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Investment Insights

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POOPY SUITS, STROBE LIGHTS, and FLARE GUNS

Once upon a time, on missions in the Sea of Japan and North Pacific, we pilots and our aircrews were required to wear what we called pooppy suits. Putting on these pooppy suits was the most difficult part of the mission. We first put on an insulated undergarment. That was easy. The next part was difficult. The bright orange rubber suit was a one-piece deal with a zipper. The pooppy suit went from the tips of our toes up to our necks. It gripped us around the neck like a too-tight dog collar. Getting into this rubber sheath was normally a two man job. I suppose, if I had immersed myself in talcum powder, it would have been easier but basically it was normally a two-man job to get in and out of the suit.

Once we climbed into the cockpit, we then hooked an umbilical air hose up to a valve in the side of our pooppy suit and turned on a fan that provided air circulation within the pooppy suit. That part was so we would not perspire to death. We then proceeded to fly our mission, looking like blown-up balloons with heads sticking out of the top.

The purpose of our pooppy suits was of course to protect us from hypothermia and death in case we went down into the cold ocean waters over which we were flying.



Other survival devices we flew with were our strobe light and a pencil-sized flare gun, both of which were attached to our inflatable life preserver. Anyone having the misfortune of being downed in the open ocean needs all the help he can get in being seen. So precautionary measures including pooppy suits, strobe lights, and flare guns were, in fact, very important security blankets for all of us flying over open ocean.

We flew with the purpose of accomplishing whatever mission was assigned to us for that particular flight. Our pooppy suits, strobe lights, and flare guns were there to help protect us in case things went very wrong. The idea was, in case things went wrong, to survive to be able to fly future missions, which was what it was all about.

The investment business, and our investment management mantra, *Do no harm and make money**, has some similar characteristics. The mission is to make money but along the way we also have to manage risk and avoid large losses. In short we want to make money but we also want to take precautions to avoid the kind of loss that could keep us from flying future missions or continue building our investment nest egg. A side note here is that investing requires patience and discipline, and sometimes our discipline can try our patience. That's just the way it is.

During the period from the 3rd quarter of 2007 to the 1st quarter of 2009, S&P earnings declined by a historic 92%. That was the largest decline in history since 1936 when that record keeping began. Since then, from the 1st quarter low of 2009, S&P earnings have rocketed up by 600%. That comes in at a level only exceeded by the latter periods of the dot-com and credit bubbles. Pause for thought.

Fundamentally, many economic problems remain problems. They center on jobs and ripple out to availability of credit, global sovereign debt, the need for a coordinated global financial system, reform and regulations that make sense and work, a new wave of mortgage resets, commercial real estate, and it goes on. The world still has a way to go to get out from under debt, or, as the term goes, to deleverage. The disconnect between the employment situation and the household debt that needs paying down remains serious. *(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%

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%

YTD thru	1/31/10
S&P500	-4.67%
NASDAQ	-5.36%
10/11/2007 HI thru	1/31/10
S&P500	-31.0%
Mar 2000 HI thru	1/31/10
NASDAQ	-57.47%

*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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Also, much of that 600% surge in S&P earnings was not so much the result of top line growth as it was in cutting costs and cutting jobs.

Corporate capital spending to upgrade corporate technological infrastructure and improve productivity will be one bright spot. Also, government spending on infrastructure projects will be a positive. Continued growth of a global middle class in emerging markets also is a positive theme for longer term prospects. In the short to intermediate term, though, there will continue to be some slogging to get these economic problems behind us and begin growing our way out of the economic malaise.

The sovereign debt problem and in particular the issue of Greece raises the question as to whether Greece may be a canary in a coal mine. It raises the question as to the extent of fragility in our global financial system. See our February Bulletin on our website for further discussion of this.

At this time, our top two asset classes on a relative strength basis are domestic equities and cash. International equities which was one of the top two relative strength asset classes has been bested by cash. Part of the reason for this is the recent strengthening of the U.S. dollar. Please see the February bulletin on our website for further discussion of the dollar. To sum up from a big picture perspective, *the relative strength of U.S. equities and cash are beating out fixed income, commodities, foreign currencies, and international equities.*

From a market risk standpoint, while there are many confusing cross currents, right now supply is in control, which means that more stocks, on a net basis, are generating new sell signals than are generating new buy signals. In other words, prices are moving down on a net basis and generating sell signals. That suggests a high level of risk and commensurate caution when we consider that about 80% of equity portfolio risk is based on market and sector risk.

As most of you know, part of our risk management is to have an exit strategy on every position that we hold. That discipline has caused us over the past several months to cut losses as some of those positions have hit their exit points and triggered sells. That has as a result increased the cash positions in our portfolios.

To the extent that we reinvest this cash we are placing emphasis on securities that have a record of generating and growing dividends. Having dividend-generating securities in the portfolio allows us to participate if the market moves up, and at the same time those dividends inherently provide some cushion in case the market moves down. For individual stocks, we also stick with companies that have strong accounting and governance ratings.

The picture, on the front page, by the way, except for the head cover, is a pretty good representation of the poop suit that I had to wear on those flights over cold-water seas. The investment business fortunately does not require poop suits but it does require its own set of precautions when it comes to managing the risk in portfolios.