

## The Birth of the Modern

What we are seeing here is not the end of the world, but it is the end of *a world*. The world of the old brokerage firms. Once upon a time there were many, and when E.F. Hutton talked... you remember. No more. Now the thundering herd is silent, the Bear is quiet, and even Lehman, perhaps the class of the street, is gone too.

In Paul Johnson's marvelous book, "The Birth of the Modern", he takes us on a quick trip around the world and through a 15-year period that made all the difference between the ancient and the modern, 1815-30. Before that, Napoleon's army moved at the same pace as Julius Caesar's, the speed of a man and a horse. A horse was, in fact, as fast as it got, for transportation and for information. Science and medicine were still pretty much a mix of philosophy, experience, and trial and error.

In Patrick O'Brian's tremendous series of historical novels of the British Royal Navy during the Napoleonic era (1800-15), the protagonist, Captain Jack Aubrey, still commands wooden ships powered entirely by sail, living in an isolated world at sea, and in remote posts connected to home only by mail, and very slow and irregular at that. Navigation was by the stars and the chronometer. News traveled slowly, to say the least. You will recall that the Battle of New Orleans, between the Brits and the Americans, was fought weeks after the War of 1812 was over. Who knew?

Shortly thereafter, the railroads, the steamships, and the telegraph transformed the planet and the existence of the human race. Communication was instant. People and freight moved long distances quickly and cheaply. Everything got faster. And real science as a force of progress kicked in like never before.

And so it goes. Here we are, having witnessed the transformation of the financial industry take place before our eyes so quickly we can scarcely grasp it. But it really has. Merrill, Lehman, Bear Stearns are really gone, and the few others left might be said to be living on borrowed time.

What happened? Well, excess liquidity and the ability to generate enormous leverage with esoteric derivatives and structured securities combined with a remarkable lack of risk management created a huge bet on "nothing at all going wrong" that would have been unthinkable even a decade ago. A mountain of arbitrage based on bad credit mortgages with huge leverage exploded with nuclear force and the world that was left was a different place, just like that. Everyone taking these erstwhile profitable bets was destroyed or badly damaged.

**From here  
you can see  
everything.**

What happens now? Well, it's funny how things seem to resolve into simplicity. Who survives of the old guard? The banks. Why? Well, two reasons:

1. The good ones, like Wells Fargo, never got into the game in the first place. How boring.
2. Others, like Citibank and UBS, took staggering losses, but were so big, and had such a large business unaffected by the debacle, that they were able to raise replacement capital and amputate the damaged parts.

The first kind provides one answer to the future. Traditional banking, taking deposits and making loans, is still an essential business, and one that is pretty well understood. The government can afford to insure and regulate these, if it is done well. Mundane things like basic lending standards (having a job, for example), things seemingly forgotten in the mad rush to finance every piece of dirt in town to 120% of its last overly-optimistic assessed value, will once again become required. Perhaps we will take that seriously now.

The other kind remains to be seen. What about the behemoths like Citibank and UBS and JP Morgan and the others? They are banks, brokers, insurance agencies, investment banks and more all rolled into one. Will they continue to invest firm capital with leverage, as the traditional street firms have done, all the while enjoying various forms of formal and informal government guarantees supporting and protecting them, because they are too big to fail? No, they won't. As we have in the past, after the debacle we learn risk control, we figure out how things went so badly wrong and we make changes. This time will be no different, except that Wall Street will never look the same again.

If this hasn't sunk in yet, just think about the name "Merrill Lynch" being the answer to a trivia question, and your younger colleagues look at you blankly. Like remembering Paul McCartney's first band.

#### **Final note: new firms will replace the old brokers**

"Financial advisory" work, such as it was in the past, has traditionally been done by banks and brokers, partly because their large firms could generate the product for them. Salesmen needed product, after all, like auction rate securities, to sell to their customers.

Now the fastest growing part of the advisory business is the independent Registered Investment Advisor (RIA), firms that are fee only and sell no product. Unencumbered by all the constraints imposed by "the house," the independents are free to give totally objective advice and select from the best investments anywhere. A radical departure from the past.

Equally radical are the discount brokers like **Schwab** who started life by destroying the monopoly the full commission brokerage firms held, enabling retail investors to trade cheaply. Then trade funds the same way. Then do it on the web. And now they are providing custody and related support services for the clients of over 5,500 independent RIA's. Unlike the traditional firms, they were not tied to an investment bank, do not make markets or trade firm capital, and happily were therefore not involved

in any of the activities that have caused the recent devastation. That is very good to know at this moment in time when safety is paramount.

These independent RIAs and their independent custodians have been taking market share from the old fashioned banks and brokers for years, and will be a major component of the future financial landscape, as some of these independent RIAs grow to advise hundreds of billions of dollars in assets.<sup>1</sup>

### **So what about right now?**

As I look at the screen, I see the madly fluctuating Dow is up 141 and change, after yesterday's 500 point fall. I see emerging markets have taken a hard hit. Russia fell 17% and then closed altogether today, as oil continued its free fall below \$100/bbl (wait, what happened to \$200 oil?). And Barclays is buying major parts of Lehman.

The real story now is AIG and the credit crunch. Spreads have widened, as treasuries rally yet again and lesser credits falter. It looks likely now that the Fed will step in with a loan, and that AIG will survive the crisis; maybe we will see the return of a little positive spirit. If not, things could get worse before they get better. There is a negative cycle here, the credit issues and real estate values reinforcing each others' declines. We are all waiting to see that stop, and are hoping to see an AIG resolution that puts us on the road to recovery.

Bottom line, though, is that the basic economy remains sound, if a little soft, and this dramatic restructuring of the financial sector, painful as it is for them and as dramatic as it appears to us, need not take down the whole economy. I agree with Alan Greenspan on that one.

Now, let's see what the monetary authorities have in store for us next.



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<sup>1</sup> We already see banks buying these firms and in some cases allowing them to remain independent, although often not. We will see more of this soon. When in doubt about a firm's status, because it can be confusing, just look to see if the people are series 7 licensed and the firm is regulated by FINRA – if so, that is **not** an Independent RIA, it is a brokerage firm.