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Investment Insights

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ROAD CONSTRUCTION

Once upon a time, I, and most likely you also, have experienced road construction and the frustration of being stuck in traffic. Recently, on a road trip home from New England, I called AAA to ask about road construction on I-81 South Bound from Scranton, PA. My wife and I have been AAA members for more years than I want to recount and have generally been very pleased with their value-added to our peace of mind while traveling.

This time though was not such a case. The service person I spoke with told me there was no construction on the I-81 South Bound stretch. She told me that we would have clear sailing. Well, not so. There was extensive construction and we were stuck for more than two hours in a grueling stop-and-go snarl of more than twenty miles of I-81 construction. The reason I had called AAA was that we had seen major backups on the South Bound lanes several weeks before when we were heading North on I-81. I simply wanted to avoid a similar fate by asking if the construction had been lifted, and if not, take a different route.

I do plan on calling AAA and providing feedback on their erroneous information. It might prompt them to fix their information problem regarding road conditions. The service person to whom I was speaking, at the end of our conversation, kindly told me to call anytime to get up-to-date traffic information. Not likely after that episode!

That being said though, life, including our investment programs, occasionally throws periods at us when we find ourselves frustrated, going backwards or no where, and just kind of feel like we're "stuck in traffic". Being "stuck in traffic" is usually accompanied by a lot of shifting of gears, accelerating, decelerating, stepping on the brakes, and perhaps muttering expletives. The latter in truth sometimes applies to me, but I know that most of you probably put on a happy face, enter into discussions, or perhaps listen to classical music as you stop and go. Having spent time in combat, I do remind myself that I could be in worse places. I could be in Iraq, Afghanistan, or some other undesirable place much more hostile than the irritating traffic jam.

Some keys to getting through these stuck-in-traffic situations are control of our emotions, patience, and a gut-level realization that at some point traffic will start flowing again. At some point we'll resume normal travel to our destination. Another key may include taking a detour that heads you in the wrong direction to eventually get around the road construction to again get headed in the right direction.



Patience, control of or removal of emotion from the picture, a longer term outlook, and occasional detours or taking small losses to avoid larger losses are also applicable in the process of investing.

Being invested in the market now is a bit like driving in an area of road construction. The investment world's road construction includes major construction of new policies regarding banking and finance, health care, fiscal and monetary policy, energy and environmental policy, and education policy to name a few. We are going through major governmental policy construction, and to boot there is great controversy on how to best do it, and how it will turn out. The results matter greatly to our future. The confusion sets the stage for a very difficult current investment environment.

So, for the time being, investing is akin to being in the middle of road construction and requires patience, requires more than a short term perspective, and includes occasional detours and setbacks. It requires the exercise of continual due diligence and the best wisdom we can apply in line with our investment management mantra **"Do no harm and make money."*** (please read the sidebar) *(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%
2008	-38.5%
2009	+18.9%

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%
2008	-40.5%
2009	+30.5%

YTD thru 7/31/2010

S&P500	-1.2%
NASDAQ	-0.6%

10/11/2007 HI thru 7/31/10

S&P500	-29.1%
Mar 2000 HI thru 7/31/10	
NASDAQ	-55.35%

*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, also called technical research. At times we will use conservative hedging techniques to limit downside risk.

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Listening to a range of very smart market and economic strategists currently depicts a market schizophrenia. One viewpoint is that the Dow could precipitously drop to 5,000. Another viewpoint is that the Dow could move nicely up to 11,000 to 12,000. THE FACT IS THAT NO ONE KNOWS WITH CERTAINTY WHAT THE MARKET WILL DO FROM DAY TO DAY OR FROM MONTH TO MONTH! Sound investment strategy requires that we continually manage both sides of the investment reward and risk coin. If the market is going against us as is the current bias it is prudent to have some assets in cash and fixed income thus reducing full exposure to a falling market. That cash and fixed income is then available to put to work at a lower level of risk and higher expectation of return.

Our independent analysis remains that a fair value for the S&P 500 is in the range of 900 to 1,000. At the end of June the S&P 500 dropped from an April high of 1217 to 1030. Since June 30 the S&P has been bouncing up and down between about 1030 and 1120 and as I write this it is about 1065. *For longer term perspective the S&P 500 at 1065 is still down about 33% from its October 2007 all time high.*

Technical or supply and demand indicators are suggesting a high level of market risk and therefore places us in a defensive or wealth preservation mode. That translates to having portfolios heavier weighted in cash and fixed income securities than in stocks. We are in fact currently more heavily weighted in cash and fixed income than in equities. There is no doubt that making a lucky investment in a particular area of the market could reap enormous rewards. The problem is that current uncertainties carry great risk in so doing and would not be appropriate or prudent.

For example, a great deal of money has been flowing into U.S. Treasuries considered to be a safe haven. As the price of Treasuries has gone up, the interest yield has been driven down, so there is not much in terms of income being generated from Treasuries. At the same time, we believe a bubble exists in the Treasuries market and if correct, (there is no real way of telling until after the fact), a mass exodus from Treasuries would cause a very rapid and precipitous drop in the value of Treasury investments. The point is that investment uncertainty abounds more than usual given current economic and government policy dynamics.

Two underlying themes or beliefs guide our investment policy right now. They include: *1. there will be continued emerging market growth and the growth of a global middle class; 2. the importance of corporate financial strength, sound business models, conservative accounting, stock dividends, and good corporate governance will pay off handsomely for stockholders over time..*

The first theme has ramifications in terms of growing demand for energy and in particular clean energy in the form of substantially rising demand for natural gas and nuclear energy in the years ahead. It also has ramifications in terms of rising demand for other commodities, in particular for agricultural commodities to feed a growing global middle class. Also, global companies in the developed world will be delivering much of the goods and services to the emerging world's middle class. Technology, entertainment, professional consulting, capital equipment are but a few examples of growing U.S. industry sales to emerging market countries.

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The second theme encourages us to place emphasis on financially and managerially strong companies with good governance and an emphasis on top line growth as well as dividends and dividend growth. Those are the kinds of companies that are in our portfolios and we expect that most will be strong winners for our clients a few years out, irrespective of short term price fluctuations.

The next year or two will be marked by a great deal of fluctuation in market prices. It will also hopefully be marked by a settling out, tweaking, and better execution of government policies, and slower domestic growth but increasing emerging market growth. The unwinding of debt will continue and this move from loose credit to tighter credit will mean slower but healthier growth at home.

To sum up, in the shorter term there are good reasons to be cautious and there could be significant market price fluctuations. Longer term though there is good reason to be investing in those companies that are strong financially, strong managerially, use conservative accounting practices, and that are expected to grow both their top line revenues and stockholder dividends. Longer term too there is good reason to be investing in certain commodities that will command increasing demand as the world's middle class continues to grow in size and financial strength. Other sectors such as technology that will be exporting to emerging markets will also be good investment areas.

Right now is kind of like being caught up in road construction. It's a good time to remember that this too will pass and times will get better in terms of investing and making money. At the same time discipline and continual due diligence regarding both reward and risk remain an important constant.