H.M. Payson & Co.

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Perspectives

Wealth Management Update

In our role as investment advisor, we are often asked by clients for assistance with broader and more critical financial issues beyond the management of investment portfolios. These range from relatively common questions about retirement planning and education funding, to more complex tax and estate planning issues. In recent years, we have devoted significant resources to building the capacity and expertise needed to provide our clients with thoughtful and meaningful guidance on such matters.

The Wealth Management Group at H.M. Payson & Co. includes three Certified Financial Planners, three Certified Trust and Financial Advisors, two Certified Public Accountants, and a former tax and estate planning attorney. This array of talent and experience allows us to address a wide range of problems from multiple perspectives and to work closely with outside advisors, so that our clients' financial assets are managed in a manner consistent with their long range goals.

The Importance of a Plan

Achieving financial success is often dependent upon the existence of a plan or structure to guide you. Investment returns on your investments are important, but without a clear vision of how you are going to achieve your goals, good investment returns do not ensure success. Because everyone's goals and situations are different, each plan needs to be individually tailored.

At H.M. Payson & Co., financial planning is a goal-driven process that begins with a full understanding of the individual's financial and personal situation. By gathering an extensive array of information, we can begin to understand the broader picture. In asking the right questions, we can identify the objectives and issues that need to be addressed in order to meet the stated goals.

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After recording data provided by the client, we review and assess assets, liabilities, sources of income, and expenses. We seek to measure risk exposure from many angles, ranging from quality of life (including issues such as disability and long term health care), to financial concerns (spending levels, market risk, inflation, etc.). We examine the client's current and projected financial condition, evaluate the estate structure, and determine whether the investment strategy is consistent with the stated objectives and risk tolerance.

Sophisticated Modeling Tools

An important step in the process is to determine whether existing and prospective financial resources will be sufficient to achieve success within acceptable risk parameters. The typical financial plan offered by most providers today assumes that investments will return a straight-line, fixed percentage each year, using historical market returns for their projections. Reality, as we know, is quite different. While one's cash needs are usually relatively predictable, market returns are not, especially in the short term. Moreover, historical returns may have little or no correlation to future returns, depending on the starting point. How many people planned their retirement in 1999, relying on 15% return assumptions, only to be sorely disappointed? We believe a more sophisticated methodology is called for.

In our work, we begin with estimated return scenarios, produced by our research department, for a wide range of asset classes (domestic stocks, international stocks, bonds, real estate investment trusts, etc.). We then use probabilistic statistical modeling software to produce long term projections based on these returns, factoring in the client's cash needs, savings rate and current financial assets. The modeling software incorporates the inherent short term volatility of the various asset classes, and allows for a range of return scenarios relative to our expectations. The projections are run hundreds of times, each one having a different pattern of returns and a different outcome. This statistical modeling produces a probability distribution, which shows a range of potential outcomes for the client's financial assets, with all of these variables taken into consideration.

Assessment and Recommendations

Our foremost concern in most retirement scenarios is whether there is a meaningful risk of exhausting one's financial resources. The statistical modeling tools allow us to identify the likelihood of failure, and to explore ways in which we can minimize that risk. In some cases, we may recommend a reduction in spending or a later retirement date. In others, we might reduce market risk, recommend inflation protection strategies, and so on. If the outcome indicates a low risk of exhausting financial resources and a strong probability of accumulating substantial wealth, then a host of other issues arise, such as estate planning techniques, charitable and family gifting strategies, and tax planning.

The goal of the initial phase of the planning process is to provide a set of recommendations for improving a client's financial position and increasing the probability of achieving success. Planning with our Wealth Management Group is a cooperative and dynamic process, involving give and take with our clients, their accountants and attorneys. Updates and revisions are performed periodically to incorporate changes in circumstances and goals. A critical component in the process is follow-up, so that the planning and investment work stay current with the client's changing circumstances.

If you are wondering about retirement, anticipating an inheritance, contemplating the sale of a business, have questions about your estate plan, or would like guidance on any financial issue, we welcome the opportunity to be of assistance. Although these services are intended primarily for existing advisory clients, we are pleased to provide consultations to prospective clients as well. Please ask for John Beliveau.

First Quarter Jitters

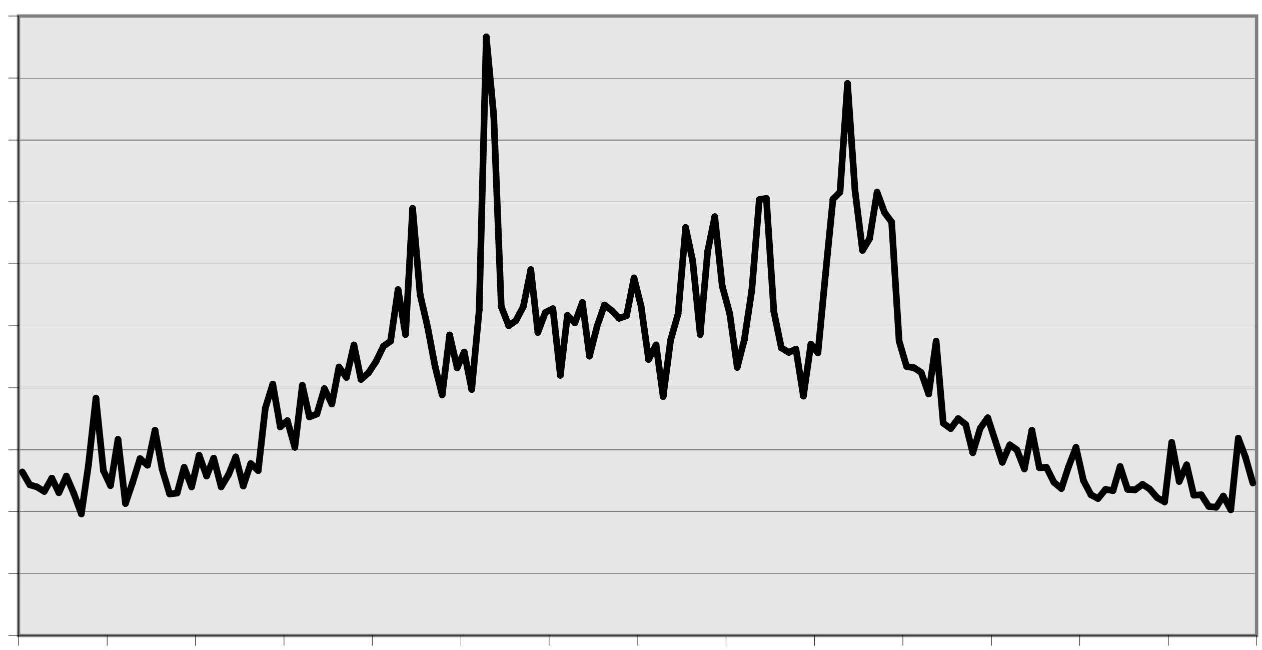
After an unusually long period of relative calm, investors were treated to a healthy dose of uncertainty in the first quarter of this year. February's big declines were initially attributed to a sell-off in Chinese stocks, but rapidly growing concerns about the financial repercussions of the real estate collapse here in the U.S. have quickly become the focus of investor angst. Although the 856 point swing (intraday) in the Dow Jones Industrial Average made lots of headlines, the 7% correction and subsequent volatility were probably long overdue. For all the hand-wringing, the major indices ended the quarter occupying virtually the same ground they held as the year began, and have since recovered the bulk of February's losses.

Until mid-February, 2007 was off to a roaring start. Despite a clearly slowing real estate market, strong corporate profits helped stocks sail through "earnings season." S&P 500 earnings came in 11% higher versus the year-ago quarter, and 16% higher for the full year. By February 22nd, the Dow, S&P and NASDAQ were up by 1.7%, 2.8% and 4.2% respectively. Foreign markets enjoyed similar gains. Then, on February 27th, the Chinese stock index plunged by 10% in one session, as the government signaled its intention to curb some of the financial excesses that were seen as potential threats to economic stability. The reaction was a classic symptom of a speculation-driven market, and the selling spread across the globe. The MSCI Emerging Markets index lost over 8%, while U.S. losses the following day were more measured (3.5%. on the S&P 500).[1]

Subsequently, fears of a potential economic slowdown in the U.S. have been building, with housing leading the way. The term "subprime" has made its way into the American lexicon almost overnight, with daily reports of losses and bankruptcies at mortgage lenders who had enjoyed stratospheric growth for the past several years by eagerly extending credit to high-risk consumers. Although the troubles in this particular segment of the financial industry have surprised very few, the bigger question has become the extent of the eventual impact on the rest of the economy. On this point there are more opinions than space will permit here – and the fact is, no one yet knows. Whatever the outcome, this turn of events has merely provided the fuel for the fire at a time when conditions for a return to more normal levels of market volatility were ripe.

Until February's selloff, the S&P 500 had not seen a decline of more than two percent in 949 days - the longest stretch since the 1950s! This extended period

Volatility Index, 1993-2007(YTD)



Source: Thomson Baseline

1 Source: Thomas Baseline

of low volatility underscored the longevity and consistency of the current bull market (beginning in late 2002), which is now one of the longest in modern market history, exceeded in length by only four previous advances. This low volatility had been reflected in a widely-followed barometer called the CBOE Volatility Index, or VIX. The VIX measures price movements on a basket of equity options, which reflect investors' expectations for near-term price volatility. The current VIX contract began trading on the Chicago Board of Exchange in 2004, but data from its predecessor is available from 1986.

The accompanying chart shows why the VIX is commonly referred to as the "fear index." The VIX moves inversely with stock prices, with disproportionately large jumps during market declines. A commonly invoked rule is "when the VIX is high, it's time to buy," which would appear to be good advice given the spikes in 1987 and 1991 (not shown here), 1998 and 2002. Unfortunately, the corollary (a low VIX indicating a Sell signal) does not appear to hold, as periods of relative calm in the market can persist. Although complacency in the market should make every good contrarian nervous, studies have shown that purchases timed to coincide with low VIX levels have not systematically produced superior returns.[2]

For the past few years, the VIX has been trending steadily lower, and in January it touched record low levels. February's market correction is reflected in a noticeable jump in the index, though it is far too early to say whether this portends more volatility ahead. It is important to remember that the VIX is not predictive, in that it reflects price movements that have already occurred; thus, if the VIX does spike, the damage will have been done - thus creating the buying opportunity.

In our last issue of *Perspectives* we examined valuations for a broad array of asset classes, and concluded that large-cap U.S. equities were the most attractively valued investment today. Given the macroeconomic backdrop of a global expansion with modest inflation, a severe decline in domestic equities appears unlikely at the moment. Rather, it would seem that recent market jitters are simply a return toward more normal levels of volatility, triggered by whatever external factors that happen to give traders a reason to sell. We continue to be reassured by the generous earnings yields offered by the common stocks of numerous high quality companies.

2 Source: investmentu.com

H.M. Payson & Co.

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