest he gets from his fields.
- It's easy for a farmer to tell an acorn from a mustard seed, and an oak will never turn into an apple tree. That's not true for the investor. It is more difficult for an investor to decide what sort of company he's looking at and how best to cultivate it: Is it a very cyclical business and best harvested prior to a recession, or will it continue to compound its growth over multiple business cycles and is best held?
- Everything grows in the spring, nothing grows in the winter. Even if your portfolio is chock full of companies you think are oaks, you still shouldn't expect them to grow during recessions or for their share prices to increase during bear markets (the investing equivalent of winter). Set your expectations appropriately.
- In our portfolio you'll usually find some of each kind of company, though the mix will vary over time. We have no strong preference between them, believing that if purchased at a good price and held for the appropriate period, you can make good returns in all of them. The underlying theme for us is the return we expect to make on the stock based on the price, the performance of the company, and the economic environment in which the company operates. 

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.

AAA bond rating is the highest possible rating assigned to an issuer's bonds by credit rating agencies. The AAA rating is assigned to bonds whose issuers can easily meet their financial commitments.

REITs, an investment vehicle for real estate that allows investors to acquire ownership in real estate ventures. REITs are required by law to maintain dividend payout ratios of at least 90%.



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Changing how the *Muhlenkamp Memorandum* is delivered

Effective January 1, 2017, the *Muhlenkamp Memorandum* will no longer be mailed through the post office to subscribers who are not clients or shareholders. If you are interested in continuing to receive the Muhlenkamp Memorandum, you may receive a copy via email or visit our website after it has been posted.

Shareholders and/or clients who receive a printed copy of our quarterly newsletter through the postal service will not be affected. Nevertheless, we urge you to consider being added to our email distribution list, as there are periodic messages which are delivered via email only.

To sign up for email delivery, visit www.muhlenkamp.com or call us at (877) 935-5520 extension 4. Your contact information will not be released to any third party.



MuhlenkampSMA

All-Cap Value

For the period ended 9/30/16

Muhlenkamp & Company's All-Cap Value SMA (Separately Managed Account) is designed for investors' accounts over \$100,000. We employ full discretion, applying fundamental analysis.

Investment Objective

We seek to maximize total after-tax return through capital appreciation, and income from dividends and interest, consistent with reasonable risk.

Investment Strategy

We invest in undervalued assets wherever they may be found. Typically, this results in holding a portfolio of companies we believe are materially undervalued by the market. Bonds may be included in the portfolio if they are a good investment.

Investment Process

We start with a bottom-up scan of domestic companies, typically looking at most U.S. companies at least four times per year. We add to that an understanding of the sector dynamics in which companies are operating, an assessment of the business cycle, and a review of macroeconomic conditions.

Our primary screening metric is return on shareholder equity (ROE). We are looking for companies with stable returns that can be purchased cheaply, or for companies with improving returns that have not yet been recognized by the market.

We don't believe that a holding period of "forever" is appropriate in all cases, but are comfortable holding companies as long as they continue to meet expectations.

Investment Risk

We define investment risk as the probability of losing purchasing power over long periods of time, which is quite different from Wall Street's definition of price volatility in very short periods of time. Taxes, inflation, and spending will ALL impact the purchasing power of your assets.



Muhlenkamp & Company, Inc.
Intelligent Investment Management

All-Cap Value Composite Performance (Net of Fees)

	Year to Date	One Year	Past 3 Years	Annualized Past 5 Years	Past 10 Years	Past 15 Years
Return	-3.40%	-0.74%	2.63%	9.49%	1.24%	4.71%
S&P 500 Total Return*	7.84%	15.43%	11.16%	16.37%	7.24%	7.15%
Consumer Price Index**	1.83%	1.06%	0.98%	1.23%	1.68%	2.06%

* The S&P 500 is a widely recognized, unmanaged index of common stock prices. The figures for the S&P 500 reflect all dividends reinvested but do not reflect any deductions for fees, expenses, or taxes. One cannot invest directly in an index.

** Consumer Price Index (CPI) – As of August 2016 – U.S. CPI Urban Consumers NSA (Non-Seasonally Adjusted), Index. The Consumer Price Index tracks the prices paid by urban consumers for goods and services and is generally accepted as a measure of price inflation. Price inflation affects consumers' purchasing power.

Consolidated performance with dividends and other earnings reinvested. Performance figures reflect the deduction of broker commission expenses and the deduction of investment advisory fees. Such fees are described in Part II of the adviser's Form ADV. The advisory fees and any other expenses incurred in the management of the investment advisory account will reduce the client's return. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the above accounts. A list of all security recommendations made within the past twelve months is available upon request.

Top Twenty Holdings

Company	Industry	% of Net Asset
Alliance Data Systems Corporation	IT Services	5.77%
Apple Inc.	Technology Hardware, Storage & Peripherals	3.56%
Gilead Sciences, Inc.	Biotechnology	3.47%
ON Semiconductor Corporation	Semiconductors & Semiconductor Equipment	3.41%
SPDR Gold Shares	Exchange Traded Funds	3.00%
Annaly Capital Management Inc.	Real Estate Investment Trusts	2.98%
Hanesbrands, Inc.	Textiles, Apparel & Luxury Goods	2.62%
Microsoft Corporation	Software	2.57%
Celgene Corporation	Biotechnology	2.55%
WCI CMNTYS Inc. Com Par \$0.01	Household Durables	2.40%
PowerShares Buyback Achievers Portfolio	Exchange Traded Funds	2.38%
Biogen Inc.	Biotechnology	2.27%
UnitedHealth Group Incorporated	Healthcare Providers & Services	2.25%
Celanese Corporation - Series A	Chemicals	2.18%
Bristol-Myers Squibb Company	Pharmaceuticals	2.10%
Tencent Holdings Ltd.	Internet Software & Services	2.03%
McKesson Corporation	Healthcare Providers & Services	2.01%
Lannett Company, Inc.	Pharmaceuticals	1.75%
Pfizer Inc.	Pharmaceuticals	1.66%
Teva Pharmaceutical Industries Ltd.	Pharmaceuticals	1.62%

Composite holdings are subject to change and are not recommendations to buy or sell any security.

Composite Top Twenty Holdings are presented as supplemental information to the fully compliant presentation on the next page.

Return on Equity (ROE) is a company's net income (earnings), divided by the owner's equity in the business (book value).

Portfolio Managers

Ronald H. Muhlenkamp, Portfolio Manager, CFA, has been active in professional investment management since 1968. He is a graduate of both M.I.T. and the Harvard Business School.



SMA Facts

Average Number of Equity Holdings 28
Cash & Cash Equivalents 36.46%
Portfolio Turnover 25.21% ‡

‡ Trailing 12 months

SMA Facts are presented as supplemental information.

SMA Information

The All-Cap Value Composite was created in December 2003 and includes fee-paying accounts over \$100,000, full discretion, under management for at least one full quarter which are invested in the All-Cap Value strategy. The composite excludes the Muhlenkamp Fund and any wrap fee account.

Minimum Initial Investment \$100,000.00
Management Fee* 1% (first \$1 million);
0.5% on the remainder

* May vary by account.



Jeffrey P. Muhlenkamp, Portfolio Manager, CFA, has been active in professional investment management since 2008.

He is a graduate of both the United States Military Academy and Chapman University.

Investment Adviser

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Muhlenkamp & Company serves individual and institutional investors through our no-load mutual fund and separately managed accounts.

Muhlenkamp & Company, Inc. All-Cap Value Composite Annual Disclosure Presentation

Year End	Total Firm Assets (USD) (millions)	Composite Assets (USD) (millions)	Number of Accounts	ANNUAL PERFORMANCE			THREE-YEAR ANNUALIZED STANDARD DEVIATION*		
				Composite Gross	Composite Net	S&P 500 Total Return Index	Composite	S&P 500 Total Return Index	Composite Dispersion**
2015	422	48	67	(4.66)	(5.45)	1.38	10.41	10.47	0.68
2014	541	51	67	10.27	9.37	13.69	9.55	8.97	2.06
2013	585	50	60	35.50	34.39	32.39	11.29	11.94	3.13
2012	491	41	66	11.29	10.34	16.00	12.02	15.09	1.14
2011	555	45	74	(2.84)	(3.67)	2.11	16.60	18.70	0.85
2010	724	59	82	2.96	2.15	15.06			1.45
2009	839	90	107	32.68	31.72	26.46			2.80
2008	759	112	155	(40.53)	(40.94)	(37.00)			1.97
2007	1886	327	289	(7.61)	(8.19)	5.49			3.77
2006	3393	371	337	6.09	5.34	15.79			3.70
2005	3471	287	289	10.04	9.22	4.91			3.38
2004	2261	197	206	24.54	23.56	10.88			3.33
2003	1350	132	167	43.36	42.10	28.68			5.57
2002	742	81	139	(19.80)	(20.49)	(22.06)			3.65
2001	699	97	124	(2.72)	(3.51)	(11.93)			5.16

The objective of this All-Cap Value Composite is to maximize total after-tax return, consistent with reasonable risk—using a strategy of investing in highly profitable companies, as measured by Return on Equity (ROE), that sell at value prices, as measured by Price-to-Earnings Ratios (P/E).

Muhlenkamp & Company, Inc. (“Muhlenkamp”) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Muhlenkamp has been independently verified for the periods December 31, 1993 through June 30, 2015 by Ashland Partners & Company LLP.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The All-Cap Value Composite has been examined for the periods December 31, 1993 through June 30, 2015. The verification and performance examination reports are available upon request.

Muhlenkamp is an independent registered investment advisory firm registered with the Securities and Exchange Commission. The firm’s list of composite descriptions is available upon request.

Returns are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite may invest in American Depositary Receipts (ADRs).*** Accounts may be shown gross or net of withholding tax on foreign dividends based on the custodian. Past performance is not indicative of future results.

The U.S. dollar is the currency used to express performance. Returns are expressed as percentages and are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. The annual Composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the Composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

* **Three-Year Annualized Standard Deviation** is a measure of volatility, calculated by taking the standard deviation of 36 monthly returns, then multiplying the result by the square root of 12 to annualize it. Since standard deviation measures the dispersion of a set of numbers from its mean, higher results indicate more variation in monthly returns over the trailing three years.

** **Composite Dispersion** is a measure of the similarity of returns among accounts in the Composite. It is the standard deviation of the annual returns for all accounts which were in the Composite for the entire year.

*** **American Depositary Receipts (ADRs)** are shares that trade in U.S. markets, but represent shares of a foreign company. A bank (the depository) purchases a number of the foreign shares and holds them in a trust or similar account; in turn, the bank issues shares tradable in the U.S. that represent an interest in the foreign company. The ratio of ADRs to foreign shares is set by the bank. ADRs do not mitigate currency risk, but can reduce transaction costs and simplify trading compared to buying the local shares in the foreign markets.