H. M. Payson & Co.

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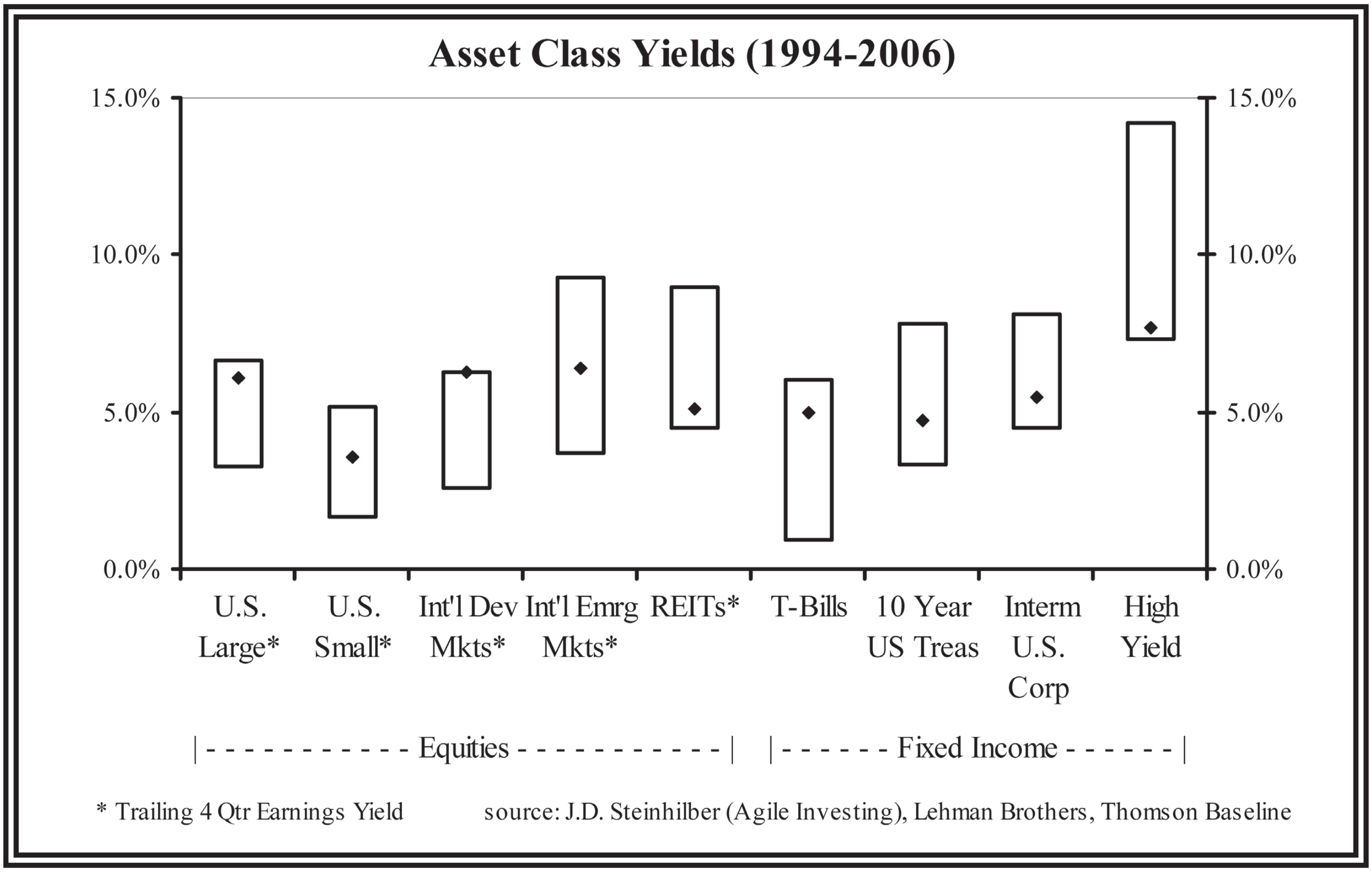
Perspectives

Did We Really WIN?

As the nation reflected earlier this month on the life, national service and lasting achievements of President Gerald R. Ford, we could not help but recall the short lived and largely ineffective Whip Inflation Now campaign of 1974. This campaign, allegedly supported by Ford's Council of Economic Advisors and its Chairman Alan Greenspan, was according to Wikipedia "...an attempt to spur a grassroots movement to combat inflation by encouraging personal savings and disciplined spending habits in combination with public measures...." As many will remember, WIN buttons were produced to be worn proudly by those dedicated to the fight against inflation. It is important also to remember that, while the WIN campaign was largely ridiculed at the time, inflation in 1974 was running at a rate of over 12%, and the stock market was in the midst of a two year decline of over 40%. Following the WIN campaign and perhaps only coincidently, 1975 and 1976 saw a recovery in stocks of 37% and 23% respectively, and a decline in the rate of inflation to 7% in 1975 and 5% in 1976. To our knowledge, there have been no economists or market historians who have connected the market's recovery to the WIN campaign. There have been many however, who cite Alan Greenspan's experience serving President Ford during those troubled economic times as critical in shaping his future inflation fighting policies.

The anticipation of a slowdown in the rate of economic growth, a decline in oil and other commodity prices, global liquidity flows and even the fear of a recession in 2007 led to a strong rally in bond prices over the past six months. The efforts of the Federal Reserve to control inflation have been quite successful and many believe the Fed's next move might be to lower rates in 2007 if the economy stumbles. Mr. Greenspan and the Federal Reserve have produced a WIN over inflation in the sense that it has remained under 4% since 1990, but we wonder whether today's 4.75% yield on a 30 year Treasury Bond adequately reflects the long term inflation risk in the context of volatile energy prices, war in the Middle East, tight labor markets, persistent deficits and the potential for tax increases and protectionism under a new Congress.

There has been much written recently of the decline in the "risk premium" on various asset classes. In simple terms, the risk premium is the difference in expected return between a risk-free asset and any other investment. To measure risk premiums, expected returns from various assets classes, such as stocks and bonds, are compared to the yields on U.S. Treasury Bills, which are considered virtually riskless. The risk premium is defined as the excess return above the risk free rate. For example, longer term U. S. Treasury notes and bonds are riskier than Treasury Bills due to the effects of inflation and changes in interest rates, and ordinarily offer higher yields. Corporate bonds add the additional risk of credit problems. Stocks offer higher historical returns, but with the risk of increased volatility and the possibility of negative returns. Other asset classes such as emerging markets,



small cap stocks, real estate and commodities carry additional potential for volatility. It is important to examine risk premiums to determine whether or not the investor is being appropriately compensated for the incremental risk.

For fixed income vehicles (bonds), the yield spread to Treasury Notes is a relatively straightforward measure of the risk premium. Investors in high yield (lower quality) debt expect higher returns in terms of yield to maturity, as the risk of default is greater. A variety of other factors come in to play, including general economic conditions and the creditworthiness of the issuer. Because of the potential risk involved, high yield bond investors should expect a fairly significant spread above the yield of a U.S. Treasury Note. When this spread narrows from normal levels, it could be inferred that the price of the high yield debt does not adequately reflect the risk involved and that the buyer of the debt is not receiving a high enough premium to justify the purchase.

Comparing the risk premium of stocks to fixed income securities is more complicated, because the dividend yield represents only a portion of the expected return. To create comparable metrics, one must first derive an estimate of expected total returns for equities. Historical returns offer one simple yardstick, but they do not account for the potential impacts of earnings growth, dividend yields, and changing valuations. As we have repeatedly discussed in *Perspectives,* these components of equity returns are not fixed, and can have a considerable influence on actual returns over a given period of time. Thus, we prefer to derive our own expected return estimates when making asset allocation recommendations.

Another useful measure for comparing valuations across asset classes is the "earnings yield," which is simply the inverse of the P/E ratio. Expressed as "Earnings to Price," this provides a percentage rate figure, analogous to a bond yield, which gives the investor a theoretical indication of what the investor is being compensated to hold a stock. Take, for example, General Electric, which over the last twelve months has earned $1.98 per share, and sells for $37. The P/E ratio is 18.7x, while the earnings yield (1.98/37) equals 5.35%.

In the accompanying chart, we compare the current earnings yields of several asset classes, relative to each other and relative to their respective historical ranges, since 1994. The dots represent the earnings yield today, while the vertical bars indicate the high and low range over the period. The higher the dot resides within the bar, the higher the earnings yield relative to its historical range - and therefore the better the value. By this measure, U.S. large cap equities, international developed equities and T-Bills look particularly attractive, while most fixed income classes (particularly high yield) appear expensive, as do REITs. It should be noted that the earnings yields on equities could be considered conservative, in that they do not reflect the potential for growth of earnings (whereas bond yields are fixed).

The volatility of the stock market itself is also used as a measure of risk. The relatively generous historical returns from equities are often used to justify common stocks as good long term investments, but the volatility of these returns - as recent history illustrates - can be harrowing.

While 2006 was far from a smooth ride for stocks many are concerned about the sharp reduction in volatility in the larger stock indices. According to the Wall Street Journal, the Dow Jones Industrial Average has gone 910 days without a one day decline of 2% or more, the longest such streak since 1942. The Volatility Index (VIX) of the Chicago Board Options Exchange is near record low levels, implying a high degree of complacency among investors. Generally, complacency in the markets is not long lived.

By examining factors such as risk premiums, earnings yields and volatility, we can make informed judgments about asset allocation recommendations. Clearly, risk premiums today are very low by historical standards across virtually all asset classes. Have the policies of Alan Greenspan and the Federal Reserve engendered a "new paradigm" of permanently low inflation? Are emerging market economies immune from economic and political turmoil? Should we be concerned about unusually subdued volatility indicators?

It appears today that the risk of inflation has been priced out of long term bonds, and the risk of default on lower quality or emerging market debt seems to be of little concern to investors. Spreads between high yield debt and U. S. Treasury Notes are near all time lows. Emerging market debt has a spread of only 1.25% over Treasury Notes, down from 2.29% in 2005 and 4% in 2004. This dramatic reduction in risk premiums leads us to conclude that high yield debt is "expensive" and does not adequately reward investors for the additional risk. Further, low real yields offered by bonds in general have led us to maintain lower than normal fixed income allocations, while generous money market rates provide an acceptable parking place for fixed income cash. Conversely, as we have mentioned, our analysis of expected returns, earnings yields and other factors continues to favor equities. Because of the surprising duration and strength of the global economic expansion, recession appears unlikely at this time; but if the economy falters, we believe that large cap, high quality stocks should perform relatively well.

Transitions

John H. Walker
Chairman of the Board

Michael R. Currie
President

Peter E. Robbins, CFA
Chief Investment Officer

William N. Weickert, CFA
Director of Research

John Walker has been named Chairman of the Board. John has been with H.M. Payson & Co. since 1967, and has served as President since 1987. He will remain active in his portfolio management, client service and business development roles. Mike Currie has been elected President. Mike joined the firm in 1997 after 16 years as a trust, estate and tax attorney for Pierce Atwood, and oversees our trust administration function. Peter Robbins has been named Chairman of the Executive Committee and Chief Investment Officer. Pete has been with H.M. Payson & Co. since 1981, and has served as Director of Research since 1995. William (Chip) Weickert has been appointed Director of Research. Chip has been with the firm since 1989, and has played an integral part in the investment research process.

"It is with great confidence that H. M. Payson & Co. enters the new year," says John. "Our realigned structure takes greater advantage of the tremendous depth of experience and talent at the firm. Mike's election as President is reflective of the increased role of Trust and Fiduciary Services at H.M. Payson & Co., while Peter's appointment as Chief Investment Officer honors our legacy disciplines: independent equity research and world class investment management. I am very excited about the future of H.M. Payson & Co."

Adds Mike: "Building on our 152 year history, our entire team of 46 employees will continue to provide our clients with the very best in investment advisory and trust services. We are immensely proud of this firm's heritage, and are committed to maintaining and furthering our standards of prudent stewardship, personalized relationships and superior service."

"Investment research will always be my passion," says Peter. "But Chip's ascension to the Director of Research position will allow me to focus on some strategic initiatives here at the firm while staying involved in research. Under Chip's leadership, our independent perspective will remain the cornerstone of our investment process as we broaden our capabilities to address an increasingly global financial marketplace."

We welcome any questions you may have, and wish everyone a happy, healthy and prosperous New Year.

H.M. Payson & Co.

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