H.M. Payson & Co.

QUARTERLY INVESTMENT PUBLICATION ♦ FALL 2008

PERSPECTIVES

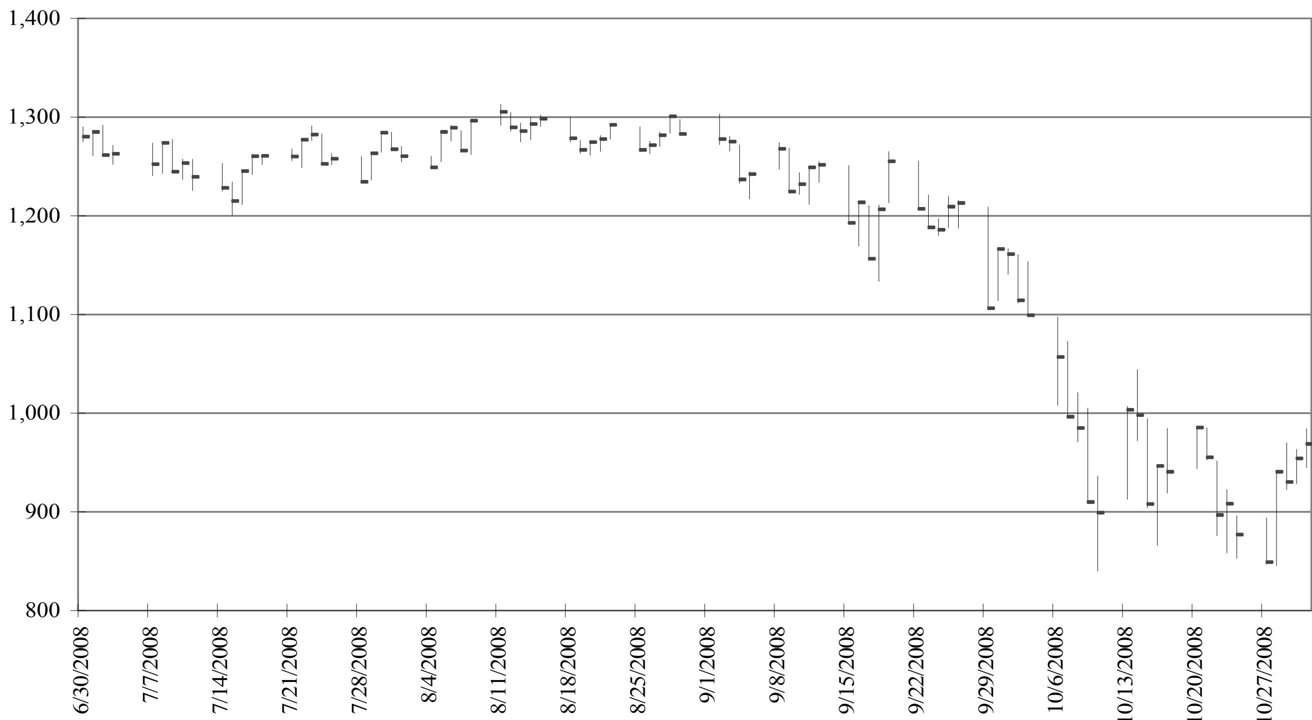
One for The (History) Books

Many books will be written about these extraordinarily tumultuous and historic times. So we will leave for later a discussion of the whys and wherefores of how our country and the world arrived at this incredible place in our financial market history. In our role as professional advisors, we believe it is more important to put the breathtaking market action of the last several months into proper context, so we can make better-informed portfolio decisions for our clients.

Our goal in these newsletters is to explain how we interpret information and data, and how we shape our portfolios around it; so we don't ordinarily fill these pages with a lot of market data you can simply find elsewhere. However, September and October were far from normal months in their stunning volatility and historic declines, and deserve some discussion.

By the end of September the S&P 500 had declined by 9.1%, the worst month for stocks

S&P 500 Daily High, Low, Close — 06/30/2008 — 10/31/2008



Source: Baseline

since September 2002. For the quarter, the index saw a total return of -8.9%. Incredibly, in 9 of the 21 trading days in September, the S&P was up or down by 3% or more, finishing in a crescendo of volatility with an 8.8% free fall on Monday the 29th - the worst single day decline since the 1987 crash. The next day brought a welcome 5.4% recovery, to close an exhausting month. However, as volatile as September was, it only set the stage for an historic and brutal October.

In October, the market was up or down by 3% or more on *13 of 21 trading days* - including two days of respite that brought gains of over 10%. By the final day of the month the market was down by 17%, leaving the S&P 500 33.5% in the red for the year so far. In a stark confirmation of the challenges faced by investors this decade, the S&P is *down by 24.8% (total return) since December 31, 1999*!

As distressing as the past two months have been, it is important to understand that the root cause of this violent market action was more "technical" in nature than a true reflection of the underlying fundamentals of corporate America. As the dearth of liquidity spread from bank balance sheets to the commercial paper and corporate bond markets, large and highly leveraged hedge funds began to experience steep losses. With the value of their positions declining rapidly, they were forced to sell any liquid asset they could in order to meet the wave of margin calls. With traditional investors reluctant to step in, this selling was met with an alarming lack of support on the bid side, causing huge percentage moves in even the largest and most liquid equities on relatively light trading volume. As the panic spread, mutual fund investors redeeming their shares served to exacerbate the decline. Corporate bond prices plummeted as well, resulting in record yield spreads (yields relative to those available on U.S. Treasury debt).

H.M. Payson & Co. Estimated 5 Year Annualized Returns*

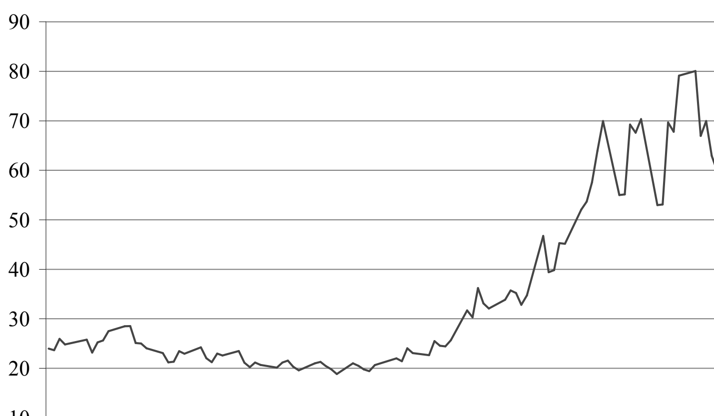
	Expected Total Return	Expected Income Yield	HMP Risk Rating	Tactical Weighting
Equities				
H.M. Payson Core Strategy**	15.0%	3.0%	Medium	*Over*
Small Cap	8.0%	1.8%	High	*Under*
International Developed	11.0%	3.5%	Medium	*Neutral*
Emerging Markets	15.0%	2.5%	High	*Over*
REITs	8.0%	6.8%	Medium	*Neutral*
Fixed Income				
High Yield Bonds	21.0%	18.0%	High	*Over*
Investment Grade	9.5%	8.6%	Medium	*Over*
Government Bonds	-1.5%	3.9%	Low	*Under*
Municipal Bonds	3.4%	6.0%	Low	*Over*
Cash	3.4%	3.4%	Low	*Under*

* As of 10/15/2008
** S&P 500 Expected Return: 13.0%

When markets lack ample liquidity, they can become inefficient and give rise to opportunity. Today we believe most financial asset classes are now depressed and inefficiently priced – which affords the long-term investor *exceptional* expected future returns, the likes of which we have not seen in perhaps fifteen years. As close observers of market psychology, the current environment appears to us to be the mirror image of ten years ago, when the risks were high and opportunities few! Indeed, in recent days numerous renowned investors, including Warren Buffett, Jeremy Grantham and Barton Biggs, have publicly acknowledged how compelling valuations have become.

By way of comparison to the thirteen Bear Markets since 1940, this Bear is getting long in the tooth. From its high on October 9, 2007 to the low of Monday, October 27th, the S&P fell 44.3% - taking 384 days versus an average of 380 days for the previous thirteen.[1] Although the S&P 500 has rallied 15% from its recent low on October 27th, signs of market duress remain: corporate bond spreads and other measures of credit market stress remain at or near record highs; the Volatility Index, which we have discussed here before, skyrocketed to a level nearly double its previous peaks, and remains extremely high by historical standards.

Volatility Index — 06/30/2008 — 10/31/2008



Source: Baseline

Typically, the stock market tends to find a bottom somewhere between halfway and three-quarters of the way through a recession. Our view is that we have probably experienced the lows for 2008. The markets will begin to recover, correctly discounting improving credit and business conditions well before the scary, negative rhetoric subsides - and even before earnings stop heading lower. As hedge fund and mutual fund redemptions slow and more liquidity finds its way into the markets, volatility should abate and prices could move significantly higher.

If history is any guide, the impact of the extraordinary measures being taken by the monetary authorities around the world could become evident well past the point of when they are most needed. Certainly, this was the experience after the Economic Recovery Tax Act of 1981 (ERTA) and the Financial Institutions Reform Recovery Act of 1989 (FIRREA). Because of this policy lag effect, we believe it's possible this recession will be shorter and shallower than the current consensus expects. As a case in point, on October 28th the S&P rallied a near record 10.8%, the day before a 0.3% decline in third quarter GDP was announced - the worst showing since the third quarter of 2001, with most economic indicators pointing sharply lower still.

In our portfolios, while we remain concentrated in companies with stable margins we have begun to move slowly into selected "real

economy" stocks, which are trading at extremely low multiples of book value and cash flow, discounting dire economic scenarios. Given the punishment they have endured this year, emerging markets are at historically low valuations and provide exposure to materials, energy and technology - all areas we expect to perform well in an eventual recovery. On the fixed income side, Treasury securities remain extremely expensive, while investment grade corporate and municipal bonds (of short to intermediate duration) look attractive.

This financial crisis has required massive public intervention, which will certainly usher in a period of higher regulation and scrutiny – and possibly, slower growth. While greater transparency in our financial institutions will be beneficial for the stability of the system going forward, it is critical that the efficient flow of capital - in the form of trade and foreign investment - is not impeded by bad public policy. Of all the risks we see to our otherwise sanguine long-term outlook, we worry most about the possible political fallout of this financial crisis. That said, free market capitalism is an amazingly resilient economic system which has repeatedly demonstrated its ability to work through the self-induced excesses that inevitably occur over market and business cycles, and we suspect this time will be no different. Regardless of who is in power after the election, the innovative spirit of a global, profit-seeking economy will continue to adapt and flourish.

[1] Source: Bespoke Research, Inc.

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