



North American Management

David H. M. Baker, CFA
Chief Investment Officer
Ten Post Office Square, Suite 1200
Boston, MA 02109 www.namcorp.com
Telephone: 617.695.2100
Fax: 617.695.2121

Conventional Wisdom and Fear September 2010

We have written about investor sentiment in previous letters, but pessimism, in our opinion, has risen to such a level that we are seeing more compelling investment opportunities, not less. Negative sentiment is pervasive across many asset classes, but nowhere more than equities, where retail money has been flowing, unabated, out of equity funds for the past eighteen months. For example, capital moving into bond ETFs has outpaced equity flows by a factor of 40:1 in the last year alone.ⁱ How about real estate? We show two Time Magazine covers, five years apart, to illustrate the power of swings in sentiment. In 2005, the homeowner was set for life, while now it's a wonder we aspire to own homes at all.

Fear has a way of obscuring supply and demand dynamics. It's perfectly plausible that the US economy might endure an extended period of subpar growth, say 1% - 3%, compared to a typical, post recovery growth rate of 5% - 7%.ⁱⁱ However, that doesn't mean that price stability of an asset, or even price appreciation, cannot be achieved. This recession has already gone a long way to reduce excess capacity built up over the last several decades, even while cautious consumers worldwide have significantly reigned in demand from peak levels of 2007.

We believe that a small shift from depressed consumption levels may be enough to avoid a double dip recession. Anything more could provide the backdrop for a more convincing, if gradual, recovery. Consider automobiles: the average age of US automobiles is now 10.2 years, and last year more autos were scrapped than registered.ⁱⁱⁱ In housing, core demand is estimated to be 1.6 million new homes per year and new housing starts have *averaged* 1.5 million for the last 50 years. The latest figures show new starts at an annualized rate of 588,000 and housing starts per capita, adjusted for population growth, are 72% below normal levels over the past 50 years!^{iv}

If over-consumption was not sustainable, neither is under-consumption. We can easily accept the popular notion of a "new normal" due to higher savings rates and higher unemployment, but if production (supply) adjusts, profits will continue, and reinvestment will grow. We question whether the equity markets are discounting far greater challenges. A few examples: 1) forward earnings multiples are at levels not seen in many years; 2) 30% of S&P 500 stocks' dividend yields exceed the US 10 year bond; and 3) 68 of the S&P 500 companies' dividend yields now exceed their bond yields.^v

Source: Time Magazine, September 6, 2010



Source: Time Magazine, June 13, 2005





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We have been raising our clients' equity exposure throughout 2010 in a deliberate, thoughtful manner. We have favored blue chip equities with solid balance sheets and growing, sustainable dividend yields. However, we have also been gradually raising exposure to "surplus economies" where growth rates are several times our own. While this activity may raise short term portfolio volatility, we must maintain the discipline of adding capital appreciation potential, not just dividend income, to client portfolios. The rest of the world seems to be either on the sidelines, or in a house of gold bricks.

ⁱ Source: Barclays

ⁱⁱ Source: Bloomberg

ⁱⁱⁱ Source: Gavekal

^{iv} Source: Gavekal

^v Source: Bloomberg

Source of Pictures: 1. Time Magazine, September 6, 2010

2. Time Magazine, June 13, 2005

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.