TIME & MONEY

Quarterly Newsletter

www.halberthargrove.com *April 2009* | *Issue XLV*

75+ years in the financial markets:
Halbert Hargrove and the lessons of history

For some time now, younger associates and, indeed, several clients have been asking about the history of Halbert Hargrove. The thought of writing a brief history seemed interesting and even meaningful, but perhaps not terribly useful. Upon reflection, however, the often loosely remembered quotation of Harvard philosopher George Santayana—"Those who cannot remember the past are condemned to repeat it"—came to mind.

There are likely some significant parallels in financial services between the early 1930s, when our firm was founded, and our current time. These have to do not so much with the state of the economy as whole, in our judgment, as in the history of financial misconduct that preceded both. As well, in response, the 1930s saw many regulatory changes subsequent to those shenanigans—and we suspect that new global regulations will arise in our own near future.

While we naturally think of the tremendous changes in society, technology and industry experienced over the last 75-plus years as unprecedented, it's not at all clear that the extent of those changes has exceeded those of the 75 years before 1933. Widespread availability of telephones changed communications, refrigeration changed food distribution and eating habits, concentration in cities due to development of "skyscrapers" (read: use of elevators) supported urbanization generally, transportation via rail and automobiles reduced isolation—the list goes on and on.

As do stories of fraud, financial manipulation, poorly regulated greed, and subsequent market crashes.

So, if we can learn something useful from our financial history, or even in how Halbert Hargrove has responded to that history, let's have at it. But let's also be careful regarding what "lessons" we learn: France's Maginot Line was built at great cost to prevent a repeat of WWI tactics, but was easily bypassed during WWII. We want to draw conclusions useful for the future, not just about the past.

The insert to this issue contains a timeline of the firm in an abbreviated context of changes in the financial services industry, the regulatory environment and the diffusion of investment information, and the firm's resulting adoption of financial products. Much of what is captured mirrors our broader society. Frequently, however, changes are accelerated and magnified by money—which is, after all, the story behind the story of Wall Street. The brevity of this timeline is not truly fair to the stories of all the men and women who've worked at our company from 1933 to the present day. But, then again, when has history been guided by fairness?

A founding and philosophy outside of Wall Street

In retrospect, 1933 and the Great Depression might seem an odd time to begin a securities business. **John Halbert** (d.1974) had made money from oil leases in the boomtown of Signal Hill,* and he chose to start a firm initially to invest his own funds. At the start, he was joined at Halbert, Hargrove & White by **Leonard Hargrove** (d.1955) and **Mortimer White**, who quickly left the firm to manage five small family banks in Montana.

It was a very different business in those days. What is now known as a "registered representative" (the correct name for a stockbroker or "Financial Consultant" not operating as a fiduciary to clients, i.e., a representative of the firm in selling to clients), was known as a "customer's man." The quaint idea, of course, though never perfectly implemented, was that the higher purpose of an investment business was to help the customer invest profitably.

Even the largest firms, usually members of the New York Stock Exchange (NYSE) and headquartered—or at least with offices—on Wall Street, operated as partnerships. With regulated commissions, access to financial information was hard to come by and jealously guarded. In many ways, control of information was the lifeblood of the business and the reason firms could charge what today would be thought enormously high transaction fees.

The height of technology was the ticker tape, carrying almost real-time messages of actual transactions (sometimes even honestly reported) that could be viewed in the broker's office. Firms were required to maintain a "Chinese Wall" preventing information overlap between their investment banking (product

*The Signal Hill oil field on the edge of Long Beach had its first gusher in 1921 and quickly became one of the most productive oil fields in the world.

manufacturing) division and their retail securities division. The two major functions of most firms were to underwrite capital to support American industry and then to place shares with retail investors.

From the start, Halbert, Hargrove & Co. was a firm outside of Wall Street, part of the National Association of Securities Dealers (NASD) instead of the NYSE. At its beginning, and throughout its life until today, the firm has had a very conservative outlook on investing and maintained long-term stock positions rather than focusing on trading. In the firm's 1991 move into the Landmark Square building, early trading and position diaries showed existing customer accounts from the 1930s which still held some of the same investment-grade holdings. The firm never held margin accounts and did not support the use of leverage in investing; in fact, according to the NASD, Halbert Hargrove was the last self-clearing small firm in Southern California before finally moving to clear (settle) trades through Pershing & Co.

1933-1974: Growth and expansion

For those with long memories and deep knowledge of Long Beach, California, the name of **Ralph Murray** (d.1988) will likely ring a bell. Ralph joined Halbert Hargrove in 1933 and remained an active partner/participant for more than 50 years. **Stan Hill** (d.1987), a high school friend of Ralph's, was recruited to join the firm in 1943, thus setting the stage for **Russ Hill** to join in 1970.

The 1950s were boom years in the U.S. and in Long Beach. During WWII, thousands of Navy personnel had transshipped through the port, many vowing to return to live in the balmy weather of the coast instead of the Midwest. They worked at the Navy shipyard or at Douglas Aircraft, as Southern California was at the center of defense manufacturing. As time went by, the Navy pulled up stakes and manufacturing followed both lower costs and political power to other states; Long Beach went into a long decline until the late 1990s. As with most businesses, the post-War years were about evolutionary growth and expansion at Halbert Hargrove.

1975-1988: Industry revolution

Evolution became revolution in May of 1975. Commission charges were deregulated, leading to the birth of discount brokers, who would eventually be superseded by their online counterparts. The old model was broken permanently. As revenues were declining, markets—recognizing the "stagflation," or stagnant growth accompanied by inflation—of the 1970s dropped through the floor.

High inflation rates led to a proliferation of new products, mostly in limited partnership format, supposedly designed to allow most investors direct participation in various industries such as oil & gas drilling, real estate, and other active businesses. Many, or perhaps most, such vehicles were actually designed to convert client capital to broker income, but there were also a number of successes. Halbert Hargrove participated in over 100 partnerships, many times as General Partner. One of the firm's proudest achievements came through a comment by an NASD auditor that the company was the only firm they'd seen without a written complaint anywhere in its files.

Craig Cross joined the firm in 1979, just prior to our nation's last inflationary pre-Volcker gasps; the limited partnership structure, and its fees and costs, worked far better in the inflationary times that were coming to an end. Stories of the company being in the wine business in Napa, developing real estate in several venues, financing drilling for oil and natural gas, and even developing and operating a small chain of cookie stores in Germany all came from this era. We ask current clients to bear in mind that "experience" often connotes something one does not need, or care, to repeat!

1989-2000: Pursuing the multi-manager value proposition

1989 saw the creation of Halbert, Hargrove/Russell (HH/R) as a registered investment advisor, thus changing the core business away from a hybrid brokerage model to a purely client-centric, fiduciary model. Though the Frank Russell Company never held ownership interest in HH/R, these years were focused heavily on the multi-manager value proposition pioneered by Russell.

The investment counseling staff grew over this time period with the addition of **Tim Anderson** (1993), **Gary Hickok** (1993), **Bruce Peterson** (1994), **Gary Corderman** (1998), and **David Overton** (1999). HH/R followed through on its commitment to create a professionally managed business rather than merely a group practice by hiring **JC Abusaid** (1996) to serve as chief operating officer. Contending with issues of growth and market cycles, and having a large and evolving business relationship with Russell consumed most of the firm's focus.

2001-present: Opening doors to meet clients' evolving needs

2001 saw a fundamental shift to fully open architecture as HH/R moved to use Fidelity as its primary custodian. This opened the full range of capital markets, products and services through one of the world's largest custodians and money managers to meet the needs of HH/R clients. The old NYSE model, which had been challenged for years by charges of conflicts of interest in relationships with customers, took a hit as custodians increasingly vied for the business of registered investment advisors.

There was no longer a more limited range of services available through smaller firms; now, the difference between independent, objective firms and NYSE firms was that the independent firms had no requirement to stuff overpriced, proprietary products into client accounts.

The firm's investment counseling staff continued to grow: **Steve Klosterman** (2003), **Mark Janci** (2005), and **Andrew Welzel** (2007) brought significant experience and ability to the firm. As the timeline shows, this past decade has also seen the creation and development of our team service model, considerable investment in training and accreditation of associates, and adoption of additional, diversifying asset types and structures.

Regulation—1930s onwards

As a response to the market manipulations and general financial opportunism of the Roaring 1920s, legislation that remains the

underpinning of the securities regulatory system was passed and regulatory agencies were formed. The first of these important safeguards was launched the year of our firm's founding: The Securities Exchange Commission (SEC), in 1933. This was followed by the Securities Exchange Act (1934), the Maloney Amendment, forming the NASD (1938), the Investment Advisers Act (1940), and the Investment Company Act (1940). The first Chairman of the SEC was Joseph Kennedy (yes, patriarch of the clan), a successful stock manipulator and known bootlegger, thought to know all the tricks of the trade and thus able to catch financial malefactors.

The original legislation was inspired by the certain knowledge that men and women do not go to work on Wall Street to help humanity any more than the lion waits by the waterhole to provide soft, Turkish toweling for the gazelle's evening bath.

Though rules and regulations have been modified along the way, they remain a patchwork quilt, subject to intense bureaucratic in-fighting and crazily depending on location, size of operation, and stated method of operation for determining who the responsible regulator may be. States generally provide oversight for insurance companies, which are adept at playing states against one other to game the system.

Federal securities regulations generally depend on whether a firm is a broker, i.e., primarily in business to sell products to customers, or an advisor (misspelled in the 1940 Act) tasked with fiduciary behavior on a client's behalf. Commercial banking and bank holding companies may be state-regulated or regulated by one of two federal agencies. Other than reporting requirements, none of the regulators carries an effective global oversight brief for increasing cross-border transactions and holdings.

Over the last 25 years or so, the strong business model of the client-centric registered investment advisor (RIA) has emerged to compete, usually successfully as measured by substantially higher growth rates, against the brokerage model. NYSE members have fought tooth and nail against the fiduciary standard modeled by most RIA firms.

Industry changes mirror evolution in information technology

The history of the securities industry from 1933 to the present, while oversimplified, can be captured by looking at the evolution of information availability and processing speed as well as capital needs in a deregulated commission environment.

Even as late as 1970, skill in dealing mentally with fractions of 1/8, 1/16 and 1/32 was very useful, along with being able to multiply two 3- or 4-digit numbers on the fly. Calculators were unwieldy and expensive: A $500+ calculator (in 1970 dollars) was required to easily handle the four functions of addition, subtraction, multiplication and division.

Increasingly, the Quotron machine began appearing on securities industry desks. It reached more than 100,000 locations by the 1980s with real-time quotes and some trading information—just in time to run head on into the PC revolution and eventually Bloomberg information and be put out of business. Early users of spreadsheet programs like VisiCalc and the revolutionary Lotus 1,2,3 were often financial professionals; life, temporarily, became much easier.

One theory of organizations is that they will thrive so long as the internal cost of information sharing is less than either the external cost of gathering information or the cost of overhead to manage the information. With information gatherers/providers such as Bloomberg and dispersion of all legal information with nearly zero cost over the Internet, operating cost pressures at NYSE firms began to push these firms in the direction of proprietary trading of principal positions—trading with their own capital—in order to keep earnings growing.

This pressure worked in parallel with the conversion of formerly private partnerships into public companies. Merrill Lynch, for example, became a public company in 1971; the next two decades saw most of their competitors following that lead. This structure now permitted speculation with both shareholder funds and customer risk to create ever-larger compensation packages, as many of the large firms became, essentially, highly leveraged hedged funds.

Lessons of History: Santayana was right, again

Once again, it appears that history has been ignored and its lessons painfully relearned. Other lessons are new—but will no doubt be disregarded and then revived at some future date. Here are several lessons and insights we regard as the most salient:

- **Warren Buffet famously said: "Be fearful when others are greedy; be greedy when they are fearful."** While the rest of us do not have the investment capital of Mr. Buffett, perhaps we can interpret his remarks to suggest that when markets are soaring, we should also pay attention to our balance sheets, both the quality of assets we own and the level of our liabilities. When markets decline is the time to reach for new investment opportunities while others are exiting them.

- **Wall Street, as an institution, is likely changed forever.** Financial engineering provided great cumulative benefits for our global standard of living, even including the recent crash in global asset values. But we should not forget the latter is a byproduct of the process, not the intent of the participants. Mismatched and out-sized incentives lead to behavior that should not be surprising—and which requires regulation. Current posturing in Washington: "I am shocked, shocked that gambling goes on here, Rick" is not useful and belies the fact that legislators have always had the ability, though not often the will, to impose oversight.

- **Even though regulation is necessary, regulators are almost always over-matched in experience and ability by those they seek to regulate.** Unfortunately, this situation is compounded by the fact the process itself is "dirty" in the same way our political system is far too beholden to lobbyists. Regulatory personnel are recruited out of law school, gain experience at the cost of the industry and at the cost of the public due to their

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initial inexperience, and then they move on to large law firms or to the firms they have supervised. Perhaps some restriction parallel to President Obama's limit of the ability of White House staffers to return as lobbyists might be in order.

- **Further, regulation needs to be unified and to cross political boundaries, just as do capital flows.** History leaves little reason for optimism that the balance will be correct. First, too much bureaucracy; second, too little actual knowledge of evolving and adapting markets.

- **Leverage works in both directions. This can best be understood and controlled when incentives are parallel and congruent.** When incentives leave upside mostly with one party and downside with another, bad results should not be surprising. This lesson can be applied to large, risk-taking financial institutions with implicit government backing as "too big to fail," or to fiercely free-market (until help is needed) hedge fund and other lightly regulated types of investment pools that have managed to scrape enormous fees from highly leveraged capital pools, temporarily disguising leveraged beta—market risk—as alpha, or skill. Leverage supported by assets whose market value or marketability fall into question during times of crisis is leverage unsupported.

- **Agency risks are real and important:** Do the people ostensibly working on your behalf have an overriding transaction or short-term bonus motive? One obvious culprit has now been revealed as the sale of poorly collateralized asset pools globally as "safe" investments. Perhaps less obvious are the effects of internal or public market incentives. Incentives matter: employees looking for short-term bonuses might well be less interested in long-term risks than shareholders would like. The unintended consequences of shareholders' demands for constantly rising earnings per share need to be recognized as well.

Charles Prince, former CEO of Citigroup, when asked about the deteriorating quality of lending to the leveraged loan market in 2007 famously said: "As long as the music is playing, you've got to get up and dance. We're still dancing." In retrospect, we are left to wonder whether so many CEOs of financial services companies truly understood the risks they were taking….

Modern Portfolio Theory is alive and well

One final insight: The lessons of recent history continue to endorse Modern Portfolio Theory (MPT). MPT is alive and well; diversification works, even though it does not protect completely against market declines. In the past six months, almost all asset classes took major hits, but their recovery patterns are already beginning to diverge and both fraud and over-concentration risks were avoided.

But MPT does not account for all risks and for uncertainty. Better risk analysis and allocation tools—we've discussed the 3 Risks paradigm—will help us both manage to expected returns and protect against future market disruptions. Not just attitude towards risk, but the capacity and necessity to bear risk must be considered. Evolving technology and asset allocation tools should prove very useful. We must always be watchful, however, for tools and techniques that just happen to solve recently experienced problems but for which universal application is limited or for which collateral problems or risks are too large. Market timing schemes, which, of course, would have avoided the markets' downdraft, are proliferating and pose a grave threat to future wealth.

As always, there remains much in the current financial markets that needs to be set aright. Over the past 76 years since HH's founding, the world of investing has been transformed in every conceivable way, and no doubt that will continue to be the order of the day as new, imperfect checks and balances are imposed and new financial products, tools and techniques emerge.

Yet certain values haven't changed: Halbert Hargrove's roots began with a philosophy bent on preserving wealth, a philosophy we hew to today. We're proud of our roots, our legacy—and our enduring practices and relationships.

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"It is said an Eastern monarch once charged his wise men to invent him a sentence, to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: 'And this, too, shall pass away.' *How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction!"*

Abraham Lincoln, in his 1859 Address Before the Wisconsin State Agricultural Society, Milwaukee, Wisconsin ■