

# William Baker

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## Investment Insights

September 2008

### READING THE RIVER

Once upon a time, I was into white water canoeing. At that time, ABS plastic canoes had come on the market. Compared to aluminum canoes, ABS hulls were fantastic. Differing from the aluminum hulls, ABS was reasonably lightweight, and, rather than hanging up on rocks, they would easily glide right over them. These ABS hulls were also very quiet, and they were virtually indestructible. ABS plastic ushered in a new era in whitewater canoeing. Kevlar hulls also came into their own, to even outdo ABS. But no matter the hull, it is still up to the paddlers to get themselves down the river safe and sound, hopefully without getting hung up or flipping over.

On one of my early days as a novice paddler, on the Rapidan River in Virginia, I could see that the rain-swollen, swift current was carrying me toward a big jam of logs and branches. I furiously began paddling to avoid a collision. In spite of these efforts, the swift current hurled me right into that dead fall with resultant scrapes, cuts, bruises, and a lump on my head. Even though I saw the danger, at that point in my paddling experience, I didn't see it early enough, nor did I have the skill to get out of its way. The paddler needs to read the river well in advance and then have the paddling and river-sense skills to make the most of the currents and to avoid mishap. Likewise, the investment manager needs the skills to use his research and execution tools, and the market's trends and relative strengths, to best advantage.

Any of you who have seen whitewater sports on TV know that trying to paddle upstream in whitewater is not a great idea. In the investment business, to invest long in the market when the market, or a part of the market, is in a down-trend, is usually not a great idea. The trend is our friend as the saying rightfully goes. Our supply-and-demand research charts can quickly tell us what the trend is for a market, a sector, and for an individual security. When the trend is against us, we will be using a defensive game plan, and we'll be in wealth preservation mode. When the trend is with us, we will be putting more dollars to work offensively, in wealth accumulation mode.

Once, three of us were canoeing the Lost (Cacapon) River in West Virginia. Shortly into it, a storm came up. My son and I, in the same canoe, both were wearing broad-brimmed hats. Those brims kept the rain from directly beating on our faces and into our eyes. Our companion, a novice paddler, not only did not have a hat, he also wore glasses. Not being able to beach in this section of the river, he had to blindly follow us by our talking him through it. He was a sad sight to see with rain streaming down his forehead and into his eyes, and water covering his glasses. With his wet hair streaming down, he literally looked like a very wet, bespectacled dishrag. Fortunately, it was a forgiving patch of water, and he made it through okay.

But it reminds me of so many investors out there. They're put in a situation to self-direct their portfolios with no idea of what the market is doing, let alone know what to do about it. All too often in stormy weather they just find themselves watching their nest eggs get smashed and tattered by adverse market actions, and are told by their phone contacts that they've got to look at it in the long term. During the depression in the 1930's, was it Keynes who said, "In the long term we're all dead."? ( Note: This is a deficiency in the 401k and retirement plan industry and will, I hope, gradually be competently and effectively addressed by firms like ours. The canned solutions to 401k and other retirement plan participants right now are, in my opinion, sadly lacking from many different standpoints)

A group of paddler friends back in those whitewater days decided to do a canoe excursion out west on a river in the Rockies. It was not the kind of river they expected. They returned home with the story that the river they had planned on canoeing was much too fast and dangerous for them. Recognizing the peril, they changed their plans, and moved to a river commensurate with their equipment and their skill level. *(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 8/31/08	
S&P500	-12.6%
NASDAQ	-10.7%
10/11/2007 HI thru 8/31/08	
S&P500	-18.6%
Mar 2000 HI thru 8/31/08	
NASDAQ	-53.1%

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

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At times the level of risk in the market, a sector of the market, or an individual security, carries too much danger. In that case the wise thing to do is to move out of harm's way, adapt, and invest in an area of the market that carries more reward potential and less risk. It's often in the midst of exhilaration in watching your money grow that the risk level becomes too high, often before you realize it. At these times, almost in a blink of the eye, all of your gains, plus more, can be violently wrenched away. In our judgment, risk management is a daily necessity.

We use research that provides us with what we call **the Reward-Risk ratio. It's a quantitative view of an investment's upside dollar potential versus its dollars of downside risk. Usually, we want a minimum of \$2 upside reward to \$1 of downside risk.** I should say that this Reward-Risk information is never gospel. It's statistically based. At times, the odds can and will go against you. But our starting position is to put the odds in our favor. If the odds go against us, we have early warning systems in place. We see it, we acknowledge it, and we deal with it to minimize the downside and to maximize the upside.

One time, while canoeing the James River in Virginia, we came to a fork in the river. Well, we picked the wrong side and ended up having to portage our canoes back to put in again on the other side, the right side. Homework should have been done in the planning to know which fork to take. If homework is not done beforehand, it might be best to beach the canoes and have a few paddlers hike ahead on a reconnaissance mission to determine the best tributary to take. Investing also requires constant homework to determine the best course by which to make money and to avoid danger. **In the capital markets there are literally thousands of forks or investment courses available. Therefore, it's imperative to have the reconnaissance (research) tools, information technology tools, and execution tools in place to help determine the best reward-risk investment opportunities.**

A few years ago, my wife and I made a short sojourn up the road from Atlanta to Ellijay. We had arranged to canoe the Cartecay river with a group led by Mountain Outdoor Expeditions, a professional outfitter. It was raining. After cutting our head and arm holes in plastic garbage bags, we all donned our improvised ponchos and put into the river. Now, it was pouring! We were about ten minutes into the trip. At this point, we could visibly see the river rising on its banks. Our guide wisely called it to a halt, we beached, and he called for transportation back to base camp. In the investment world we call it cutting our losses. When investing, if the trend turns against you, the prudent action is to cut your losses and get out of harm's way. Disappointing results happen in spite of the best laid plans. Just gotta deal with it. And we are continually improving our tools and game plans to deal with it.

One last experience comes to mind. My brother-in-law hired a guide to lead a group of our immediate family members on a gentle canoe trip on the Wacissa River, through the Slave Canal, to the Aucilla River. It's an archeological treasure trove area in the vicinity of Tallahassee, FL. The Slave Canal was a business enterprise that used slaves to build a canal to connect the two rivers to facilitate cotton trade in this area. It was a commercial failure, but now, more than 150 years later, it makes for a unique canoe trip! *(continued on next page)*

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Our guide, who had not done this trip in a long time, missed the turn and instead guided us into the middle of the swamp. He finally decided – it was quite obvious to everyone – that he messed up.

So we paddled upstream (by the way, the current was only about 3 knots) and climbed over lots of fallen cypress trees to find our way back. The guide finally redeemed himself, found the Slave Canal, and we finished the trip without mishap and with a good story. The point here is that the experts sometimes can and will lead us down the wrong path when investing. That is why it is important to use the best experts and research available, but also to understand that wrong turns will occur, and to have sound disciplined methods in place to recognize and correct them before they get out of hand.

My intent in these monthly newsletter stories is to provide you with a better gut-level understanding of the world of investing. What makes the stories and analogies viable are many ingredients: excellence in research, a sound methodology, use of cutting edge management tools, a continual effort to improve at all levels, wisdom gained from years of experience, discipline, teamwork, and plain hard work. Also helpful are curiosity, a passion, a constant effort to maintain a deep humility, and a continuing endeavor to improve our understanding of the markets and investing.

Let's take a look at our here-and-now investing situation.

In late July our supply-and-demand research indicated that demand was gaining control in the market: more stocks were giving new buy signals than new sell signals. It was time to ease the canoe back into swifter currents or increase our equity exposure and get back into wealth accumulation mode. However, since then not much has happened in terms of the indices or bottom-line portfolio values other than up-and-down oscillations of a few per cent. It's akin to being stuck in an eddy when canoeing. An eddy is a circular current or a current running against the main current. When stuck in an eddy you're not making headway. You also may not be sure how you're going to come out of it.

When demand regains control, as it has, we hope that the current is going to move us along favorably. The main current right now is in our favor but for the past month or so we're kind of stuck and going around in an eddy. It's pushed us back a little recently, but we're happy to say that for the year, the paddling has gone pretty well. Our account values still remain much better year-to-date than what the major indices have done.

Even though price action has been sort of like that oscillating eddy, we have seen additional positive indications that more individual security trends are reversing from down to up. Also, we continue to see more individual securities giving new buy signals. Those are positive ongoing signs but no guarantee! There's a chance we may test the July lows. In so doing we may have to move back to more tranquil water, i.e., back into wealth preservation mode from wealth accumulation mode. That would be in line with our mantra, **“Do no harm and make money.”**\* (please read sidebar.)

2008 continues as an unusually volatile year in the stock market. All of the information that was in our July Client Bulletin remains applicable. You can click on Client Bulletins in the upper right box located on our home page [www.wmbakerinvest.com](http://www.wmbakerinvest.com), if you would like to review our perspective on major market themes. Previous 2008 newsletters are also archived there under Newsletters.

We always value your feedback and your referrals and appreciate your continued interest and support. Thank you!