

Newsletter & Portfolio Review

June 2011

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Baker Financial Services

June 30th Market Update

Moving into the sixth month of the year, many analysts were calling for a stock market "pullback" as well as increased volatility. And - looking back at the last 30 days, it seems as though June held up its end of the bargain! An intra-month decline of 5% as well as large swings in the stock indices made June unnerving for many investors. Now that it looks like we are in the sights of a long hot summer, it is anyone's guess if the recent pullback will continue or if the stock market will bounce higher. As always, we will rely on discipline, patience and a watchful eye to get through the rest of 2011.

Although we do agree that the recent 26 month run-up in the markets has put it in a position for some type of correction, it is impossible to know; when the move lower will begin, how much that correction will be and how long it will last. In fact, 2010 is a great example of no one knowing for sure these three things. Last year the S&P 500 declined 16% from April to August.

However, (even though most 'experts' were calling to get out of the market altogether because September is historically a bad month for the stock market) the S&P 500 staged a huge rebound in the 4th quarter and finished the year up double digits.

So- rather than knee-jerking and trying to be smart enough to time the markets, we will continue to move forward utilizing sound investments, rebalancing strategies and tactical allocation across many market segments and sectors. We still believe that this approach will help you achieve your long term investment goals.....no matter what the financial markets have in store for the future.

Please know that we are watching the economy and financial markets closeley and look forward to speaking with you soon.

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Social Insecurity

All of us who work feel the bite that Social Security taxes take out of our paycheck. Most of us take comfort in the hope that when we retire, Social Security will be there, giving back all the money that we paid into the system over the course of our careers. Isn't that how it works?

Well, the short answer is no, it doesn't work that way. The Social Security taxes deducted from your paycheck are not sitting in a special account someplace, earmarked to be returned to you upon your retirement. Instead, the taxes you pay today are used to pay benefits to today's beneficiaries, just as when you retire, the benefits you receive will come from the taxes paid by people who are still working. This arrangement works as long as there are enough people sending in taxes; it doesn't work so well if the number of current workers per retiree is decreasing.

The baby boomer generation (those born between 1946 and 1964) have started to retire in 2010. This large group's retiring, coupled with increasing life expectancies and decreasing birth rates, means that the number of retirees will grow faster than the number of workers. As the graph illustrates, according to the Social Security Administration, the number of workers sending in Social Security taxes to pay each retiree's benefits has plummeted from 42 workers per beneficiary in 1945 to 2.9 in 2010. What is more is that this number is projected to go down even further to 2.1 workers per beneficiary by 2035. Since the ratio of workers to retirees is expected to continue declining, a shortfall in future Social Security funding is likely.

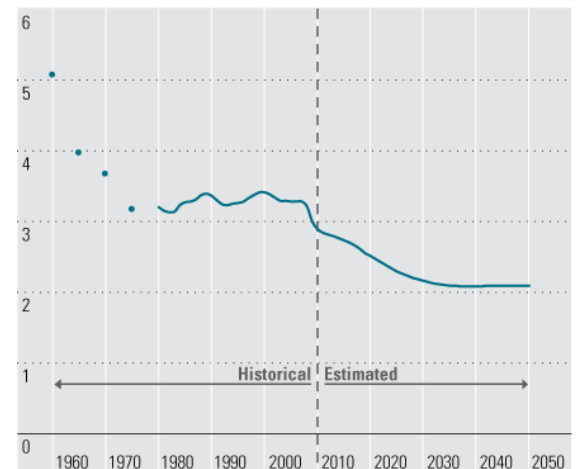
The trustees of the Social Security program estimate that benefits paid will exceed payroll taxes collected in 2010 and 2011, be less than payroll taxes collected in 2012 through 2014, then once again exceed tax income in 2015 and remain higher thereafter. Moreover, they are forecasting that the Social Security trust fund will be exhausted in 2037 unless changes are made.

What does all this mean for you? Well, that depends on how old you are and what changes the

United States government decides to implement. If you are nearing retirement, it is unlikely that your Social Security benefits will change dramatically. Younger workers, however, are more likely to see sweeping changes in the way Social Security works in the form of higher taxes, lower benefits, or a combination of the two.

Bear in mind that Social Security was never intended to provide Americans with all of the income they would need in retirement. Social Security is only one leg of a three-legged stool that also includes pension plans and personal savings. With concerns mounting over the stability of one leg of the stool, you need to take control of your retirement by investing in personal savings plans such as IRAs and 401(k)s.

Ratio of Workers to Beneficiary



Source: The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, August 2010, Social Security Administration.

Dividends and Total Return

Income is important to consider when choosing an investment. Especially important for investors approaching retirement, income can add meaningfully to one's total return, which comprises income and price return (capital appreciation). Investors can pursue income returns in many ways including bonds, real estate investment trusts, and stocks.

Stock income is typically paid in the form of a monthly, quarterly, annual, or special cash dividend, which can be used to finance current consumption or to reinvest. Dividends are typically expressed in terms of yield. Like an interest rate, yield is represented as a percentage rate and is calculated by taking the annual cash dividend divided by a stock's current price. For example, a stock trading at \$20 with a future annual cash dividend of \$1 would have a dividend yield of 5%.

Keep in mind, though, that there is no guarantee a dividend will be paid, even if a certain company has a consistent dividend-paying track record. A company can increase, decrease, and even eliminate dividends altogether, depending on its financial situation. Furthermore, if a dividend is declared, the company has to pay dividends for preferred shares first, before any common share dividends can be paid.

Although stocks can be a source of income return, not all stocks are created equal in this regard. Some companies distribute significantly more of their profits in the form of dividends than others, and some don't distribute dividends at all. The following image demonstrates this point. Historically, dividend-earning stocks—represented by Morningstar's Dividend Composite Index—have had compound annual returns of 6.9%, while large stocks have had compound annual returns of 5.0%. Additionally, higher-yielding companies—represented by Morningstar's Dividend Leaders Index—have outperformed large stocks: Dividend Leaders Index components had a compound annual return of 9.0% compared with 5.0% for large stocks during the period studied. For investors looking

both for income and total returns, dividend-paying stocks can be a reasonable place to invest.

Although higher-yielding stocks have demonstrated an ability to outperform large stocks, all that glitters is not gold. Dividends are paid at a company's discretion, and exceptionally high yields can indicate a potential dividend cut. For example, had investors been lured to many high-yielding bank stocks in late 2008, they would have been sorely disappointed when many banks subsequently cut their dividends as profitability declined during the credit crisis. When looking at dividend-paying stocks, investors should focus on reasonable dividend yields with companies that have the earnings power to increase their dividend distributions over time. Many large companies with recognizable brand names have demonstrated an ability to offer this slow and steady income distribution to shareholders.

Dividend-Paying Stocks May Provide Better Returns



This is for illustrative purposes only and not indicative of any investment. Assumes reinvestment of all income and no transaction costs or taxes. 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. Dividends are not guaranteed and are paid solely at a company's discretion.

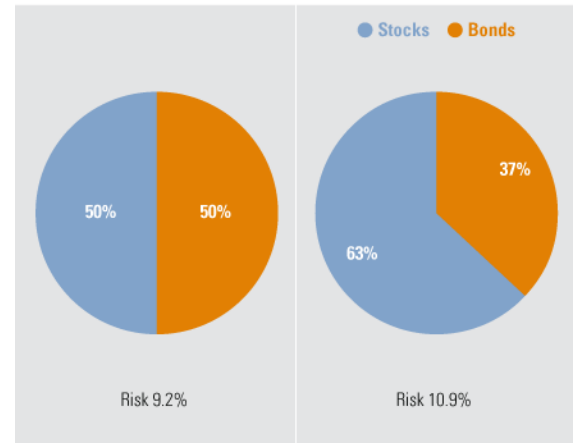
Source: Large Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Dividend-Paying Stocks—Morningstar Dividend Composite Index; High-Yield Dividend-Paying Stocks—Morningstar Dividend Leaders Index. Stocks in both indexes have a consistent record of dividend payment, have the ability to sustain their dividend payments and are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index. The Morningstar Dividend Leaders Index captures the performance of the 100 highest-yielding stocks.

The Importance of Rebalancing

Over time, your asset-allocation policy can veer off track because of market ups and downs. This is illustrated quite clearly in the attached image; a strong stock performance can cause a simple 50/50 portfolio mix to become unbalanced over time. After 30 years, what was once a 50% allocation to stocks now sits at 63%—quite a jump. Moreover, not only does the portfolio's allocation change, but the portfolio's risk also changes, rising sharply from 9.2% to 10.9%. If your needs and/or risk tolerance have not changed, your allocation shouldn't either.

But why would anyone want to sell investments that have done great in order to purchase laggards? While rebalancing might seem odd at first, it is all about risk control. If more and more of your total portfolio winds up in one investment, you risk losing a lot should that investment stumble.

Change of Portfolio Allocation:
January 1981–December 2010



Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The sale of an investment for the purposes of rebalancing may be subject to taxes. Risk is measured by standard deviation. Standard deviation is a statistical measure of the extent to which returns vary from the expected returns. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and is considered to be representative of the stock market in general; Bonds—five-year U.S. Government bond.

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