

# 2011 Second Quarter Review and Market Outlook



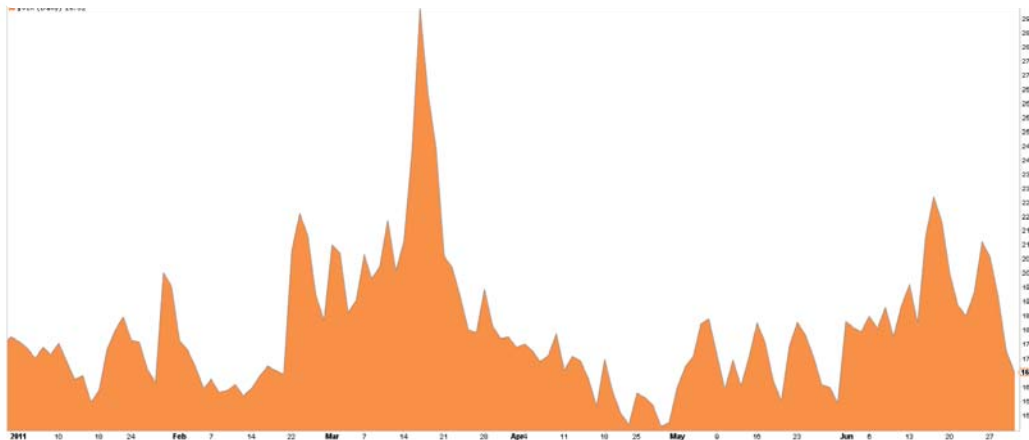
June 30, 2011

## The Volatility Ride Continues

The widely quoted adage “sell in May and go away” would have been an excellent strategy for most investors as volatility returned to the markets in the second quarter. Sovereign Debt concerns in Europe, a slow down in China, and higher unemployment rates in the US all contributed to rattle markets.

As measured by the CBOE SPX Volatility Index, or “VIX”, volatility increased 28% at its highest point during the quarter before moderating at the end of June. When the VIX increases, it indicates that systemic risk is reentering the market. Traders may view increases in volatility as an opportunity, however at Baker Avenue we believe that there is an even greater risk of losing capital and therefore taking a more defensive posture.

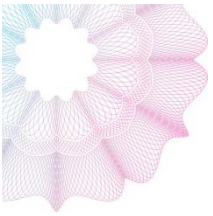
Figure 1: CBOE Volatility Index Q2/11



Source: Stockcharts.com

Additional confirmation of market risk was evident as the Baker Avenue Market Sentiment Indicator (BAMSI) broke below 50 and entered into negative territory in early June. The BAMSI measures the percentage of stocks in a 4,000 stock index that are in bullish uptrends. When the BAMSI declines below 50, it means there are more stocks in new bearish downtrends than uptrends.

“Traders may view increases in volatility as an opportunity, however at Baker Avenue we believe that there is an even greater risk of losing capital and therefore taking a more defensive posture.”



# 2011 Second Quarter Review and Market Outlook

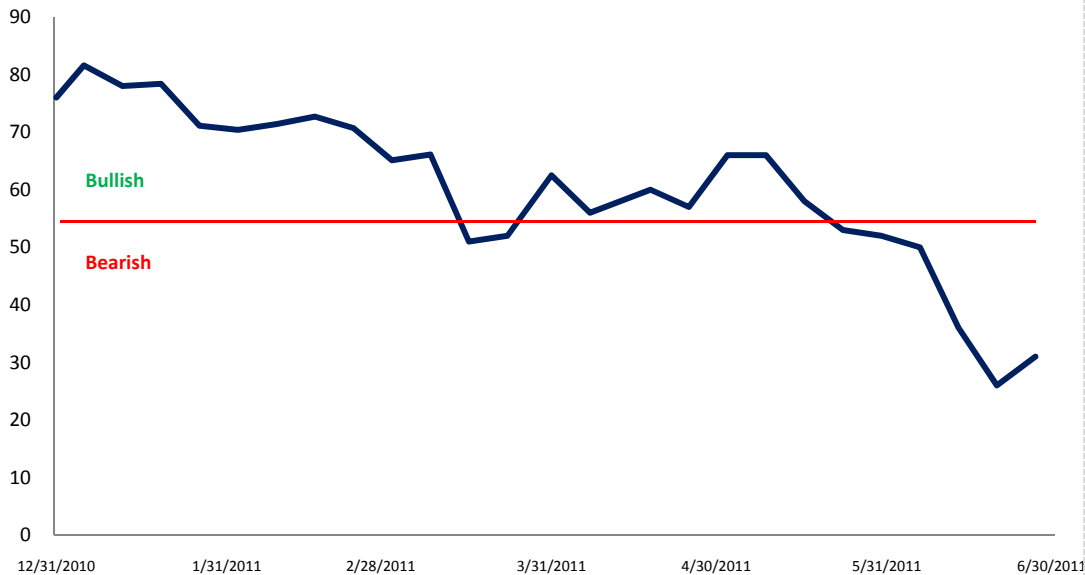


What are the implications for the stock market when the BAMSII is negative? When the BAMSII turns negative, there is heightened risk of owning equities since there are more stocks falling than rising. It does not necessarily mean that stocks will take a steep dive, but the odds of that happening increase significantly in a higher risk environment. What is most important to understand, however, is that every severe down move in the market was preceded by the BAMSII first turning negative.

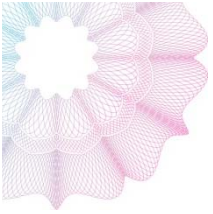
In June, the market was at risk of a steep selloff due to the stalemate of the Greek austerity plan vote. The European Union withheld aid from Greece until an austerity plan was approved by the Greek parliament. If the austerity plan was voted down, it may have triggered a liquidity crisis on par with that of the Lehman bankruptcy in 2008. With the austerity plan finally ratified in mid-June, the market may have averted a financial crisis at least for the time being.

“What is most important to understand, however, is that every severe down move in the market was preceded by the BAMSII first turning negative.”

**Figure 2: Baker Avenue Market Sentiment Indicator (BAMSII) Q2/11**



Source: Baker Avenue



# 2011 Second Quarter Review and Market Outlook



## Strategy Review

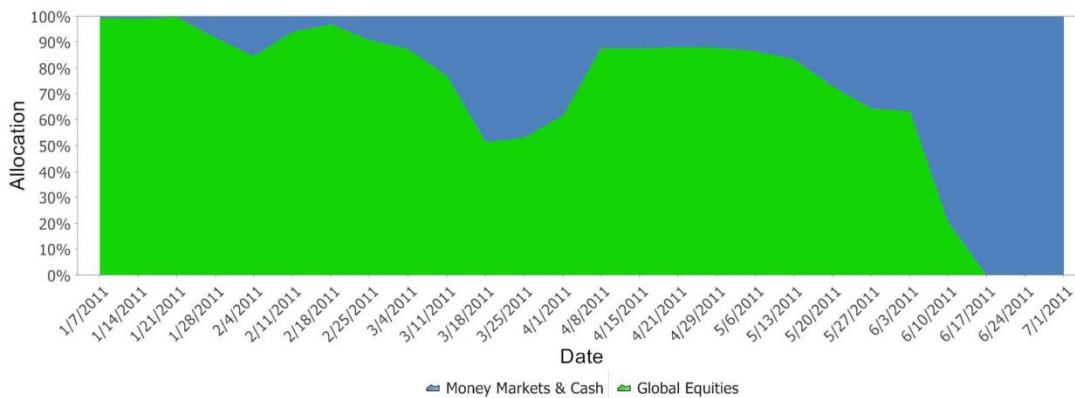
### All Cap Core

In the All Cap Core strategy, we invest in stocks that are showing leadership on both fundamental and technical factors. When the BAMSI is positive (above 50) we invest in a basket of market leading stocks. When the BAMSI shows signs of deterioration we begin to raise cash, but when the BAMSI drops below 50 we move 100% to cash.

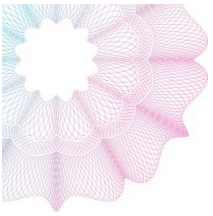
When the BAMSI showed signs of deterioration in May, we began to raise cash by selling our weakest positions and taking profits off the table. By the time the BAMSI dropped below 50 in June, we already had approximately 50% in cash on the sidelines. When the BAMSI finally broke below 50 and our confirming indicators also showed that the market was at risk, we moved 100% to cash to protect principal.

“When the BAMSI showed signs of deterioration in May, we began to raise cash by selling our weakest positions and taking profits off the table.”

**Figure 3: Cash/Equity Ratio Q1-Q2 2011**



Since moving to cash, the market has remained relatively flat, but nonetheless the ride has been volatile. With ongoing concerns in the Euro zone and the debt ceiling situation in the U.S. unresolved, the market is still at an elevated risk level which is why we remain in a high cash position in the strategy.



# 2011 Second Quarter Review and Market Outlook



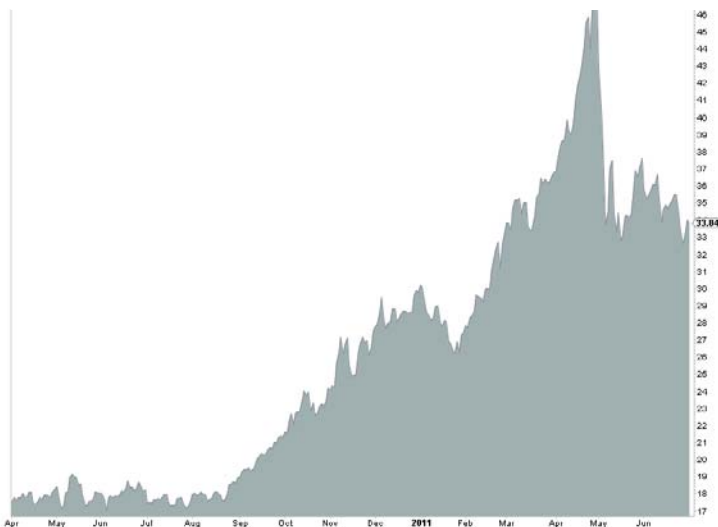
## Global Tactical ETF

In the Global Tactical ETF strategy, we invest in asset classes that are showing attractive fundamentals and positive momentum versus the market. The strategy moves to cash when long-term market trends are negative. The strategy was over weighted in precious metals and commodities as they benefitted from the effects of “QE 2” which caused the U.S. dollar to devalue and inflation pressures to increase.

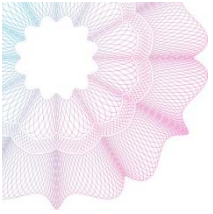
Commodities faced a challenging environment in May and June as a stronger dollar and concerns about an overall global economic slowdown caused downward pressure on commodities and precious metals. A stronger dollar makes commodities more expensive for international currencies as commodities are denominated in U.S. dollars. We reduced our commodity exposure in the strategy in the second quarter due to pressure on commodities as we saw more evidence of a global slowdown coupled with a rebound in the dollar. In hindsight we would have reduced our commodity exposure more quickly as prices fell very quickly. Although we took profits in silver just shy of the record high near \$50, silver remained very volatile. Silver dropped nearly 20% in the month of May alone. The metal appears to have found a bottom near the low the 30’s and recently has seen a rebound in price. When market sentiment turned negative we raised cash and implemented inverse market hedges to protect the existing positions in the strategy.

“Commodities faced a challenging environment in May and June as a stronger dollar and concerns about an overall global economic slowdown caused downward pressure on commodities and precious metals.”

Figure 4: Silver ETF (SLV) Q2/11



Source: Stockcharts.com



## 2011 Second Quarter Review and Market Outlook



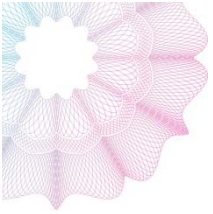
### Blue Chip Core

The Blue Chip core strategy continues to outperform the S&P 500. It will remain invested until the long term trend and market sentiment both turn negative at which point it will raise cash. IBM is quite possibly the least interesting, but the best performing company in the portfolio. Big Blue as the company is nicknamed recently celebrated a 100 year birthday since forming in 1911 with a diversified product lines from meat and cheese slicers to punch card systems. Since then, IBM has invented everything from the PC to universal product codes. Recently, they have moved away from low margin hardware sales to focus on software and global IT services. Shareholders have been rewarded as the margin expansion has increased profits despite slowing revenue growth.

What is most interesting about IBM is the shrinking number of shares outstanding. Take a look at the graph below which compares the market cap with the share price over the last 10 years. In 10 years, the share price is up 63% in contrast to just a 13% increase in market capitalization. How can this be? Management has been slow to issue employee stock options which dilute existing holders and they have been aggressively buying back shares in the open market. What a contrast with other companies that have flooded the markets with secondary offerings and dilution over the years. Bank of America is an easy target given their mortgage problems. In contrast, Bank of America's chart plotting shareholder return in comparison to market cap is a flip of the IBM chart below. The shares have declined by 60% despite the market cap rise in the last 10 years..

Figure 5: IBM 2001 - 6/29/2011





## 2011 Second Quarter Review and Market Outlook



### Dividend Opportunities

When comparing the tortoise and the hare, stocks and ETFs that pay outsized yields are often the slow moving reptile. During the quarter, they lagged the broad market in April as higher beta names outperformed but they held true to their defensive ways as volatility picked up during the second half of the quarter. Recently, ETFs that hold preferred shares have performed best as yields on corporate and treasury bonds decline once again. Energy and commodity oriented REITs have tempered gains giving back the strong performance earlier in the year. The chase for yield in a low growth environment could continue in the coming quarters.

### Market Outlook

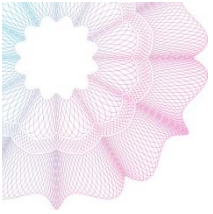
As we write this update, there are already talks of another possible round of quantitative easing as the U.S. economic recovery remains sluggish. However, one can argue that recent rounds of quantitative easing have had limited success of reigniting the economy. Deflationary concerns have dissipated, instead replaced by a surge in food and energy prices which have been like an added tax on consumers.

A bigger concern looming is the ongoing debate about the debt ceiling. If this is unresolved, it would increase more volatility in the market place and it could potentially affect the credit rating of the U.S. Until this is resolved and market sentiment turns positive, we are maintaining a conservative posture to protect principal.

Sincerely,

Baker Avenue Asset Management

“However, one can argue that recent rounds of quantitative easing have had limited success of reigniting the economy.”



## 2011 Second Quarter Review and Market Outlook



### Disclosures:

The Baker Avenue Asset Management (“BAAM”) All Cap Core (“ACC”) Equity Composite is designed to generate a positive return over the medium to long term, with a focus on capital preservation. For comparison purposes, the composite is measured against the S&P 500. We believe the index that best replicates the market capitalization of securities we purchase for clients in the ACC are best represented by this index. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represents over 80% of the investable U.S. equity market. The index is presented as total return (reflect reinvestment of dividends, interest and other income) and is unmanaged, cannot be invested in directly and is never comprised of a cash allocation. BAAM may or may not trade in securities that are represented in this index. No representation is made that the performance or volatility of the ACC will track or otherwise reflect a particular index.

Past performance is not indicative of future results.

The minimum account size for inclusion in the composite is \$100,000. The U.S. Dollar is the currency used to express performance. Returns are presented net of a Model Advisory Fee and net of transaction costs. Returns are total return, i.e., they include the reinvestment of dividends, interest and other income. The composite includes both bundled-fee (wrap fee) and non-bundled fee portfolios. As a result, the returns presented are net of a model investment presented net of an annual fee of 1.5% applied monthly which represents the highest annual fee currently paid by a portfolio in this composite. For bundled accounts in the composite, this fee includes management fees, brokerage commissions, portfolio monitoring, consulting services and in some cases custodial services. The composite includes accounts that did not pay an advisory fee; since the completion of the first year, less than 2% of assets in the composite have been from non-fee paying accounts. BAAM may waive or reduce the management fee with respect to one or more clients or agree to apply a different management fee for a client. Full details of the fees charged are available in our ADV Part II, available upon request.

The BAAM All Cap Core Equity Composite was created on January 1, 2005. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. The composite consists of fully discretionary fee paying accounts that invest in all cap equities and cash. Portfolios are included after one full calendar quarter under management; terminated accounts (those no longer with the firm) are included through the last full calendar quarter prior to termination. Carve-outs are included in this composite from inception on January 1, 2005 until March 31, 2009. After March 31, 2009, only pure accounts were included in the composite. The portfolio accounting system automatically allocates 100% of the total cash to the carve-out. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Additional information regarding policies for calculating and reporting returns and copies of prior verification reports are available upon request.

We may move to cash at times when the risk is not appropriate. However, there is significant dispersion between the performance of our composite and the index as the index is unmanaged and cannot move to 100% cash as we may do for our clients (and thus, this is reflected in our composite). For the time periods stated below, 1/1/05 through **12/31/10**, the following time periods reflect when the Composite had a 100% cash allocation as a defensive component in the ACC. As a result, the negative performance of the S&P 500 is not reflected in our performance as we did not have the market exposure. Time periods are 49 days from 9/29/05 to 11/17/05, 30 days from 3/9/07 to 4/8/07, 63 days 11/8/07 to 1/10/08, and 40 days from 2/20/09 to 4/1/09. There were 5 time periods where the cash exposure was 100% but for less than 30 days. We have examined these time periods and believe the impact is, overall, not material. In total from 1/1/05 to **12/31/10** we were in 100% cash for 346 days.

Baker Avenue Asset Management, LP is an independent registered investment adviser. The firm maintains a complete list and description of composites and models, which are available upon request to [info@bakerave.com](mailto:info@bakerave.com).

**Baker Avenue Asset Management**  
301 Battery Street  
San Francisco, California 94111

**San Francisco**  
415 986 1110

**Boston**  
617 584 9784

**Dallas**  
214 624 5226

**New York**  
212 901 0636

**Seattle**  
206 447 1474

**Website**  
[www.bakerave.com](http://www.bakerave.com)