

Newsletter & Portfolio Review

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Baker Financial Services

December 31st Market Update

We lost track a long time ago of how many times the Financial Panic of 2008 was called the “worst crisis” of the modern era. Politicians (in a rare moment of true bipartisanship!), pundits, economists, and investors all called it “the worst.” Stocks plummeted and President Bush gave a primetime speech in which he suggested we were on the brink of another Great Depression. Firms with household names collapsed overnight.

Unemployment spiked and GDP dropped faster than at any time in decades. Monetary velocity plummeted and deflation became a very real threat. It was a Panic like we haven’t seen in 80 years. And in a panic, people are willing to believe almost anything. Forecasters and analysts who had been (wrongly) predicting recession for years all of a sudden became infallible soothsayers. The press hung on their every word and their pronouncements of long term doom and gloom were considered unarguable.

The “smartest guys in the room” and the enabling press, thought that the US economy would languish for years. The recession, they argued, would last at least through the end of 2009 and perhaps well into 2010. And once the recovery started the best we could anticipate was growth in the 1.5% to 2% range for many years to come.

As it turned out, the recession ended in mid 2009 and the economy has clearly outperformed those dire forecasts. Real GDP has expanded for five straight quarters. Meanwhile, private sector jobs have grown for ten consecutive months and the American economy has once again surprised everyone with its resilience.

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December 31st Market Update Continued

This is not the first time and it won't be the last. The recession after Hurricane Katrina – that was forecast by the same famous soothsayers of 2008 – never materialized. More amazing was the growth after 9/11. The economy was in an official recession on that day, but started its recovery in November.

Certainly things are not perfect. Unemployment is still high and uncertainty is prevalent. And politicians are using economic weakness to argue for what they want. Republicans want tax cuts, while many Democrats want more spending. This has created a “vacuum of political optimism” which is damaging to economic confidence.

Nonetheless, individual Americans and their companies remain resilient and are still moving forward. Amazon has created an application to scan prices at retail stores and compare to online prices. Brick and mortar retailers may not like this, but transparency and competition always helps consumers.

And as long as this process of invention and entrepreneurship is alive and well, the economy is in good hands. This is what politicians should be focused on – how to strengthen property rights, contracts and the rule of law. Staying out of the way is, and always has been, the fastest and surest way to prosperity.

As always, please know that we are here to answer any questions that you have and that we are doing our best to keep a watchful eye on both the economy and the stock market.

Everyone here is proud to call you a Baker Financial client and we look forward to seeing you soon.

Achieving the Proper Balance of Risk and Return

An important decision that every investor must make is determining the amount of investment risk to assume while maintaining a level of comfort. Risk is simply defined as the probability that the actual return for an investment will differ from that which was expected. It is possible that some or even all of an investor's original investment may be lost. In other words, there are no sure things in the investment world.

All investments contain some degree of risk; however, some investments are considered more volatile (riskier) than others. Low levels of uncertainty, or low risk, are usually linked to investments with low potential returns. On the other hand, investments with high levels of uncertainty, or high risk, are generally accompanied by high potential returns. The relationship between risk and return is such that one must be willing to accept greater risk if one wants to pursue greater returns.

A common misunderstanding among investors is that higher risk will lead to greater returns. According to the risk/return tradeoff, however, higher risk investments provide an investor with the possibility, not the certainty, of higher returns.

Consider the table below showing the periodic returns of three hypothetical investments. Investment A fluctuates very little from period to period. It has low volatility or a low amount of risk. However, this low risk is accompanied by low average returns. Conversely, Investment B has greater periodic fluctuations from one period to the other and has even lost money in one of the periods. On the flip side, Investment B's average return is higher than that of Investment A, corresponding to this higher level of risk. The riskiest investment of the three is Investment C, which has experienced a double-digit loss in one period. The returns for Investment C have also been periodically quite high, resulting in the highest average return of all three investments.

As the saying goes, "There is no free lunch"; in many cases, investments that generate high returns also come with high levels of volatility or risk. These high returns act as a compensation for investors, for assuming high risk. Further, it is very important to realize that taking on a high level of risk in hopes of attaining a high level of return is not for everyone.

An investor's risk tolerance varies according to age, income requirements, financial goals, and other considerations particular to each investor's unique situation. It is essential to determine your attitude toward—and your tolerance for—risk, while (all the time) keeping in mind that past performance is by no means a guarantee of future results.

Periodic Performance of Three Investments

	1	2	3	4	5	6	7	Average
Investment A	4%	7%	5%	7%	5%	2%	5%	5.0%
Investment B	2%	12%	-4%	21%	12%	1%	8%	7.4%
Investment C	5%	22%	-14%	32%	16%	-4%	13%	10.0%

The End of the Recession

In September 2010, the National Bureau of Economic Research announced the long-awaited news: an end date for the recession that had begun in December 2007. The NBER determined the official end date as June 2009, quieting down (if not completely silencing) double-dip fears. NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. Looking back at the performance of the main asset classes during the recession and in the months following the official end date, gold was the best overall performer, and long-term government bonds offered consistent positive returns. Out of the investments with the worst performances during the recession, REITs posted the most-impressive return in the 16 post-recession months.

Returns During and After the Most Recent Recession

	Recession Dec 2007 to Jun 2009*	Aftermath Jul 2009 to Oct 2010*
Gold	19.3%	44.1%
Long-term government bonds	8.4%	14.5%
Treasury bills	1.9%	0.1%
Small stocks	-33.8%	42.5%
Large stocks	-35.5%	32.2%
International stocks	-39.7%	28.4%
REITs	-48.1%	81.8%

*Returns in table represent cumulative returns during time periods indicated, not geometric returns.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Holding a portfolio of securities for the long term does not ensure a profitable outcome, and investing in securities always involves risk of loss. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. REITs are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. Small stocks are more volatile than large stocks, are subject to significant price fluctuations, business risks, and are thinly traded. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks, REITs, and gold are not guaranteed.

Source: Gold—Wall Street Journal London P.M. closing price. Long-term government bonds—20-year U.S. government bond. Treasury bills—30-day U.S. Treasury bill. Small stocks—Dimensional Fund Advisors, Inc. (DFA) U.S. Micro Cap Portfolio. Large stocks—Standard & Poor's 500® Index, an unmanaged group of securities considered to be representative of the U.S. stock market. International stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. REITs—FTSE NAREIT Equity REIT Index®.

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