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Investment Insights

November 2008

We'll See.

Once upon a time there was a Zen farmer. The farmer's horse disappeared one day. His neighbors, noticing the horse was missing, gathered at the farmer's house and remarked upon his terrible luck. The Zen farmer shrugs and simply says, "We'll see." The next day the horse returns and brings with it several wild horses that the farmer can use to speed up his plowing in the field. The neighbors gather once again and remark on such good fortune. The Zen farmer shrugs and says, "We'll see."¹

"We'll see." suggests that wisdom is not to think of yourself as being a victim or a master of fate, but rather of being a student of life, and of being effective in dealing with *what is*.² To apply this Zen wisdom is to maintain inner peace and calm in the midst of events over which we have no control. As we let go of those things that we can't control, it frees us up to focus on those things that we can.

The Zen Farmer isn't necessarily better than his neighbors; he's just better at focusing on the things that are important, the things he can change. He lets go of the things he can't. So, too, is a good investment professional better at focusing on the things that can be managed within a portfolio. He lets go of forces on a portfolio that cannot be controlled. Important things to be managed are how money is divided across asset categories, the selection of individual securities, and the reward and risk profile. Things that cannot be managed are what the Fed does next about the "bailout", or what policy changes a new administration might bring, or who will preside over the new administration, or what the market or a security will actually do tomorrow or the next day.

We live in a world of probabilities and improbabilities. In spite of our best laid plans sometimes not-so-good things happen. Farmers deal with droughts and insects, businesses deal with recalls and recessions, and investors deal with Bear Markets.

We're in the throes of one of the most vicious Bear Markets experienced in the past hundred years. It started last October 2007. Then last month, October 2008, it descended on investors around the world with unexpected and unrelenting fury.

With the exception of those assets in cash equivalents, there was little place to hide. Year-to-date, performance is abysmal. Hedge funds that have an objective of an absolute positive return, are down minus 20-30%+, asset allocation funds have lost minus 20-25%+, diversified growth funds have been hammered to minus 30-45%+, and foreign funds are pulverized to minus 45-75%+. Even bond funds sold off to minus 15%+.

It was a very ugly month, the worst October since 1987. End-of-month statements will shock investors around the globe. In our managed accounts, since we had cash on the sidelines, we've done well on a relative basis. On an absolute basis though, October brought bad news. BUT, in the face of apparent bad news, the key, as the wise Zen farmer understood, is to focus on doing well, those things that we have the tools and the power to do.

In line with our investment management mantra "**Do no harm and make money.**"³ (please read the sidebar caveat) we've been hard at work to adapt, to identify opportunities, and to take advantage of some excellent values that have surfaced in the markets. We've already made significant portfolio adjustments and will continue to improve reward and risk profiles as we go forward. In spite of October, we have confidence that our relative strength, and our portfolio adjustments, will work very well for recovery and continued growth.

Historically, 40 days after a Bear Market bottom, the market is back up by plus 33%. If that holds true, our portfolios will be faring well this year. That would be good news, but the fact is that it's a *we'll see* thing and there is no guarantee what will happen. Other investors, not using a risk-managed approach, experienced the brunt of the Bear Market. Most investors with losses of 30%-40% will require gains of 43% to 67% to get even. Let me reiterate that there is no way to know how far the market will rebound, or when, or how long it will take. We think the October 10th bottom will hold fast knowing that it's a "We'll see." In the meantime, *we'll deal with what is.* (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%

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%

YTD thru 10/31/08

S&P500	-33.9%
NASDAQ	-35.1%

10/11/2007 HI thru 10/31/08

S&P500	-37.6%
Mar 2000 HI thru 10/31/08	
NASDAQ	-37.9%

³ 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.

(continued)

What is, is good news! I mentioned a ray of sunshine in the October 27 Client Bulletin. Since then, more good signs fell in place at the end of October in terms of our supply-and-demand research. One has to do with relative strength (RS). If one security has RS over another, it means it goes down less in a down market, and goes up more in an up market, relative to that security it's being compared to. We continually monitor RS of markets, asset classes and individual securities. It's a valuable tool. At the end of October, stocks (after several months of trailing) finally beat out money markets and bonds in terms of relative strength. That important change in RS is a definite positive for the stock market.

Another very good sign is that our main supply-and-demand indicator gave us a positive signal from a very washed-out level of risk. That means that demand (higher prices) in the stock market is making headway against supply (lower prices). In plain words, our primary supply-and-demand indicator is telling us that we are back in wealth accumulation mode. That means that the prudent move is to put more investment money to work in stocks. Will it work? *We'll see*. That is why a risk management component in your investment program is so important. In case it does not work we have a risk management game plan and an exit strategy.

There have also been some other positives such as the breakout of the U.S. dollar into an uptrend. The point is that the odds are improving to make money in the stock market. It's always a *We'll see*, but the odds have significantly improved.

From a fundamental economic standpoint, most of you have been inundated with information on the bailout and the coordinated government intervention to free up the credit markets and rescue the banks. That's having a positive effect on the markets, but going forward this intervention too will remain a *We'll see*.

I remain as optimistic and pragmatic as I was when I wrote last month's newsletter. Our experience, research tools, and risk-managed investment methodology work, realizing that occasional setbacks are a normal part of the process. Our team strives continually to be the best in our field to grow and protect our clients' assets. The market does what it does. We can't control it but we can be students of it and understand how to best make it work for us most of the time. We do continually monitor what's going on with excellent research and judgment, and consistently work to stack the odds in favor of our clients.

You may know investors out there who have borne the brunt of this Bear Market. There are many. If you think they need and would appreciate our help please direct them to us and also to our website: <http://www.wmbakerinvest.com/> Our archived newsletters and client bulletins can be found in the dark blue box, upper right, of the home page.

¹ Zen is a distinct school of the Buddhist religion and was first documented in China in the 7th century. It emphasizes experiential wisdom, which in my interpretation would be wisdom gained from unemotionally observing and pragmatically dealing with what is in the world that we ourselves cannot control. I don't know who originally wrote this little story (which I adapted) about the Zen farmer, but I first read it in a book called *Keep Pedaling Zen Farmer* by Dorsey Wright and Associates, Inc. Other adaptations of the Zen Farmer story, *We'll see*, are available by googling the words Zen Farmer.

² *We'll see* is similar to my June newsletter story *What is, is*, but with a slightly different twist. Please see our June 2008 Newsletter found in our website.

³ Please read sidebar caveat.