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September 30, 2011 Market Update

We often use words such as discipline, diversification and patience when discussing the stock market and investing for the future. While these words may ring hollow during a period of severe financial uncertainty, we still believe that they are the cornerstone of a good investment strategy.

At Baker Financial Services, we do our best to implement this strategy– have a plan in place, work towards that plan, make portfolio modifications as circumstances warrant and strive to meet our client's long term goals….without walking away from the plan itself. Although this can be extremely difficult at times, this strategy has proven to be successful.

That said, there are still many uncertainties and head-winds for the market and economy; a stagnant housing market, on-going concerns in Greece, a government that can't seem to agree, and high unemployment levels…… to name a few!

In our eyes, the issue isn't necessarily whether the economy will recover, but when and at what rate. And, more importantly, how many stumbles will there be along the way? We try not to get caught up in the advice of newspapers and television media and which stocks will do well this month or this quarter. When it comes to short term predictions about the economy or the stock market, we feel that most of them will be wrong.

So – as we move forward, we will continue to work diligently to monitor the financial markets as well as your portfolio. It can be hard to ignore the short term distractions but we ultimately believe that a diversified investment strategy appropriate to each client's risk tolerance as well as patience and discipline will help achieve long term goals.

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Government Health-Care Spending: Medicare

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of government health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years.

Medicare and Medicaid were both created in the mid-1960's as part of Lyndon Johnson's Great Society agenda. As of 1970, 62% of total health-care spending was still private, with out-of-pocket spending the single most significant source. During the subsequent forty years, however, Medicare and Medicaid each expanded by more than 11% annually due to benefit expansions and demographic change, pushing public-sector spending up to nearly 50% of total health-care expenditures. During the same time, private-sector spending also grew at a robust 8.7% annually, as employer-sponsored insurance became the predominant conduit of health-care spending.

Looking forward, the Centers for Medicare & Medicaid Services (CMS) project 6.5% annual health-care spending growth over the next decade. Public sector growth is again expected to outpace private spending growth, with a 6.9% growth rate compared to 6% for the private sector. Combined, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010 and 17% in 1970.

Medicare is a federal government program that provides health insurance to people over age 65, and people with certain disabilities. In 2009, more than 43 million people received health insurance benefits through Medicare at a total cost of approximately $510 billion. Medicare benefits are divided into three parts: Part A Hospital Insurance, Part B Medical Insurance, and Part D Prescription Drug Insurance. Part C created a private version of Medicare, now called Medicare Advantage. More details about these benefits can be found in the attached table.

Original Medicare's relatively high cost-sharing provisions and lack of a limit on out-of-pocket spending can leave beneficiaries exposed to potentially devastating expenses in the case of a serious adverse health event. For this reason, most Medicare beneficiaries also carry supplemental insurance. Employer-sponsored retiree health plans, though becoming less common, still cover approximately 30% of the Medicare population. 20% of Medicare beneficiaries purchase individual supplemental policies, also called Medigap policies. Medicaid helps pay Medicare's premiums and cost-sharing for another 20% of the Medicare population. Only about 10% of Medicare beneficiaries are estimated to be completely without supplemental coverage.

Medicare Benefits Breakdown

Benefit	Approx. % of Spending	What Does It Cover?	What Does It Cost Beneficiaries?
Part A	39	Inpatient hospital care, skilled nursing facilities, and in some cases hospice or home care.	Generally no monthly premium as long as the beneficiary paid sufficient payroll taxes while working. Deductible and co-insurance for hospital stays exceeding 60 days.
Part B	26	Physician services, outpatient care, and in some cases physical or occupational therapy and home health care.	Monthly premium, deductible, and 20% co-insurance after the deductible is met.
Part C	23	Same benefits as Part A, Part B, and often Part D. Medicare Advantage plans are offered by private insurance companies as an alternative to original government-run Medicare.	Monthly premium, deductibles, co-pays, and co-insurance.
Part D	11	Prescription drugs.	Part D benefits are only offered through private insurance companies, which charge a premium in addition to deductibles, co-pays, and co-insurance.

Source: Kaiser Family Foundation and Medicare.gov

The Labyrinth of Financial Statements: The Cash-Flow Statement

The Labyrinth of Financial Statements: The Cash-Flow Statement Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the cash-flow statement.

The cash-flow statement shows cash going in and out of the firm during a period of time. Based on activity type, it is organized into three sections: cash flow from operating activities, investing activities, and financing activities.

1. Cash flow from operating activities This section lists the sources and uses of cash that result from normal, day-to-day operations of the firm. The operating activities portion always starts with net income (the profit the company has made). Usually, there are four items that need to be added to or subtracted from net income in order to arrive at operating cash flow: depreciation, the change in accounts receivable, the change in accounts payable, and the change in inventories. The result is net cash flow from operations.

Depreciation represents the decrease in the value of physical resources resulting from wear and tear over time. For example, a piece of equipment is originally purchased for $50,000, but after being used for a year, its value decreases to $40,000. The $10,000 difference is depreciation. Accounts receivable designates the money the company is waiting to receive as payment for products sold or services rendered. Let's say the company sells a product for $5,000 on Oct. 3, but it does not expect payment until the end of the month. That $5,000 will go under accounts receivable until the actual payment is made. Accounts payable is just the opposite—the company has already received a product or service, but will not pay for it until later. Inventories represent the raw materials, work in progress and finished products the company has in stock at a certain point in time. Changes in all these items affect operational cash flow.

2. Cash flow from investing activities A company, just like an individual, can invest its money in order to increase the value of its assets. For example, if a construction company purchases new construction equipment, this will probably be considered an investment in property, plant, and equipment (PP&E), and the cash outflow will show up under investing activities on the cash-flow statement. A company can also invest in the equity of other firms, subsidiaries, joint ventures, acquisitions, and others.

3. Cash flow from financing activities This section indicates how the company is raising capital to finance its operations. Cash inflow can be created by stock or bond issues, and cash outflow by debt payment or the repurchase of shares. Also, if the company pays a dividend to its stockholders, this will have to be recorded here (dividend payment is usually a significant financing cash outflow).

The sum (positive or negative) of cash flows from operating, investing, and financing activities represents the net increase (or decrease) in the firm's cash during a certain period of time (normally a year). Of the three numbers, the most important one is cash flow from operations; ideally, this would be the company's largest cash inflow. The cash flow statement is essential in determining a company's situation because it focuses on what's happening to the firm's cash. Even if net income looks great on the income statement, a company's position may be very weak if it doesn't have enough cash coming in.

Benefits of Diversification

"Don't put all your eggs in one basket" is a common expression that most people have heard in their lifetime. It means don't risk losing everything by putting all your hard work or money into any one place.

To practice this in the context of investing means diversification—the strategy of holding more than one type of investment, such as stocks, bonds, or cash, in a portfolio to reduce the risk. In addition, an investor can diversify among their stock holdings by buying a combination of large, small, or international stocks, and among their bond holdings by buying short-term and long-term bonds, government bonds, or high- and low-quality bonds.

A diversification strategy reduces risk because stocks, bonds, and cash generally do not react identically in changing economic or market conditions. Diversification does not eliminate the risk of experiencing investment losses; however, by investing in a mix of these investments, investors may be able to insulate their portfolios from major downswings in any one investment.

Over the long run, it is common for a more risky investment (such as stocks) to outperform a less risky diversified portfolio of stocks, bonds, and cash. However, one of the main advantages of diversification is reducing risk, not necessarily increasing return. The benefits of diversification become more apparent over a shorter time period, such as the 2007–2009 banking and credit crisis. Investors who had portfolios composed only of stocks suffered large losses, while those who had bonds or cash in their portfolios experienced less severe fluctuations in value.

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