

The Birth of the Modern - Part II

June 2009

How to Invest in this New Market Environment?

The question we read and hear everywhere we go is this one – what to do now? The spoken or unspoken premise to the question is that we are living in a new world. The old rules don't apply, and traditional investing approaches, disparagingly referred to as “buy and hold” by second rate pundits and your local broker, are worse than useless. Sound familiar?

In a letter from last year, we discussed Paul Johnson's great book describing the transition of the world that took place in the period 1815-1830. Are we now in such a “post 1830” period, and just starting to experience the new world and how different it is from the old? That is a thought to give one pause.

Interesting parallels. Funny, I remember way back in the late 80's and early 90's, when the impact of all the new technology was just starting to be seen and felt - remember those brick-size cell phones and suitcase-sized portable computers with the little green screens? Word out then was that there appeared to be no productivity improvements from the technology! Amazing ignorance, as it was abundantly clear we were all doing more, faster and better, than ever before, but the measurement tools were inadequate.

So have we gotten past the early stages, and has the overall change been sufficient to cause this kind of fundamental restructuring of the world and all of its activities? At one level, it remains to be seen if this is that kind of historical change, but at the more basic level it is obvious that much is changed forever. I think we all understand that. But what does that imply for the fundamental approaches to investing?

**From here
you can see
everything.**

Remember that the first phase of implementing new technologies is typically to do the same things faster; then you learn to do them differently, and then you learn to do new things. So where are we? It's still pretty early. For example, while cars are better, they really aren't very different. Steering wheel, gas and brake pedals, same old gas mileage. I thought they were supposed to fly by now?

Clearly technology is advancing very rapidly and in ways that simply have to be impossible to predict. Remember as well that pioneers of new technology frequently go broke (e.g., an early railroad company in the Panic of 1837, as you will recall). Picking your spots to invest is not as easy as knowing that many things will happen.

What about Financial Markets and the World Economy?

Sorry, for a moment we forgot about the short-term issues in the financial markets as we gazed in awe into a bright future (we hope). We do have some problems. An excellent treatment of these issues is afforded by a recent book by Mohamed El-Erian of PIMCO, called "When Markets Collide: Investment Strategies for the Age of Global Economic Change." I would heartily recommend this book to those willing to work pretty hard; it is not an easy read. Written just before the worst of the financial cataclysms of 2008, it is remarkably prescient in setting the stage for the kind of drama enjoyed right after he set his pen down. That being said, I would suggest that his conclusions and recommendations are not entirely consistent with ours. The analysis is perhaps the best part, the guidance less useful.

Just as technology advances, so does what you might call "financial technology." El-Erian makes the point that we see a recurring pattern wherein structural changes in markets and the development of new derivatives and approaches to managing risk outrun the ability of our regulatory agencies to properly supervise them. FINRA, the SEC, and a hodgepodge of other regulatory agencies, state and federal, missed the huge buildup of leveraged risk off the balance sheets of our major financial institutions. All those bad credit mortgages got packaged as AAA securities and became part of portfolios (e.g., insurance companies') that normally required strong credit quality, not to mention

leveraged bets by banks borrowing cheap cash and making the spread, until the music stopped and the mortgages starting defaulting.

Keep an eye on events in Washington now as they discuss regulatory reform. Our system is in desperate need of a major overhaul, but the odds of that happening are not good, unfortunately. Too many of the current “power players” have a big stake in the status quo and still fail to understand the environment.

The Emerging Giants

Perhaps the biggest development in the world at large is the advent of the age of the emerging markets countries. Not to blow our own horn, but our clients have been investing in emerging markets (equity and bonds) all along, not as a matter of market timing or guesswork, but as a consistent allocation to businesses that represented, in aggregate, an excellent investment opportunity. Well, things have changed in the last few decades, and these risky countries, which were forever debtors to the developed nations, are now the creditors! They are making a lot of money exporting to the developed world, especially to the U.S., and then they invest the profits, hundreds of billions of dollars, in U.S. Treasuries.

El-Erian notes that this is likely to be a permanent change. We are moving from a world dominated first of all by the U.S., and also Europe and Japan, to a world where major parts of the world’s capital markets and economic activities are located in what used to be called “the third world.” El-Erian expects that the massive imbalances, America buying and borrowing while the emerging countries sell and lend, will not continue, and a more sustainable balance of trade and capital flow will develop. Hundreds of millions of desperately poor people are being lifted out of poverty and enormous new economic growth and opportunity is being created.

El-Erian asserts that people are slow to recognize major structural change, and thus the markets and the regulators failed to comprehend the impact these changes were having. For example, Alan Greenspan was baffled in February of 2005 because long term treasury rates had dropped even as the Fed raised short rates by 1.5%. The traditional relationship

was broken, and no one seemed to know why. Well, despite the low yields in treasuries, all that emerging markets money (their reserves) was flowing into the treasury market and driving prices even further up (and yields down). Everyone missed it. Likewise, one prediction of inflation after another was proven wrong, as the massive impact of all that cheap labor (much of it educated and highly skilled!) from the emerging countries drove productivity higher and higher and kept wages low.

So what is our strategy now? What is the new course for the new world?

There is one fundamental fact that makes crafting flexible new strategies challenging. One can readily see that there are excellent growth opportunities all over the place, and major dangers. Volatility is historically high, and recent history warns us that our downside risks, the “tails” everyone loves to discuss these days, may be larger than they were until recently. There is considerable risk of major policy failures by governments, which threaten to be far more deeply involved in economic activities than ever before, and these failures could have catastrophic consequences. Or no (as they say in Minnesota). But the fundamental fact is that the market is doing its best to put prices on all of the available investments that reflect all the opportunities and risks.

Prices count for everything. It is no good to buy a great company if the price is too high; growth investors frequently lose money when a great (and expensive) company becomes slightly less great (and a lot less expensive). Conversely, a bad company may represent a good investment if it is cheap enough. The market has made and will make plenty of errors, but can you do better? El-Erian thinks he can (and started a global allocation fund to prove it, of course), but this is where we part company. The highway is littered with the bodies of geniuses who could outguess the market.

There is no free lunch. If you want return you get exposure to risk. If you want to hedge risk you pay a price. And if everyone knows that risk is high, the price of protecting against that risk is high. We hear, over and over, that people want some risk protection, flexibility, a nimble value-added strategy that captures the upside and protects on the downside.

There are many sad stories of people who invested with Bernie Madoff, the man who produced good returns and never lost money. People looking for magic solutions are often easy prey for snake oil salesmen. Don't be a victim of fear or greed. Don't look for magic. Take the right amount of risk, no more and no less, and find a way to live with it. You will never get better advice than that.

Best Regards,

A handwritten signature in cursive script that reads "Roger C. Hewins III".

Roger C. Hewins III
President

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