MuhlenkampMemorandum

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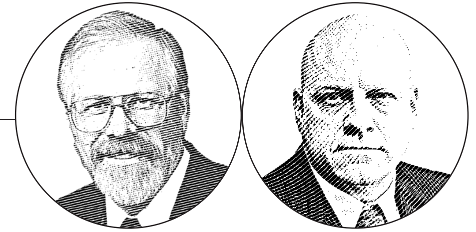
Quarterly Letter



By Ron Muhlenkamp and Jeff Muhlenkamp, Co-Managers

Fellow investors,

If you had told us a year ago that the market would rise 20% in 2017, we would have been skeptical. Yet, here we are at the end of the year and the S&P 500 Total Return Index was up 21.83% for 2017. The S&P 500 Index was up 19.42%. (The difference is the Total Return Index includes dividends.) Technology stocks led the charge; health care, consumer discretionary, and industrials also beat the average. Every other sector delivered below-average returns with energy and telecommunication services posting losses for the year. Our performance was quite close to the S&P 500 Index all year. (Please refer to the 12/31/2017 Fact Sheet for our final performance numbers.) Apple, Inc. (AAPL), ON Semiconductor Corporation (ON), and Universal Display Corp. (OLED) contributed the most to our performance this year, while Teva Pharmaceutical Industries (TEVA), Spirit Airlines (SAVE), and Allergan PLC (AGN) were the biggest drags.

Economically speaking, U.S. Gross Domestic Product (GDP) growth during the first three quarters (4th quarter data hasn't come out yet) averaged a little over 2.1%, but 1st quarter was the low quarter, and 3rd quarter was the high quarter—so the trend was up (which has been the case since June 2016). Unemployment is generally low, inflation is low, and most of the economic metrics we keep an eye on are looking benign. If you want more detail on that, we'll refer you to the webcast we did at the end of November.

At a high level, two "big things" are happening. First, the Trump administration and Congress are working to remove legal and regulatory impediments to economic growth. They are obviously not unified in this effort and the process has been, shall we say, contentious. Nonetheless anti-growth regulations have been rolled back to a degree and a new tax law was signed just before Christmas. We think this is the reason Small Business Confidence jumped post-election and remains at a very high level. We think the new tax law and the shift in the regulatory environment are generally positive developments. We think of it in these terms: when businesses are fleeing your borders, it is a HUGE sign that you are doing something wrong. When businesses hire armies of lawyers to avoid taxes instead of simply paying them, it's a sign you are doing something wrong. It's been happening in the U.S. for years now, as companies merge with foreign businesses to shift their headquarters to more welcoming tax and regulation locales or create complicated corporate structures and hold cash overseas to reduce taxes. Erecting barriers to exit was the knee-jerk reaction but it never works. Congress is taking action to address the root causes of businesses leaving the U.S. and we think what they've done will improve the situation. It's also happening at the state level, just look at Illinois as businesses move to Indiana. Illinois hasn't figured this out yet and continues to chase businesses away. Does anybody think Amazon is seriously considering putting its second headquarters in Chicago? We doubt it.

The second "big thing" is the movement of interest rates in the direction of what we think is "normal" and the reduction of assets held by the U.S. Federal Reserve. As you probably know, for two years the Federal Reserve has been gradually raising short-term rates. Allowing rates to rise to where they "should be" relative to inflation is a positive. If they raise rates more than that, it will become a negative. Additionally, this summer the Federal Reserve started executing a plan to gradually reduce the assets they hold on their balance sheet by not reinvesting all of the money they receive when bonds mature. Their plan is to initially reduce their assets by $10 billion per month ramping that up to $50 billion per month over time.

Simultaneously, the European Central Bank has announced a reduction in its bond purchase program beginning in January 2018. The Bank of Japan is the only major Central Bank that has not signaled a reduction in its "print and purchase" program. We believe that all the money printed during the last 8 years helped boost asset prices—stocks, bonds, houses. As central banks start slowly withdrawing some of that money, it may well have a reverse effect on asset prices. The Federal

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Don’t Let the IRS Define Your Investing

By Tony Muhlenkamp

During our November webcast (archive available on our website), we mentioned the idea of “spend the income, don’t touch the principal.” It’s an investing mantra that has been passed down and has become the guiding principle for how to invest in retirement; invest for the maximum income; spend that income, and don’t touch the principal. I think this ignores the effects of inflation and taxes on your assets (see our essays: *What is Risk?* and *Problems with Investing for Income*); and it’s a trap that hinges on allowing the IRS to define the terms of investing. I strongly recommend allowing the IRS to define the terms when it comes to paying your taxes; but it’s a bad idea to let them do it when you are doing your investing.

As an investor, it benefits you to lower your tax bill by earning returns in ways that the IRS taxes at a lower rate. A return in long-term capital gains will often cost you less in taxes than the same dollar amount of “ordinary income.” If it is spending money that you need, you could invest for growth then cash out any gain made on your investment. So you don’t always need to rely on *income*, when *capital gains* can accomplish the same goal (give you money to spend) at a lower tax rate.

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The IRS defines income as W-2 type salary and wages; interest on bonds and fixed income investments; dividends on stocks; rental on property, etc. Capital gains result from selling an asset for more than you paid for it; capital losses result from selling an asset for less than you paid for it; and principal is what you get to keep after paying taxes on any and all of the above. (This description is not all inclusive or comprehensive, but it suffices for purposes of discussion; call it illustrative but not definitive.)

Imagine you are at your favorite restaurant or watering hole, and you tip your server with a $20 dollar bill. Is your server going to ask if that $20 bill is interest from a bond, dividend from a stock, capital gain, capital loss, or principal? Will your server refuse to take the $20 bill if it’s a capital gain resulting from the sale of an asset instead of income? Will they care? Will you care?

Who cares whether that $20 bill is the result of income or capital gain? The IRS cares, because they tax capital gains and income at different rates. As I said, the IRS trumps all other considerations when it comes to paying your taxes; but should have no bearing on how you actually earn those dollars in the first place. We revise “spend the income and don’t touch the principal” to read “spend what you make after taxes and inflation” and instead of investing for income, we invest for total returns (a combination of income and capital gains) to try to earn returns sufficient to meet cash flow (spending needs); pay the taxes; and cover the shrinking effects of inflation on the purchasing power of our assets. So if we want to spend $20,000 a year from a million dollar base of assets, then we want to grow those assets to cover spending, to cover inflation, and to cover the taxes on that growth. Investing the million dollars for total return is key; and capital gains are preferable to income because they are taxed at a lower rate; but fundamentally the first priority is to earn that total return however we can; then worry about the taxes.

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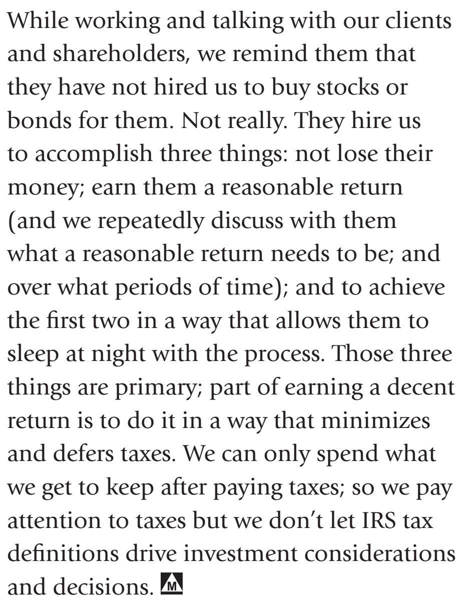
I'm not suggesting we ignore interest and dividends when investing. I'm suggesting we focus on our objectives; short- and long-term goals; what those goals require in terms of investment returns and over what periods of time; and then selecting those investments that meet our goals and criteria according to how we have defined them. Once we have earned the requisite returns we can check with the IRS on how those returns will be taxed.



While working and talking with our clients and shareholders, we remind them that they have not hired us to buy stocks or bonds for them. Not really. They hire us to accomplish three things: not lose their money; earn them a reasonable return (and we repeatedly discuss with them what a reasonable return needs to be; and over what periods of time); and to achieve the first two in a way that allows them to sleep at night with the process. Those three things are primary; part of earning a decent return is to do it in a way that minimizes and defers taxes. We can only spend what we get to keep after paying taxes; so we pay attention to taxes but we don't let IRS tax definitions drive investment considerations and decisions.

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

Investing in stocks, mutual funds, and other assets involves risk. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Principal loss is possible. Past performance does not guarantee future results.

Please consult your tax adviser for advice concerning your particular situation and for any updates to the tax law.

Quarterly Letter

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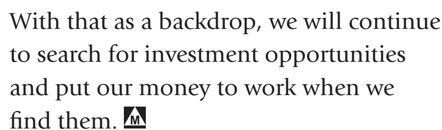
Reserve certainly *intends* to draw down their balance sheet slowly enough that markets don't even notice, but they may not succeed in that. We laid this out in greater detail during our November webcast, take a look at that or give us a call if you want to have a fuller discussion of our thoughts on this.

As we look forward to 2018 then, we see two "big things" working in opposition to each other as far as the markets are concerned: prospects for improved economic growth is a plus, while a reversal (U.S) or reduction (Europe) of central bank support is a negative. Each of these forces may get traction at different times.



With that as a backdrop, we will continue to search for investment opportunities and put our money to work when we find them.

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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 Reserve (commonly referred to "the Fed"), composed of twelve regional Federal Reserve Banks located in major cities throughout the country. The main tasks of the Fed are to supervise and regulate banks, implement monetary policy by buying and selling U.S. Treasury bonds, and steer interest rates.

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

Announcements

Register for our Upcoming Webcast
Please join us for our webcast with Tony, Ron, and Jeff Muhlenkamp.

Thursday, February 22, 2018
4:00 pm – 5:00 pm ET

Register at www.muhlenkamp.com or call us at (877)935-5520 extension 4.

Webcast Archive Available on Website
During the webcast on November 30, 2017, Ron and Jeff Muhlenkamp shared their review of 2017, a year with unusually low market volatility, record-high market levels, and expensive equity valuations. They provided charts and checklists to better explain consumer and business spending and optimism, inflation, investors' margin accounts, and many other items they monitor to determine where the economy is at year end and what concerns them going into 2018. They also explained how actions of the Japanese and European central banks may be influencing the U.S. stock market. Visit www.muhlenkamp.com for the webcast archive and to access other videos and essays available in our Library collection.

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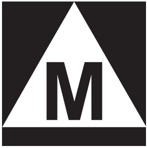

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Intelligent Investment Management

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Upcoming Webcast

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