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Investment Insights

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THE PAPER ROUTE

Once upon a time, my older brother sold me his newspaper route. He had grown the route to about 65 customers. It was pure and simple capitalism and entrepreneurship.

Value and trust were two threads that tied that paper route enterprise together. The Paterson Evening News had to roll the presses with valuable content every day. Their truck driver had to get my bundle of papers to me. I had to deliver them to the customers. In turn, the customers paid me at the end of each week. I paid the Paterson Evening News their 27 cents per customer. My profit was 5 cents plus tips. It was a system based on **value and trust** (reliability, accountability, and responsibility were all a part of that trust). It worked well. Everyone did OK. Eventually I sold the route to one of my friends after building it to about 135 happy customers.

Getting back to value and trust, I remember one customer on that paper route. She had been weeks late in paying her 32 cent weekly charge. The modus operandi was that I would go up and ring her doorbell on Saturday morning; a curtain off to the side of the door would move ever so slightly; she peeked out perhaps thinking I did not see her; and when she saw who it was she didn't answer the door. She wanted the paper but she didn't want to, or wasn't able to, pay for it. Remember, I was only making a nickel a week on my paying customers. I had to pay the newspaper 27 cents a week whether my customers paid me or not. That customer would have fast driven me out of business. She had breached the trust, she was destroying the value of my route, and she avoided any direct conversation with me to resolve the situation. I had to leave her a note and cut that loss before it turned into a bigger loss. She only represented about 1% of my customers but often that 1% as we've seen in recent years can wreak substantial damage if not dealt with early on.

What's happened over the past few years has been a breakdown not so much at the individual citizen level, but a breakdown of value and trust at the highest leadership levels. Too many top leaders at banks, rating companies, in our political parties, in CEO and CFO corporate positions, and in regulating bodies – all whom should be bastions of

public trust and safety - have been the really egregious offenders who melted us down. At the same time many of these 'stewards' of our institutions were sowing horrendous acts of disservice and in the process reaping enormous gains for themselves. Yes, there were also lower level people and sales forces who gained from high commissions by pushing homes on to people who could not afford them. And yes, many people should not have gotten overextended in taking on debt that they could not service.

Our institutional leaders however were the ones who were at the helm. They had the trust and the fiduciary responsibility. These institutional leaders certainly were smart enough to know right from wrong. Yet they incentivized the creation of dodgy debt, allowed it to be packaged up with fancy names, attached phony financial ratings to it, and then sold it to trusting buyers around the world. They were at the helm, they destroyed value, they destroyed trust, and they made a bundle for themselves in so doing.

In short, for too many years, public stockholders have too often been raped and pillaged in terms of losing money on their stockholdings while top management and board members have been aggrandizing wealth – in spite of their incompetent or mediocre performance. That shareholder **financial loss is just a small part of the tangible breakdown. The intangible breakdown is in part a result of leaders strictly looking at numbers but without an ethical or moral compass to do what's right.** That behavior has led to a **massive breakdown between leaders and their constituencies in terms of the intangibles of trust and confidence.** (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 04/30/2010

S&P500	+ .06%
NASDAQ	+ .07%

10/11/2007 HI thru 04/30/10

S&P500	-23.63%
Mar 2000 HI thru 04/30/10	
NASDAQ	-51.26%

*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.

The ongoing BP oil rig disaster in the Gulf will most probably be a classic example of leaders looking at numbers, shortchanging safety and social responsibility, and doing enormous economic and ecological damage as a result. That enormous tangible disaster is matched by the intangible destruction of public trust and confidence in BP as well as the entire oil industry and government leadership. Lacking checks and balances, and lacking wise and trustworthy leaders, safety and regulation went out the window resulting in lost lives and catastrophic long term damages.

The system, to work for everyone, has to be grounded on value and trust. It has to operate within a framework of not only law but also in a framework of service to others and with the guidance of a sound ethical and moral compass. Those are needed in addition to and in harmony with bean counting necessities. Bean counting and profitability are a hard requirement but so are social and ethical responsibilities. It'll take more time, more debate, and a major paradigm shift to get the pendulum back to where it ought to be. I am optimistic that will happen but the when is clearly unknown.

Let's discuss market conditions that continue to evolve against a backdrop of concern over value and trust.

As repeatedly mentioned in newsletters and bulletins going back to the beginning of this year, the level of market risk has been very high. Market and sector risk is about 80% of the price movement or risk in a portfolio. Over the past couple of weeks the market has been correcting down. While we expected and had positioned for a correction we had no idea as to the when. Well a correction has now occurred and we'll monitor how it plays out from here. Our judgment has been and remains that a fair value range for the S&P 500 is between 900 and 1,000. The S&P reached a recent high of 1220 in April and as I write, it is down to 1074, or down by about 12%. In line with our investment management mantra **Do no harm, make money.*** (please read the sidebar caveat), we had already reduced exposure to equities. While down some, we have withstood the downturn well and have cash on the sidelines to put to work as we see demand taking back control.

Will the market go lower from here? No one knows! *Based on similar past circumstances the odds suggest further downside. As always though there are no guarantees.*

Let's take a quick look at our various asset classes. **Cash/Money Markets:** The money market from a relative strength perspective edged **International Equities** out of its number 2 relative strength position on May 6. **Fixed Income:** Fixed income just last week replaced **Domestic Equities** which had held the top relative strength spot. At this writing Domestic Equities have corrected down more than 10% and Foreign Equities have corrected down about 10-20+%.

Cash/Money Markets and Fixed Income now hold the top two asset class spots in the relative strength pecking order. An overweighting in these two asset classes is reasonable until we begin to see demand taking back control in other asset classes. Those four other less-favored asset classes for now, are **Domestic Equities, International Equities, Commodities, and Currencies.**

Domestic and International Equities: As mentioned above and in previous newsletters we've been concerned with the high level of market risk, with what we consider to be an overvalued and overbought equities market, and with a very suspect fundamental economic backdrop. A correction in the equity markets has occurred since the recent April highs and that correction could deepen. *(continued)*

Commodities: Amongst the over 100 commodities in the global market place, industrial metals have corrected down recently more than 20%. Gold remains in most of our portfolios in very modest amounts and we believe it to be a prudent hedge position.

Currencies: The US Dollar has been making a comeback as the least worst alternative currency. It however is bouncing up against a technical ceiling and so we'll have to see what happens from here. The Japanese Yen is holding up well. The Canadian Dollar another relatively strong currency is resting at a floor of technical support and like the US dollar it's best to see where it goes from here.

Cash/Money Markets and Fixed Income, as we said earlier, hold the top two relative strength positions. The fundamental economics that are tied to employment, the mortgage situation, global sovereign debt, and continued deleveraging are very muddy. Europe has major problems and China is wrestling with its own real estate bubble. There may be more shoes to drop. Therefore, until more clarity emerges, going slow makes sense to us. At this time the market is oversold so while we can expect ups as well as downs, as always is the case, going slow in the present market and economic environment still makes sense.

In our research and planning we are focused on uncovering securities that generate dividends and interest. For individual stocks we are also placing priority on high accounting and governance ratings. In other words, we are focusing on companies that generate dividends, are financially sound, have a history of profitability, **consistently add economic value**, and have **leadership teams whom we can trust**. We are also being very sensitive to valuation, position sizing, and diversification all of which are risk management techniques. There are a great many crosswinds in the investment world today – probably more so than I've seen in my career. There are also great opportunities emerging with all of the changes in store. We're excited about that but in the near term we believe that patience and a very measured approach to investing will pay off down the line.
