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Investment Insights

January 2010

FROM RUSSIA WITH LOVE

The Cold War Days

Once upon a time, during a naval training mission, a group of Russian shipboard sailors flipped me the bird.

The incident occurred in those years when the cold war and the Vietnam conflict coincided. This incident happened while en route to fly combat in Vietnam. We were cruising in the Sea of Japan and were flying anti-submarine warfare operations around the clock. In retrospect, I think it was part of U.S. policy to demonstrate to the Soviets that we had more military breadth and depth than they could ever muster up. That is just my opinion but our overwhelming military and economic might was finally instrumental years later in ending the arms race and the Cold War and bringing down the wall in Germany in 1989-90.

We were working ourselves pretty hard to keep birds and crews airborne twenty four hours, continuously day and night, day after day. You can imagine the strain on everyone, the ship's company as well as all of the aircraft maintenance crews, flight deck, carrier air tower personnel, and we the aircrews.

I took off a little after daybreak. Our training mission was to find a submerged attack submarine. The submarine's training mission was to sink (simulated of course) the USS Hornet, our aircraft carrier. I was pretty much of the opinion that in that game of "hide and seek", that our attack submarines were much better at hiding and killing, than we, who were tasked to seek out and destroy (simulated) the submarines, were at finding them. It was basically a mismatch in technology – our nuclear attack submarines usually had a big edge over us flyboys.

Since we were so close to the border of the Soviet Union and were in a cold war, soviet ships were right in the middle of our operation. For those of you who remember, it was the time that the *headlines trumpeted several incidents of actual collisions between the soviet ships and our own playing chicken with each other*. It was one of those hot moments in that cold war.



Well I flew right along side one of those Soviet vessels, close enough to see their eyeballs and the lines on their faces. I was surprised to see one female amongst them. At that time we did not have females aboard our ships. Not having anything personal against any of them, especially the female, I smiled and waved at the group of soviet sailors staring at us. My copilot at the time had the colossal audacity to chide me that I was just trying to get the female's attention. I immediately mumbled something formal and official back at him. Then in choreographed unison, and in what I thought was a decidedly uncalled-for gesture in response to my friendly wave, the soviets all flipped me, or should I say us, the bird.

I'm going to tell you a secret that, given the years, doesn't matter now. At the time, that momentary cross-cultural exchange of mismatched salutations was instantly forgotten by me. The press of our training mission was to find the sub. It wasn't until a long time later that I reflected on the incident. We had a two man crew in the back of our chopper. In reflection I wonder, I just wonder, could one of my own crewmen in the back, unbeknownst to me, have precipitated that un-neighborly salutation to my friendly smile and wave? Could one of my own crewmen have flipped the first bird? I guess I'll never know. But that's one of my own true stories of *From Russia with Love*.
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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 12/31/09

S&P500	+18.9%
NASDAQ	+30.5%
10/11/2007 HI thru 12/31/09	
S&P500	-28.24%
Mar 2000 HI thru 12/31/09	
NASDAQ	-55.1%

*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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Not exactly the same, but in some ways similar, every investment action we take is with the intent of getting a positive response from the security that we purchase. Often though, the security, just like those Soviet sailors, will flip us the bird and do the opposite of what we expected. The idea is not to get emotional about it but to press on with our mission. And that mission is to grow and preserve our clients' capital. If a security flips us the bird, just like that pretty Russian female sailor and her crewmates did, we have a strict discipline to cut the loss and press on. The idea is to have high reward-risk ratios (e.g. \$2 upside to \$1 downside or better). We want to keep the downside risk small so that if we do have to cut our losses we keep them small. We do our best to take rapid and decisive action to keep small losses from turning into large losses.

Large hard-to-recover losses are what will do serious damage to a portfolio and potentially to an investor's financial security. Chasing after high returns is usually a mistake because by the time you begin chasing after them, they are likely to have run out of steam, and are getting ready for a pullback. And that is where the real opportunity arises, on those pullbacks when valuations have come back down to earth. It takes discipline and patience but over time that discipline and patience will pay off handsomely.

Markets, industry sectors, and individual securities such as stocks or mutual funds breathe in (prices go up) and breathe out (prices go down). That's a normal phenomenon. Two key activities in our portfolio management are monitoring the level of risk in markets, sectors, and individual securities. About 80% of the risk in a stock portfolio is market and sector risk. It is extremely important to keep watch on those risks! The other key activity is to assess where the strengths and weaknesses lie amongst and within asset classes. Right now for instance, International Equities and US Equities are the two sweet spots amongst six major asset classes that we monitor. Those six asset classes include U.S. and International Equities, along with Fixed Income, Foreign Currencies, Money Markets, and Commodities.

Having just said that International Equities and US Equities currently are showing the highest relative strength amongst the six asset classes, it is also true that the level of risk of equities is increasing. Several significant indicators including our world indicator, based on more than 20,000 stocks, are suggesting more caution and positioning portfolios to preserve rather than grow wealth. Therefore, an increasing level of equity risk suggests that it's prudent to have some money in other asset classes. That is our situation.

Expect to see lower monthly values in your end-of-January portfolios as a natural result of a recent breathing out of the markets and sectors. If the risk continues to increase, in line with our mantra **Do no harm and make money***, we will take action to further reduce equity exposure to position ourselves for a better buying opportunity ahead.