



# Newsletter & Portfolio Review

September 2010

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Baker Financial Services

## September 30th Market Update

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Heading into September, many market ‘experts’ were quick to remind us that the ninth month of the year carries with it a horrible reputation.....dropping an average of 1.2% since 1928. With August being the worst performing month of 2010 and negativity at a peak, many market analysts were bracing for the worst with some even recommending an “all cash” strategy.

What a difference a month can make! Not only did September buck its reputation it actually rocketed higher with its best September performance in 71 years. In fact, all of the major indices moved much higher in September with the DJIA rising 7.8%, the S&P 500 gaining 8.8% and the Nasdaq enjoying a 12% rally. Although we certainly don’t base our long term recommendations on monthly or even quarterly swings, it was nice to see the market show such extreme strength in the face of several headwinds.

As we have discussed before, these movements illustrate the importance of sticking with a game plan and not trying to out think the stock market. More importantly, September reminded us of the pitfalls of trying to “time the market”, which is a losing proposition. Instead, we will continue to implement a diversified investment strategy that utilizes tactical allocation changes based on individual long term risk tolerance and planning goals.

Please know that we are following the economy and stock market closely and that we are always here to answer any questions that you may have.

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# The Many Faces of Inflation

Since the recent recession started in December 2007, it seems all we've seen and heard about the economy was bad news: the housing market collapsing, 401(k)s suddenly being worth much less than before, a lifetime of savings almost disappearing in a few months, rising unemployment, and fluctuating prices. Now that we're on the road to recovery (even though the recession is not officially over yet), inflation is becoming a concern once again. In this uncertain economic climate, it may be helpful to learn about the different types of inflation and their immediate effects.

**Inflation:** Inflation is defined as a continuing rise in the general prices of goods and services. Simply put, if prices, on average, are going up in an economy, then you've got inflation. With a set amount of money in an inflationary environment, consumers are able to buy less and less over time. High rates of inflation can generate uncertainty, lower productivity and discourage investment. The leading measure of inflation in the United States is the Consumer Price Index (CPI). The government can change its monetary policy to control the money supply and keep inflation in check, although this is not the only variable affecting inflation.

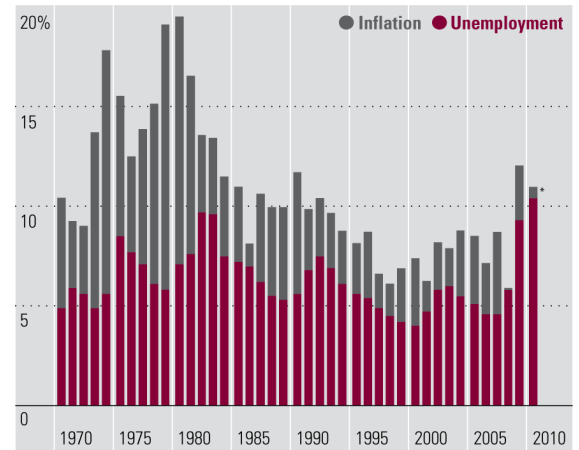
**Hyperinflation:** Hyperinflation is extremely high, out of control inflation, caused by a steep increase in the money supply without a corresponding increase in the output of goods and services. Well-known examples include the German hyperinflation after World War I and the hyperinflation in Hungary after World War II. It appears that such an extreme phenomenon occurs mainly as a result of radical changes and prolonged economic instability.

**Deflation:** Deflation is the opposite case: a general decline in the prices of goods and services. In the U.S., deflation occurred as recently as 2008 and 2009: The change in CPI was negative in the third and fourth quarters of 2008 and in the fourth quarter of 2009, a clear indicator of deflation. The obvious positive effect here is lower prices—many argue that deflationary periods are good times to

buy. The problem with deflation, though, is that consumers reduce spending and businesses stop growing, which is not good for the economy.

**Stagflation:** This is the worst-case scenario: high inflation and slow growth simultaneously. Normally, there is an inverse relationship between inflation and unemployment; if the economy is able to tolerate a higher rate of inflation, lower unemployment can be achieved, and vice versa. But during a stagflation period, both inflation and unemployment go up. An interesting measure for stagflation is the misery index, which, as illustrated in the image, combines the unemployment and inflation rates. The U.S. experienced severe stagflation in the 1970s, when unemployment and inflation reached a combined high of almost 20%. There has been talk of stagflation during the recent crisis as well, but the potentially encouraging news is that the misery index is not nearly as high now as it has been in the past.

The Misery Index



\*Data is for the 1st quarter of 2010.

Source: Inflation is represented by the Consumer Price Index, and unemployment by the national unemployment rate, not seasonally adjusted, from the Bureau of Labor Statistics.

## Investing with a Long-Term Focus

It's easy to follow a long-term investment strategy in good times; the hard part is sticking with it in bad. What should you do if you are a long-term investor sitting in the midst of a bear market? If you are holding a well-diversified portfolio, the answer is rather straightforward: stay the course.

Volatile markets can cause investors to abandon their long-term goals for risky short-term investment strategies. Volatility can range from a single-day market crash to extended periods of jagged performance. The market has undergone cycles with high and low annual returns from 38% (1995) to -37% (2008) over the past 50 years. It can be tough to stay the course in the face of such fluctuations.

The graph illustrates the annual stock market performance since 1960. The bull market from 1991 to 1999 lasted the longest, with an average annual return of 21%. In contrast, a majority of the downturns shown in the image have lasted shorter periods of time. Despite the ups and downs over the years, the stock market generated an average return of 9.5% over this historical time period.

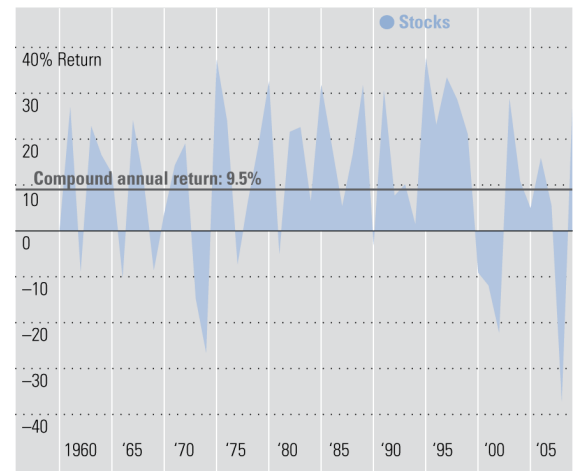
It goes without saying that the market will head south at times, but history shows that despite this, the market's long-term trend is upward. Consequently, the sooner an individual implements an investment plan, the better. By contributing early and as often as possible to such a plan, an investor's money compounds over time. Compounding is the ability of an asset to generate earnings from previous earnings, which serves to accelerate the growth of your assets as time moves on.

A disciplined investment approach is still the best strategy for handling market downturns. This includes maintaining a well-diversified portfolio and using dollar-cost averaging, instead of lump-sum purchases, to ease into new investments. Dollar-cost averaging involves the purchase of securities, usually mutual funds, in fixed dollar amounts at regular intervals. This strategy is maintained no matter what direction the market

is moving. Finally, staying focused on a long-term investment plan may enable you to participate in recoveries.

Overall, the stock market has exhibited positive performance in the past, but be prepared for periods of underperformance. The fact is no one can predict market declines with any type of certainty. As a result, a portfolio consisting of both stocks and bonds can serve as a good strategy for short-term diversification. On the contrary, investors who have a larger appetite for risk may want to consider long-term investments in stocks. With a disciplined approach to investing, one may be able to take advantage of market rebounds and may enjoy superior returns in the long run. Don't be sidelined by market expansions and contractions.

Annual Stock Market Performance: 1960–2009



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed.

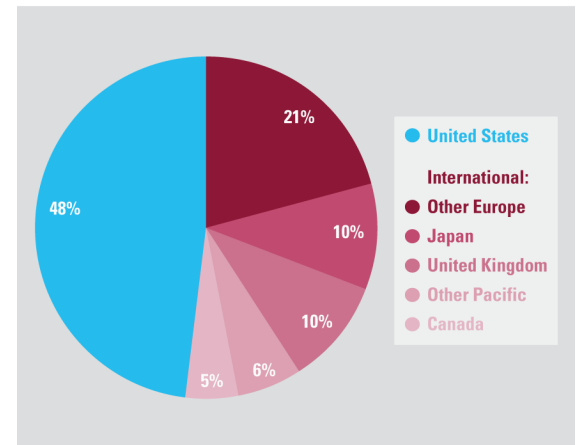
Source: Stocks—Standard & Poor's 500<sup>®</sup>, which is an unmanaged group of securities and considered to be representative of the stock market in general.

## A World of Opportunity

As trade barriers continue to break down, the world economy has become a small neighborhood. Should investors seek to participate in this wave of globalization, or are they getting all they need here at home?

Historically, foreign investments have acted in a significantly different way from domestic investments. When the U.S. market slumped, various opportunities abroad have prospered. An American investor who put some money into foreign markets may have reduced risk while still attaining attractive returns. With the spread of globalization, this benefit decreases as companies across the globe are acting more like each other. However, as the image illustrates, an investor who doesn't take advantage of options outside of the United States is missing out on roughly half of the investable developed stock market opportunities in the world.

### World Stock Market Capitalization Year-End 2009



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.

Source: World Market Capitalization by Country is from the Morgan Stanley Capital International Blue Books. The data is expressed in U.S. dollars.

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