



## North American Management

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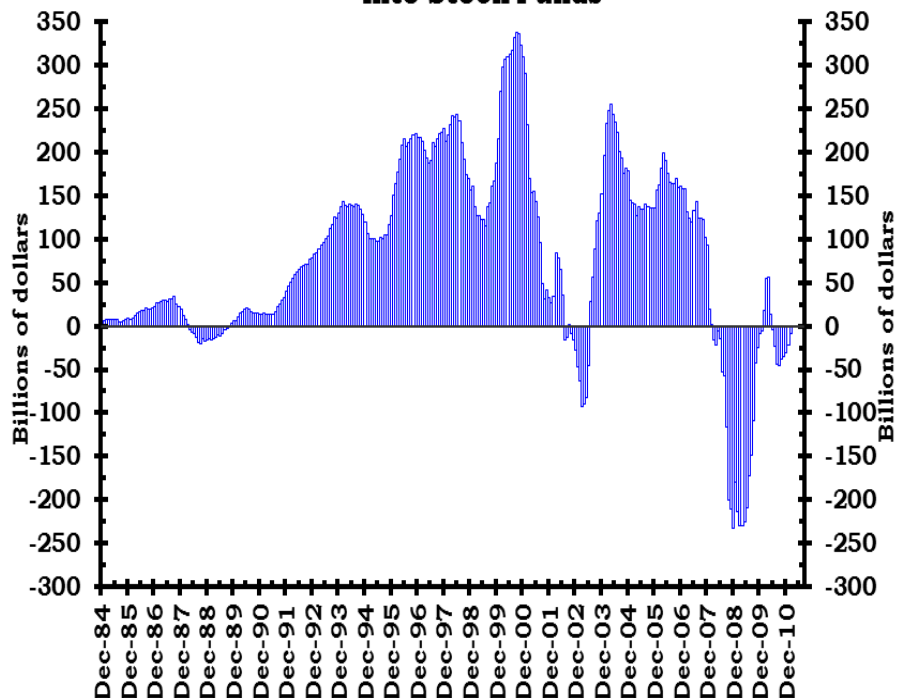
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### First Quarter 2011

Most investors, having watched equity markets double off their lows of March 2009, were waiting for a shoe to drop in the first quarter, and, ostensibly, two of them did. First, cracks in the North African authoritarian political structure, a tacit, if distasteful paradigm for smooth oil delivery to the West, began to show in Tunisia, then rapidly spread to Egypt, Jordan, Libya, Syria and – of all places – Saudi Arabia. Less threatening, but still noteworthy, were projections of the Tunisian “Jasmine revolution” spreading in China, and numerous protests that popped up in Europe and at the State level in the US. Second, an epic natural and human disaster occurred in Japan, killing tens of thousands and displacing hundreds of thousands, releasing radioactive material in harmful quantities locally, and in minute, but detectable quantities globally. The leaks from the nuclear plants near Sendai are still not fully contained, and the global supply chain, another given in the daily lives of producers and consumers, is temporarily fractured, with undeniable effect on global GDP.

Although Egyptian and Japanese equities destabilized, dropping 35% and 19% respectively, these dramatic events, with their potential to alter the energy landscape for decades, caused far less disruption in the broader markets. Most commodities, save for oil and precious metals, have actually dropped in value since mid-February, and the MSCI World Index, though down 1% in March, is still up 4.9% for the Quarter. The S&P 500 was flat in March, and is still up 5.9% year to date.

**12 Month Rolling Sum of Net New Cash Flow  
into Stock Funds**



After lowering equity exposures marginally in February, we have been somewhat surprised by the resiliency of global equity markets. It is not clear to us whether the rapid decline in volatility after the Tsunami indicates complacency, conservative valuation metrics, or just another crisis in a zero interest rate environment where investors in search of yield have few other options but to take equity risk. Just twelve months ago investors endured a flare up of the European debt crisis and a global growth scare. We now wonder whether that 16% peak to trough drop in the S&P 500 in the second quarter of 2010 was justified. It may be that investors are reacquiring some tolerance for risk as the crisis of 2008 recedes. Put another way, the wall of worry we must climb after every recession, and this one is a doozy, does eventually diminish. Recent economic data is mostly positive, showing moderate improvement in employment, growing M&A activity and rising corporate profits, though some sectors are experiencing margin pressures. Valuations seem reasonable, with the forward multiple on the S&P 500 hovering around 14 times earnings against a 10 Year Treasury bond yield of 3.5% at the end of the first quarter.

Fundamentals being reasonable, we find ourselves studying investment flows. It seems most investors are content to be more cautiously positioned relative to the boom years of 2003 – 2007. Concerns over inflation? They own commodities, especially gold. Volatile banks with toxic balance sheets? Most retail investors don't own them. Emerging markets? "Equity tourists" have stayed on the sidelines while central banks tighten liquidity. Equity mutual funds? Most mutual fund investors haven't even rebalanced after the crisis (see graph above), preferring to stay in cash. Yet even though we believe equities are "under owned," and that the worst crises are probably behind us, we still would not be surprised to see a significant correction in 2011, given the political uncertainties in every corner of the world, and intense pressures in the currency and commodities markets. We reduced our equity exposure somewhat in the first quarter in order to manage correlations and volatility, both of which have been dropping throughout the QE2 era. The relative calm in the markets is not unwelcome, it just makes us wary. Counter to recent momentum in the fixed income markets, we have been selectively extending maturities, adding longer term bond exposure when we find attractive yields and credits. We don't dispute that rates may rise, but most fixed income investors are still hovering at the short end of the yield curve, with substantial exposure to Fed tightening, should it come later this year.

**Source of graph: Bianco Research**  
**Source of data: Bloomberg**

*The information in this discussion is taken from sources that North American Management believes to be reliable. Notwithstanding, North American Management does not guarantee the accuracy of the data.*