

# William Baker

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## Investment Insights

December 2009

### A CHRISTMAS STORY

Once upon a time, on a Christmas day, I was one of a half dozen aircraft commanders temporarily deployed to Flagstaff, AZ. That area of the country had been immobilized by a severe blizzard. Our mission was to deliver food and medicine and, in some cases, do medical evacuations. We arrived after the storm on a clear, cold, bright blue day. My helo was loaded up with Department of Agriculture forty pound burlap bags filled with canned goods and dry food staples. We were flying over a place adjacent to the Grand Canyon, known as the little grand canyon. Each of us was assigned a sector. We were briefed that if a mirror flashed at us, we were to fly over and drop a bag of food. It sounded simple enough.

We took off from our improvised staging area and headed out toward our mission sector. We flew above a great expanse of high desert, canyons, and mountains. The landscape below us was breathtakingly beautiful in its brand new Christmas suit of pure white snow. We were at once a witness to, and a subject in, one of Nature's most wondrous works of art. It was truly God's country.

We expected that there would be only a handful of people living there. Well, we quickly discovered that there were quite a few hundred Navajo Indians somehow making a life in this rugged terrain. Not only that, but every one of them seemed to have a personal mirror hanging around his neck.

We were all of a sudden beset with mirror flashes **Mirrors, mirrors all around**, flickered and shined in our eyes as we flew. We were overloaded in an instant, and I shook my head at my original thought that this would be a simple mission. Wrong! Given the impossibility of one single bird responding to all of those mirror signals, my decision was to essentially set up and fly an expanding box pattern. I would drop food to those mirror-flashers who were closest to our flight path. We had no way to tell whether one mirror signal might reflect more need and distress than another mirror signal. We just did the best we could, and I know we helped at least some of those stranded souls in the middle of God's country.

At one point I landed next to a lone hogan. The Navajo hogan is a primitive, beehive-shaped, mud dwelling. The grandmother in her very colorful outerwear was standing outside. Next to her, sitting on a leather saddle up against the side of their mud residence, was her two-to-three year old granddaughter with big beautiful eyes and raven black hair. She was also bundled up in colorful clothing. On her lap, she embraced a little white lamb. I had decided to debark my helicopter to personally deliver the food and take a picture. Both the little girl and lamb were looking curiously up at me.



That very human moment was *A Christmas Story* still etched in my heart and mind. Not a word was spoken, but the gratitude on the grandmother's face for that burlap bag of food was one of the best Christmas gifts I have ever received. Christ's words "It is more blessed to give than to receive." hit home on that crisp and cold but very warm Christmas Day. The spirit of giving hit home in all of its truthfulness and power!

Now let's get back to the mirrors, mirrors all around dilemma and to the investment business. The expanding-box pattern was the best I could come up with in Navajo territory since we had no way of knowing the real story behind one mirror or the other.

Investing presents a similar dilemma in that there are thousands upon thousands of public investments all around the world. The dilemma is how do we screen them and narrow them down to make the best possible investment decisions?

First let's state our broad investment objective. It is embedded in our investment mantra *First Do No Harm and Make Money!*\* (please read the sidebar) (continued on next page)

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**S&P 500 Look back**

2000	-9.11%
2001	-11.89%
2002	-22.10%
2003	+26.68%
2004	+10.87%
2005	+ 3.00%
2006	+13.62%
2007	+ 3.52%
2008	-38.5%

**NASDAQ Look back**

2000	-39.18%
2001	-20.78%
2002	-31.25%
2003	+50.76%
2004	+9.14%
2005	-1.4%
2006	+7.87%
2007	+ 9.27%
2008	-40.5%

YTD thru 11/30/09

S&P500	+17.6%
NASDAQ	+26.47%

10/11/2007 HI thru 11/30/09

S&P500	-29.5%
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March 2000 HI thru 11/30/09

NASDAQ	-57.53%
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\*\*There is no risk-free investment! Investment portfolio values fluctuate and past performance is never a guarantee of future results. "Do no harm" translates into structuring and managing an investment portfolio to conform to a client's risk tolerance and time horizon.

Proactive asset allocation, diversification within asset classes, and continual monitoring and risk management of each position are methods we use in structuring and managing portfolios. Our approach includes corroborating fundamental research, with capital markets supply-and-demand research, also called technical research. At times we will use conservative hedging techniques to limit downside risk.

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We know, from research and experience that *how we have money diversified across asset classes given market conditions determines more than 90 per cent of portfolio performance*. We also know that *risk if it goes against a portfolio can drastically reduce a portfolio's value very quickly*.

We manage with the help of leading edge information management technology; computers and very powerful data base systems.

Use of this technology provides two results. First it reduces an unmanageable overload of information to something we can work with. Second, it filters out the noise and gives us valuable and actionable information.

We tell the system what information we want to screen for. It then sorts through and gives us what we want. For example, we can tell the system we only want to look at stocks in a certain industry. Also, we can tell it that we only want to see those companies that use conservative accounting techniques, and that have a record of excellent governance by their Board of Directors and top management. There are many other criteria that we also enter but this gives you the idea.

So with the thousands of investments out there, with **mirrors, mirrors all around**, it is that information management technology that helps, in part, to point us in the direction of those mirrors that will help us the most in protecting and growing our clients' assets. We are at the leading edge in our industry in the technology that we have and that we use, and we are committed to continually improve it.

We break up the capital markets into six major asset classes. Those **six asset classes are cash, domestic equities, international equities, fixed income, commodities, and foreign currencies**. With the exception of cash, within each asset class there are a wide range of investments from which to choose. This is important. For instance, during the Bear Market of 2000 to 2003 only one area of the domestic equity asset class did well and that was small cap value. It is important to have the tools to determine where to be.

Here's how we are doing that and how we have recently improved our process.

**Our supply-and-demand research uses two sets of tools.**

**One set helps us determine the reward vis-a-vis risk in the markets and asset classes that we monitor. In other words it helps us assess the level of risk in which we are operating.**

Briefly if the level of risk is high we want to take a defensive posture and vice-versa if the expectation of reward is high we want to be in an offensive position. 2009 generated some false and conflicting signals and that made it more difficult for tactical asset allocation approaches.

**The second set of tools gives us a continual picture of relative strength across our six asset classes and within our six asset classes.**

In short, we have tools to check the relative strength of anything against anything else in the capital markets. This includes markets, sectors, individual securities and asset classes. In a rising market, if an investment increases percentage-wise more than another investment it is showing relative strength. In a falling market, if an investment decreases less than another, percentage wise, it is still showing relative strength over the other since it is decreasing less.

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By including **cash** as one of our six asset classes we can continually monitor the relative strength of the five other asset classes compared to **cash**. If **cash** begins gaining relative strength over other asset classes, it provides us with powerful visibility into reward vis-à-vis risk and that is valuable and actionable investment information. This subtle change of using cash as we continually monitor relative strengths among asset classes, directly and continually helps us to better-manage reward and risk. It is a new corroborative tool that we can now use in conjunction with our conventional supply and demand risk management tools.

While we have a mirrors, mirrors all around situation in the investment world, we also have the technology and analytical tools in place to help determine which mirrors are the most important. It is far better than what I had over Navajo country back on that once-upon-a-time White Christmas day.

We believe that our methodology and our leading edge tools help to position us to be among the best in the industry in preserving and growing our clients' assets over market cycles. (peak-to-peak, trough-to-trough)

Current market conditions still place international and domestic equities as the top two relative strength asset classes. The level of market risk remains high from a technical and a fundamental perspective. Also, our technical signals continue to send out mixed signals. Our portfolios remain partially exposed to the market and partially in cash and other non-correlating assets. That way we will participate if the market continues higher and will also be cushioned in case of a market downturn.

On behalf of all of the members of our team here at William Baker & Associates, Inc., I wish each of you a very Happy Holiday Season and a Healthy, Happy, and Prosperous New Year.

