ROEs AT A REASONABLE PRICE: A TOP-DOWN BOTTOM-UP APPROACH

FUND FACTS

MUHLENKAMP FUND (MUHL)

CATEGORY:
Growth

PERFORMANCE (thru 12/31/00)

Compound Annual Return (%)	Fund	Category
1 year	25.3	3.5
3 years	12.9	11.0
5 years	20.0	16.1

RISK
Above Average

TOTAL ASSETS: (as of 3/1/01)
$320 million

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Last year was a rough year for most diversified stock funds, including many long-term top performers. Most stock indexes, with the exception of the S&P MidCap 400, actually lost ground.

Some funds, though, managed to turn in impressive performances for an overall down year. One fund that did quite well was the Muhlenkamp Fund, which with a 25.3% return was among the top 20 growth funds for 2000. The fund is also among the top 50 among all no-load and low-load funds for the 10-year period through year-end 2000. Currently it has about $320 million in total assets.

In early March, portfolio manager Ronald Muhlenkamp discussed his investment approach with Maria Crawford Scott.

What is the investment objective of the fund?

The fund is total return and diversified. We are looking to buy good companies at reasonable prices.

Do you have any particular size of company that you focus on?

No, we think market capitalization is a useless number. We think a good company versus a poor company makes a difference. We think a fair price versus an expensive price makes a difference. Whether they're big cap or small cap—we don't care.

We think our fundholders pay us a fee to make them a good return within the public markets wherever we can find it. So, we have the capability of going to bonds if they look good. We have the capability of going to foreign stocks if they look good, we can go into real estate, although we would use REITs. We're broadly defined, we're total return, we're diversified, and we're no-load.

How do you start the investment process? Do you use a top-down approach, looking at the broad economic and investment environment, or do you use a bottom-up approach, searching at the individual company level?

We use a little bit of both. What we always do is look for good companies, and if I had to start with a number, I would start with return on shareholder's equity. Since World War II, the average ROE in the United States has been 14%, plus or minus 1%, and we don't like below-average companies, so we want an ROE over 14%. But what we're willing to pay for that company depends on the level of inflation and interest rates.

Some people use growth at a reasonable price; we use return on shareholder's equity at a reasonable price. We find ROE to be a little more stable, and people get all excited when you start talking about growth, whereas they tend to be a little bit more reasonable when you're talking about profitability.

We set our hurdles based on inflation and sometimes based on interest rates, depending on how those two relate to each other. We always look for good companies, but we set prices that we think are fairly valued and look to buy at probably 30% below that.

For instance, in the early 1980s, we were big buyers of bonds because inflation was 10%, interest rates were 14%, corporate ROEs were 13%, bonds were selling at par, stocks were selling at book, and we were looking at a 14% return on bonds and 13% on stocks. There was no equity premium, if you will.

The point is, we measure one against the other, but we also measure against our hurdle. We won't buy bonds unless they're more than 3% above inflation, and we're not interested in buying stocks unless the return to us, the shareholder, looks like more than 6% above inflation. So, there are times when you just simply want to keep your money in your pocket—the 1970s were a pretty good time for that.

In today's market, inflation is roughly 2.5%, so we're not interested in bonds unless they're over 5.5%, and they're roughly there. We would need to see about an 8% or 9% return to be interested in stocks. Basically we're saying that in today's market, we want a price-earnings ratio below the ROE.

What is your definition of a 'good company?'

I start with ROE. If they have consistently made a good return on shareholder's equity, they're a good company. But I use other things to flesh it out. For instance, can the ROE be sustained, or are we seeing just a flash in the pan? Is their balance sheet keeping up?

What about non-statistical measures?

The smaller the company, the more you have to get to know management. But by and large, if there's good management, it comes through in the numbers.

Basically, I look at companies in four ways:

First, I monitor what their revenues are doing. The revenues simply tell you whether the public is buying their product. If their revenue is not growing, sooner or later it gets tough to grow their bottom line. We raised red flags a couple of years ago on companies like Coca-Cola and Gillette because people were expecting earnings growth of 15%, and yet the revenues were growing 0% to 5%. Revenue tells you whether the public is buying the product.

Second, the way you make profit is cost control, so I look at that.

Third, what does the balance sheet look like? What do the finances look like? Are they going to need more capital one of these days?

And fourth, I look at labor relations.

Basically, those are the four keys in any company.

What gets interesting is the relationship between ROE and the growth rate. If the growth rate is higher than ROE, sooner or later you will probably have to sell stock. If the ROE is higher than the growth rate, you probably have free cash flow.

What we saw with a lot of the young companies in 1999 was that it was easy for them to sell stock, but in 2000, it got tougher. For a high growth company with low profitability, we say, 'Okay, what's their capability to raise equity when they need to?'

The flip side of it is, if you have a very profitable company that's not growing, then the question becomes, 'What are they going to do with the cash?' Most companies have a core business that they are very good at. Where they get in trouble is when the cash burns a hole in their pocket and they go do dumb stuff with it. But at least if you have the cash, you're in control of your own destiny, which is one of the reasons we like ROE as a starting place rather than growth rates.

When you are examining financial items, whose numbers are you using? Your own estimates?

That depends. When the numbers look interesting to us, and we allow the numbers to do the initial screen, we then call up the company, and our three favorite questions go as follows:

Number one, are there people on Wall Street who do the job of following your company? And that simply saves us a lot of work if the answer is yes.

Number two, by what criteria do you judge yourselves in terms of how you run your company? Thirty years ago, people talked about payback. Now some talk about ROE, some talk about economic value added, some talk about discounted cash flows, and all of those are valid. We want to know what they use internally.

Number three, at what point do your people start earning a bonus? We think of ourselves as owners of the business, so we want to know what criteria and what levels they use to judge themselves as a business. And then we can determine whether or not we want to be partners with them.

Do you have any rules regarding concentration in a particular company or industry?

When we're buying, it would be less than 5% in the company. Industries get interesting, because you can always redefine them. For instance, in the early 1990s we were finding that in a number of industries we could buy the financial arm cheaper than we could the manufacturing arm. In 1991, we bought Merrill Lynch because we thought it was a retailer. Now, is that really a financial? We don't care, but some people do. If you held me to an industry definition, I can jiggle those numbers in ways that would make it nonsense, so we don't worry about it too much. We have limits, but we don't get too hung up on them.

When you purchase a stock, do you look for any signs that the market is about to recognize it—are there any momentum figures that you look for?

Not really. We find if we buy good values, sooner or later the market figures it out. If we could find any market indicators that were reliable, we probably would use them, but after 30 years, we haven't found any.

What is absolutely fascinating is that people talk about timing the market. Well, if the price is right, the time is right. I can build a discipline on price—I can determine what is a fair price, or what is expensive or what is cheap, with a fair degree of accuracy. It's not totally accurate, but it's at least a reasonable range. And I can determine a fair price a whole lot better than I can determine the appropriate time. If the price is right, you'll find out the time is right.

We don't try to forecast the future. We do try to understand the present. Very few people understand the present. That's literally what we do.

So when you're looking at inflation and interest rates, are you actually making a prediction or are you really looking at where things are right now?

We're trying to understand where things are now and the trend that they're in. For instance, we think that interest rates are coming down now. Everybody says, 'How far; how long?' I have no idea. It will go down until it stops.

What we were saying in 1999 was that as long as interest rates were going up, it would be tough for most stocks to do very much, and as long as the hype stocks were running, there wasn't a big reason to look outside that group. In April of 2000, we said long-term interest rates rolled over in January and it looked like the hype stocks were peaking. And that was the perfect time to go and buy things like housing stocks, which we did. So, we don't try to predict how long or how far, we simply monitor for when it turns.

Back in 1999, were you in what you called the 'hype stocks'?

No. We owned some capital goods. We also owned things like applied materials. The hype-stocks game lasted longer and went farther than we expected. So to that extent, we were wrong. When they did roll, I didn't have the guts to short them, but I did have the good sense not to buy them at the top, having not bought them at the bottom.

We think there are two things that go on all the time. We're in the business of investing, but a lot of people play "the game" in the stock market. Both go on in the same arena at the same time, but it's a very different discipline. Playing the game is basically psychological, and if you're good at crowd psychology, and if you were good at fashions in high school, you should probably ignore everything I've told you. But I'm not good at that. What I am pretty good at is knowing a reasonable value for a company based on inflation, interest rates and corporate profitability, and what's a reasonable price to pay. And I've got a pretty good stomach as long as the fundamentals are holding true. So, those are the skills I build on to make money for people.

What would prompt you to sell?

If the company's fundamentals disappoint, or if the stock is acting poorly and we can't figure out why, many times we sell just because you can get out and get back in for a percent or two.

In a sense, the rule is we sell when relative strength breaks down. I learned a long time ago that I can call up corporate management, and they can tell me the good news for the next five years, but they usually won't tell you the bad news until after it's happened and it's too late.

What we do with every stock is to set a number that we think is a fair value based on the fundamentals. If the price gets too far away from that, typically up, but even down, out of that plus or minus 20% to 30% range, then we say, 'Okay, this is a fair value, but it's trading on psychology.' If it runs up well beyond that number, we may ride it as long as it's running, but we don't kid ourselves into thinking that it is a fair price.

What I'm saying is, you don't adjust your number just because the market moves the price. You have to recognize that it's trading on emotion, not on reason.

What's your current outlook?

We don't think inflation is a problem, and we think interest rates probably will come down some more. The interesting question is: Are we on a soft landing, or will it be something more dramatic than that? The way things are acting, it's looking more and more to us like a soft landing. For instance, Ford's down a quarter today but those kinds of stocks are acting very well; housing stocks are acting very well. Consumer purchasing of housing is holding up. So far, it looks to me like it's probably a soft landing with a very quick inventory adjustment. But I have to keep my eyes open, knowing that it could deteriorate from here.

If it turns out to be a rougher landing than you thought, how would you change the fund?

We would buy more bonds and probably sell some of the financials.

Your fund has done very well on a long-term basis. To what do you attribute your long-term success?

Sticking with the things that work, but also keeping a bit of an open mind.

There have been about three times in the 30 years I've been doing this that the public changed its mind about something. We call that a climate change, and that changes the investment environment. For instance, what worked in the 1960s didn't work in the 1970s, and what worked in the 1970s didn't work in the 1980s. In each of those periods the public changed its mind, and if you try to keep doing the things that work prior to that, you get your head handed to you.

Now, you don't have to predict these changes, but you have to recognize it, because it sets the tone for many years. And I think the key to all of this is inflation. We have a slide show on our Web site that explains this in quite a bit of detail.

The fundamentals always apply, but they change when the value of money changes, and so you have to look at things from different angles and different perspectives. What we've added to the game over the years has been that perspective, and frankly it's worked out very well. ✦