H.M. Payson & Co.

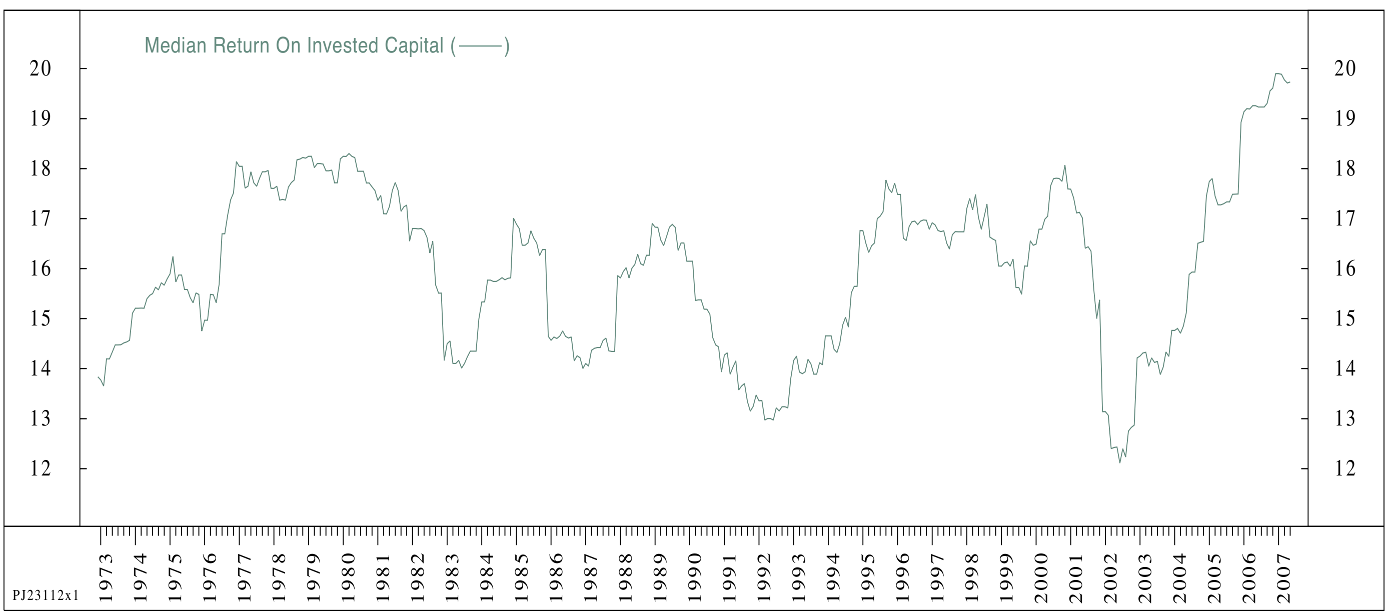
QUARTERLY INVESTMENT PUBLICATION ◆ SUMMER 2007

PERSPECTIVES

Peak Profit Margins: Portfolio Implications

We remain cautiously constructive on equities generally, notwithstanding their very strong total returns over the last four years. Despite a 71% advance in the S&P 500 since 2002, operating earnings for the companies in the index have almost doubled over the same period, resulting in still reasonable price-earnings ratios. Today, corporate profitability hovers near sixty year highs - yet a closer look at this earnings growth reveals issues of potential concern. We expect macro and microeconomic factors will conspire to drive profit margins and earnings growth lower, probably sooner than later.

S & P 500 Companies



Since we emerged from the last recession in 2001, businesses have enjoyed very strong demand in this global economic recovery and resulting commodities boom. Net profit margins for US companies are up 30%, and (as shown in the graph above), return on capital for the S&P 500 is up 40% since 2002. During this time, economically-sensitive companies have benefited most from broad pricing power and strong unit growth.

Additionally, at the beginning of the decade - in the wake of the tech-wreck of 2000, the 2001 recession and the terrorist attacks - corporations behaved very cautiously in their commitments to new capital investment, which resulted in strong earnings leverage to the existing capital base at the beginning of this upturn. Very low real interest rates provided smaller or less well-capitalized companies an opportunity to strengthen their balance sheets and reduce their cost of capital, further enhancing profitability. The obvious risk to this cyclical earnings boom is that the elements of earnings leverage cut both ways. Higher interest rates and/or a slowing economy

	Return on Capital (ROC)	5 Year Avg. ROC	Earnings Stability R^2	5 Year Dividend Growth Rate	Dividend Yield (Indicated Rate)	Price/Earnings (LTM)
Notes:	1	2	3	4	5	6
HMP Core Model	20.0%	18.4%	0.84	18.5%	1.9%	17.2x
HMP Growth of Income Model	19.0%	18.2%	**0.88**	20.5%	2.0%	17.5x
HMP Total Return Model	**21.4%**	**19.6%**	0.86	**22.7%**	1.8%	**16.7x**
S & P 500	15.2%	12.7%	0.77	14.2%	1.8%	19.6x
S & P 500 Growth	19.1%	16.9%	0.86	17.5%	1.3%	20.8x
S & P 500 Value	11.4%	8.9%	0.69	11.5%	**2.3%**	18.5x

1. Return on Capital is a measure of profit in dollars generated by the firm's total invested capital (Shareholder Equity + Long Term Debt)
2. Average of 5 full fiscal years of return on capital
3. This value measures the deviation of a company's earnings from its historical earnings growth rate. (An R^2 of .99 would indicate that a company has a constant growth rate
4. Annualized rate of change in dividends (excluding special dividends) over the past 5 years
5. $\frac{\text{Latest Dividend x Dividend Frequency per Year}}{\text{Current Price}}$
6. $\frac{\text{Current Price}}{\text{Sum of Latest 4 Quarter's Earnings}}$

Data Source: Thomson Baseline, H.M. Payson & Co. Research Dept.

could pose a problem for the same companies who have enjoyed the strongest earnings gains.

We also see a fundamental microeconomic reason to assume that current strong profit margins are unsustainable. Empirically, profit margins revert to an average level over time. Theory and practice suggest this should be the case. During periods of lower profits corporations have little incentive to invest net new capital, which sets the stage for healthy earnings leverage when economic conditions improve. On the other hand, large profits will attract further competition and new capital, driving profits on all capital lower until profits are no longer high enough to attract more capital. This is capitalism at work!

Corporate managements talk about capital discipline and about being good stewards of shareholders' capital. In every profit cycle, however, corporations tend to increase capital expenditures to meet increasing demand. Or, to maintain their position in the marketplace, managements are compelled to increase capital expenditures if their competition invests in new plant, equipment or research. Indeed, today we are seeing significant increases of new capital investment in the Materials, Industrial, Technology and Energy sectors. Over time, real earnings growth requires an increase in the real capital base of corporations generating this earnings growth. However, in the shorter-term it seems reasonable to expect that large investments of net new capital could depress overall returns on capital for the S&P 500.

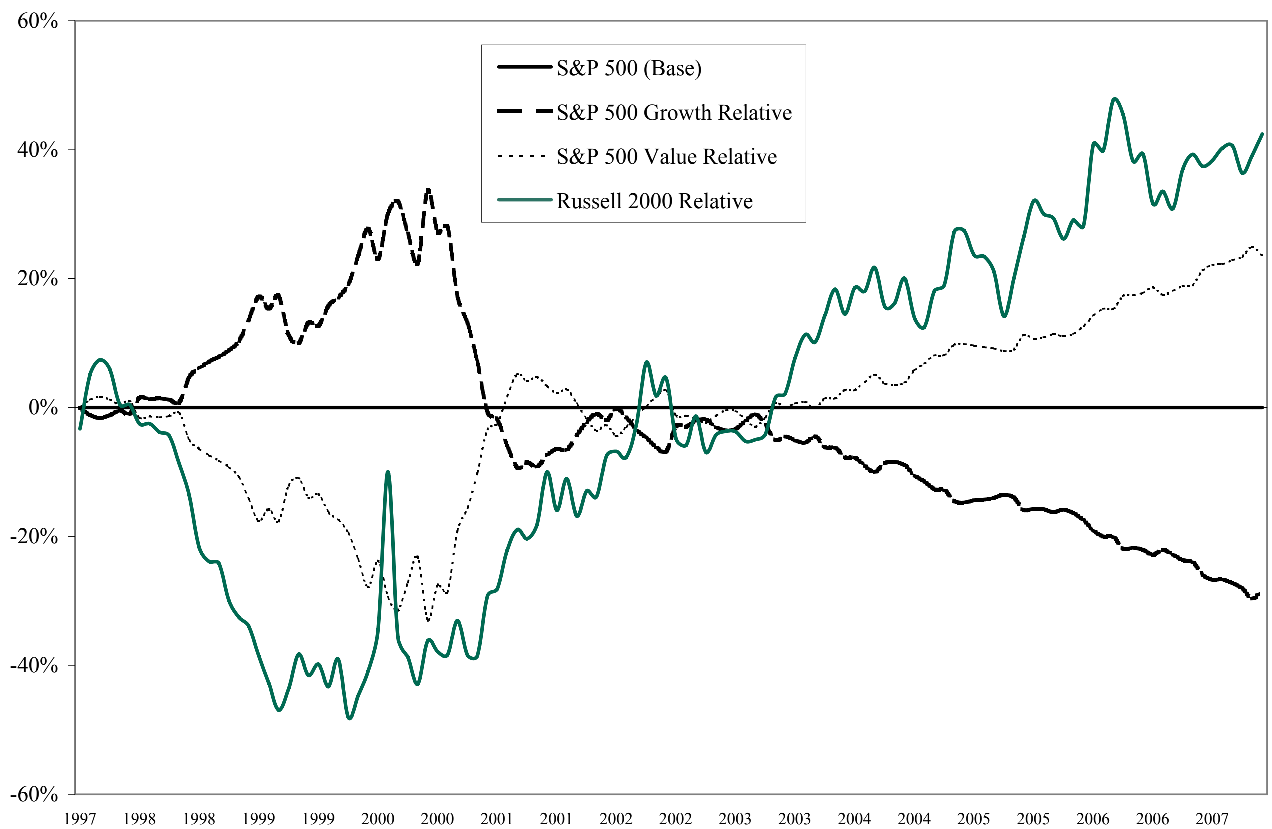
We believe our portfolios are well-insulated against the likelihood that profit margins will come under pressure. The table reflects the vastly superior earnings quality, stability, margins and dividend growth embodied in our portfolios compared to the S&P 500. Moreover, our model portfolios all provide at least the same current yield as the S&P 500 and trade at meaningfully lower multiples of trailing earnings - which is a very important metric in the risk/reward equation.

For the entire list of model portfolios and S&P indexes in the table, trailing one-year returns-on-capital are higher than their five-year average return-on-capital. However, our portfolios are operating at a lower multiple of significantly higher five-year margins. So, when the downturn in profitability comes, earnings for the S&P 500 and smaller-stocks, generally, seem likely to be impacted to a far greater extent than our higher quality portfolios.

There is another important element to this discussion. The graph below shows the price performance of the S&P 500 Growth and Value indices, as well as the Russell 2000 (a proxy for the performance of smaller stocks), relative to the S&P 500. Obviously, much of the relative stock market strength in smaller and/or cyclical companies has been driven by strong margin improvement and above-average earnings growth. However, we believe the market has essentially "double-counted" this strong earnings performance by according these more economically-sensitive companies higher PE's on earnings we view as unsustainable. As cyclical margins revert to normal levels, we expect the market will come to appreciate the high and stable margins of companies such as those in our portfolios.

As predictably as profit margins revert to a mean level, trying to predict *when* this profit cycle will end is treacherous. Still, the much publicized problems in the so-called sub-prime debt market may turn out to be the "canary in the coal mine" for capital markets and for the economy, which has been driven by an abundance of cheap corporate and personal debt. Indeed, today we see rapidly deteriorating credit conditions for consumers and corporations alike, both in terms of higher real interest rates and more stringent lending standards. This much less favorable monetary environment can only serve to raise the cost of capital to corporations and test what has been a remarkable resilience among consumers - which, taken together, could slow the economy and dampen profitability.

In the meantime, the companies in our portfolios should continue to produce generous free cash flow and growing earnings which they can use to maintain stock buy-back programs and/or to keep raising dividends. At attractive multiples of these high-quality earnings, we're confident our portfolios are well-positioned to provide healthy total returns compared to the overall market and other asset classes such as bonds and cash.



Sources: Standard & Poors and
Frank Russell Company

Payson Fund Update

Since 1992, H.M. Payson & Co. has served as investment advisor to two mutual funds: the Payson Value Fund and Payson Total Return (formerly Balanced) Fund. These funds have provided a convenient and efficient solution for clients seeking to diversify and avail themselves of our management services, in situations where a separately managed advisory account is not practical (typically, for more modest amounts of capital). The funds have been ideal vehicles for IRA accounts, gifts to minors' accounts, or individuals in the early stages of accumulation.

In 2006, we initiated the process of merging the two funds in order to reduce operating expenses which are borne by the shareholders. This merger was completed earlier this year, and the combined fund exists today as the Payson Total Return Fund. As the name implies, the fund maintains a versatile approach to asset allocation (the mix of stocks and bonds), giving us the flexibility to adjust to market conditions and invest where we see the most favorable opportunities. Looking ahead, as discussed above, we are encouraged by the current positioning of the portfolio in high quality domestic equities.

Please ask your portfolio manager for more information, including a prospectus, if you think the fund may serve a specific need for you.

Before investing you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the prospectus, which is available upon request. Please read the prospectus carefully before you invest.

H.M. Payson & Co.

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