



North American Management

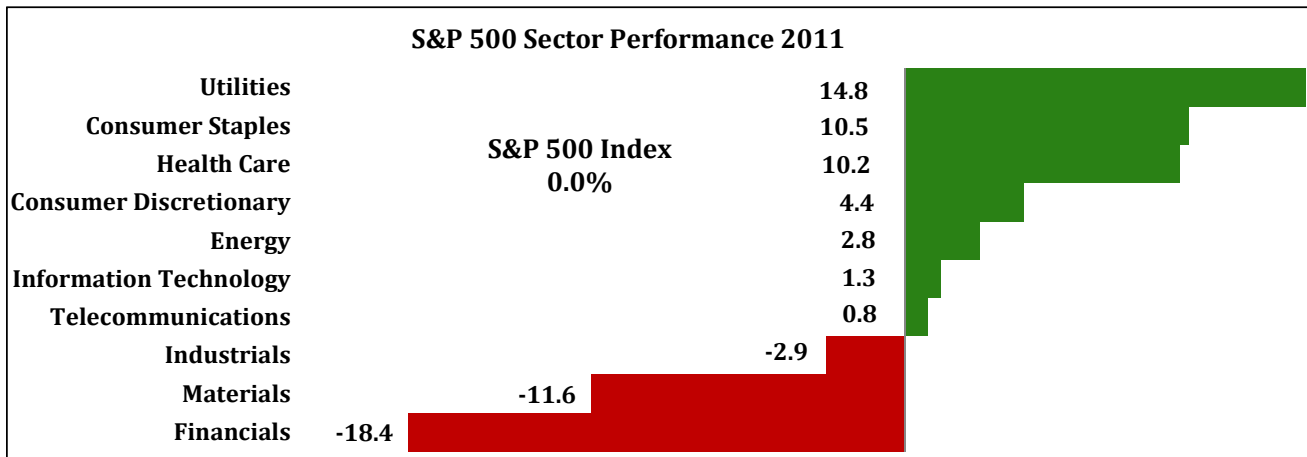
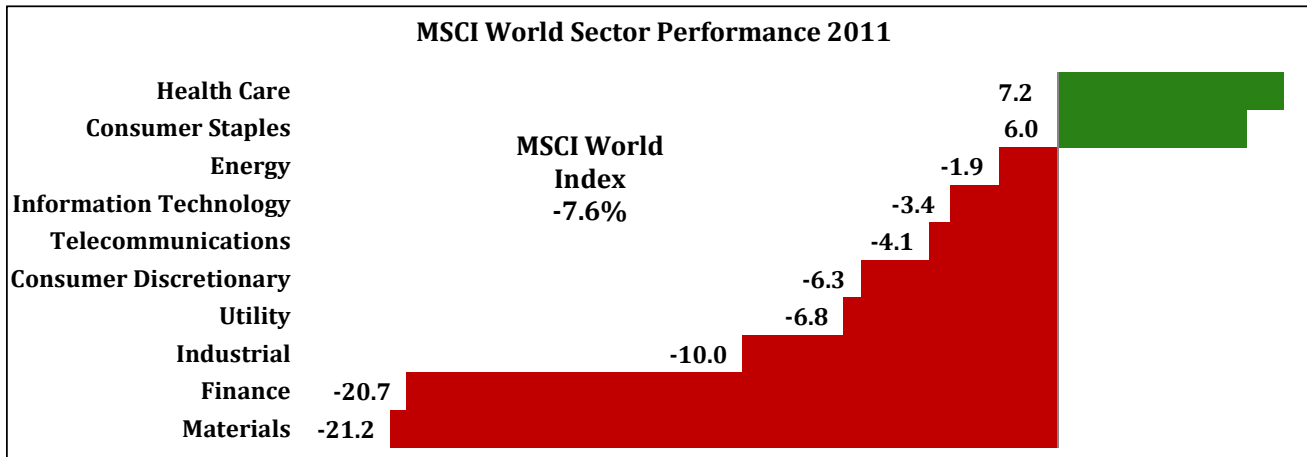
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Fourth Quarter 2011

Return-Free Risk

The market "labored like a mountain but brought forth a mouse" (Horace, 65 BC- 8 BC).

So much agitation, fear and anxiety in 2011 for such meager results, though at least US stocks were able to show a small gain after dividends are included. It was a wild ride: there were 49 days in 2011 in which the S&P 500 Index saw 90% of its daily volume up or down, with 20 of those days occurring in the Third Quarter.* The number of stocks moving in the same direction at the same time made life very difficult for fundamental investors, though at the finish line the clear winners were at the low end of the risk spectrum: US Treasuries, gold, municipals, and dividend aristocrats. Owning anything viewed as higher risk or liquidity challenged – most European or Emerging Market stocks or high yield bonds for example - handed one sizeable losses. In the graphs below, note the difference in year-end price performance between a globally diversified index (MSCI World, top, down 7.6%) versus the S&P 500 (bottom, flat), and how defensive sectors led cyclicals.



Our long term objective is to build and maintain a globally diversified portfolio, with a meaningful growth component, even though this type of exposure penalized investors a little in 2011. In this context, most of our clients fared well enough relative to the MSCI World Index, but many lagged the S&P 500 total return. As described above, cyclical equity exposure (industrials, financials, energy) weakened performance, as did our positions in international and emerging markets. However, defensive sector allocations (utilities, healthcare and staples) helped cushion the volatility. Some of our allocations to high yield bonds and preferred securities suffered meaningful price drops as liquidity conditions deteriorated in the Third Quarter, but have since rebounded.

How is the world supposed to get out of this mess? We presumed, along with most market participants (and central banks), that money would be printed, financial assets would reflate, credit would then flow, growth would rebound and unemployment would eventually fall. We assumed that the pound of flesh extracted for this type of recovery would be structurally higher inflation, perhaps 3% to 5% CPI for the next decade. Not too bad an outcome for the fixed rate borrowers of this world, including sovereigns, if they are able to cut entitlements, and not necessarily bad for equities or real estate either. Less enjoyable, however, for fixed rate lenders, and for consumers whose wages, already stagnant for a decade, will likely be taxed at higher rates. Downright nasty for the burgeoning demographic of retirees on fixed incomes, with limited ways to hedge a loss of purchasing power.

Instead we got a *deflation* scare in the Third Quarter. The budget talks failed, US debt was summarily downgraded, buyers fled from risk assets, volatility spiked, and global equities moved in step with extreme correlations not seen since the Great Depression. Even though US Treasuries rallied after the downgrade, a substantial paradigm shift occurred: much of the world's sovereign debt stock is now viewed as a potential credit risk, not simply interest rate risk. To us this means that a great many investment portfolios are overweight credit, and we note the supply of "risk free" assets is dwindling further - on Friday, January 13, S&P downgraded France and eight other Eurozone countries.

Is there a case for a more optimistic outlook, and when will investors get paid once again to take risk? In 2011, the most attractive returns came from sectors and asset classes that were not starved for capital to begin with, while many industries levered to global growth were (and are still) facing prohibitive costs for equity capital, financials in particular. We believe such attractive valuations on more stable balance sheets (ex-Europe), together with historically low interest rates and anemic top line growth, may spur a frenzy of M&A at some point. The activity we have seen to date in the energy sector, for example, has transacted at huge premiums that are supportive of today's multiples. At this stage, policy error, as opposed to management blunders or sharp declines in profitability, is highest on our list of hazards. In fact, heightened political risk is one of the main reasons we are not more fully invested at this time.

In the First Quarter of 2012 we do expect to continue to build back some equity exposure, having lowered it to bear market levels early in the Third Quarter of last year. Our focus has always been first and foremost on protecting capital, but our relative value and liquidity analysis gives us caution where interest rates and credit are concerned. From an equity perspective, there are already vast pools of cash earning a negative return, and the slightest hint of positive news from Europe, although few expect it, could spark a very sharp rally in equities. Indeed the month of January has been productive so far for risk assets.

In addition, we intend to stay focused on what we see as the most compelling long-term global growth themes: further penetration of robotics in the manufacturing sector, prevalence of obesity and diabetes along with changing diets in the emerging world, more active seniors, continued digitization of content, and the impact of advancing technology across all economic sectors, to list a few. Technology gains have recently impacted the energy sector, where new extraction techniques have led to new energy sources that

may dramatically reduce US dependence on foreign sources of energy over the next decade. The influence of these themes and others that will doubtless emerge, coupled with thoughtful asset allocation, will define our strategy in the years ahead.

We wish all of our clients and friends a healthy, happy and prosperous New Year.

Robert G. Scott
Chairman & CEO

David H. M. Baker, CFA
Chief Investment Officer

Source of graphs and data: Bloomberg
**** Source: Strategas Research Partners***

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