

# William Baker

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## Investment Insights

February 2008

### MORE ON THE 2008 INVESTMENT SCENARIO

To quote from our January newsletter, "Since October, the stock market has come off of its highs by about ten percent.....while some of the risk has gotten washed out, there is no reason the stock market could not get more washed out....." Since 1965, there have now been 24 times that the S&P500 has corrected down by 15% or more. On average that would mean a 15% correction would occur about every two years. This current market was going for five years without a 15% correction in the S&P. It was getting a little long in the tooth.

Our investment management mantra is **"First and above all do no harm.\* And make money.\*"** Please read the caveat in the sidebar. Part of our continual due diligence is assessing market and sector risk, and making adjustments based on our assessment of that risk. Remember, about 75-80% of a stock portfolio's performance, is tied to market and sector risk. Effective analysis and execution, based on risk management, is therefore very important and useful in preserving investment wealth (the avoidance of harm)\* and in growing investment wealth.

What did happen in January? January was a bad month for the market. On January 23<sup>rd</sup>, the S&P fell 19.4% and the NASDAQ slid 23%, from the October 2007 highs. For just the full month of January, the S&P slid 6% and the NASDAQ fell by 9.9%.

There were a few bright spots. The building, financial, and real estate investment trust sectors bounced up from extremely oversold levels. Consumer cyclicals, transportation, certain commodities, and gold also did OK. The question still remains, Is the worst yet to come?

In late January a broad array of supply-and-demand research indicators that we follow turned up. In short,

demand was gaining traction and suggested that an offensive (make money) posture be taken. So at this writing in early February, we have moved from a defensive mode to a cautiously-invested offensive mode.

We expect that the January 23<sup>rd</sup> bottom will be retested. As that retesting occurs, either that January bottom will hold, or it will fail. For the time being, we remain on the offense. We have our game plan in place in case the risk goes against us. Our preference is that we see higher bottoms and a rally up from here. However, if the previous bottom is broken, more downside should be expected.

Bottoming is a very choppy process with lots of ups and downs. During this bottoming process we remain diligent with regard to managing risk. That includes cutting losses if the risk moves against us. There are never any guarantees, but we do pay a great deal of attention to what is, is, in the market place. And, we also continually look ahead with a game plan to avoid harm\*, and to make money. During this process, and in fact always, portfolio values will fluctuate up and down, and that is to be expected.

We believe that our actively managed portfolios have done pretty well in capturing good 2007 gains and in preserving most of those gains through the October 2007 - January 2008 downturn. At this point, we're navigating through strong crosswinds and turbulent seas.

From a fundamental viewpoint there are some positive signs. Congress is looking to put some money back in the hands of the consumer. The worrisome credit crunch is recognized as a crisis (continued)

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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%

### 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%
S&P 500 10/11/07 high—	
1/31/08	-12.5%
NASDAQ Mar 2000 high—	
1/31/08	-52.7%

\*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, that is technical research. At times we will use conservative hedging techniques to limit downside risk.

(continued)

by both the government and the private sector. Credit rating agencies have been exposed for doing a poor job of assigning financial ratings. Much bad news is already out there. The Fed has lowered rates. There is admission in some quarters that perhaps a better job of regulating is needed. The FBI is investigating the mortgage industry for potential criminal acts. Some of our devastated banks that were not adhering to basic risk management techniques have been bailed out by foreign money. Some CEO's and CFO's have been replaced for being poor stewards or worse. Yes, there's a lot of bad news already out and at least some beginning steps to fix the problems.

A side note here. Historically, institutions as well as individuals, can both get caught up in the make-money syndrome when things are going well. We now know some banks and mortgage companies disregarded their own risk-management policies and procedures. Realistically, good times often cause periods of amnesia when it comes to downside risk. Often that downside risk that is being conveniently forgotten can be substantial. This "amnesia" is human nature, but a part of human nature, that can do harm very quickly.

There's been much talk of recession. My analysis of research suggested last November that the odds were pretty good that we would have a recession. A market downturn is of course one predictive indicator of a recession. We do not know whether we have a recession until it's officially proclaimed by the National Bureau of Economic Research, after the recession is over. Some readers might be concerned about what the impact of a recession will be on the stock market. Well, since WWII, the stock market more often than not, has been higher at the end of a recession than at the beginning.

Our premise is that investment wealth is created by consistent, prudent, diversified investing over time. As important, investment wealth is created also by managing risk and by avoiding large losses. To follow the path of investment wealth creation requires a disciplined methodology. Our methodology is continual due diligence, analysis, and judgment calls regarding where the opportunities lie and also where the risk lies. It requires wisely diversifying assets, and adjusting as changes occur in the investment environment. It requires having price objectives for each investment, and exit strategies for each investment. It requires execution when changes are required. It requires managing risk along the way.

Please call us with any questions or referral suggestions..