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Investment Insights

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CLIFF DIVERS

Once upon a time, I had the opportunity to witness the Cliff Divers of Acapulco, Mexico. These Cliff Divers officially and formally organized themselves in 1934, though they had been diving many years before that from the craggy cliffs of La Quebrada. They are now a major tourist attraction in Acapulco and there is a restaurant, La Perla, from which you can dine and also watch the divers who perform both day and night.

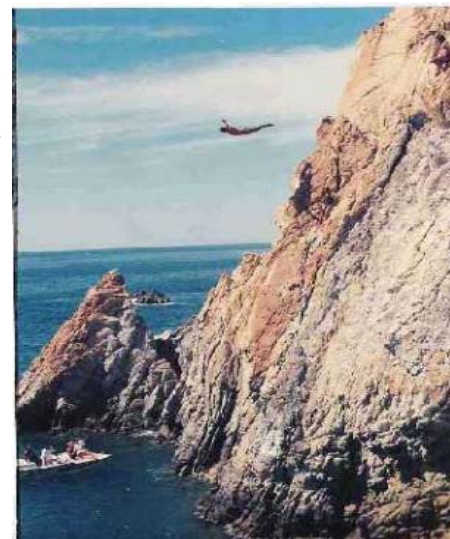
From a cliff ledge about 150 feet above a narrow ocean inlet, these skilled divers have to judge the ebb and flow of the ocean water in that inlet. If they get it wrong they will plummet into the sand and rock shallows below. If they get it wrong the odds are that they will be badly injured or killed. Every time they make a dive, it's pretty much an all or nothing situation.

There are some close similarities between La Quebrada cliff diving and investment management. There are also some major differences!

What are the similarities? Cliff diving and investment management both involve risk and the need to manage risk. Success for both activities requires a great deal of training and continual attention and diligence to here-and-now conditions. Each requires effective execution that accommodate those conditions. The divers have to be exact in their reading of the ebbing and flowing ocean waters into the inlet. They have to execute so as to enter the water just at the point that it has flowed into the inlet to be plenty deep enough to absorb their dive. Investment managers have to assess market and sector risk, which represents about 80% of the risk in an investment portfolio. They then have to manage that risk by adjusting portfolios to avoid large, hard-to-recover losses and over time to grow and make money. To be successful requires that both fields have a professional level of expertise.

Another similarity that comes to play in both of these activities, to be successful, is the ability to control human emotion. If a diver becomes either scared on the one hand or over-emboldened on the other, he becomes an accident

waiting to happen. The same can be said of investors. If they become frightened or panic-stricken or, vice-versa, overly aggressive, the danger flags are flying for them. Both cliff divers and investment managers, to be successful, have to learn and adhere to a disciplined,



unemotional approach that has been proven over time.

What are some of the differences? One big difference between cliff diving and investment management is that the cliff divers can depend on the constancy of mother nature. If the diver reads the waters correctly he can be sure that it will be deep enough for his dive. It's similar to being able to depend on the sun coming up every morning. The reliability factor is very high. Investors can't know for sure what is going to happen from day-to-day, month-to-month, or year-to-year. Sound research and statistics are helpful in investing and in fact our primary effort every day is to stack the odds in favor of our clients based on our mantra of ***Do no harm, and make money****. (please read the sidebar) The investment world is not near as reliable though as the sun coming up every day. There are too many things that can happen in day-to-day worldly activities that can send an investment or an investment methodology into "tilt" mode. That is part of the reason for diversifying, for position sizing (i.e. not being so overweighted in one investment that it could cause serious harm if it went wrong) and continually monitoring the reward and risk in the portfolio as well as the individual assets in the portfolio. (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 05/31/2010

S&P500	-.55%
NASDAQ	-.05%

10/11/2007 HI thru 05/31/10

S&P500	-29.9%
Mar 2000 HI thru 05/31/10	
NASDAQ	-55.3%

*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

Another difference is risk. The risk in cliff diving is to life and limb. The risk in investing is to portfolio value. The big risk which has to be managed in an investment portfolio is the risk of a large hard-to-recover loss. Another difference is that cliff diving is a singular life or death activity. The diver climbs on the cliff and dives off. That's it. The investment manager has many investment alternatives and tools to manage and to hedge risk. Time is also a friend in investing but not in cliff diving. We know that ups and downs in portfolio value are very normal. They are to be expected. The investment public gets it wrong, very wrong when they expect a constant slope up in their portfolio values. That constant slope up is what Bernie Madoff, the biggest ponzi scheme artist in our history, offered his clients. He gave them what they wanted, a 9-12% gain year-after-year. That's what they got until they learned that it was a sham, that he was robbing them blind, and that they really didn't have anything.

Capital markets and portfolio values fluctuate up and down and sometimes, as in late 2008 and early 2009, they can fluctuate violently. You cannot be an investor in the capital markets and expect CD-like stability and constancy. Investment management unlike cliff diving cannot depend on the constancy of the ebb and flow of the ocean water at the La Quebrada inlet.

One other difference that I should mention is that cliff diving is very much a raw man vs nature thing. When out there on that ledge the divers have their God-given senses and their experience, judgment, and training and that's all. Investment management, at least the way we do it, relies on our years of training, experience and judgment and also uses many information technology tools that help give us an edge in terms of research, analysis, and execution.

Those tools for instance first showed BP losing relative strength to our markets as early as 2008. This year it gave its first sell signal back in February. BP has now had its disaster and has given subsequent sell signals. The point is that our tools suggested that something was wrong under the hood with BP several years ago.

One of our activities is to develop watch lists of investments that we might like to make given the right price and supply-demand conditions. Those tools help track the investments that are on our watch list. For instance one recent buy has been natural gas. Fundamentally we believe that the demand for natural gas in the years ahead will be strong and that government and private sector efforts will support its growth. From a technical standpoint natural gas just recently gave a buy signal from a long-washed out condition and we've taken a modest position. We expect up –and –down fluctuation but our reward to risk calculation is close to \$3 upside to \$1 downside. We now have put a monitoring system in place to notify us on specific natural gas price points. That tool helps us manage both the upside and the downside.

As I write this, the market indices are down year-to-date, and down both in May and June. They reached a recent high at the end of April but have retreated from that high over a short two month period. The S&P 500 is down almost 15% from its April high and off about 7% year-to-date. At this time the cash and fixed income asset classes outrank domestic equities, international equities, currencies, and commodities from a relative strength standpoint. That suggests that a higher weighting in cash and fixed income is prudent until changes occur that show that other asset classes are gaining strength and overtaking cash and fixed income on a relative strength basis.

(continued)

Our supply-and-demand indicators, on the other hand still suggest taking an offensive position in stock investing. This is in spite of the relative strength picture telling us not-so-fast with regard to stocks. In short, current fundamental and technical indicators are throwing off confusing and uncertain signals. I think that reflects the reality of extreme uncertainty right now across many parts of the economy.

It's important to recognize that it would be wrong to compare this time period to historically recent post WWII periods. Some pundits are doing that and I believe they are way off the mark. We have been through a very atypical recession to an extent not seen since the great depression. We still have close to 10% unemployment. Extreme financial leverage by banks is no longer the norm as it was from about 1990 forward. Therefore we expect that stock valuation measures will head lower. It remains difficult for small and mid-size businesses to obtain credit. Those businesses employ more than 60% of our workforce. Corporations are holding back on spending because of the uncertainty. Government stimulus has been nursing the economy and it is not sustainable over a long period. Banks have been reporting record profits using allowable but bogus accounting methods. States and local governments are feeling the pinch and will be creating more unemployment. We'll also see a higher degree of municipal bonds defaulting as time goes on. This recession caused by extraordinary leveraging and then a global and systemic banking failure is not comparable to what we've seen in our recent past!

In this current situation we continue to hold sizeable amounts of assets in the two top relative strength asset classes – the money market and fixed income securities. We also hold positions in precious metals and natural gas. We expect to increase our position in precious metals but only on significant price pullbacks. The equity positions we hold are either diversified and dividend producing funds, or individual stocks that have excellent financial strength, strong accounting and governance, and also generate dividends while their prices bounce around. It's a time to be careful and patient and to continually seek out opportunities at a good value.

You are welcome to share this newsletter. Also, please let us know if you think of someone who could use our services. We work continually to be at the top of our field in terms of advice, service, and performance and thank you for your continued support and referrals.