Muhlenkamp Fund

FOR THE PERIOD ENDED 06/30/12

OBJECTIVE

Seeks to maximize total return to its shareholders through capital appreciation, and income from dividends and interest, consistent with reasonable risk.

STRATEGY

Invest in the common stock of highly profitable companies, as measured by Return on Equity (ROE), that sell at value prices, as measured by Price-to-Earnings Ratios (P/E).

PORTFOLIO MANAGER

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

VESTED INTEREST

The majority of Mr. Muhlenkamp's long-term investment assets are invested in the Muhlenkamp Fund.

TOP TEN HOLDINGS

Company	Industry	% of Net Assets	Industry % of Portfolio
Abbott Laboratories	Pharmaceuticals	5.60	9.4
Intel Corporation	Semiconductors & Semiconductor Equipment	5.59	6.9
Philip Morris International, Inc.	Tobacco	5.50	5.5
Alliance Data Systems Corporation	IT Services	5.28	5.3
Microsoft Corporation	Software	5.25	7.8
Covidien PLC	Health Care Equipment & Supplies	4.01	4.0
State Street Corporation	Capital Markets	3.79	3.8
Sonic Automotive, Inc. - Class A	Specialty Retail	3.26	4.3
JPMorgan Chase & Co.	Diversified Financial Services	3.16	3.2
Berkshire Hathaway, Inc. - Class B	Insurance	2.60	8.1

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

AVERAGE ANNUAL RETURNS AS OF JUNE 30, 2012

	Year to Date	One Year	Past 3 Years	Past 5 Years	Past 10 Years	Past 15 Years
Return Before Taxes	5.84%	-2.69%	9.08%	-6.19%	2.85%	5.58%
Return After Taxes (1)	5.84%	-2.70%	9.06%	-6.71%	2.54%	5.25%
Return After Taxes (2)	3.80%	-1.73%	7.81%	-5.08%	2.52%	4.94%
S&P 500*	9.49%	5.45%	16.40%	0.22%	5.33%	4.77%

(1) ***Return after taxes on distributions*****
(2) ***Return after taxes on distributions and sale of Fund shares*****

Performance data quoted, before and after taxes, represents past performance and does not guarantee future results. 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. Current performance of the fund may be lower or higher than the performance quoted. Performance data shown is current to the most recent month end.

* 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.

** **After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on your situation and may differ from those shown. Furthermore, the after-tax returns shown are not relevant to those who hold their shares through tax-deferred arrangements such as 401(k) plans or IRAs.**

Quasar Distributors, LLC., Distributor 06/12

INVESTMENT ADVISER

Muhlenkamp & Company, Inc.
5000 Stonewood Drive, Suite 300
Wexford, PA 15090-8395
(877)935-5520

www.muhlenkamp.com

GENERAL INFORMATION

Style	All-Cap
Inception Date	11/1988
Ticker Symbol	MUHLX
CUSIP	962096103
Minimum Initial Investment	$1,500.00 †
Sales Charge	None ††
Expense Ratio	1.25%

† *Or $200 if the Automatic Investment Plan (AIP) is chosen. Automatic Investment Plans do not assure a profit and do not protect against a loss in declining markets.*

†† *Although the Fund is no-load, investment management fees and other expenses still apply. Please refer to the prospectus for further details.*

FUND FACTS

Number of Equity Holdings	46
Total Net Assets	$460,618,644.68
Average ROE	17.59% ‡
Long-Term Earnings Growth	11.59% ‡
Average P/E	13.87 ‡
Portfolio Turnover (2010)	75.49% ‡‡

‡ *Source: Bloomberg as of 6/30/12*
Note: Average ROE has been adjusted. Reported ROEs >60% have been marked down to 20%, providing a lower, more conservative, (and we believe more meaningful), valuation for the company.

‡‡ *Audited*

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

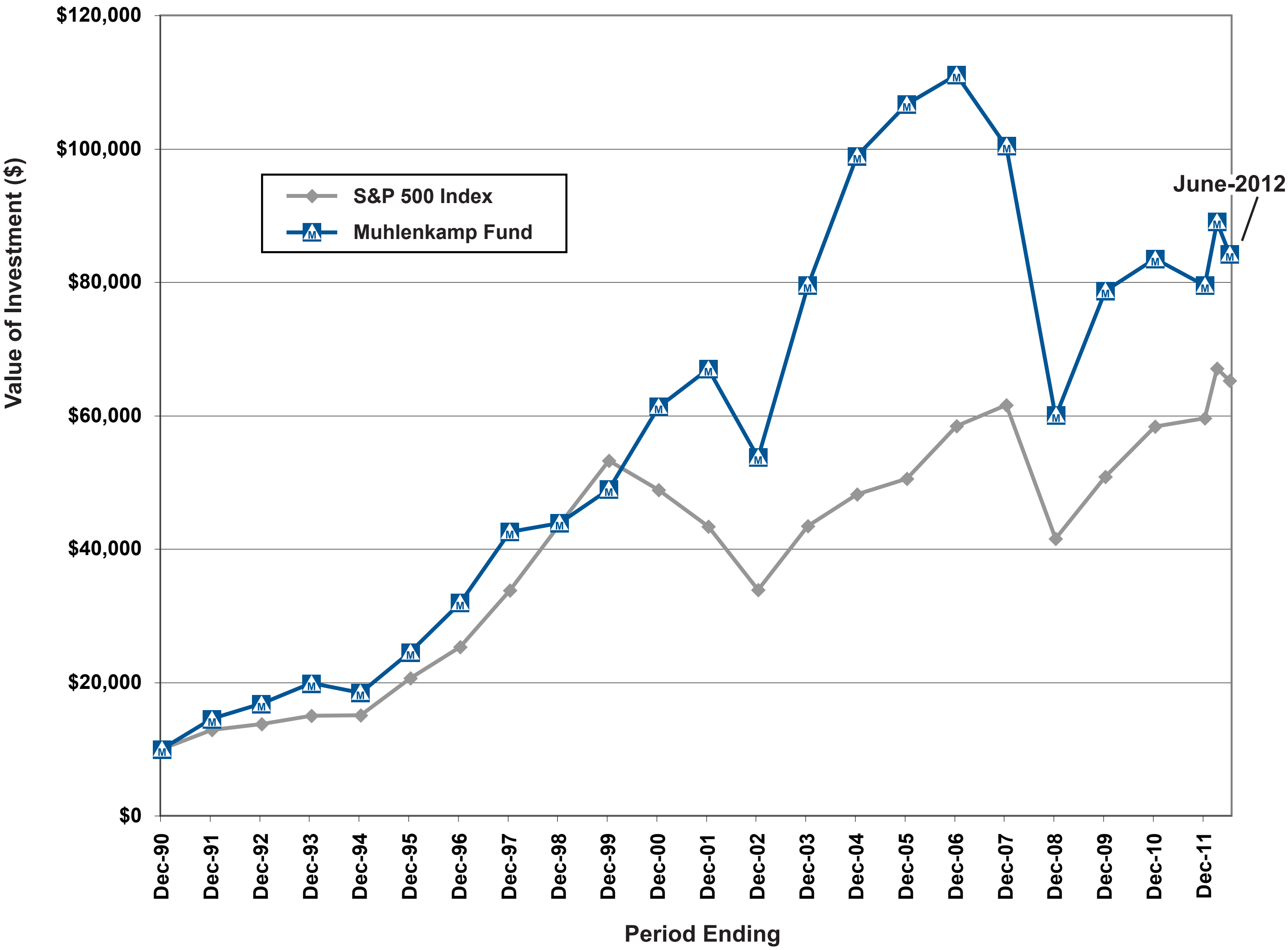
Price-to-Earnings Ratio (P/E) is the current stock price divided by the earnings per share.

Long-Term Earnings Growth is not a forecast of the Fund's future performance.

Muhlenkamp Fund

GROWTH OF A $10,000 INVESTMENT SINCE DECEMBER 31, 1990

This chart illustrates the performance of a hypothetical $10,000 investment made in the Fund on December 31, 1990, and assumes reinvestment of dividends and capital gains. This chart does not imply future performance.



Mutual fund investing involves risk. Principal loss is possible. The Fund may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund may also invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value as interest rates rise. This risk is greater for longer-term debt securities.

The Fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling (800) 860-3863, or visiting www.muhlenkamp.com. Read it carefully before investing.

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

Muhlenkamp Fund

Muhlenkamp and Company
Adviser Conference Call: Amended Transcript

July 12, 2012 / 4:15 p.m. ET

SPEAKERS

Anthony W. Muhlenkamp – Executive Vice President, Client Service Team
Ronald H. Muhlenkamp – Founder, President, and Portfolio Manager

PRESENTATION

Tony

I appreciate you joining us here on a hot summer's afternoon. Hopefully, we'll have some answers to your questions, give you some ideas, and let you go back to your office with some thoughts and information for your clients.

I want to start as I normally do, by asking Ron to give us the big picture: what he is seeing today and how that has changed in the last three months… What's the most interesting thing he can think of, or observe going on, right now. Ron?

Ron

We're seeing a continuation of the things we've been talking about for a couple of years and, frankly, I haven't seen a whole lot that's changed in the last three months. The three big headlines remain: Europe, China, and the U.S.

Europe has not fixed its problems. Our suspicion is they're about to go on vacation to repeat what they did a year ago, and two years ago, which means not much will occur soon. The names have changed a little bit. Last year, Greece was at the top of the list and it came back briefly with its elections earlier this year. But now, Spain is at the top of the list. A day or so ago, short-term interest rates in France went negative, which is very hard for a lot of us to fathom. So, we don't see that Europe has changed its mind or is fixing its problems. We did see it buying itself a few months of time with the LTRO, (long-term refinancing operation). We played that reasonably well—as did the markets. The markets got what some people called a 'relief rally.' We think that ended a couple of months ago, and it's been spazzing around since. So, we haven't seen anything that says Europe has really dealt with its problems, or is about to.

When it comes to China, we are now at the point where China has lowered interest rates twice. If you have been following us, you know that we think China has been the trigger or the sensitive area for the cyclical part of the world economy. And the cyclical part in China has been slowing sizably. For example, Caterpillar hydraulic excavators are down year-over-year for 10 or 11 months in a row.

The old rule of thumb in the U.S. had always been when the Fed lowers interest rates three times, the market starts to take off. There's no sign yet that the Chinese economy or its markets are taking off after taking two steps down in interest rates. Nevertheless, we're monitoring this fairly closely. So far, the numbers have been coming in less positive than the Chinese had expected—less positive than a lot of other folks had expected.

And, of course, when they [Chinese officials] do manage to turn things around…they have said, and we have no reason to disagree or to not believe them, that the focus this time would be on the consumer and not infrastructure. So, for instance, we told you a couple of years ago that the commodities that China was buying tended to be the stronger commodities (e.g. oil, copper, and iron ore). We're not sure that China's going to be buying commodities big time this time around.

Yesterday, or maybe the day before, we saw reports out of Alcoa. Alcoa continues to talk about a global aluminum supply deficit. What the deficit is relative to I'm not sure because they also state that over the last year, aluminum prices have declined 18 percent. If the supply deficit were relative to demand, I don't think prices would be coming down.

Those of you who monitor basic material prices notice that everything from aluminum to copper to steel has been trending down, not up, in concert with the Chinese economy slowing down. Don't get me wrong, the Chinese economy's GDP is not negative, but its growth has slowed down from where it had been. We've been saying for some time that China had taken its foot off the brake, but has not yet stepped on the accelerator. They're in that transition. So, whether or not you might call two drops in interest rates the beginning of a push on the accelerator, we're not seeing signs that either the economy or the markets have quite jumped just yet.

In this country… I don't know if any of you had the chance to listen to CNBC's *Squawk Box* this morning. They had Alan Simpson and Erksine Bowles, along with Warren Buffett. Alan Simpson said flat out that until the election in November, nothing would change in this country. That's our read as well. The good news, of course, is that we have a date when, hopefully, decisions are made and we'll have some idea going forward what the new standards and new rules will be. So, we tend to agree with him that not much is going to get done in Washington, D.C. until then.

Alan Meltzer (American economist and professor of Political Economy at Carnegie Mellon University) had a nice column in the *Wall Street Journal* a couple of days ago on what the Fed was doing. The problem we now have is not a monetary problem—it's a fiscal problem. Lowering interest rates might have been useful two years ago—or even QE1 might have been useful—but you saw no useful effects from QE2, or from getting rates down to zero, or from Operation Twist.

Lowering interest rates discourages retirees who are trying to live off their income; it discourages them from spending. It also makes major problems for pension funds. The idea was that it would help younger people to buy houses with mortgages. Well, that's been ineffective because the reason they're not buying houses has very little to do with interest rates.

But, the long and short of it is, in my opinion, the Fed has 'shot its wad.' It's no longer being effective. Frankly, I hope they don't do another round of QE (quantitative easing). Yes, it helped the markets to some extent, but we've got more at stake than a short-term swing in the marketplace. If we get the rules for the economy right, the markets will take care of themselves.

There was a short article in yesterday's *IBD* on the job market that reflected our point of view. We've been saying for about two years now that as long as we keep penalizing employers, employment will not come back. Employment hasn't come back. Anybody who's out there, I would encourage you to put yourself in the employer's shoes and ask whether you would be hiring people when you don't know what your tax rate will be, what your regulations will be, or what your cost of healthcare will be.

There's a whole lot of uncertainty out there. We think the macro [environment] is overriding the micro [fundamentals]. Obviously, the companies that we own, we like. We continue to own companies that have rock-solid balance sheets and a good cash flow[1]. Many of them have decent dividends, which we've never really focused on in the past. But we think that with the difficulty of finding decent returns—either in money market funds or in bonds—that some people who are looking for income will be placing a premium on decent dividend yields.

So, the companies we like, we own. But our fear is that the macro overrides what's happening with individual companies. We are finding companies that we like, at prices we like. First quarter earnings came through in pretty decent shape. There's less confidence in second quarter earnings. So far, what we're seeing is that any company that's had a negative report has gotten slammed—whether it's Cummins Engine, which reported its revenues might be flat instead of up 10%—or whether it's SuperValu—or almost anything else.

One of the questions we received prior to this call pertained to China, but it also pertains to a whole lot of other things: "With some companies doing reasonably well, would that make us more bullish?" Yes, it does, but we're also a bit cautious because, so far, the market has not been willing to pay up for good news. It has been quite willing to knock you out if you relay any bad news. Hopefully, one of these days, bad news will cease to have its impact. When you get bad news on a company *and* the stock doesn't get hurt, then, we're likely to be more active in buying the companies we're identifying.

If you look at our top ten holdings, they're pretty much the same as they were a quarter ago. PNC Financial moved out because we sold it and replaced it with JP Morgan. We've said for a couple of years, or maybe a year-and-a-half, that the U.S. international banks were improving themselves into a pretty good place, and that the European international banks were probably continuing to shrink. We bought JP Morgan a bit lower than it is right now. It had a run up, and came back down. We still like the idea—obviously, I wish I had been savvy enough to trade it short-term, but frankly, our plays are longer-term.

---

[1] Cash Flow - represents the cash a company is able to generate after paying out the money required to maintain or expand its business.

We also sold UnitedHealth. It had a good run for us. We thought it might be somewhat susceptible to whatever came out of the Supreme Court ruling on ObamaCare. It looks like that [outcome] will now be left up to the electorate, which frankly is where it should be—November's going to be a big date for us. UnitedHealth Group, Inc. was replaced by Berkshire Hathaway, which we've owned for a long time. This action simply allowed it to move up into the number 10 spot, instead of the number 11 spot.

We're finding good companies at cheap prices. We are insisting on strong balance sheets and good cash flows. Our fears are macro. We see a continuation of what they've been doing in Europe. We do expect China to turn somewhere in the foreseeable future, so we're monitoring that. In the U.S., we think the elections in November will have a major impact. If nothing else, it should clarify what the rules are likely to be going forward. It's hard enough to have rules that are hard to live with, but when you don't know what the rules are, it makes it even more difficult. So, it's a continuation of what we have been seeing. We're about to publish our quarterly newsletter [*Muhlenkamp Memorandum #*103]. Sometimes our *Memo* says, "See last time." That's nearly what we're saying this time: it's a continuation of what we've been seeing and talking about. I hope that's helpful.

Tony

It is helpful—and I'm going to ask you to elaborate on some of that. Let's go back to Europe. You said they've not yet fixed their problems. Are they buying themselves time, or are they allowing the problems to snowball? Are they creating greater problems by not addressing them and going on vacation? Any ideas?

Ron

I want to say yes, and yes, and yes....

For those who have been watching, it was interesting to us that in July of last year, Ireland announced it was cutting the pay of public sector employees by 15 percent. At the time, Irish bonds were selling at $0.60 on the dollar, and Greek bonds were selling at $0.60 on the dollar. Since then, Irish bonds have gone to over $0.90 on the dollar and, of course, Greek bonds went to $0.20 or $0.30, and then there was a structured default. Of course, in the meantime, Greece has had two elections.

Some people say, "Even if we take actions today, it'll take a long time for them to take effect." My point is if the markets believe that your actions are appropriate or useful, the markets are going to take it into effect long before we see it in the fundamentals of the economy. So, we're seeing the differences between what 'an Ireland' did and what 'a Greece' did.

I said for a couple of years that in the U.S. election that we will have in four months, we get to choose between the path of Canada and the path of Japan. We're seeing in this country what's happening in various states. The numbers are out there for people who want to look at what works in the economy and what doesn't.

Again, we think that Europe bought itself on the order of five or six months with the LTRO last year, but now, the five or six months are up. It did give a real nice relief rally in the marketplace, including ours, but we don't think it has solved its problems.

Tony
Remind us what the U.S. exposure is to European problems.

Ron
Primarily, it's a contagion among the banks. In international banking, the European banks are far more active than the U.S. banks are, but they all get painted with the same brush. So, when one has a problem, they all continue to have a problem.

Now, if the European banks shrink their balance sheets, that should allow institutions like a JP Morgan and a Citigroup to pick up marketshare internationally. But, right now, banks are pretty sensitive.

Tony
That hasn't happened yet?

Ron
It certainly hasn't happened in the stocks, it has happened in the businesses. They [U.S. international banks] are buying some divisions or portfolios of some of the European banks. So, it's helping their business—but, then, J.P. Morgan manages to lose $2 billion on some trades, and it's become a huge whipping boy for Congress. My guess is that doesn't stop any time soon.

It'll be interesting to see what Jamie Dimon (chairman and chief executive officer of J.P. Morgan) has to say. They announce earnings tomorrow. Incidentally, anybody who has it, I encourage you to read his comments in the J.P. Morgan annual report. It amounts to something like 40 pages, but it goes through a whole lot of topics in pretty thorough detail.

But, to answer your question, we don't think that Europe has solved its problems, and we're not sure it's on the road to solving its problems. Other than the financial contagion, we don't export enough to Europe, or import enough from Europe, that we think it is a fundamental problem to the American economy.

Tony
But, our financial institutions are exposed.

Ron
Yes.

Tony

Banks…maybe insurance companies?

Ron

The difficulty is in assessing the impact of collateralized debt obligations and the like. Banks will tell you what their net exposure is, but it's hard to find out what their gross [exposure] is. Net is fine, if all your borrowers pay off. When they don't—just because the guy who owes you money doesn't pay, doesn't mean you don't have to pay the guy to whom you owe money. And there's a big disconnect there. From everything we are able to get a handle on, that has decreased big time over the last three years, as you would have expected. But we can't get firm numbers on what remains. So, we think the vulnerability is through financial contagion, not fundamentals, or GDP contagion.

Tony

Switching into China… China, as you've been saying, has been driving both the cyclicals and, to some extent, the commodities. Can you elaborate on that?

Ron

Commodities are cyclical. We [U.S.] had our stimulus in '09 and '10. Relative to GDP, China did a stimulus that was about three times ours. Much of that was poured into infrastructure; so they were buying steel and copper, and probably aluminum.

Tony

Cement and equipment and machinery…

Ron

China built infrastructure.

This time around, they have said that the stimulus won't be as much as it was, and that it's going to have a different character. So, right now, what's been happening in the last six months is the Chinese market has been slowing down—all of the cyclicals, including the commodities. I differentiate between base metals and gold and silver. Gold and silver have whole other aspects.

Tony

There's another dynamic to them?

Ron

Yes, there's another dynamic—but what we're seeing in the base metals is that they've been coming down for a period of time. What typically happens, particularly in the commodities market, is once a generation or so, the prices will run up. Everybody opens new mines and new plants. It catches up to demand—this happens over maybe a five or eight year period—and then, they spend the rest of a generation competing with each other because once the mine is open, you run it on variable costs, not total costs. We may be at that point.

A year ago, Consol Energy was talking about opening another coal mine. It's starting to export coal to China. Well now, it's closing coal mines because coal is being displaced by natural gas by U.S. utilities.

Tony
… in this country?

Ron
Right. Export markets for coal still look good, but the domestic markets do not. So, when we say that China has been on the swing end of the cyclicals (commodities), that's what we're talking about.

Tony
So, the U.S. markets are exposed or, to some extent, driven by the cyclical swings coming out of China and the financial swings coming out of Europe.

Are there any areas that are independent—that are not exposed—to those two areas?

Ron
We find a great long-term advantage to natural gas in this country—either at current prices, or with the companies that supply it or ship it, or with the companies that store it or convert it [provide conversion kits]. We own a fair amount of Westport Innovation, which has joint ventures with Cummins and, now, with Caterpillar, to convert diesel engines to run on natural gas.

Natural gas is a real game changer. I suspect that over the next three to five years, the price of energy in this country will drop by a third, or by half. It's already dropped about 15%, even at the pump. When you look at [the price of] crude, the price of natural gas is well below crude—and it will continue have an effect on pulling crude prices down. If that happens, it becomes a huge tailwind for major, major parts of our economy. So that, we think, is somewhat immune from all the other forces we're talking about.

Tony
Periodically, I hear people lament that we don't make things in this country anymore. We've gone from being a manufacturing economy to a service economy. Whether that's true or not, there's potential here for us to be an energy economy, too—to be an energy producer.

Ron
First of all, we do make things. We make a lot of things—but we do it with a lot less manpower than we used to. We produce the same tons of steel we did in 1960, but we do it with one-eighth of the manpower. So, the real complaint is, "There aren't the jobs that there used to be." The only counter to that is if you ask the people who work in steel mills if they want their kids to work in steel mills they say, "I want them to be a doctor or lawyer or something else."

It's also true that there haven't been almost any chemical plants built in this country in a generation because it was much more economical to build them where the sources of natural gas or crude were. So, Qatar has been building chemical plants, but the U.S. has not. Now, all of a sudden, there's talk of building chemical plants in this country.

When you lower the cost of energy or the price of energy, it has repercussions all up and down the manufacturing chain. So, we're looking there as well.

Tony
How much or how fast are you investing in that area? Are you finding enough [companies] to keep you occupied?

Ron
Right now, we're getting our ducks in line. We haven't seen a need just yet to spend a lot of money. Westport ran from $22 [per share] where we bought it, to $44 [per share]. We sold half of it. The share price then got back down to $24 or $25. It ran back up when it signed agreements with Caterpillar.

Westport has agreements with Cummins for over-the-road trucks. It has agreements with Caterpillar where they're talking about off-road vehicles and also talking about freight engines, railroads. Don't be too surprised if you see a tender behind railroad engines. The tender would be holding natural gas because it takes more volume than what's available in diesel tanks.

The price of natural gas is now around $2.80 per Mcf, actually up from $2 Mcf. The *Wall Street Journal* pegged this just about right. When it hit $2 per Mcf several months ago, it speculated that the stock price might to go zero. When people talk about prices going to zero that usually means that all the negatives are in it.

So, we're looking for companies that benefit from this, and it will include the chemical companies, but we haven't yet seen a big need. The pressures right now are on stocks moving down on a macro basis.

Tony
Let's talk about the portfolio a little bit. You mentioned some of the changes in the top ten. What's your cash position right now and how does that come about?

Ron
Our cash position is about 20 percent. We've been a little quicker to sell, and a little slower to buy, because of what we've seen from the macro basis.

Tony
Okay. So, you haven't said, "Gee, we need to be 20% cash here."

Ron

We're comfortable with where we are and, yes, I'm comfortable with 20% cash.

Tony
Are there companies you're in any hurry to buy right now?

Ron
Well, there are companies that I want to buy, but I'm not in a hurry just yet.

Tony
Prices can always get cheaper next week?

Ron
I want to see what happens in the current earnings reports.

Tony
Historically, you have said, given a certain rate of inflation, you look at a return on equity (ROE) that you want and, then, a price you're willing to pay [for a company's stock]. So, with inflation today of 1%-2%, what are your ROE and P/E [price-to-earnings ratio] criteria?

Ron
Average [U.S.] corporate return on equity is about 13 percent. We want more than that. Right now, [within our portfolio] we're averaging about 18%, and that's making adjustments for companies like a Philip Morris which nominally has an ROE 60 percent. A 60% ROE is accurate, but not meaningful; we mark anything over 60% down to 20 percent. So, we have above average companies in terms of profitability, and our average P/E is 11 or 12.

Tony
So, those criteria remain in place?

Ron
Yes. The thing is inflation—the Fed got it to 2% on purpose, if you recall. It looks like we're now reading a bit less than that.

Whatever inflation is, long-term treasury rates should be 3% above it. They aren't—and this is on purpose.

Somebody said the Fed had 'its thumb on the scale.' I said, "Man, it has a whole arm on the scale!" The Fed is distorting a whole lot of things by keeping interest rates below where they economically should be. And the difficulty from that, of course, is that it gives all kinds of wrong signals to the economy.

So, relative to bonds, stocks look dirt cheap. Relative to inflation, however, they look fairly cheap.

Tony
But relative to bonds, they [stocks] look dirt cheap because bonds are lower than they should be.

Ron
Bonds are mispriced… And I come back to why France would be at a negative interest on the short end.

Tony
Well, what are some of the implications of that? How does that factor?

Ron
I guess if you're in Spain or Italy...

Tony
You'd rather lend money to France than keep it under your mattress.

Ron
If you're in Greece or Spain or Italy, you're not worried about the return *on* your money—you're worried about the return *of* your money. U.S. Treasuries have benefited from that for a long time. They're the least ugly of the group. On the face of it, it makes no sense.

Tony
With all the money that the U.S. has been pumping into the economy through low interest rates and the Fed, is inflation an issue?

Ron
For three years, we've argued that it wasn't. A lot of people feared that when the Fed put money into the system—when the money supply grew so much—it would be inflationary. But what the Fed does is put money into the banks. If the banks were lending money, it would be inflationary. Recently, we've seen an uptick in commercial and industrial loans, so banks are lending a bit more than they were.

Tony
… To businesses?

Ron
Yes, to businesses—both commercial and industrial. That's the definition of commercial and industrial loans. If this were to pick up steam, then, in my opinion, the Fed would need to

reabsorb some of the money it put into the system. Remember: the Fed put money into the system because the velocity (turnover) of money collapsed. Today, velocity remains modest.

Regarding velocity: it's hard to measure; you can only impute it from what else is going on. But, at some point, if people get a little bit more confidence in our economy, and commercial and industrial loans pick up, and other kinds of loans pick up, the Fed will have to reabsorb some of that money. Now, I don't know how much. The Fed doesn't know how much—nobody does. The reason we haven't had inflation yet, some people say, is because we [businesses] are running below capacity. Well, that was happening in the '70s as well, but that didn't do it [prevent inflation].

So, inflation has now become a 'red flag' because we're seeing commercial loans pick up a little bit. Maybe it's a 'yellow flag,' but it's back on our radar. To add to the metaphors, it's been on the back burner for three years; we're now moving somewhere between the back and the front.

Tony
How critical will the timing be for the Fed to start sopping up that money?

Ron
Very critical. Bernanke suggests the Fed could change its mind in 15 minutes. And, yes, it can—but will it? The Fed does not have a good history of getting ahead of that curve as opposed to behind it.

Tony
So, what's your defensive posture as you monitor inflation? As you said, it's now a yellow flag versus red. If it becomes a red flag, what do you do?

Ron
At that point, you take a look at what you own and probably sell. In the interim, while that's going on, we'll probably get a pretty good rally in the marketplace. If all that money flows from the banks into the economy, that's going to feed a lot of companies. You will probably see those numbers before you see the inflation numbers.

What I learned in the '70s and the '80s—and it didn't surprise me in the '70s, but it did surprise me in the '80s—was the market reacted to inflation with a lag. It reacted quickly to a lot of other things—but with inflation, it reacted with a lag.

Tony
So, not only is the timing of the Fed going to be critical, but your timing as a money manager, to some extent, is going to be! You're going to have to be on the ball, right?

Ron
That's right.

Tony
Hence, the need to continue to monitor inflation… But you now think it's gone from being a white flag to a yellow flag at this point.

Ron
Yes.

Tony
Back to the U.S.… You had talked about the employer being penalized. How is the employer being penalized in this country right now? Why is that so critical to you?

Ron
As an employer, I've been promised that my tax rates are going up. Every dollar I pay in taxes, I can't pay in wages. Further, we received a sheet of paper a couple of months ago—actually about 15 sheets of paper of increased regulations in an industry that's pretty well regulated already. Not one of them had any benefit to it. And they've just begun—they're only halfway through writing the regulations for Dodd-Frank…

… And consider the impact of providing healthcare insurance. A couple of months ago, our health insurance premiums for the company went up 20%, after having pretty much doubled in the prior ten years.

So, as an employer, I say, "If I don't know what my tax rate is going to be, and I don't know what the regulations are going to be, and providing healthcare insurance is getting more and more expensive…" We've said for three years that because of such pressures on employers, employment will be slow to come back. And because employment is such a politically sensitive item, our fear has been that Congress would keep doing dumber and dumber stuff to try to get employment up. So far, they [Congress] have relied on the Fed—and the Fed's lost its traction. We've got about four months to go until the elections. We'll see what happens with all this… but the first step is to clarify the rules.

Tony
You were on CNBC yesterday with Liz Ann Sonders from Schwab and Rick Santelli from the *Closing Bell.* What did you learn from them? What did they have to say about some of this?

Ron
Well, they always do a pre-interview. Apparently, with Liz, they talked about the fiscal cliff.

Tony
What's the fiscal cliff?

Ron

The fiscal cliff says at the end of December of this year that the Social Security tax which, for employees, for the last two years has been 4.2% instead of 6.2%, will go back up. They didn't change the rate for the employer, but they changed it for the employee. So, as of the end of this year, you will go from paying 4.2% into FICA [Social Security Tax] to 6.2%—that's 2% of your income! Also, they've promised that the Bush tax cuts expire, so everybody's tax rates will go up. If you add these various things together, it will be on the order of a 4% increase in taxes to the average person; i.e. 4% of his income.

Now, you may recall that back in the fourth quarter of '08, when the average family went from saving 1% of its income to saving 5% , you had a 4% decline in spending which gave us a huge drop. Well, that was voluntary. That was because people were afraid—and they voluntary cut their spending by 4 percent. Well, we're about to have a *mandatory* lowering of your after-tax income by 4 percent. That's the fiscal cliff—which would probably slow this economy down or take us back into a recession.

As they said this morning—if you didn't listen to CNBC's *Squawk Box* with Simpson and Bowles this morning, I encourage you to do so [listen to an archive]—it's inconceivable that we wouldn't deal with this issue beforehand, but, with the gridlock currently going on in Congress, it's hard to see how they would! That's the fiscal cliff that's facing us at the end of this year. It's mandatory. It's not voluntary.

Tony
But, it's also known.

Ron
Yes, it's absolutely known. It's the most predictable thing out there.

Tony
So, it [the sentiment] is generally negative, right now?

Ron
Yes.

They [CNBC's *Closing Bell*] talked to Liz [Sonders] about the fiscal cliff and, then, they asked me about stocks. I responded, "Folks, I'm a money manager, but I'm also an employer. Why would I hire anybody when I don't know what my tax rates are going to be? I know the regulations are getting worse, and I know [the cost of] healthcare is getting worse." The show moderator [Maria Bartiromo] then turned to Santelli and asked for his thoughts, and he responded, "What Ron said." She returned to Liz, and she replied, "Well, I've got to agree with what Ron says."

Everybody knows it—but no one wants to say out loud that the reason employment is not picking up is because they're penalizing the employer. We all look at it from the point of view of the employee, but you can't have an employee without an employer. So, it was a bit gratifying [to have their consensus], but it's also a bit disheartening.

Tony
So, nobody appears to have a better solution or a better description than you do.

Ron
We said a couple of years ago that Senators Simpson and Bowles [co-chairs of President Obama's Deficit Commission, who released a broad plan on December 1, 2010 to reduce the federal deficit by cutting spending and raising taxes] provided a great starting place. It gets us at least halfway home. This morning [on CNBC's *Squawk Box*], the Senators said that one of their recommendations was to tweak Social Security, making it solid for 75 years. Another was to increase the retirement age by a year, 20 years from now.

Tony
So…for someone like me, basically?

Ron
Yes.

The eighteen members of the commission thought they'd done a nice job. Simpson said the pushback they received was from the AARP—which, apparently, wasn't interested in a solution. And Congress wanted their plan in a different format. So, of course, nothing happened.

Their recommendations, however, have now been put into bill language. So, Congress has the format it wants.

Tony
So, Congress has something to work with when they are ready?

Ron
Whether there's enough time between the first of November and the end of December—if nothing else, in my opinion, Congress should say, "Let's adopt the Simpson-Bowles plan, and trim around the edges later." I think doing that would give such a boost to our economy—and to our markets—that it might be hard to fathom, because, all of a sudden, you would know what the rules are. Right now, no one knows what the rules are going to be.

In any case, it was an interesting five minutes yesterday [on CNBC's *Squawk Box*], but it didn't resolve anything.

Tony
We've got ten minutes left on the call. Why don't we go ahead and see if anybody has any questions for Ron.

Coordinator
It looks like right now we have one question in the queue. Our first question will be coming from Timothy Garr. Timothy, please go ahead with your question.

Tim Gaar
Ron, you're basically saying that nothing's going to happen until the elections in the U.S. So, I'm going to put you on the spot. Worst case scenario, best case scenario: where are you leaning?

Ron
The best case scenario is we resolve the rules.   This morning, Alan Simpson was talking about tax income into the country… what he's really talking about is money going into the government. The money going into the [federal] government right now is about 15% or 16% of GDP. The money going out [in federal spending] is about 23% or 24%; it briefly hit 25% [of GDP].

All the politicians and pundits seem to agree that what worked fairly well—pretty much since World War II—is when taxes to the government were on the order of 18% or 19%, and government spending was on the order of 20.5 percent. In fact, Buffett suggested 'a 2.5% deficit is something we can live with'—which basically means the economy is growing faster than government spending. When your deficit is growing slower than the economy, you're at least sustainable.

I think what we observed from Bill Clinton was that he'd rather be president than stick to his ideology, so he was willing to work with Congress in the '90s. I've got to give him credit for that, even though I wasn't a fan of a whole lot of things he did.

In contrast, I believe President Obama believes in the ideology he espouses. I don't happen to believe it. I think anybody who looks at the numbers can pretty much conclude that when government [spending] grows faster than the economy, you're in trouble.

So, the best case scenario is we get a new president and a majority in the Senate. I think what the House has been doing has been good work, and if it would continue with that… However, Ken Dupre [one of my Investment Analysts] says that he likes gridlock. I'm not a fan of what George W. Bush did when he was in office and the Republicans had all three branches of government—excuse me, two branches, the Executive and the Legislative. We tended to go too far off in one direction.

But, right now, what we need to do is to get government spending under control. If there were to be increases in taxes, let's have them in a way that doesn't shut down the economy. In the Simpson-Bowles plan, they suggested eliminating all the loopholes in the tax code. Most people don't consider mortgage deductions to be a loophole... I think the Simpson-Bowles plan recommended limiting mortgage deductions to one house as opposed to a second or third house, and up to a $500,000 mortgage… I think it could be a whole lot worse—so why not simply adopt that?

Incidentally, the moderators on *Squawk Box* pointed out that President Obama let the whole thing drag on. Alan Simpson said [sic], "At the time, anything Obama would have endorsed, the Republicans would have countered—just because he [the President] liked it." I think that if the President would have endorsed any of the plan's recommendations, his whole base of Democrats would have revolted. In any case, Senator Simpson seemed pretty sympathetic to the choice that Mr. Obama faced when they introduced their plan.

Nevertheless, here we are, a year-and-a-half later—pushing two years later—and nobody has come up with anything better. So, I think if we had the Simpson-Bowles plan in place, then that would be a best case scenario.

The worst case scenario is what President Obama and Harry Reid [Senator from Nevada, serving as the Senate Majority Leader since January 2007], want to do: impose more taxes. They want to penalize employers. If the Democrats took the House, then, frankly I'd have to find some other country to put my and my clients' money in, because I think we'd be going the way of Japan or France. And it would take very little to get us 'on the road to Greece,' but we'd be on that path.

Does that help you, Tim?

Tim Gaar
Yes.

Ron
I will say that in the 40 years I've been doing this [managing investments], what has surprised me is when 'push comes to shove,' things get too far out of whack in either direction. I think the American public has a pretty good record of bringing us back to the middle, so that we muddle through fairly well in this country.

I did not predict a Ross Perot coming out of left field. I did not predict the Tea Party coming out of left field. What happens with all of this, I don't know—and I don't think polls will tell you. People will tell you they'll lie to pollsters, but when they pull the lever in November, that's real.

Tim Gaar
Let me ask you one other question. The Tea Party is throwing such a wrench in the mechanism. Do you think that's been positive or negative?

Ron

So far, it has been positive. Tony got me out to a couple of meetings a couple of years ago, and what I found interesting about the Tea Party was, it's all the local small businessmen.

Tony
Who normally don't have time for politics, by the way...

Ron
It's [the Tea Party] a whole lot of people who have never been political. Sometimes you've got to throw a wrench—when the gears are going the wrong way, you got to throw a wrench in. The difficulty with the guys in D.C. is they think if they talk to the president of General Electric or General Motors that they're talking to businessmen. Those people are closer to bureaucrats than businessmen.

Do you remember a provision in the original healthcare bill, mandating that small businesses that spent $600 on another vendor had to issue a W9 form at the end of the year? If that provision had stayed in, you and I wouldn't be able to hire a plumber! Or, if you needed plumbing work to be done, the plumber would come out, give you a list, and say, "You go to the Home Depot and buy these things, and I'll install them." I haven't yet met a plumber or a carpenter or an electrician who likes doing paperwork.

I have a good friend who's a carpenter. If you hire him to do a job, you won't get a bill until he needs the money. He puts all his receipts in shoeboxes—hates to do the paperwork. So, until he needs the money, you won't get a bill from him. Well, he's got a backlog of two years of people he hasn't billed yet!

The real point is, whoever wrote that into the law was of a mindset so far removed from the real world that I wonder what else is in those 2,500 pages! Only a lawyer, or maybe an accountant, could have put that into the law—certainly no one who gets his hands dirty for a living.

Tony
Do we have any other questions in queue?

Coordinator
I do not show any other questions in queue. (Operator's instructions)

Tony
Well, Ron, we've got two minutes left; so, let's wrap it up. November is four months away. What do you do in the interim?

Ron
Once again, we're in midst of earnings season. Buffett said this morning [on *Squawk Box*] that in the last four to six weeks—he, of course, has very close access to the numbers on a whole a lot of companies across the spectrum—it looks like business in the U.S. has slowed down. Based

on the first quarter, that's a bit of a surprise. So, it's going to be interesting to see what we hear from companies—and it's going to be interesting to see how the markets respond, but I really don't see a big move one way or the other until some of these issues get clarified in November.

Tony
Very good.

Ladies and gentlemen, thank you for joining us. I hope that if you do have additional questions, you'll send us an e-mail, or give us a call. A lot of this discussion will be elaborated on in our quarterly newsletter. It'll be coming out in a couple of weeks. You are also able to go online, and view a video of our seminar on May 3.

So, thanks again for your attention. Please let us know if we can help you with anything and have a good week.

Coordinator
Ladies and gentlemen, this will conclude our conference. Thank you for attending today.