



## North American Management

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### **Opportunities and Risks January 2011**

As we begin the New Year, we like to review several key themes that could lead us to attractive investment opportunities in 2011. That said, there are also certain risks that have the potential to increase market volatility and undermine these prospects. While our investment process and security selection is based on fundamental research, it is imperative we also evaluate macroeconomic trends that can influence capital allocation and investment decisions.

There are three trends we would like to highlight as possible investment themes in the coming year: improving capital management, diminishing regulatory pressure, and the continued rise and resurgence of the global consumer. Key risks include weakening or unresolved sovereign credit issues and inflation, though we still believe the latter is less likely in the short term.

We look for improved capital management, i.e. smarter allocation of resources and bolder deployment of cash in pursuit of top line growth, to materialize as Western economies continue to recover and companies emphasize shareholder value over capital preservation. This will likely be achieved with a combination of internal reinvestment, share buy-backs, expanded M&A activity, and rising dividends. Increasing productivity should allow companies to sustain margins overall, though escalating raw material prices may pressure profits somewhat. Finally, we expect to see increased bank lending after years of inactivity and risk aversion.

At the same time, the sharp edges of post-crisis regulation are likely to be dulled as policymakers and voters come to the realization that new regulations have often aggravated the problems they were seeking to solve. When government involvement recedes, and market forces take over, we expect to see greater dispersion among the winners and losers - a huge positive for thoughtful stock selection. Consequently, credit will be much more expensive for undercapitalized firms (or governments), but strong entities should prosper.

The emergence of global consumerism after a prolonged hibernation is a longer term trend that provides us many investment ideas. In the West, as the recovery continues, we expect higher employment, stronger consumer balance sheets, and a stabilizing, even slowly improving real estate sector will all contribute to stronger levels of consumption.

Simultaneously, a rising standard of living among emerging nations will continue to promote spending patterns that emulate Western economies.

Sovereign credit risk, which has dominated headlines over the past year and a half, will continue to do so this year and perhaps into 2012. We believe some EU countries and some American states will be forced to restructure their debts, and currencies will fluctuate under the strain. We anticipate this will promote continued, intermittent volatility that may provide us opportunities to purchase additional shares of the strongest companies.

We are not complacent about the risks to our constructive stance on recovery. The tsunami of government spending, which is now beginning to crest, carries with it the possibility of destructive inflation. We differ from some of the more negative pundits as we view inflation to be a longer term issue. We believe that moderate inflation, say, global consumer prices rising less than 4% supports our thesis, while high inflation obviously does not.

We plan to make a number of tactical moves in 2011 to capitalize on the trends we see developing, but will stay consistent to our research and investment process, and above all will pay close attention to any adverse signals in the fixed income markets.

Two administrative notes - first, we would like to update you on a regulatory change concerning cost basis reporting. Congress passed the Emergency Economic Stabilization Act in October 2008, which included a requirement for custodians to report adjusted cost basis information to the IRS via Form 1099. As you know, until now, most custodians have been reporting only gross proceeds on sales for taxable accounts. Starting in 2011, custodians will be required to supply gain/loss information to the IRS for taxable equity positions purchased after December 31, 2010. **These cost basis reporting changes do not impact tax reporting for 2010.** Please don't hesitate to contact our tax department if you have any questions.

Second, we have decided to shift to a quarterly format for our investment letters. In the interim, we are always available to share our thoughts and views with you directly.

*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.*