H. M. Payson & Co.

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Perspectives

Grow with Earnings

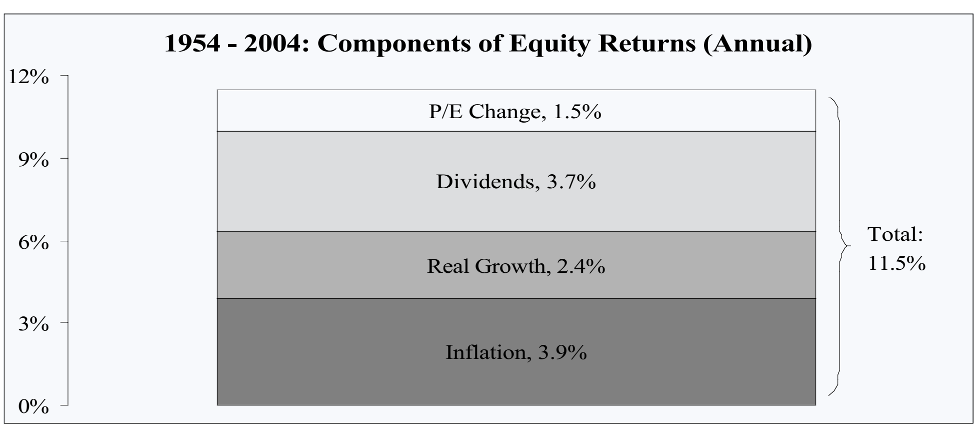
Most people who own stocks would say they are "long-term investors". Yet, why are so many investors compelled to check their stocks' prices every day? And, if equity mutual funds are truly seeking "long-term growth", as most purport to be in their prospectuses, why does the average annual turnover in mutual funds approach 100%? All the attention investors and the media devote to short-term market fluctuations completely misses the point of being invested in stocks.

Since equity returns are highly unpredictable, the academic and practical notion of investment risk is that our portfolios might be worth less tomorrow, next quarter, or even a year from now. But, as long-term investors, this shouldn't be our first concern. Rather, over time our primary objective is to keep the principal value of our portfolios and our dividend income growing at least as fast as inflation, and hopefully a little faster. Therefore, short-term price volatility is not a good proxy for the most important risk we confront.

So, how does owning equities help us meet our long-term objective of keeping up with inflation? It's all about growing earnings! Current and growing earnings provide the primary source of equity returns. Dividends are paid out of earnings; and retained earnings help fund future earnings growth. Over time, earnings have grown faster than inflation – providing our portfolios a critical measure of protection against a loss of purchasing power since stock prices ultimately follow earnings as they grow. It's really earnings per share (and dividends paid from earnings) that give stocks their value.

For example, between 1953 and 2004[1], earnings for the S&P 500 increased 2250%, or 6.3% per year. Over the same span of time, inflation increased 600%. We can break down the 6.3% annual earnings growth into its two components: inflation, which accounted for about 3.9% per year, and earnings growth above inflation, or "real" growth, which was 2.4% per year.

Over the whole period, stocks returned a total of 11.5% annually – so earnings growth contributed 55% of the total return – which, again, includes the effects of inflation on company earnings, as well as some growth *above* inflation. Dividends contributed another 3.7% per year, or 32% of the total return; and higher prices for earnings (expanding price-to-earnings multiples) accounted for only 1.5% annually, or just 13% of the overall return from stocks over this period.

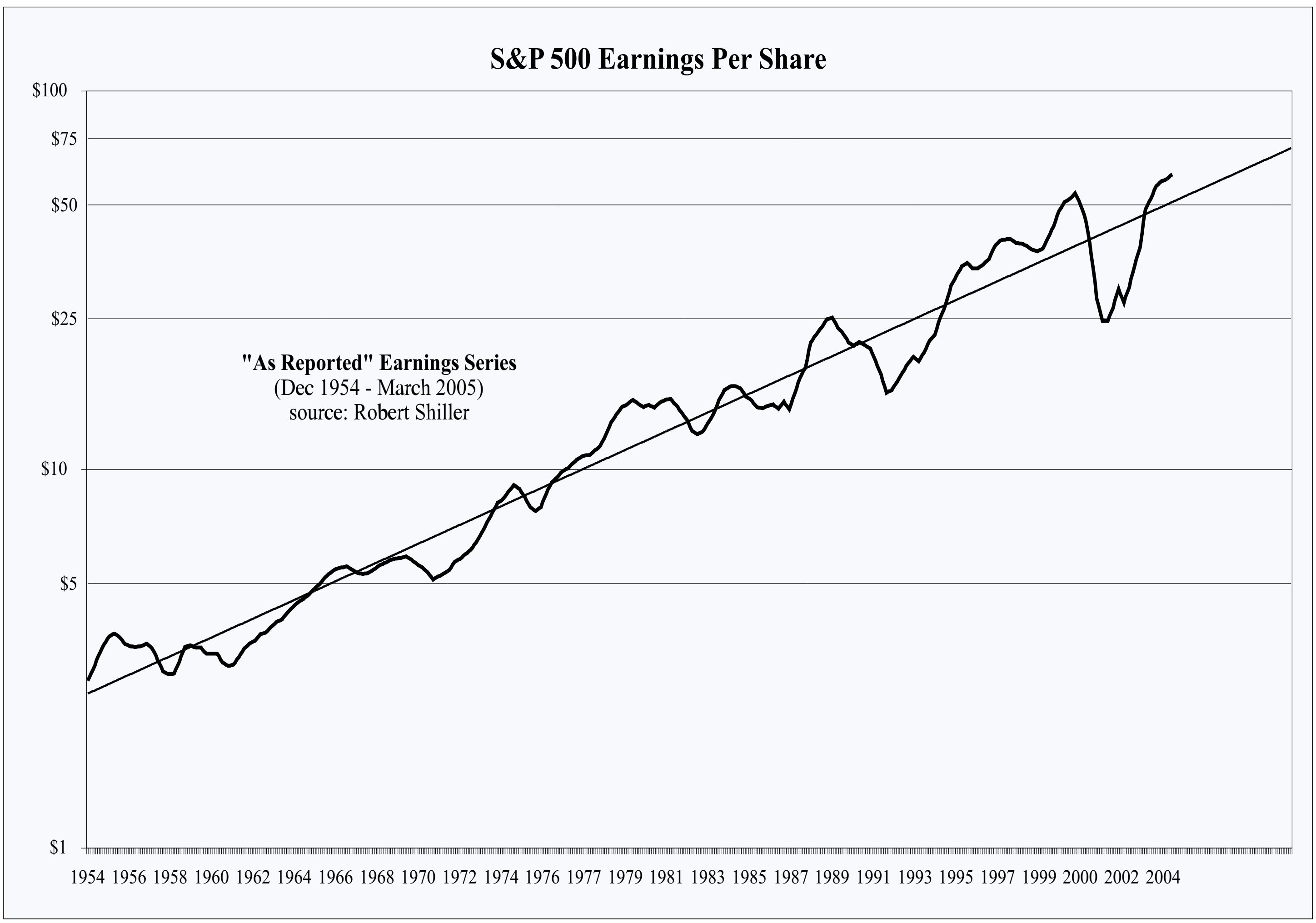


[1] We focus on the post-WWII period since it was around this time dividend yields moved below bond yields where they remain. However, longer periods of time render quite similar results in the decomposition of equity returns.

What makes the earnings story really compelling, however, is how *persistent* the growth of earnings has been over time. As you can see from the graph below, earnings move closely around a trend-line growth rate of about 6.1%. Statisticians use the term "R-squared" to measure the strength of a trend, with an R-squared of 1.00 describing a straight line. Long-term growth of historical earnings for US stocks has persisted with an R-squared of 0.96, a remarkably stable and predictable rate of growth! This powerful trend in earnings growth should give our daily-price watchers something to feel good about!

To be sure, there have been some difficult periods for earnings, especially real earnings after inflation. The worst five-year stretch for earnings in the last 50 years was 1977 - 1982, a period that embodied our economy's last full-blown recession, when real earnings dropped 26% [2]. On average, however, over five-year holding periods since 1954, earnings have grown 36%, and 11% higher than inflation – a pretty strong tailwind and a compelling reason to hold stocks. Moreover, earnings growth has been positive in each of the ten five-year holding periods over the last 50 years; and real growth was negative in only *one* of these periods. Importantly, earnings growth consistently comprised the largest portion of the total return stocks provided over these relatively short time frames of just five years.

Clearly earnings growth has been much more stable and predictable than stock *prices;* which brings us to a crucial point. As reliable as earnings growth has been at driving equity returns, we must always be mindful of what we



2 Earnings including inflation were still *up* 16% - but inflation for the period was 57%!

pay for a dollar of earnings. An historical case in point would be 1966-1981, a dismal 16-year period for large-capitalization US equities during which they returned 5.9% per year (but -1.1% after inflation), even though earnings growth essentially matched inflation, increasing almost 200%, or roughly 7% annually. Smaller stocks, on the other hand, returned 14.1% per year over the same period. The difference resulted from the fact that smaller stocks were trading at much lower multiples of their earnings than their larger brethren at the beginning of the period[3]. More recently the lackluster market returns of the last five years resulted from the excessive valuations of the late 1990s. This period serves as a fresh reminder that the price one pays for earnings can be an important determinant of future returns.

In our investment process we strive to buy quality earnings and dividends at attractive prices. We don't constrain our portfolios to Large or Small stocks, or abide by a "Value" or "Growth" style (however one chooses to define these). Rather, we believe every market presents opportunities. Typically, we find them in stocks not currently in favor, trading at reasonable multiples of their earnings, and possessed of strong fundamentals the market might be overlooking.

Over the last two years we have been in a bull market for earnings. Since 2003, earnings for the market have increased 32%. Yet P/Es have gone from 21 times earnings to 17 times earnings as the market seems to be expecting earnings growth to slow. Taken together, recent earnings growth and contracting P/Es have conspired to produce a 25% headwind over this period. Today the good news is that we find the stocks of many large, established companies very attractively priced given their exceptional balance sheets, stable margins, strong free cash flows and high quality earnings. These companies should continue to perform well, especially if the economy were to slow, adversely affecting the fortunes of companies with more volatile, economically sensitive fundamentals.

Our focus on high-quality earnings is particularly important since inflation is on the rise, as we've been anticipating. We've been diligent about inflation's return owing to the steady rise in commodity prices and the poor fundamentals for the dollar. While it's true that rising inflation poses a heightened risk to equity prices, in the intermediate term we expect corporate earnings will reflect and embody this higher inflation. Already several consumer product companies have announced plans to raise prices to help preserve their margins in the face of higher raw material and transportation costs.

For most of our clients, preserving the purchasing power of their capital is their paramount objective - so too, the potential loss of purchasing power is their greatest risk. Therefore, in the current investment environment we believe it is important to concentrate our portfolios in the highest-quality real assets, such as large-capitalization stocks, whose stable and growing earnings should provide some haven against the long-term effects of continued higher inflation.

3 A period in the annals of market history known as the "Nifty 50 Era" wherein the largest 50 stocks went to extraordinary valuations before falling precipitously in the ensuing bear market of the mid-seventies.

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