MuhlenkampMemorandum

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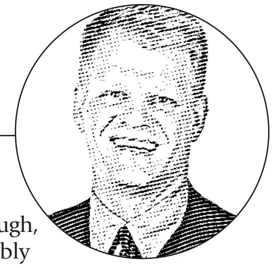
Quarterly Letter

By Anthony Muhlenkamp



Tony had some ideas and observations he wanted me to share, but I thought it made sense for him to tell you directly in this edition of our Quarterly Letter. — Ron

2014 was a year of mixed results and mixed emotions.

The headlines make no secret that "the market" is setting new highs. However, the market they are referring to is the S&P 500, which is dominated by the 20 largest market capitalized companies in the United States. Outside those top 20 is a mixed bag of winners and losers. Small caps in the Russell 2000 are flat for the year; energy stocks are down for the year; international stocks were down for the year; bio-tech was up for the year.

Additionally, the gains did not occur uniformly; instead prices were choppy and advanced/declined with your particular choice of stocks. If you were out of the market on particularly good days, or particularly bad ones, then your performance differed radically from that of the market. If you were taking out some money, or adding some money, the timing of that transaction could make a big difference in your performance.

A friend of mine confided that his wife's 401(k) is allocated 30% international, 30% domestic, and 30% bonds and that her performance this year was just 1%. So how you did this year hinged on what you owned (or didn't own) and when you bought or sold it. This was not the homogeneous market we hear about on the news.

For our clients, we continued the strong performance we had in 2013 through the first half of the year, to the extent that we started harvesting the companies that had done well for us and realized some capital gains. In the third quarter the market prices of our companies were bid down and from there it was a mixed bag.

A big factor in the last half of the year was the price of crude oil dropping from $110 per barrel to $60 per barrel; a drop of 45%. Our energy holdings are primarily natural gas related and should not have been impacted by oil prices being halved, or so we thought. We know the price of natural gas and the price of oil have been on separate tracks since 2009; (see our booklet "Natural Gas: An Energy Game Changer"). The separate tracks for the prices of oil and natural gas continued in 2014 but the prices of the stocks of the companies involved went down with the price of crude. This should be an opportunity, but owning natural gas companies hurt our performance in the last half of the year.

The big beneficiary of the decline in the price of oil is the U.S. consumer, and to a lesser extent, the world consumer. There are 42 gallons in a barrel of oil, so a $50 drop in the price per barrel is a drop of $1.20 in the price per gallon, and you've seen that at the gasoline pump (and to a lesser extent, so far, at the diesel pump). We talk more about the effect on consumers around the world in the accompanying article "Effects of Currency Manipulation."

The people hardest hit by the decline in the price of oil are the producers of oil, both domestic U.S. producers and international producers, including the drillers, the service companies, the landowners; etc. Producers who are particularly vulnerable include the nations of Venezuela and Russia. Their problems are compounded by the rapidity of the decline. The producers, their owners, and their lenders have not yet had time to react. We expect some of them to go bankrupt.

Our biotech companies helped us, as did our airlines and our financials. But you never own enough of the ones that go up, and you always own too much of the ones that don't.

We are disappointed when we under-perform "the market," but that disappointment is tempered by the realization that we own very good companies that are selling for less than they are worth. We have written in the past about our internal performance benchmark being average annual returns of at least 5% over inflation for periods of time measured in years, not in days, weeks, or quarters; and we continue to meet that standard.

Returns of 5% over inflation are not available in cash or bonds, so we are looking for companies that are profitable enough, and priced low enough, that we can reasonably expect those returns over time. We are focusing on our companies and how profitable they are; how well they are growing; how well they are managed; and whether they are currently selling for more or less than they are worth. What is the business worth? Can I buy it for less than that or sell it for more than that? How much less, how much more? Simple questions that don't always have simple answers.

We are also paying attention to central banks, government policies and economies around the world because they set the terms by which our businesses have to operate. We have spoken and written extensively comparing investing to farming and how it helps to know the climate and the season you are operating in, and these macro factors determine the investing climate and season. These macro factors help us know what to plant and what is ripe and can be harvested. They determine whether our companies enjoy tail winds or face head winds as they run their business and provide the products and services consumers desire. Those same macro factors can also influence whether consumers have the desire and the ability to purchase those goods and services. In a free economy, the consumer is king and companies do well that benefit the consumer; so consumer incentives are important.

Today we observe that the market is a mixed bag; some companies are profitable and growing, some companies are not. Some companies are selling for much less than they are worth, some are selling for much more. We call that a stock picker's market, and it's where we like to live.

We observe that economies around the world are growing, although some are not growing as fast as they could. Some consumers around the world are OK; some are being squeezed. In general they are OK—not starving, but not necessarily thriving either—and we are on the lookout for policies that will make the consumers life easier, or harder.

We are finding enough companies that meet our criteria, and we think macro conditions are good enough, that we are fully invested in common stocks.

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Intelligent Investment Management

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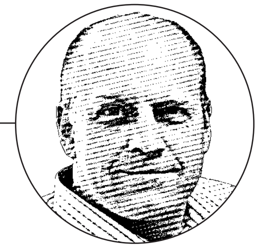
Effects of Currency Manipulation

by Jeff Muhlenkamp



At our November 12, 2014 investment seminar, I stated that the devaluation of the Japanese yen may prompt other export-reliant countries to devalue their currencies in turn as they try to keep their exports competitive. A listener asked me later what the impact of such competitive devaluation would be. In short, it would squeeze consumers in the countries that successfully devalue their currency. Let me explain how I arrived at that conclusion.

First an important point: when you talk about devaluing, you have to devalue against something else—it is always relative. So you can devalue the dollar against the yen, the Euro against the dollar, or the won against the yen… but you can't just devalue the dollar. Since the U.S. dollar is the closest thing the world has to a global currency and most commodities are priced in dollars, most countries try to devalue against it. So let's say Country X is interested in growing its economy and employing more of its population by increasing its exports. In order for their export products to be more competitive internationally, they choose to lower the price. Reducing the selling price without reducing the production cost will put their companies out of business, so Country X must also reduce the cost of inputs—typically mostly labor. Workers generally don't like wage cuts very much, so another way to achieve a lower selling price is to manipulate the exchange rate. If the exchange rate falls the international price of the country's exports will drop, but worker's wages will remain unchanged (measured in the currency of Country X). Everyone wins! To execute this plan the central bank prints money and lowers interest rates. (If their exchange rate is pegged, they lower the peg over time.) This combination usually results in a lower exchange rate; i.e. more of Country X's currency equals the same amount of U.S. dollars. Country X's products are cheaper internationally, sales go up, more citizens are employed, etc.

But did everybody really win?

No. Because the exchange rate declined, anything County X imports is more expensive than it had been. Devaluing Country X's currency benefits the exporter (a business with employees) and hurts the importer (another business with employees), along with anyone in Country X who buys imported goods. What really became cheaper from an international perspective is the cost of labor in Country X. Since Country X's labor got cheaper, there is more demand for it and employment goes up. Who benefitted? Consumers outside Country X that buy Country X products at a lower price and newly hired employees inside Country X. Who paid the price? Country X's workers who received less compensation for their labor than they otherwise would have, Country X consumers who pay more for imported goods, and the workers outside Country X who lost their job to cheaper labor in Country X. Everyone can't win, there are always those who benefit and those who are hurt. There is no free lunch.

Growth through exports aided by a cheap currency is called mercantilism. Mercantilism has been tried by a lot of countries, often with a fair degree of success in the short- to medium-term. Japan did it coming out of World War II. You could buy cheap Japanese cars in the U.S. in the '70s because Japanese workers and engineers worked cheaper than their American counterparts, and the exchange rate was a big part of that. China has done it for the last 20 years: they pegged their currency at an artificially low level, so their products were cheap, and cheap Chinese labor attracted a lot of industry to their shores starting with the really labor-intensive stuff like making clothing and assembling electronics.

This method of growth requires at least the tacit cooperation of the foreign trading partners. Generally, after a time, mercantilism reaches its limit and other means of growth are necessary. Notice that the Japanese yen in the 1970s traded at 300yen/dollar; now, it is about 110yen/dollar. Depreciation against the dollar gave way to appreciation against the dollar. The Chinese renminbi is similar. You may recall during the 2008-09 recession there were loud calls in America for China to quit manipulating its currency and allow it to appreciate. America became more interested in the welfare of its exporting workers than its importing consumers and tolerance for a cheap renminbi declined.

Today, Japan is very interested in devaluing its currency against all other world currencies and is printing money at a fantastic rate to do that. Their goal is to spur economic growth through exports. Their problem is they import most of their raw materials and energy. Their exporting companies will benefit, but their consumers will see costs go up. There is both a benefit, and a cost—you never get one without the other.

There are several other countries whose governments are interested in economic growth via exports, including Korea, China, and Germany. Highly engineered German and Korean capital goods compete directly with Japanese capital goods. As Japanese products get cheaper, they should sell more of them—at the expense of their global competitors. Those competitors may decide to fight back, in part, by printing money and lowering their interest rates; i.e. devalue their currency! (against the dollar). Now you have multiple countries simultaneously trying to devalue their currencies in order to maintain market share in their export markets and thus keep their citizens employed.

Why is that so bad?

Remember that Country X's worker was hurt as he received lower compensation than he otherwise would have. Country X's consumer of imported goods was also hurt as import prices rose. Often, currency devaluations are accompanied by domestic inflation (which is a stated goal of Japan's central bank). Inflation hurts the saver and benefits the borrower. Sum that all up and what do we get?

- If Japan, Korea, Europe, and China simultaneously try to devalue their currencies it only has a hope of working if the U.S. doesn't join in. (The U.S. must tacitly allow them to devalue against the dollar.) This implies a strong dollar and lower commodity prices (measured in dollars).
- Who benefits? The only clear beneficiary is the U.S. consumer of imported goods. Japanese, Korean, European, and Chinese exporters don't gain market share, they only succeed in holding what they had. If there is

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We continue to believe that emotional decisions are bad decisions. This is almost universally true, and clearly true for investing. We write these letters, hold our seminars, and publish booklets on various topics to help build an intellectual framework for investing and to counter the corrosive effects of the emotions that are so prevalent among investors. Please let us know how we are doing and if there is more we can do for you.

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

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.

Russell 2000 refers to the Russell 2000 Index, a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The Russell 2000 is by far the most common benchmark for mutual funds that identify themselves as "small-cap."

One cannot invest directly in an index.

inflation in Japan, Korea, Europe, and China, it will benefit entities that borrowed in those currencies.

- Who loses? Japanese, Korean, European, and Korean consumers of imported goods. All of those countries are big energy importers, so all of their consumers pretty much lose. (For example, the price of crude oil has recently dropped by 45%, from $110 per barrel to $60 per barrel. Since oil is still priced in dollars it has benefited the U.S. consumer, but the Japanese consumer has seen no benefit because the yen has been devalued relative to that same dollar.) Their export workers lose. To the extent they have domestic inflation, all of their savers lose.
- Any foreign entity that borrowed in dollars, but whose income is in a foreign currency, will find it increasingly difficult to make their interest payments; expect defaults. And, of course, one man's debt is another man's bond, so the holders of those bonds lose.
- The drop in commodity prices due to the strong dollar makes it more difficult for the Bank of Japan and the European Central Bank to achieve their stated goals of 2% inflation.

What happens if the United States tries to prevent other currencies from devaluing against the dollar and lowers interest rates and prints money like everybody else? Then, the only beneficiaries are the debtors, as their debts will be denominated in increasingly worthless paper. All savers lose, all consumers lose, and most workers lose. Since the biggest debtors are governments, they win—at the expense of their citizens.

Where are we today? Until October 2014 the U.S. was actively printing money. While the Federal Reserve didn't say it wanted a weaker dollar, that's what happened for the last few years (on a longer time scale, a weaker dollar has been happening for decades). The U.S. has ended Quantitative Easing (QE), and may raise interest rates in the next six months. The dollar has been stronger against most currencies over the last 6 months; commodity prices are falling (measured in dollars), in some cases quite dramatically, creating additional trouble for Russia, Indonesia, and Brazil. Japan is actively devaluing its currency, so far successfully. If the other nations of the world allow Japan to continue to do so the pain will be limited to Korean, U.S., German, and Chinese exporters, and the Japanese consumer. If other countries begin to devalue, the pain spreads as described above.

We pay attention to these types of macroeconomic issues because doing so helps to avoid risk and identify opportunities for investment. As we learn things that are of interest and not well covered or understood by mainstream media we will continue to pass them along.

The Healthcare Industry and the Consumer

by Anthony Muhlenkamp

The headline topic for our November 12, 2014 investment seminar was "Game Changers in Biomedical Science" delivered by Tammy Neff, an analyst on our investment team. She has written about the topic in *Muhlenkamp Memorandum #112*, and in a booklet that we can mail you or that you can download from our website, but I would like to highlight an element from her talk that I found particularly interesting. What are the effects the consumer is having on the healthcare field; and what are the effects that the advances in biomedical science are having on the consumer?

Today, on a per-person basis, $.22 of every dollar spent in this country goes to healthcare. This average includes the money that you pay out-of-pocket, along with benefits paid on your behalf by your healthcare insurer. It encompasses doctor visits, hospital stays, lab testing, medications, outpatient physical therapy, etc.—and it's the "biggest piece of the pie" of total consumer spending. Comparing apples-to-apples, 11% of all consumer spending went to healthcare in 1980. Stepping back even further, healthcare spending averaged 6% in 1960.[1] So, starting in 1960, we nearly doubled what we spent on healthcare by 1980—and we doubled it again from 1980 to 2013.

Some argue this is a bad thing and conclude that healthcare costs are too high. We think it's indicative of people being more prosperous than they were and not having to spend it all on food, clothing, and shelter. Despite best efforts, there appears to be a limit to what people can eat, and how much house and clothes people need. So spending on health care is a rational next priority.

Today, over $130 billion is invested annually in biomedical research[2] and consumers are benefitting. If you were born in 1900, the average life expectancy was about 47 years; in 2012, it's about 78 years.[3]

We think the significant increase in consumer spending on healthcare over the last 54 years results from a combination of:

1. Continuous Innovation: For example, in the 1960s, open-heart surgery was perfected. In the 1970s, we gained MRI technology, enabling less invasive, more precise diagnoses. Today, there is genetic-based testing and precision treatment for cancerous cells.
2. Aging Baby Boomers: As the U.S. population ages, consumers demand more services like hip and knee replacements.
3. Expanded Insurance Coverage: 1966 brought us Medicare, providing healthcare coverage for Americans ages 65 and older. 2010 brought us the Patient Protection and Affordable Care Act, providing millions of Americans access to health insurance coverage. Additionally, in the '60s, health insurance predominantly covered hospital stays and surgical procedures. Insurance coverage now includes outpatient care, physical therapy, chiropractic care, medications, artificial limbs, etc.

We have often observed that in a free economy the consumer is king, and that any product or service that has direct and measurable benefits to the consumer is likely to have legs. The advances in the field of biomedical science is an area that may well fit that description. More and more people seem to be receptive to the idea of "living long enough to live forever," and that can be a powerful trend.

With that in mind, we focus on those companies that we think will ultimately provide cost savings to the healthcare system, and the consumer, through the following game changers:

- Transforming the model of healthcare from disease management to disease prevention through personalized medicine;
- Rethinking the approach to the war on cancer; and
- Curing diseases that were previously life-long conditions.

To learn more, please visit the seminar archive on our website, or call to request the DVD.

[1] U.S. Bureau of Economic Analysis; all data is adjusted for inflation.
[2] Research America; Truth and Consequences: Health R&D Spending in the U.S. (FY11-12)
[3] 1900-1960, Andrew Noymer, University of California Berkeley; 1961-2014 World Bank

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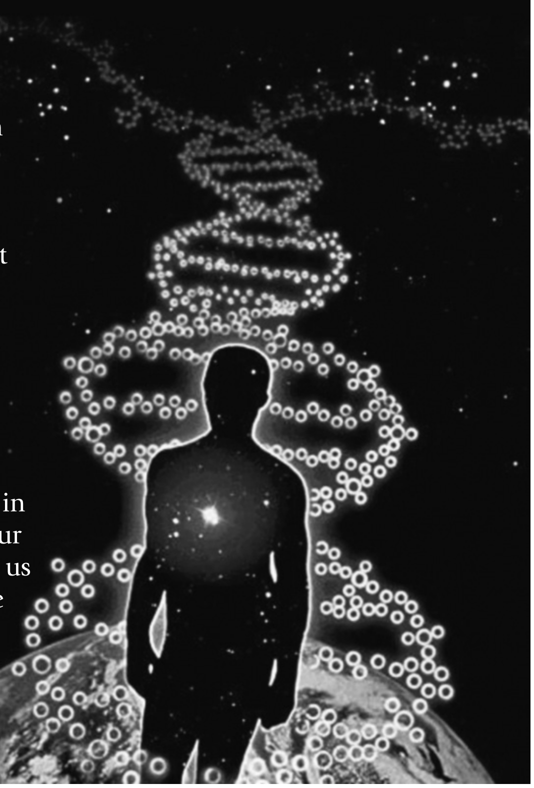
At our investment seminar on November 12, 2014, Tammy Neff, Investment Analyst, addressed ***Game Changers in Biomedical Science***. Additionally, Ron Muhlenkamp, Portfolio Manager, provided a market update, and Jeff Muhlenkamp, Investment Analyst and Co-Manager, provided an update on what's taking place in Europe and Japan.

A video archive of the presentations is available in the "Library" section of our website. If you prefer, call us at (877)935-5520 and we will mail you a DVD.



GLOSSARY:

Currency Peg is when a country or government's exchange-rate policy "pegs" its central bank's rate of exchange to another country's currency. (Currency has sometimes also been pegged to the price of gold.) Also known as a "fixed exchange rate" or "pegged exchange rate," currency pegs allow importers and exporters to know exactly what kind of exchange rate they can expect for their transactions, simplifying trade. In turn, this helps to curb inflation and temper interest rates, allowing for increased trade.

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"), comprising twelve regional Federal Reserve Banks located in major cities throughout the country. The main task of the Fed is to conduct monetary policy that promotes maximum employment and stable prices.

Quantitative Easing is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. Central banks tend to use quantitative easing when interest rates have already been lowered to near 0% levels and have failed to produce the desired effect. The major risk of quantitative easing is that although more money is floating around, there is still a fixed amount of goods for sale. This may eventually lead to higher prices or inflation.