H. M. Payson & Co.

ESTABLISHED 1854

RESEARCH NOTES

SEPTEMBER 16, 2008

These are historic times, though painful and unsettling. Taken together, Lehman's bankruptcy announcement, news of Bank of America's acquisition of Merrill Lynch, Treasury Secretary Paulson’s stated refusal to bail out American International Group and the stock market’s 4.7% decline will place yesterday among the most remarkable and memorable days in modern market history - if not the entire history of our markets.

We are witness to recent events and developments that will surely prove transformative not only for our financial markets and regulatory structure, but also for how our financial intermediaries will interface with consumers of all nature of financial services and products. The confluence of circumstances leading up to yesterday's startling events took a long time to develop and unfold; and we suspect the aftershocks of yesterday's news and further developments to come will resonate throughout global markets and our economy for just as long. In the meantime we expect more market volatility engendered by continued uncertainty about how this historic episode will play itself out and its implications for our economy and corporate earnings.

We are in no better position to measure the depth of this crisis than anybody else; but we are at once impressed and concerned by the Treasury’s and Fed's extraordinary measures, which indicate to us they are not underestimating the scope and scale of the systemic risks still confronting our financial systems, and by extension our economy.

As you know from many of our previous missives, we always favor higher-quality assets in our equity and fixed-income portfolios. Over the last two years, in particular, we've concentrated our portfolios in the securities of companies with very large and well-capitalized balance sheets producing large amounts of free cash flows and generating high and stable profit margins. We have been pleased that the market has presented us many opportunities to own such companies at very reasonable prices, and this strategy has served our portfolios extremely well over the last, very difficult year. We believe our portfolios are recession-resistant given the stable nature of their margins and their exceptional balance sheet strength, as well as their large component of foreign revenues which should provide some diversification across global economies.

For the most part, we have sidestepped much of the pain this market has wrought on investors of all disciplines and ilks by steadfastly limiting our exposure to the financial sector - and more recently, concentrating select, new positions in the financial sector in the strongest companies we view as ultimate survivors in this debacle.

Indeed, it's important to remember the paradox in all of this market pain and turmoil: lower prices have set the stage for higher expected returns in the future - from both stocks and bonds. Remarkably, though very much in line with our (unpopular) forecast at the beginning of this decade, the S&P 500 has returned -5.56%, including dividends, between December 31, 1999 and yesterday, September 15, 2008. By all accounts, September has been a very nasty month so far, with the S&P returning -6.91%. Today, our five-year annualized return forecast for the S&P 500 is slightly above 6% - which is our highest forecasted return this decade – and we feel strongly that our portfolios remain very well positioned to generate returns in excess of the S&P 500 given their superior earnings growth and relative valuations.

Nonetheless, our portfolios will not be totally immune to the difficult market conditions that might lie ahead, and we expect riskier assets will continue to get cheaper and higher-quality assets might become overbought and maybe even expensive. So far, we see no need or incentive to relinquish our prejudice for extremely high-quality assets in our portfolios.

The larger question overhanging the equity market, in particular, is what effect further financial system disruption will have on our economy and, critically, on our wobbly housing market. Although, statistically, the US economy has not rolled over into recession, we do expect corporate earnings to remain flat. However, if we do end up in a recession, S&P earnings will have farther to fall.

So far, we give Fed Chairman Bernanke and Treasury Secretary Paulson high marks for their swift and decisive actions. It was critical that they keep Fannie Mae and Freddie Mac operational, if not solvent, for if either entity were to disappear the housing market would seize up - which would surely prove disastrous at this point in the crisis. While we commend Paulson's attempts to limit the taxpayers' direct exposure to this crisis of confidence and liquidity, we believe the Treasury and the government will end up playing a larger role as lender-of-last-resort before this episode is finally behind us. We'll see.

In the meantime, though we do our best to maintain a long-term investment perspective, we recognize these difficult times require an especially high degree of vigilance. We continue to work on solutions and strategies to safely shepherd our clients' portfolios through this market panic, as we have in panics past - all the while calmly and patiently searching for new opportunities the market presents us.

Thank you for your continued confidence in HM Payson & Co.

Respectfully,

Peter E. Robbins CFA
Chief Investment Officer