



Quarterly Update

FALL 2009

NEWSLETTER OF BAKER BOYER WEALTH MANAGEMENT SERVICES

Just over one year ago, the world changed forever. On September 15, 2008 Lehman Brothers closed its doors due to insufficient capital to continue on. The aftermath that followed started off as a shudder and then progressed to an all out 10.0 earthquake that shook the financial world to its core. We all know now that the after effects of the subprime debacle were much worse than the original hit to the housing industry. The construction industry was hurt, but the people who held pieces of this toxic debt were taken out at the knees.

One year later every major economy in the world has had to prop up their financial industry as credit ceased to flow throughout the globe. The all-powerful G7 nations, which include the US, Japan, the UK, Germany, France, Italy, Canada and sometimes Russia, were expanded to the G20 which included many more emerging economies; most importantly China. Other countries, such as Iceland and Ireland, were forced to cover the majority of lending in their territory.

In my seminars I highlighted how unfettered greed got the best of many investment professionals, but ALL investment managers have had to deal with the aftermath. Financial experts who chose to look the other way, or take their bonuses on ill-conceived investment products made



enormous profits and those same products caused a cascading event of bank failures, cash flow crises at corporations and eventual bailout by national governments.

One year later many lessons were learned. I am including in this newsletter the top 5 that I think should be enduring lessons that we never forget.

1. Cash Flow is King! I went to the University of Washington, and a professor in the business school created a statement called the statement of cash flows. It measures the net inflows and outflows of cash that a company sees on an annual basis. When a company doesn't have enough cash coming in to pay their expenses and make their debt payments they become illiquid. Many of the companies that were on the brink of collapse last year were not bad companies. They had floated
continued on page two

Inside this Issue

- 1 Economic Update
by Mark Kajita
- 3 An Outlook on Wheat
by John Mathwich



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short term bonds and as they came due, bond buyers all over the world just left the market. In other words, it wasn't that these companies were poorly run; they simply did not have enough cash to pay off their short term loans because they couldn't sell the next bond. At Baker Boyer we had focused our efforts on purchasing the stock of companies who had negligible debt loads, huge cash reserves and had positive cash flow. Even with that, stock prices throughout the world tumbled as investors started dumping stocks of great companies, as well as those which faced a short term cash liquidity problem.

2. Due Diligence is a Must. Many investors were frustrated with their investments because their financial advisors were not privy to the core thoughts that were forming in the minds of the fund managers whose funds they had bought into. A number of financial advisors were relying on brief snippets from fund managers that tried to explain, through the eyes of the

fund managers, why decisions and investments were made, altered or held onto. The problem is that these brief snippets and short letters were designed by sales people and the information was flowing one way only, down. In other words the financial advisors were not able to receive answers to the questions they themselves had asked. Many financial advisors didn't know where to start with the questioning, and due to that, there was very little communication between themselves and their clients.

Baker Boyer has direct access to the majority of the fund managers whose funds we currently hold. During the crisis, we asked that our philosophy of holding very liquid companies with exceptional cash flow be implemented within their funds to alleviate large volatility in valuations. In addition, we were proactive in holding seminars for the public to keep them informed of the financial situation. Those seminars were also posted on the web at bakerboyer.com.

3. Explore Risk Management with your Investment Manager. You should be able to discuss with your investment manager why certain assets are being held and what the overall philosophy is regarding the allocation of assets in your own account. Don't be afraid to ask your investment management firm to run a cash flow analysis for you personally. This is an extremely useful tool to determine if your assets will last through your retirement or if the goals you have planned for are still achievable. Isn't that what you really want to know? Not that you lost 10% in your account, but that your dreams are still achievable. Once you know that your lifestyle isn't changing, you can once again sleep well at night.

4. Oversight, It's Not a Dirty Word. As much as many of my readers may want to trust in the free market system, there are people out there that use our current regulatory system against the innocent. Certain firms who locate

their funds offshore in places like the Bahamas or the Cayman Islands or transact with offshore accounts frequently are inherently more susceptible to error or malfeasance. **THIS DOES NOT MEAN** all offshore account managers are frauds; quite the contrary, most fund managers are trying their best to represent their asset values as accurately as possible.

It does mean that rules like audits of financial firms and SEC compliance regulations are there to catch the outliers who take advantage of others. Those rules apply to registered investment funds which are based in the US, but not to offshore accounts that can play by other rules. As we would later find out, Madoff exploited this hole in regulatory compliance and used his clout as a Wall Street tycoon to convince the SEC that he was legitimate.

At Baker Boyer we prefer to use registered funds in order to assure ourselves and our clients that their assets are being protected, not just by the morality of the fund manager and the due diligence of Baker Boyer, but also by the oversight of regulatory compliance. We can use offshore accounts, but our level of due diligence must increase to match the additional risk.

5. Fundamental Investing Over the Long Term is Probably Best For Conservative Clients. Over the past few years there has been a war between two different investment philosophies. One is the technical side of investing which relies

heavily on computer software and programs to base their decision on whether or not to buy or sell an asset. The other is fundamental investing which relies on a person's understanding of the current investment scene to determine how

that we will be analyzing this time period now known as the "Great Recession," for generations. My grandchildren will be asking me questions many years from now. In the future, I can tell them that at this time the financial system was

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to invest in certain asset classes, sectors and styles of companies.

During the last year the faults of the technical investing style have become apparent. Mathematical models didn't take into account illiquidity in the markets, history of the data set used and wide variations in bid and ask prices within the market. In other words, the models didn't work. Fundamental investing styles ended up beating the markets over the last few years, as many of them didn't buy into the inflated assets that were being touted by the technical analysts.

At Baker Boyer we rely on fundamental investing in order to protect our clients over the long term.

In conclusion, there were so many lessons to learn from the last year

under the greatest threat that we had seen in generations, but with cool headedness we were able to survive with a new vision and a new determination to succeed going forward.

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The farm economy has a significant impact on our local area and many individuals have invested in farmland. Baker Boyer Bank has been involved with farmland management since 1916, and I thought a review of the past couple of years and the current outlook would be of interest.

The Walla Walla region produces many crops, but wheat is the pre-dominant crop and the subject for this column. Using approximate numbers, there are five hundred thousand acres of farmland in Walla Walla County, one hundred and twenty five thousand acres enrolled in the Conservation Reserve Program that are non-producing and three hundred and seventy five

thousand of producing cropland. A portion of the producing cropland is fallow each year, but the end result is that the region produces about fifteen million bushels of wheat each year.

Supply, demand and the resulting speculation control the price of wheat. In 2006 and 2007, the supply was down, demand was up and those betting on the market went wild. There were concerns that the world could not even produce enough wheat to meet future demand. Prices headed for previously unknown levels and many local farmers sold their soft white wheat in the \$8-\$9 per bushel range. For 2008 and 2009, world wheat production had been and is projected to be 13% higher in comparison to the prior five years. This translates to an extra seventy five million metric tons each year. I have trouble visualizing a million metric tons, but consider it to be quite a pile. With the increase in supply and demand becoming somewhat anemic, the current local price of soft white wheat is right at \$4 per bushel and the outlook for this next year shows no improvement.

The cost to produce a bushel of wheat varies among farmers, but I believe it is safe to project that some farmers will not cover their total costs with \$4 wheat. I guess that's why we had a couple of good years—to buffer the years that aren't so good.

To benefit our clients we follow the grain markets, USDA programs, crop insurance and changes in the farming industry. Give me a call if you would like to discuss our perspective on the local farm scene.

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