H.M. Payson & Co.
QUARTERLY INVESTMENT PUBLICATION FALL 2007

PERSPECTIVES

Actions Speak Louder Than Words

For those who wait by their mailbox for each issue of *Perspectives,* you'll notice we're a little late. It's not for a lack of trying, but the events of the past eight weeks or so have been unfolding at such a dizzying pace that the conclusions to be drawn are changing with each day's headlines. Although the stock market quickly recovered from the August lows, the increasingly alarming stream of damage reports from the credit market turmoil provides more reason for careful thought and reflection. As believers in the benefits of owning equities and skeptics of market timing tactics, we're certainly pleased by higher stock prices. Yet, we wonder whether recent actions by the Federal Reserve and Treasury Department are an indication of policymakers' unspoken concerns. In this light, the stock market's rapid recovery and the retrenchment of credit spreads may have been prematurely sanguine.

Housing Woes Worsen

August's stock market correction was brought about by more waves of worrisome data on housing, and troubling revelations about bonds backed by mortgages. It seems that none of the parties involved in the creation and proliferation of the mortgage-backed securities market (mortgage brokers, investment banks, rating agencies) had properly quantified the risks of a decline in home prices. But the risks have been made very clear in recent months as a decline has in fact occurred. As home prices skyrocketed over the past few years, many borrowers increasingly saw the adjustable rate mortgage structure as the only solution to an affordable monthly payment. As everyone now knows, these mortgages re-set to a higher fixed rate after an initial period. The simple way around the anticipated higher monthly payment, folks were told, was to refinance when the re-set came along, and take out another ARM. Unfortunately, refinancing requires equity; and when prices decline, equity obtained through leverage evaporates! Thus, with the refinancing option off the table, many borrowers (sub-prime and otherwise) have begun to default.

The Mortgage Bond Market

For the past twenty years or so, most mortgages have been packaged into bonds and sold to investors, making the mortgage-backed segment a large component of the global bond market. In a low interest rate environment, investors of all shapes and sizes eagerly snapped up these instruments, which typically offer higher rates than Treasuries or investment grade corporate bonds. The bonds are segregated into "tranches" of quality, to – ostensibly - allow investors to discern between higher and lower risk pools. The problem is that in many cases the rating agencies misjudged the risks, and mushrooming defaults have impacted the values of numerous issues – including some tranches that received "Aaa" ratings.

There is a large and liquid secondary market for these bonds, which has now been thrown into turmoil. The problem is that no one – not even the erstwhile sophisticated market participants such as hedge funds - knows which bonds are at risk and to what extent. Without an appropriate measure of risk, prices have plummeted, or bids disappeared completely. As this market began to freeze up in August, banks were having difficulties selling mortgages and other "asset backed" loans into the market, which tied up their capital and hindered their ability to make loans. A smoothly functioning credit market is the oil of our modern economy, and the situation quickly became a concern.

Structured Investment Vehicles

In the meantime, another less publicized phenomenon was taking place in the more obscure corners of the hedge fund world: the collapse of the SIV. Structured Investment Vehicles were the relatively recent brainchild of two London bankers who began their careers at Citigroup. SIVs are typically established as third party investment funds that purchase a variety of longer duration asset-backed and corporate bonds, and are generally funded by the issuance of short term commercial paper. The investment model for the typical SIV is to borrow short (sell commercial paper) and lend long (buy longer duration asset backed debt).

In a normal yield environment, when short term rates are lower than long term yields, the spread between the SIV's cost of capital and its investments represents profit potential. Aiding the spread is the sponsorship of some SIVs by large U.S. and European banks. Issuing commercial paper backed by the creditworthiness of the banks, the SIVs enjoy lower borrowing costs. In the perfect world, SIVs issue (and roll over every 30, 60 or 90 days) highly-rated commercial paper to fund longer duration purchases. They capture the spread, split it between the owners and sponsoring bank, and everyone wins. Through the use of leverage, the SIV owners and investors enjoy generous returns, and the banks enjoy fee income from assets that do not show on their balance sheets (thus avoiding some capital requirements and regulatory scrutiny). As one might expect, assets in these vehicles ballooned, mostly in Europe and the Canary Islands.

As we have seen repeatedly through history, financial ingenuity and greed are often a dangerous combination. The interest rate environment since 2005 has been anything but normal. The Federal Reserve and other central banks raised short term rates, while long term yields have held steady - and at times have been *lower*. With a flat-to-inverted yield curve, profits evaporated for SIVs seeking to match short term borrowings to longer term assets of *comparable quality*. Thus, in desperation many resorted to lower quality, longer duration instruments, including sub prime mortgages.

Almost overnight, by virtue of some staggering losses, this esoteric corner of the financial markets has been thrust into the spotlight. The potential magnitude and implications of the losses began to appear through the commercial paper market, which is a large and important cog in the global liquidity system. When two Bear Stearns & Co. hedge funds collapsed in June, and concerns were raised about other unknowns waiting in the wings, investors began to shun asset backed commercial paper as these obligations rolled over. In the course of just a few weeks, a $1.14 trillion market declined to $899 billion, a decline of twenty one percent.

The dislocations in the bond market and huge portfolio losses recently disclosed by several major financial institutions are a concern for two reasons: first, the global economy depends on smoothly functioning U.S. credit markets, and there is much more at stake here than the perceived comeuppance for a few greedy mortgage brokers and banks; second, as financial institutions adjust the market value of their holdings, losses of the magnitude we are witnessing could impair the ability and willingness of banks to make loans (and in the case of SIVs, the commercial paper market to function).

Fed and Treasury Response

Much has been written and said about the "moral hazard" faced by the Federal Reserve. That is, any move to rescue financial institutions and investors could reward bad decisions, prolong any necessary cleansing of the system, and possibly make the eventual remedy even more painful. With this dilemma so clearly in view, the Fed's decision in September to cut interest rates by a full 50 basis points surprised many observers.

The Treasury Department's response to the SIV situation has been equally intriguing. Treasury Secretary Paulson dispatched a team to broker a solution, enlisting the participation of Citigroup (reportedly, the most exposed), J.P. Morgan and Bank of America. The bold stroke arising from these deliberations was the creation of a "Master Liquidity Enhancing Conduit" or MLEC. The MLEC will be funded with approximately $100 billion from these and other banks. The details are still being worked out, but the reported objective is to cushion the anticipated disruption in the commercial paper market in November, when tens of billions of dollars of asset-backed SIV paper is scheduled to mature or roll over, by providing a ready buyer for the more creditworthy assets. Although some SIVs hold higher concentrations of bad loans, most hold a mix of good assets and "junk." The hope is that the existence of this conduit will prevent a free fall in the prices of the solid assets and a potential impairment of U.S. bank capital structures.

Bailouts, or Triage?

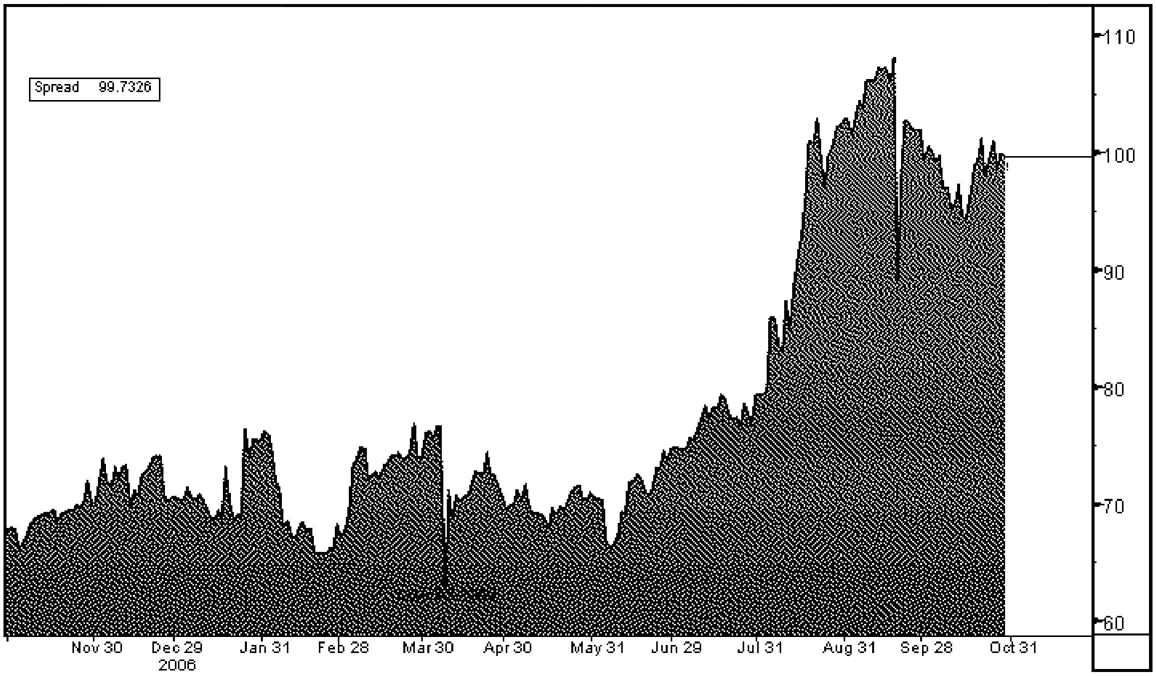
Although the government's response to these two distinct but related crises initially calmed financial markets, it has been the subject of a great deal of criticism and second-guessing. The Fed's quick and decisive action caused many to question Chairman Bernanke's resolve and motivations, particularly in this period leading up to an election year. Had he changed his focus from fighting inflation to artificially prolonging up a sustained period of prosperity? Surely, lower U.S. interest rates will only exacerbate dollar's slide, most agree. The SIV rescue has also garnered criticism, and has been widely viewed as yet another bailout of the avaricious and unfettered hedge fund industry. There is deep disdain among the public for seemingly limitless Wall Street greed, and most free market proponents would have preferred a good cleansing of the system.

We suspect a more nuanced view of these actions is appropriate. Chairman Bernanke's decision to cut rates, knowing the consequences (both political and economic) of such a controversial action, amounts to an unspoken acknowledgement of the risks the current crisis poses to the economy. The Fed Board of Governors is not a political body per se, and has access to much more data than the rest of us. Something in that data must have raised the level of concern to the point where the risks of taking no action had overshadowed the risks (and criticism) that would accompany an easing of monetary policy. The heightened level of risk to the economy would appear to be confirmed by last week's additional quarter point rate cut. Similarly, the Treasury Department's involvement in routine financial market operations is unusual. Secretary Paulson, a highly regarded Wall Street veteran, must also have been sufficiently anxious to avoid a crisis to take on the political risks of intervention. In fairness, we would point out that Treasury is only indirectly involved in the formation of the MLEC, and bad assets will still have to be written off by holders. Critics looking for a cleansing of the system will get their wish, to some degree. The hasty departures of Merrill Lynch CEO Stan O'Neal and Citigroup Chairman Chuck Prince may be just the beginning.

Implications For Our Portfolios

Only time will tell whether the Fed and Treasury actions were appropriate or sufficient. For the time being, financial markets have been calmed somewhat. But the housing decline and credit market dislocations have advanced to the point where credit

Credit Spreads Begin to Widen



10 Year AAA Corporate Bond Yield Spreads to US Treasuries
Source: Bloomberg

will undoubtedly be restricted at the margin, putting additional stress on the already long economic expansion. These conditions could usher in the retrenchment of corporate profit margins that we and other market observers have been anticipating.

On the other hand, the global economy is indeed strong, interest rates are low, and the banking system is in much better shape than it was during the 1991 recession. Companies with strong balance sheets and access to liquidity will fare well, while smaller, less stable concerns with limited (or costly) sources of funding access may not. This situation plays into the strength of our current portfolio approach, focusing on larger, global, less economically-sensitive companies with relatively predictable cash flows.

For the bond markets, further rate cuts and a steepening yield curve would appear likely. We have been surprised at the degree to which yield spreads (between Treasuries and lower quality issues) have narrowed after an initial spike in August, as shown in the chart above. We suspect the credit market will continue to price risk more appropriately as events unfold, and look for spreads to widen further.

H. M. Payson & Co.

A FOUNDATION OF TRUST – FOR 150 YEARS

ESTABLISHED 1854

A MAINE TRUST COMPANY &
REGISTERED INVESTMENT ADVISOR

One Portland Square, Portland, Maine

(207) 772-3761 800-456-6710

hmpayson.com