H.M. Payson & Co.

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RESEARCH NOTES

BEAR STEARNS: A CRISIS OF CONFIDENCE **MARCH 17, 2008**

The rapid succession of events in the financial services sector over the course of the last few days is one of the most significant in memory. For long-term investors, now is not the time to panic, given the steep declines in many stocks already. In the near term however, we expect more volatility in the capital markets. The potential for further failures in the financial sector still exists as weaker companies remain vulnerable.

The forces behind the demise of Bear Stearns, the nation's fifth largest investment bank, will influence the world of finance for some time to come. That being said, the bank's collapse and the resulting impact on the industry is a natural market response to the excessive build up of debt that has occurred over the last several years. The painful deleveraging process we are now going through is in many respects a sign of a functioning capitalist system (albeit, with a level of government intervention not seen since the Great Depression), and should ultimately arrest the deterioration of credit conditions.

Successful restoration of confidence will depend on a fully coordinated response from the Fed, US Treasury, global central banks, and perhaps Congress. Domestically, investors need some assurance that home prices will stabilize, and that the short-term liquidity problems that plagued Bear Stearns will not spread to other institutions. There is no denying financial institutions have incurred substantial losses from bad investments and excessive leverage, but the biggest concern in the short run is the crisis of confidence that has ballooned in recent days. For the moment, the best hope is that the Fed's latest actions will begin to sow the seeds of a recovery. Perhaps the demise of a proud institution like Bear Stearns will be the cataclysmic event that marks a turning point in this turbulent episode.

Although we believe confidence will return, we do not discount the significance of these events. Nevertheless, such periods often create opportunities for patient investors. We have been strategically underweight financial services stocks in client portfolios over the last several quarters, anticipating a slowdown in earnings and a heightened level of balance sheet uncertainty. At the same time, we have maintained a focus on companies with higher quality earnings and cash flow streams and healthy profit margins. This approach, along with an emphasis on companies with international exposure, has helped our results relative to the major U.S. indices.

While the headlines focus on Wall Street's problems, much of our economy is faring reasonably well through this slowdown. Just this past week for example, Caterpillar Tractor raised its earnings guidance, citing strong global demand for its products. Despite a slowing US economy, global growth remains generally healthy, which, combined with a weakened dollar will support our export economy. Even in the financial sector all is not lost, as turmoil creates both winners and losers. Basic loan demand will continue, and higher quality financial institutions will be in a position to pick up market share from weaker lenders.

In this volatile and unpredictable period, our approach to tactical portfolio changes will be measured and highly selective. As is always the case, we will continue to look for opportunities to enhance portfolio characteristics and build investment value for the long run.

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