



SUMMER 2008

Special Report

A SPECIAL REPORT FROM BAKER BOYER WEALTH MANAGEMENT SERVICES

In this time when there is so much volatility in the markets, it is important to understand WHAT markets we are really talking about and WHY they are volatile. As most people are aware, the stock and bond markets are in extreme flux: but the question of why they are in flux has had little attention. The real question is what caused the stock and bond markets to gyrate. For that answer we need to look at a totally separate market, the market of hybrid investments, otherwise known as alternative investments.

The alternative investment market is little understood because it is relatively opaque and is used mainly by professionals. In this market, most of the investments are relatively short lived and include things like hedges and short positions. They include Frankenstein-like investments, where the investment professionals have taken bits and pieces of a bunch of different investments and sold them as something new and exciting. The problem with Frankenstein-type investments is that there are few buyers and sellers. It is best described by that special word that we have all heard by now; liquidity (i.e. the ability to sell your asset quickly for the price you want). Liquidity is very low for alternative investments.



Think of it this way, the regular equity and bond markets are like a supermarket, where there is a lot of variety, prices are pretty much the same from one supermarket to another, and the quality of the items doesn't go below a certain level. In contrast, the alternative investment market is like a flea market. It is relatively disorganized, price is always negotiable, the quality has a wide range, and it is basically a barter or negotiation atmosphere. Also, not everything sells in a flea market and if it doesn't, the price just keeps getting lower and lower each time it goes out for sale.

Wall Street did an amazing thing over the last few years by putting a facade on the front of the alternative investment market that said, "Nieman Marcus," and proceeded to bring in investors to sell them what were
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essentially flea market items. The quality was not there, but they convinced these investors that they had exactly what they needed.

These alternative investment flea markets attracted some financial banking institutions which were lured into purchasing hybrid products like collateralized debt obligations (subprime housing mutual funds). Bank regulators allowed banks to purchase alternative investments with the highest quality rating which produced a higher yield than U.S. treasuries. The good times didn't seem like they would end until finally the inevitable happened: a fire broke out and burned down the facade and everyone realized that they weren't in Nieman Marcus, they were simply in a parking lot at a local racetrack buying flea market goods. Instantly the value of everything that everyone bought was called into question. "Did you and your friends get a flea market gem or a flea market dud?" was the question on everyone's mind, both for those who bought the flea market goods and those who were watching from the outside.

So what happened to all those people who went on a shopping spree in the faux Nieman Marcus? Everyone who bought these now illiquid assets has been asked by their regulators and accountants to write the assets down. Those financial institutions who participated in the alternative investment market are being forced

to write down their assets, negatively impacting their earnings and net worth; while those who saw through the facade are doing great... it's that simple. Fortunately, the majority of banks have plenty of capital to weather the storm.

So how did this alternative investment market meltdown spread into the stock and bond market? A contributing factor is that these regulated banks can't afford to make another bad investment so they have decided to really clamp down on any lending at all. This has caused shockwaves throughout the US economy, as there are good businesses around the country that have done nothing wrong, but who can not get financing from banks because the banks are too scared to lend (all this in an economy that has been relatively sound this year). This has contributed to an economic stumble.

So what has the government done to help this situation? They have injected cash into the system with the hope that this will spur lending by banks. They have bailed out Bear Stearns, one of the biggest buyers in the alternative investment flea market, because to let them fail would send the message to everyone in the flea market that everything they purchased was worthless. They have also worked to stabilize public confidence in the banking system by propping up Fannie Mae and Freddie Mac, the two largest housing lenders in the country.

Recently, Secretary of the Treasury, Henry Paulson and Ben Bernanke, Chairman of the Federal Reserve, have both stated that the alternative investment market has been unregulated for too long. They want regulations to provide minimum quality levels and proper labeling so that everyone who buys at the alternative investment market knows what they are buying and how much it is really worth. These regulations should alleviate the possibility of this happening again in the future.

So where is Baker Boyer during this turbulent time? Megan explained it very well when she stated that we are not involved in subprime or in the quasi investments spawned in the alternative investment markets. To put it another way, after nearly 140 years we were wise enough to see the facade and realize that it was a flea market. Baker Boyer is not in jeopardy and we will weather through this just as we did the Spanish American War, World War I, the Great Depression, World War II, the Korean War, the Oil Embargo, the Savings and Loan Crisis, the Dot Com Bust, September 11, and Enron. The key to our success has always been our ability to employ wisdom during irrational times and to never lose the confidence of our most cherished asset: our clients.

Mark H. Kajita, CPA
VP & Senior Portfolio Manager
kajitam@bakerboyer.com

Contact Us

Walla Walla Home Office
7 W. Main • P.O. Box 1796
Walla Walla, WA 99362
509-525-2000 • 800-234-7923

Tri-Cities Trust Office
7601 W. Clearwater, Suite 404
Kennewick, WA 99336
509-783-6800 • 800-234-7923

Yakima Trust Office
909 Triple Crown Way, Suite 101
Yakima, WA 98908
509-576-9000 • 866-525-2262