



Client Bulletin

William Baker
& Associates, Inc.

400 Galleria Pkwy, Suite 1500 Atlanta, GA 30339 Phone: (770) 956-4073
e-mail: wmbaker@wilbankssecurities.com www.wmbakerinvest.com

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INVESTMENT MANAGEMENT: UPSIDE AND DOWNSIDE

It'd be great if we could invest in a single stock or a single asset class and just watch it double, triple, quadruple and more. That can and sometimes does happen. Many of you who are reading this article may know someone who invested in Home Depot in the 80's, or maybe a small technology company, or maybe a unique niche sector just to watch it grow and grow. Many of you may have gotten into a successful investment and then may have pulled out too quickly and lost much of the additional upside. I've listened to many, and have myself experienced, stories to this effect. Vice versa there are just as many stories about buying into the hot investment bandied about the water cooler, and then watching its price quickly go down to nothing.

Stewarding large amounts of money though is a challenging business. Dealing with your serious nest egg money is not the same as dealing with casino money when you're on vacation in Las Vegas, New Orleans, or Atlantic City. Some, including me, would say that the casino approach is what some of our banks have been using over the past few years. Stewarding large amounts of money is serious business. Recovering a large loss is usually not as easy as it is to incur that large loss in the first place. The corollary is that it's usually easier to make up lost opportunity than it is to make up lost money.

Years ago, when I was flying off of the USS Hornet, one of my squadron mates (a pilot) happened to be the only survivor of a night helicopter crash off the California coast. He was not at the controls, but a passenger riding in the jump seat between and slightly aft of the pilot and the co-pilot, also my squadron mates. They had just taken off from the carrier and had begun a climbing turn. They were flying visually when they should have been flying using their instruments. Not flying their instruments, they were looking out the window into a black night with no visible horizon. They had no depth perception and they were not scanning their instruments. Neither pilot was aware that their climbing turn had morphed into a gradually descending turn. They flew the bird right into the water. My squadron mate was catapulted thru the front cockpit window and he somehow survived. He was the sole survivor. Afterwards, in debriefing the squadron, he told us that he was looking at the radar altimeter as they descended in altitude. He told us that even though he watched the descent on the altimeter he was transfixed on the instrument and was in a kind of a trance. (Target Fixation is another term used in similar deadly aviation mishaps.) In that trance-like state of watching, he did not alert either of the pilots of their in-extremis situation. Four souls were lost.

In managing investments and investment portfolios a similar situation can quickly happen to the money being managed. Without understanding the "target fixation" phenomenon, and without having a disciplined methodology to manage the downside as well as the upside, what can happen? Watching asset values go down, and not having a disciplined methodology in place to stop that descent, can incur large losses so fast it would make your head spin. A trance-like immobility can occur that keeps an investor from executing a sell order early enough to keep losses small. Many investors think that money managers and mutual funds will do this for them. My experience in the industry is that, more often than not, the sell discipline, the risk-management discipline, is absent. After this most recent meltdown, it should be obvious to most that, in large part, effective risk-management was absent not only in our banking and mortgage industries, it was also obviously absent in our money management, and mutual fund industries. *(continued on next page)*

Wealth building is not so about chasing after high-risk gains as it is about avoiding large, difficult-to-recover losses!
- Bill Baker CIMA/CIMC circa 2007.

(continued)

In our practice we place a priority on excellence in both reward and risk management. In no way does that mean we are risk-averse. What it means is that we want to stack the odds in favor of making money and avoiding large losses. In late June and early July for instance, our indicators were rapidly deteriorating and we aggressively moved to a defensive cash position. Our risk indicators suggested a good chance of another 15% downside. We got fooled! The market turned around and zoomed up. What we lost was a little money at the lower point where we raised cash. We also lost some opportunity gains as the market moved back up. The term we use is whipsawed and it sometimes, not often, but sometimes, it happens. When it does we adjust to the new circumstances, change our game plan, and go on knowing that given the information our call was OK. The outcome though, sure wasn't what we were hoping for. No, we do not like our portfolios to get whipsawed but that's just part of doing business using a disciplined, well-proven methodology. A main point is that taking action to avoid large losses when the odds are against us, preserves our capital, and gives us the wherewithal to recoup sooner than later. Every so often we forego opportunity but opportunity can usually be made up easier than a large loss of money.

Some words on our current situation and then I'll close.

The fundamental economic picture has improved substantially in the past year. Nevertheless, a lot of uncertainty remains. We believe the uncertainty hinges largely on the unemployment picture, the related foreclosure and real estate price picture, the future state of consumer spending, and how well we do in creating new industries and new value. Will continued government efforts be effective? Will trillions in government spending/loaning be just a flash in the pan or will it prime the pumps of the private sector? Plenty more bank failures are in the offing, plenty more debt at all levels needs to be paid down, the real estate market has to be stabilized, and companies need to start generating top line income. *The main point is that even with the economic improvements we see, the fundamental economic picture still carries a great deal of uncertainty and risk.*

One other fundamental economic wildcard is the U.S. dollar. It continues to weaken and the question is will that trend change at some point? If it does, it will affect our investment strategy so we continually keep a hawk eye on what the dollar is doing.

The technical or supply-and-demand signals are very strong. The run up in the stock market over the past quarter, after the early July fake-out, is compelling. From here, while it could go either way, the technicals lean in the direction of higher stock prices. The relative strength amongst asset classes now emphasizes domestic and international equities (over fixed income, commodities, and cash) The one technical negative is that the equity indices are in the red zone. They are in the overbought zone. That, however, does not mean that equities cannot get even more overbought.

In summary, we have a situation where real fundamental risks and uncertainties are counteracted by a very positive technical (supply and demand) picture. Therefore, it makes sense to be invested in equities, but it also makes sense to invest in asset classes not correlated to equities. That's what we're doing. We're also as always, paying close attention to high reward /risk ratios for each investment we make and to keeping tight stops in place to cut losses early if a security shows signs of deterioration.

Sometimes, short term investment results may be frustrating to us as well as to our clients. At those times we remind ourselves that investing is a marathon and not a hundred yard dash, and also that performance is best measured over an entire market cycle from peak-to-peak or from trough-to-trough. Patience coupled with a sound methodology usually pays off handsomely. We continually work to improve our tools and processes to be the best in the industry in terms of performance and wealth management advice.