H.M. Payson & Co.

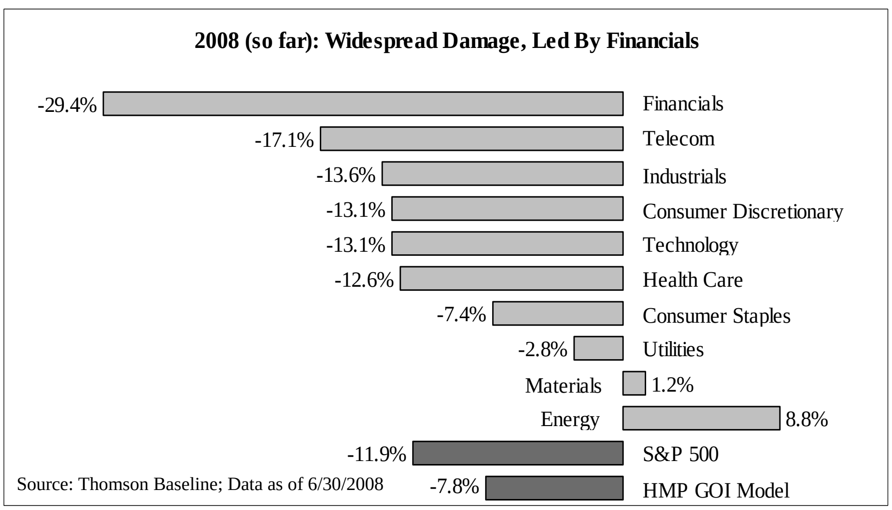
QUARTERLY INVESTMENT PUBLICATION ♦ SUMMER 2008

PERSPECTIVES

Weathering the Storm

***"Economic progress, in capitalist society, means turmoil."* - Joseph A. Schumpeter**

Ordinarily, we are inclined to call attention to the silver linings in the clouds that periodically gather over the markets. But if you feel badly about the state of the economy and the markets today, we're not going to deny you that right. For the first time in a while, we will admit that it feels bad, because it *is* bad. Oil continues to trade at new highs on almost a daily basis… gasoline is now well above the $4 mark… the housing market is still in decline, and (largely as a result of housing) the banking industry continues to announce billions of dollars in write offs, dividend cuts, lay-offs and capital infusions. Last week's employment data showed some acceleration in job losses, increasing the odds of a prolonged recession.



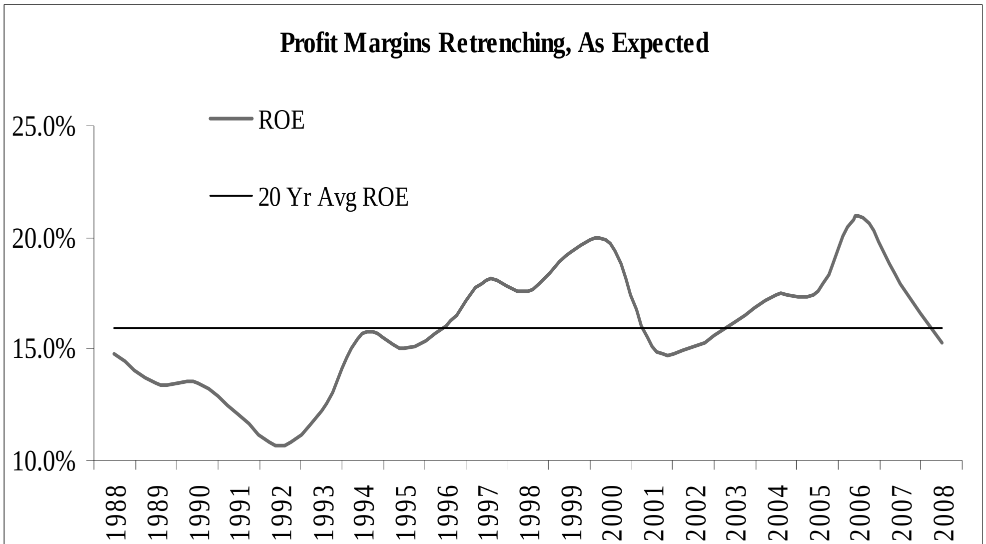
For the year so far, the S&P 500 index is down 15%, and 20% since October – officially in "bear market" territory. Until recently, the market had been remarkably resilient in the face of so much bad news; but after a brutal June (the worst since 1930), the S&P turned in the worst first half-year since 1970. These issues are real, and the path forward seems less apparent than in other recent market downturns. Nevertheless, while acknowledging the seriousness of the current situation, we believe we can offer a credible framework for coping, as well as a token dash of optimism for good measure.

We were struck by a recent piece from our friend, prolific author and renowned investor, Peter L. Bernstein. In his July edition of *Economics and Portfolio Strategy*, Bernstein urges us to remember the eminent economist Joseph Schumpeter's principle of *creative destruction* when digesting the daily headlines. Bernstein's advice serves as a cogent reminder that capitalism – by far the most vibrant and productive economic system known to man – does not guarantee or even suggest an equilibrium state of prosperity for the population or for investors; rather, by its very nature, capitalism is characterized by a "gale of creative destruction." Though unsettling, what we are witnessing is a global redeployment of capital to more efficient uses, and a significant reassessment of risk.

Because we are skeptical of the efficacy of market timing strategies, our emphasis is on being as prepared as possible for these developments within a fully-invested posture. As a case in point, we refer to our Summer 2007 issue of *Perspectives*, when we discussed the potential for profit margins, then at record levels following a five year economic expansion, to decline. We explained our approach to reducing our clients' exposure to this possibility as follows:

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

Although we certainly weren't wishing for it, the subsequent retrenchment in profit margins and earnings over the past year has put our approach to test, with encouraging results.



Source: Thomson Baseline
2008 = Trailing 1 Year ROE as of 6/30/08

In this broad and severe correction, portfolio losses have been difficult to avoid. Yet, our disciplined investment process has generally produced relatively good results over the past eighteen months. For the past year, we have consciously underweighted financial stocks in our portfolios, and maintained a market weighting in energy. We have been overweighted in technology issues, whose global businesses and pristine balance sheets leave them less susceptible to a U.S. consumer-led recession. Most of our consumer discretionary selections possess defensive characteristics, which has helped to soften the blow from a meaningful consumer retrenchment. Our preferred issues in the industrial sector have benefited from a strong export economy and increased defense spending. Although "losing less" may be of little consolation, minimizing losses in a declining market is a critical element of a successful long term investment approach.

Despite the very real deterioration in the economic outlook, there are reasons to hope the worst of the market decline is behind us:

- Investor sentiment, a reliable contrary indicator, is at or near extreme negative levels. A recent Ned Davis Research report showed volume, volatility, and sentiment indicators all at levels rivaling those of the 1987 crash, the recession lows of 1990 and 2001, the Asian currency crisis of 1998, and the scandal-plagued sell-off of 2002.

- The oil and commodities spike should eventually level off, perhaps sooner than later. Extreme price increases have already begun to alter consumption patterns. Higher energy prices are expediting the development of alternatives and bringing more supply on line. Although the growing call for more domestic exploration and production will not open the spigots immediately, it may send a signal to the futures markets that more supply is on the way.

  Agricultural commodities are able to adjust more quickly than oil, as more crops can be planted in response to higher prices. Industrial metals prices are extremely sensitive to changes in demand, and with the likelihood of a global slowdown increasing, prices have begun to level off.

  In the equities markets (which tend to anticipate macroeconomic shifts), this adjustment process may have already begun. Oil stocks have not been nearly as strong as the commodity itself, indicating some level of doubt about the sustainability of the spike in crude prices. In recent trading sessions, energy and raw materials stocks have seen meaningful declines, which could be indicating the beginning of the end for one of the most profitable trading strategies of the past few years.

- By many measures, equity valuations are very reasonable today, which could help support stock prices eventually. Anecdotal evidence suggests there is a good deal of institutional cash on the sidelines, waiting to take advantage of attractive valuations. In the troubled banking sector, the ownership of impaired assets is gradually transitioning from distressed, regulated institutions to well-capitalized (and more patient) pools of private equity.

On a broader level, the global financial markets have been undergoing a major reassessment of risk for the past two years. Though painful, lower prices will bring about more rational expected returns, and could lead to a more stable investment atmosphere in the long run. As Bernstein puts it, "the moral of this story for the future is simple: *We won't allow ourselves to get into that kind of mess again*. As a result, the new environment will be shaped by widespread aversion to taking risks." Going forward, Bernstein suggests, liquidity will be limited, which implies a slow recovery. The benefit is that investments with any degree of risk will offer generous expected returns, and the excesses that lead to trouble (such as we have seen) will be constrained.

Today, our basic positions on asset allocation, sector weightings and security selection have not changed. We believe equities offer expected long term returns superior to other asset classes, and in our portfolios we continue to emphasize companies with stable global businesses and strong balance sheets. In a more difficult return environment, we expect a growing dividend stream to be an important contributor. The recent steepening of the yield curve, brought about by aggressive monetary policy actions, makes cash a less desirable parking place; so in fixed income portfolios we are increasing commitments to short-term investment grade corporate and municipal bonds, which offer higher yields relative to Treasury Notes.

Yes, things are bad, and the headlines may continue to be disquieting for some time. In fact, there is a real possibility that this recession, once it becomes official, could rival any since World War II. To top it off, the predictably populist rhetoric coming from Washington could bring about tax and trade policies that would not be welcome by investors. Nevertheless, we believe the risk inherent in attempting to time market bottoms justifies a fully-invested stance with a disciplined approach to security selection. Against a backdrop of attractive valuations, low interest rates and global growth, any easing of the threats now battering the markets could bring rapid relief. While we work to navigate these turbulent times, we offer our best wishes to all for an enjoyable Maine summer!

Announcements

Systems Conversion

We are very excited to announce some important changes we are making to our business model in the very near future. As you may know, H.M. Payson & Co. operated for many decades as a "broker-dealer," buying and selling securities for our clients on a commission basis. In 1982, we became an SEC Registered Investment Advisor, and in 2000 a Maine-chartered Non-Depository Trust Company.

Since becoming an RIA, our exclusive focus has been on the advisory and trust businesses. The retention of the trading function to this point has provided our clients with the convenience of having all aspects of the operation under "one roof," but carries some disadvantages as well. Custody and brokerage operations today require significant scale, and beget ever more strident regulatory and compliance burdens.

Over the last several years we have invested a great deal of time studying alternatives and researching various solutions, comparing our proprietary custody system with the functionality of other technologies within the industry. After a lengthy due diligence process, we have engaged Atlanta-based Reliance Integrated Solutions, a division of Reliance Trust Company, to manage our custody operations. Additionally, we will relinquish our NASD membership as part of our decision to exit the brokerage business.

We believe the set of solutions available through Reliance represents best-of-breed offerings across the custody, portfolio management, trade order management and client reporting functions. Our clients will enjoy lower trading costs, secure Internet access to account information, and customizable, more user-friendly reporting features. Most importantly, this transition will allow us to focus all of our resources on providing the highest quality investment counsel, wealth management, and client service.

We expect to be up and running on our new systems platform sometime in the next month or two, and will provide regular updates to clients in the weeks ahead.

H.M. Payson & Co.

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