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Investment Insights

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MEATBALL, LINEUP, AIRSPEED

Once upon a time, I, and most of you, went through a student driving course. Two lessons in my, and most likely in your, driver training were the importance of *planning and scanning*.

Have you ever gotten behind the wheel and, not thinking, began driving to work even though you wanted to go to a totally different destination? Having your own trip planning trigger point reminder helps prevent this. My trigger point reminder of choice is when I reach for the seatbelt. I've taught myself when reaching for the seat belt to simultaneously think about my destination and driving route. Other parts of this planning mix may be the GPS and the use of TV and radio traffic reports, and computer-generated directions. Planning is important.

Perhaps once on the road you get to talking or daydreaming and forget about what's going on all around you while speeding along at 70 mph. Getting preoccupied and forgetting about scanning the road and traffic all around you is easy to do. It's also dangerous! Most of us have some memories and incidents that would confirm the importance of *planning and scanning* in driving.

For those pilots amongst our readers you also know the importance of planning and scanning in taxiing, taking off, climbing, flying en route, descending, and landing. Planning and scanning are important lessons to learn and to use in a disciplined way.

In preparing for my first carrier landing out of Pensacola, I remember my instructor was a grizzled, old, navy pilot. At that time, to we young men, he looked at least as old as Methuselah. He had also nurtured hundreds or more young naval aviation students in making successful carrier qualification landings and takeoffs.

I remember three distinct words he drilled into us. They were "*Meatball, Lineup, Airspeed*". The idea was to stick to and execute on that "meatball, lineup, airspeed" scanning pattern when flying in to a carrier landing. With a little luck thrown in, "*Meatball, Lineup, Airspeed*" would result in a safe tail hook landing from which we could walk away. For those wondering, the meatball was what

we actually saw in the mirror-landing-system aid that all of the carriers used. Keeping the orange spot or "meatball" in the center of the mirror, and there were lights that indicated whether it was centered or not, kept us on the correct glide slope to fly down to the deck and catch a wire with our tail hook. Lineup? That was simply keeping our aircraft lined up with the centerline of the flight deck. Airspeed of course was and is always a key factor to monitor, one key reason being, to avoid stalling out and spinning in.



Planning and scanning are just as important to assure your future financial security and to achieve a successful investment program. The latter, future financial security and a successful investment program, don't normally happen overnight. They occur over time, over many up-and-down cycles, perhaps with some very negative surprises, and perhaps with some very positive surprises. Future financial security and successful investment programs though, are more likely to happen if planning and scanning are a continual part of the process.

I'd like you to look at a graphic produced by T.Rowe Price on the following pages. It is a statistical analysis based on the past. It offers a perspective on the odds of your nest egg withdrawal percentage and your nest egg investment mix getting you through your retirement or not. It does not consider Social Security, established pension income, or income from part time work. This graphic is focused only on your nest egg money and it is an example of one tool that can be used in your Financial Planning. (continued on next page)



»»HELP SUSTAIN YOUR ASSETS: BE BULLISH IN RETIREMENT

A successful solution begins with a well-developed strategy. That's why a careful evaluation of your asset allocation and initial withdrawal amount in retirement is vital. The following tables show how stocks—in varying proportions—coupled with a realistic initial withdrawal amount could increase the probability of comfortably funding a 25-, 30-, or even 35-year retirement.

For example, the middle table suggests there is a 91% chance that a mix of 40% stocks and 60% bonds would sustain a 4% initial withdrawal amount (increased 3% annually for inflation) throughout a 30-year retirement.

25-Year Retirement

Initial Withdrawal Amount	Stock/Bond* Mix				
	100/0	80/20	60/40	40/60	20/80
3%	97%	99%	99%	99%	99%
4	89	93	95	98	99
5	76	79	81	82	80
6	60	61	58	50	33
7	45	42	35	22	6
8	32	27	18	7	1

30-Year Retirement

Initial Withdrawal Amount	Stock/Bond* Mix				
	100/0	80/20	60/40	40/60	20/80
3%	94%	97%	98%	99%	99%
4	83	86	89	91	92
5	67	69	68	63	49
6	50	49	42	29	10
7	35	31	22	9	1
8	24	18	10	2	0

More Likely Less Likely**

35-Year Retirement

Initial Withdrawal Amount	Stock/Bond* Mix				
	100/0	80/20	60/40	40/60	20/80
3%	91%	94%	96%	98%	99%
4	77	80	81	81	77
5	60	60	56	46	26
6	43	40	32	17	3
7	30	25	15	5	0
8	19	14	6	1	0

Armed with the above, investors can customize an asset mix and initial withdrawal amount to coincide with their specific requirements.

IMPORTANT: The projections or other information generated by the T. Rowe Price Investment Analysis Tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. The simulations are based on a number of assumptions. There can be no assurance that the projected or simulated results will be achieved or sustained. The charts present only a range of possible outcomes. Results may vary with each use and over time, and such results may be better or worse than the simulated scenarios. Clients should be aware that the potential for loss (or gain) may be greater than demonstrated in the simulations.

*The following allocations include short-term bonds: 60/40 is 60% stocks, 30% bonds, and 10% short-term bonds; 40/60 is 40% stocks, 40% bonds, and 20% short-term bonds; and 20/80 is 20% stocks, 50% bonds, and 30% short-term bonds.

**The likelihood of having at least \$1 remaining in the portfolio at the end of the retirement period.



Monte Carlo Simulation

Monte Carlo simulation is an analytical tool for modeling future uncertainty. In contrast to deterministic tools (e.g., expected value calculations) that model the average case outcome, Monte Carlo simulation generates ranges of outcomes based on our underlying probability model. Thus, outcomes generated via Monte Carlo simulation incorporate future uncertainty, while deterministic methods do not. Monte Carlo analysis is described below:

Material Assumptions

The investment results shown in the tables were developed with Monte Carlo modeling using the following material assumptions:

- The underlying long-term expected annual return assumptions for the asset classes indicated in the tables are not historical returns but are based on our best estimates for future long-term periods. Our annual return assumptions take into consideration the impact of reinvested dividends and capital gains.
- We use these expected returns, along with assumptions regarding the volatility for each asset class, as well as the intra-asset class correlations, to generate a set of simulated, random monthly returns for each asset class over the specified period of time.
- These monthly returns are then used to generate 100,000 simulated market scenarios. These scenarios represent a spectrum of performance possibilities for the asset classes being modeled. The success rates are calculated based on these scenarios.
- We do not take any taxes or required minimum distributions into consideration, and we assume no early withdrawal penalties.
- Investment expenses in the form of an expense ratio are subtracted from the expected annual return of each asset class. These expenses are intended to represent the average expenses for a typical actively managed fund within the peer group for each asset class modeled.

Material Limitations

Material limitations of the investment model include:

- Extreme market movements may occur more frequently than represented in our model.
- Some asset classes have relatively limited histories. While future results for all asset classes in the model may materially differ from those assumed in our calculations, the future results for asset classes with limited histories may diverge to a greater extent than the future results of asset classes with longer track records.
- Market crises can cause asset classes to perform similarly over time, reducing the accuracy of the projected portfolio volatility and returns. The model is based on the long-term behavior of the asset classes and, therefore, is less reliable for short-term periods.
- The model assumes there is no correlation between asset class returns from month to month. This means that the model does not reflect the average periods of "bull" and "bear" markets, which can be longer than those modeled.
- Inflation is assumed to be constant; variations in inflation levels are not reflected in our calculations.
- The analysis does not take into consideration all asset classes; asset classes not considered may have characteristics similar or superior to those being analyzed.

Model Portfolio Construction

Five model investment portfolios were designed by our investment professionals according to the principles of Modern Portfolio Theory, which is used to achieve effective diversification among different asset classes. An effectively diversified portfolio theoretically consists of all investable asset classes, including equities, bonds, real estate, foreign investments, commodities, precious metals, currencies, and others. Since it is unlikely that investors will own all of these assets, we selected the ones we believed to be the most appropriate for long-term investors. The asset classes used for the model portfolios are stocks, bonds, and short-term bonds. We did not consider real estate because of its illiquidity and the significant exposure many investors already have through homeownership. We believe the fixed income asset class we chose fairly represents the broad, liquid, domestic capital markets. We selected short-term, investment-grade bonds to provide stability and eliminated any explicit allocation to cash because we believe that the investor is best positioned to determine his/her own allocation to cash based on his/her near-term needs.

The portfolios were constructed based on our analysis of the complementary behavior of asset classes over long periods of time, which enables us to identify investment mixes that offer greater efficiency through low correlation.

T. Rowe Price has analyzed a variety of retirement savings strategies using computer simulations to determine the likelihood of "success" (having at least one dollar remaining in the portfolio at the end of the retirement period) of each strategy, shown as a percentage in each grid. The initial withdrawal amount is the percentage of the initial value of the investments withdrawn in the first year where the entire amount is withdrawn on the first day of the year; in each subsequent year, the amount withdrawn is adjusted to reflect a 3% annual rate of inflation. The simulation success rates are based on simulating 100,000 possible future market scenarios and various retirement income strategies. The underlying long-term expected annual return assumptions (gross of fees) are 10% for stocks; 6.5% for intermediate-term, investment-grade bonds; and 4.75% for short-term bonds. The following expense ratios are then applied to arrive at net-of-fee expected returns: 1.211% for stocks; 0.726% for intermediate-term, investment-grade bonds; and 0.648% for short-term bonds. These examples only present a range of possible outcomes. Actual results will vary, and such results may be better or worse than the simulation scenarios.

The Monte Carlo analysis results are not predictions, but they should be viewed as reasonable estimates.

Source: T. Rowe Price Associates, Inc. (TRPA), T. Rowe Price Investment Services, Inc., Distributor (TRPIS). TRPA and TRPIS are affiliated companies.

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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 9/30/2010

S&P500	+2.28%
NASDAQ	+4.19%

10/11/2007 HI thru 9/30/10

S&P500	-26.56%
Mar 2000 HI thru 9/30/10	
NASDAQ	-53.1%

*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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The above was included to help you think about financial and retirement *planning*.

What about *scanning*? Scanning is part of the execution process. Scanning and managing the "meatball, lineup, and airspeed" helps get a carrier pilot safely back aboard the boat. Likewise, scanning the reward and risk potential in the capital markets, and using that information in managing investments, will help get an investor safely into and through retirement.

Let's discuss scanning as a disciplined activity to help determine investment reward, investment risk and to help achieve positive returns over time.

Many who have invested over the past ten years have little to show for their investing efforts. 2000 to 2003 and more recently 2007 to 2009 gave us market meltdowns of more than 50% on major indices. Our investment management mantra: **Do no harm, Make money*** (please read sidebar) is continually stressed and tested over short term periods sometimes with victory and sometimes with defeat. Over an entire market cycle though we continue to improve our methodology and are pleased with our comparative results over the duration of complete market cycles. The scanning process is integral to our investment process and will become even more valuable going forward.

What is this scanning process or better yet scanning processes that we use? What's the equivalent of the carrier pilot's "Meatball, Lineup, Airspeed" to the investor's scanning protocol?

Actually investment management as we do it applies scanning at a number of different levels.

We place a great deal of emphasis on scanning supply and demand information within and across the capital markets. That includes scanning the trends and relative strengths of six asset classes including cash, fixed income (e.g. bonds), domestic stocks, international stocks including real estate, currencies, and commodities. We then scan and narrow down the thousands of securities that make up these asset classes. Our equivalent to "meatball, lineup, airspeed" is "**Offense or Defense, Field Position, Players**". In plain words the latter indicates: Are we in wealth accumulation or wealth preservation mode given market risk? – Offense or Defense; Do we want to run conservative or more aggressive plays in making an investment? – Field Position; What specific securities do we want in our portfolios? – Players.

We know that supply and demand determines price movement and is all important to what direction the value of our investments move. Underlying supply and demand though is the fundamental economic backdrop. Fundamental economic conditions in the long run will out. The fundamental economic conditions eventually trumped in the dot-com bubble and brought the stock market crashing down. More recently, fundamental economic conditions; credit excesses, criminal behavior, overleveraging, and a broken regulatory system trumped in melting down almost all investment asset classes.

Scanning technical or supply and demand information along with fundamental economic information is important to our investment success. (continued on next page)

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Currently, our scanning of the fundamental economic backdrop sends us mixed signals because there remain so many uncertainties with regard to employment, real estate, credit, banking issues and more. Longer term a growing global middle class supports the concept of increasing demand for goods and services and in particular for food, energy, and things including technology things. Also, shorter term we expect that there will be increased corporate and individual spending on technology next year.

Our nagging concern is that current valuations have been bid up beyond a point of sustainability. From a technical standpoint we are on the offense, but the field position or level of market risk is high. Also the very uncertain fundamental economic backdrop suggests caution. Combined, they suggest to us that having some money on the sidelines is a prudent course of action.

We continue to place emphasis on those securities that generate a dividend, and preferably have a track record of conservative accounting and rising dividends. Whatever the election results no one can be sure what the market will do in the short term. We do need sound and effective government policy on many fronts though to get our economy back on track. We'll see what happens.

In mid-November, I will send a Bulletin to clients. It will cover some very specific planning and investment items. For your information, Newsletters as well as Bulletins are posted on our website usually within one month after they are initially published.

Our business success is partially determined by your referrals. Please contact us if you know of anyone who needs help in their financial planning or investing.
