WINTER 2008

Quarterly Update

NEWSLETTER OF BAKER BOYER WEALTH MANAGEMENT SERVICES

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Many people have asked me to explain to them what is going on in this volatile market. I often look at them a bit perplexed because it isn't as simple as saying it is one thing or another. In fact there are thousands of tiny variables that are now affecting the markets in ways that no one could have imagined a year ago. Don't get me wrong, I love talking about the economy but I can't simply discuss one small point without it affecting hundreds of other points going on in the market at the same time. That has made this newsletter the most difficult one I have ever written, because the real question is where to begin and how to wrap it all together. So I am going to start with an analogy to one of my favorite artists, Seurat. Bear with me; it will come together in the end...

Seurat was a master painter who painted using "pointillism" with one of his most famous works being, *A Sunday Afternoon on the Island of La Grande Jatte*. Using pointillism he created his paintings by placing hundreds of thousands of tiny dots onto a canvas. They were all different colors, and if you stood a few inches away from the canvas it was impressive to see the precision with which he placed the multi-color dots. But the art came when you stood 15 feet back and saw an amazing picture made of individual dots. Seurat took the "science" of placing precision dots

and made a work of "art." In fact there is an "art" and "science" to every profession.

Take, for example, the medical profession. Few doctors are general practitioners anymore. Most of the time doctors specialize in fields like neurosurgery or cardiology. The evolution of our medical system has driven this structural change in their profession. You may go to an internist but then immediately you are "referred" to a specialist. The internist may have little contact with you in the future, but in most cases they have the most complete understanding of all your medical conditions and history.

In many ways the investment field has specialized in the same way. You may want to know about a certain company or sector but you will need

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to talk to an investment analyst who specializes in that area. There are few analysts and managers who are good general investment specialists anymore. Unfortunately that's where the problems arise.

There is a science to investment management. That is to say that there are right answers and wrong answers and you can create a computer program to help you decide what answers are generally right or wrong. Investment managers use computers much in the same way when they implement "Quant-itative Models," into their investment strategy. They input massive amounts of data into a computer and the computer will make investment selections based on specific parameters and what the program says to buy. In some of the most specialized models it takes all human interaction out of the equation all together; it makes it a "science." But, equally important to investing is the human element of investment management, or the "art" of investing.

Wall Street, in recent years, has taken the approach that the science of investing is more important than the art of investing. Game Theory and other physics and mathematical theorems have become all the rage. Thousands of

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Municipal Bonds & Insurance

During the last few months of 2007 volatility abounded in both the equity and fixed income markets. One area that was hit the hardest was the municipal bond market, and their dependence on bond insurance companies. In order for most municipalities to get a AAA rating on a bond issuance they need to pay for insurance to be added to the bond. This is due to the "underlying," credit worthiness of the municipality being below AAA. The lower the credit rating of the municipality the more the municipality is required to pay for insurance.

Over the last 5 years municipalities paid insurance companies an annual average of $ 1.99 billion in premiums to gain their AAA rating. Recently, two of the largest issuers, AMBAC and MBIA, have had their own credit ratings lowered as they have come under scrutiny for insuring CDOs, structured investment vehicles, and other subprime lending vehicles.

As municipalities are now no longer achieving a AAA rating even with bond insurance, many have elected to issue bonds without insurance. Over the last month only 25% of new municipal bonds had insurance, versus 50% of all municipal bonds over the previous 5 years. The majority of municipal bonds are investment quality without insurance, and over the last 5 years only 1 in 2,000 municipal bonds rated investment grade have defaulted. Due to the low default of municipal bonds, and as the spread between insured and uninsured bonds is shrinking, we expect the trend of less insurance to continue.

Baker Boyer has generally invested in insured municipal tax-free bonds with very high underlying ratings. This has shielded us from dramatic decreases in bond values that other municipal bond holders have seen.

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mathematicians and physicists have been hired by Wall Street firms to create programs that will take into account the historic tendencies of the equity and fixed income markets.

In 2007 many of these programs stumbled. Most stumbled because they were not able to take one piece of data into account and quantify it. That one element is human emotion. Fear, joy, trepidation, confidence… how do you quantify those things that define us as human beings? You can't, and that's where "art" comes into investing.

This is where logic and common sense have to override the computer programs or the science of investing from time to time. Those who put too much faith in the science of investing often times aren't able to see the big picture. Like Seurat's paintings, they see only an enormous stream of data but they don't see the big picture; in this case the masterpiece. Other investors have been adept at seeing both the science and art of investing, take for example Warren Buffet.

So how did the science of subprime and high risk investing lead to the current financial sector crisis that we now see? Why did banks and others make so many risky loans? The simple answer is that there was a lot of money to be made by a lot of people. That included those who sold the risky loans, those who financed the mortgages, and those who ultimately purchased the loans. When there was that much money involved people were very willing to believe that a scientific computer model would guarantee them a high rate of return. The big error that people made was not accounting for the fact that the entire market was dependent on double digit returns on house values. When the party came to an end, every nook and cranny of the financial sector was affected by subprime and high risk investments. Most of the investors who lost billions were right on Wall Street in downtown New York City.

Remember, the subprime debacle was primarily a quagmire that was created by Wall Street mathematicians and theorists and then packaged and sold by Wall Street salespeople. That old salesman joke of, "I have a piece of Louisiana swampland with your name written all over it," was alive and kicking when Wall Street sold subprime to an unsuspecting public. When the dust settled, everyone on Wall Street was dirty, either through direct involvement in subprime and high risk lending or through the theoretical models they established to create the original problem.

Now the question is: how far will the problem spread? If you think of the dilemma like a ripple effect in a pond, the original pebble may have been high risk lending, but the ripples have reached farther and farther out. The closest and largest ripples were at the center affecting financial sector companies such as, Citigroup, Washington Mutual, Goldman Sachs, JP Morgan and the rest. But the ripples seem to be going past those original instigators. The fear is that far away from the center is the average upper middle class consumer, whose purchases of goods and economic clout are imperative to push the economy through the subprime mess.

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The ripples seem to be getting closer and closer to this group, but nobody is yet able to quantify the impact on them. If they are hit hard a recession is likely. If it is relatively small we will work our way out of the problem. We at Baker Boyer believe the impact will be slight. There seems to be growing evidence that the upper middle class is weathering through this crisis and continuing to support the US economy and ultimately the world economy. Not to mention a new wealth group, the group of wealthy farmers that have been created with record grain prices. Things change in an instant though, and we are monitoring this critical piece of data very carefully.

It will also make you happy to know that Baker Boyer prefers to think of the art as well as the science of investing. To that end, several years ago the Bank opted to not be involved in subprime lending… period. This philosophy went for the investment of client assets that Ted Cohan and I manage, the investment of bank assets that Mark Hess manages, and the origination of mortgages for our clients that Lyle Hansen and Judy Hicks manage. In other words we truly believe in our motto of "Guiding you to a Brighter Financial Future."

I am very proud of our team here at the Bank. All three areas of the Bank that could have been involved in subprime lending independently and unanimously decided it wasn't in the best interest of our clients or the Bank to do so. That wasn't an easy decision to make, but our small town common sense told us that Wall Street had it all wrong. We didn't have a fancy program or doctorate in physics or mathematics, but to all of us, "it just didn't smell right." Ultimately it is small town common sense that good investment decisions are based on. Thank you Warren Buffet for reminding the rest of the world of that point from time to time.

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