

A Harrowing Journey October 2009

As we look back and contemplate the recent economic and market events, no one could blame us for being left speechless. I think any truly thoughtful person has to be stunned and somewhat humbled by what has transpired. Of course, the pundits on CNBC have not missed a beat...

One of our favorite money managers (and pundits, sad to say!) is Mohammed El-Erian of PIMCO. Formerly manager of their emerging markets bond fund, then Harvard's endowment (which has suffered terribly post El-Erian; witness their recent confession of \$500 million in losses from bad bets on interest rates alone), and now back to PIMCO as co-CIO and CEO. He and Bill Gross have been touting the "New Normal" state of world affairs, where the slow growth economy is hindered by high taxes, a heavy regulatory burden and deleveraging (paying off debts, saving more and consuming less). The massive and wasteful spending by the U.S. Government will result in huge deficits and trillions in new national debt, undermining the dollar and severely hampering any economic recovery, at least in the U.S. Lest you dismiss him as a right wing doomsayer, let me add that he is an Obama supporter. But he is also very smart and realistic.

That being said, his record as a prognosticator is, shall we say, mixed. The New Normal story resonated in the first quarter as markets appeared on the verge of collapse and many rushed for the exits. It seemed easy to accept their general prescription of "tail hedging" and "guarding against black swans." Asset allocation was discredited; it's time for more "active," "flexible" strategies. Aside from suggesting that you put money into their active allocation funds, however, he never finished up by telling us what, specifically, we needed to do. I read his book and articles and listened to his speeches, but no course other than "be smarter" and "be opportunistic" and "protect against the left tails" was offered. More emerging markets, perhaps...

Let's be clear, I think very highly of Mr. El-Erian, particularly his money management and analytical skills. He is among the very best. But he is not particularly good at forecasting markets or telling you how to invest NOW. No one is. I think that is abundantly clear.

So what is this letter about?

Some of us love numbers. We read tables of numbers and angels sing, drama unfolds, history comes alive quarter by quarter, index by index! My experience tells me that most of you are normal people, not numbers junkies, so this letter will try to make sense

**From here
you can see
everything.**

of things for you, focusing quarter to quarter on different aspects of the markets, of history, of financial planning, of things meaningful and important to you. We publish the numbers and an overview of market results in summary form as well, and, for those who want more, we recommend *The Economist*. This letter has a specific focus each quarter, and we hope you get something good out of it.

This quarter I would like to touch on two topics. One is a journey much like the one we have taken over the last two years, and the other touches closer to home, a brief discussion of some core values we hold dear and what they mean for you.

Desolation Island

200 years ago the Napoleonic Wars raged across Europe, and across the seas as well. Patrick O’Brian wrote a series of 20 historical novels taken largely from the British Royal Navy Archives, and one of these seems to capture our recent experience very well indeed.

As you will recall, after several very good years we have had a very bad two-year bear market, with six straight bad quarters (ties the record) followed by the best two consecutive quarters in decades. Well, our good Captain Aubrey, aka “Lucky Jack” for his good fortune in his first few commands (the *Sophie* and the *Surprise*, among others) takes command of a ship so horrid, so jinxed, so ill-thought of, that it was universally known as “The Horrible Old Leopard.” Students of American Naval history will recall that this was the ship that fired on the virtually unresisting Chesapeake in peacetime, killing many Americans, humiliating our young nation, and adding to the growing resentment of the British and their practices in the build up to the War of 1812.

Needing the Command, Captain Aubrey accepted this ship, and a mission which included transporting convicts to Australia, a loathsome task indeed. At the risk of spoiling the surprise for those of you inspired to read this great book, we will summarize their ill-fated journey briefly.

- Terrible disease broke out on the ship.
- They were becalmed near the equator and stuck there for weeks with a crew full of dying men.
- They were beset by a Dutch 74 (a 74-gun ship considerably more powerful than the 50-gun *Leopard*), and with half a crew at best, outmanned and outgunned, Captain Aubrey fled.
- They seemed to lose the Dutch 74, only to find it tracking them again, over and over. They came to think of it as some kind of Ghost Ship for the way it kept finding them in the vast south Atlantic.

- After finally making land in Brazil to drop large numbers of the sick and replenish water and food, they resumed sailing for the Cape of Good Hope with a skeleton crew and the remaining prisoners, only to be intercepted again by the Dutch 74!

Is this starting to sound like 2008?

- Unable to make the Cape because the Dutch 74 always was between them and their destination, they were forced south, into the lower 40's and 50's, where their battered old ship with a skeleton crew faced storms most of us cannot imagine: 100 foot waves, hurricane winds, and the unrelenting pursuit of the Dutch 74.
- Finally (December 08) they escape the Dutch ship (not going to tell you what happened, you'll have to read it), and things appear to be stabilizing, until...
- They hit an iceberg!
- They are taking on water, pumping furiously, lost their steering...
- Did I mention Captain Aubrey was deathly ill and confined to his bed at this point?
- So a senior officer takes half the crew in the ship's boats and leaves them!

You can't make this up. Although this is an historical novel, most of this happened. This last part sounds like "The Capitulation of March 09" when people gave up the ship. It looked very black.

Believe it or not, the resourceful Captain and the intrepid remnant of his crew pumped enough to stay afloat, rigged a crude steering device and just made it (through yet another storm) to a very remote place, their last chance: Desolation Island. And after rest and repairs they limped their battered hulk back into a friendly port one sunny morning, much to the surprise and delight of the British Admiral in command.

So here we are, limping into a friendly port. After two excellent quarters we are "saved" for now, but still battered, still down from two years ago, memories of those towering seas and the pursuing Dutch 74 fresh in our minds. Older and hopefully a littler wiser.

Core Values

We recently had the pleasure of pulling our back office crew aside for some introspection as we celebrated our tenth anniversary as a firm and looked ahead to the next ten. We were indeed gratified to find that we needed little coaxing to produce a short list of "core values" which we share. In light of the story above, it is particularly interesting that we were able to create the acronym FRIGATE for the seven values! As you will recall, Captain Aubrey's best days were spent as Captain of a frigate, HMS

Surprise, a fast and weatherly ship well-suited to tasks and missions of all kinds. Our own USS *Constitution* was perhaps the greatest of these marvelous ships ever to sail.

The “I” is for integrity. What that means to us is that we disclose everything; we earn only fees from our clients and nothing else; and we always tell the truth. What this means for you is that you can be confident there are no hidden compensation issues or other conflicts of interest causing us to act in our own best interest and not in yours.

A sad but typical counterexample we recall consisted of a non-profit investing in a broker wrap program. They were misled into believing that there were no hidden costs, and they adopted a sub-optimal program full of expensive trading and proprietary product. The brokers call all the hidden compensation they earn “production.” The client does not know about it, nor do they understand that they were steered into investments in order to maximize the production for the brokerage firm and the brokers.

Our integrity means you have full knowledge and transparency. No one is perfect. Each manager and fund can’t be top quartile, but you can have our best efforts and the best asset allocation and managers/funds at the lowest cost. And we are always here to explain everything and work solely in your best interest. That’s the way we want it, every last one of us.

Integrity was the most important Core Value for our people. We’ll tell you about the others that make up our FRIGATE in future letters.

Sincerely,



Roger C. Hewins III
President

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