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Investment Insights

March 2010

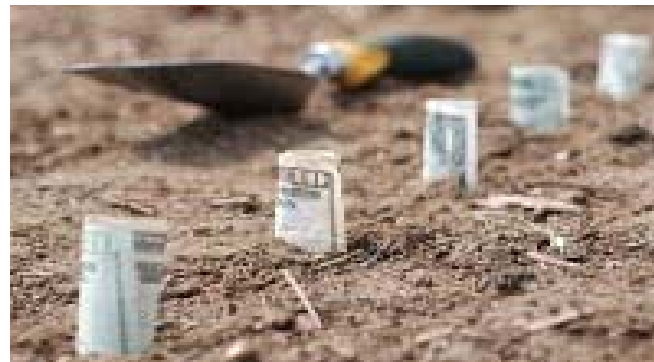
GARDENING

Once upon a time, many of us grew up with a garden being a part of our lives. Typically, you would have planted tomatoes, beans, cucumbers, corn and maybe squash and pumpkins along with perhaps some herbs and flowers. Gardens were hard work, a labor of love, fun, frustrating, and usually successful but subject to set backs. The best part was to enjoy eating the fruits or vegetables of your labor at the dinner table and sharing them with friends and family.

Gardens require constant tending. They can be attacked from under the ground by moles and voles, and attacked on the surface by a variety of beetles and caterpillars. Some of you may remember those yucky green, horned tomato worms that were so hard to find and destroy because of their camouflage. We also had rabbits and deer to fend against. Then, from the air a variety of birds would sometimes descend on the garden, ignoring our makeshift scarecrow, to do what damage they could. When it did not rain we would of course have to water the garden ourselves. Gardens generally needed tending on a continual basis. At least that was my experience.

There are many parallels between gardening and investing. Major parallels that jump out are that *each requires a lot of upfront thought and preparation, takes hard work, and requires time and patience. Also, research and technology play a huge part in both gardening and investing.* My first rototiller was a Godsend as were the new disease-resistant plants. In investing, our forensic accounting research is extremely valuable in assessing the investment worth of specific companies. Our supply-and-demand research give us valuable information on reward vis-a-vis risk, and our information technology tools are instrumental in keeping us on the cutting edge. Our methodology and tools don't work all of the time, but over the long haul they go far in giving us an edge to **Do no harm and make money.*** (please read the side bar caveat)

There are other parallels. Just as different crops are seasonal, so are different sectors of the market, and individual securities. In gardening we have no control over the



weather or what the population of rabbits or locusts might be in a given season. In investing, we have no control over what the market or a given security might do today, tomorrow or in the future. We plant our gardens knowing that not everything will come up, bloom, and be bountiful. When we construct a portfolio we also know that not everything will work. We have to weed out both gardens and portfolios. We have to continually manage for a healthy outcome and manage the risks so as to avoid major losses. I could go on but you can probably think of some of your own parallels between gardening and investing. Given that Spring is here I thought it would be fun to think of investing in terms of gardening and perhaps gain some insights in so doing.

For those of you who follow the market indices, they have been moving up slowly and with some pullbacks since March 2009. The volume supporting this up move has been unspectacular. Fundamental uncertainties still abound and there are still serious credit and bank problems that are being swept under a rug of speculation for the time being. From a supply-and-demand research viewpoint, demand (higher prices) recently took back control but at a high level of risk. Our investment stance given the crosscurrents has been to maintain some exposure to the market but also to have a substantial amount of assets on safer ground until the reward-risk picture improves on the reward side. In other words, we are concerned that the present environment is not the best in which to be overly exuberant about the market.

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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

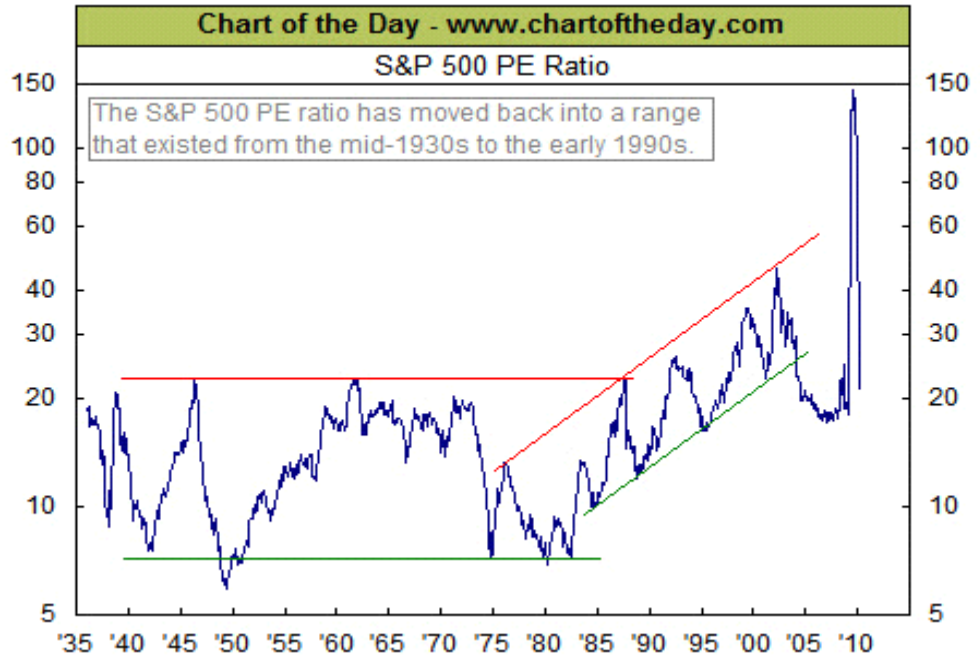
2000	-39.18%
2001	-20.78%
2002	-31.25%
2003	+50.76%
2004	+9.14%
2005	-1.4%
2006	+7.87%
2007	+9.27%
2008	-40.5%

YTD thru	
S&P500	-10%
NASDAQ	-13%

10/11/2007 HI thru	02/28/10
S&P500	-28.93%
Mar 2000 HI thru	02/28/10
NASDAQ	-55.68%

*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

The following S&P 500 price to earnings chart illustrates one of my concerns from a historic perspective. Let's use the price-to earnings ratio as a rough proxy for valuation. Looking at the chart you can see that from 1935 to about 1990 that valuation fluctuated up and down between the two horizontal lines.



In about 1990, you see the band (the two lines) going up and to the right, a marked departure from the fifty five years previous to that. Why? Underlying this change, in my view, was a period in which sound regulatory enforcement was emasculated (the Bernard Madoff scandal had its origins in the early 1990's), leverage by banks and financial institutions was getting out of hand, and sound business, underwriting, loan and accounting practices along with ethical practices deteriorated. Price-to-earnings ratios or stock valuations expanded up and to the right in part because of more leveraging, and more aggressive accounting. It was what I would call *our dark Golden Age of financial engineering*. It evolved in a *me-first environment in which mediocre to disastrous results were rewarded instead of penalized*. I think it will be looked at historically in a very bad light but that's just one opinion.

Take a look at the chart again. On the far right side you can see that in the past year or so the P/E or valuation chart has precipitously dropped down below the lower line of the upward-sloping band. However, that puts it at the top line of the horizontal band, the valuation band that worked before all of these shenanigans came into vogue. So, is the market undervalued or overvalued here? It depends on which band you look at. My guess is that upcoming financial reforms will take a lot of the leverage out of the system, reinstitute checks and balances, and that we'll move back in the direction of that horizontal valuation band that ran from 1935 to about 1990. If that P/E ratio reverts back to its horizontal-band range from 1935 to 1990, we could see another serious contraction in stock prices. From that perspective, the market looks overvalued at this juncture. The fact is that I nor does anyone know for sure. But to me it does suggest that some caution is in order.
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In the most recent Hussman Fund report, <http://www.hussmanfunds.com/>, John Hussman relays the following. “As of last week, the S&P 500 was priced to achieve an average annual total return of just 5.83% over the coming decade, based on our standard methodology. Prior to 1995, the lowest implied 10-year total returns priced into the S&P 500 in post-war data were:

November 1961: Implied 10-year total return 6.26%.
Actual 10-year subsequent return 6.16%

October 1965: Implied 10-year total return 5.89%.
Actual 10-year subsequent return 3.11%

November 1968: Implied 10-year total return 6.19%.
Actual 10-year subsequent return 2.51%

August 1987: Implied 10-year total return 6.29%.
Actual 10-year subsequent return 13.85%. “

The 10-year actuals from August 1987 were out of line with the other three. That period was the start of that *dark Golden Age* I talked about earlier. Hussman goes on to say “Once the market becomes overvalued, further gains are ultimately paid for by a period of sorry returns later. To expect normal or above-average long-term returns from current prices is to *rely* on the market bailing out the rich overvaluation of today with extreme bubble valuations down the road.” In short, Hussman, based on a variety of criteria, believes from a fundamental standpoint the risk in the market is high right now and that in the next several months we will have more clarity as to the extent of some potential problems, namely whether or not more shoes will drop regarding credit, mortgage foreclosures, unemployment, and government policy issues. Until that clarity surfaces he suggests caution and also suggests that a pullback in the market may be in the cards.

Our technical or supply-and-demand indicators show that demand is in control but at a high level of risk. Our assessment also suggests caution until more clarity emerges over the next few months.

Where is the current strength in this market? On a relative strength basis domestic stocks and cash are the favored of six asset classes. They in a word are behaving stronger than the four other asset classes: foreign equities, foreign currencies, commodities, and fixed income securities. Other very specific areas of strength include small company stocks, emerging markets, real estate, basic materials and steel, finance, consumer cyclicals, and technology. Japan, even though it may be in recession, is showing early signs of stock market strength and we have begun scaling into that market. Corporate and international bonds are favored areas in the fixed income sector.

To wrap up, we are placing emphasis on caution and to the extent that we invest we are emphasizing dividend-generating equity funds and specific dividend-generating stocks. Dividend funds provide some downside protection in that they are diversified baskets of securities and are also producing dividends along the way. We have also begun to invest in very strong rising-dividend stocks. In all cases we have exit strategies in place as well as target prices on the upside. We continually monitor and adjust our portfolios as conditions warrant.