H.M. Payson & Co.

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PERSPECTIVES

A Healthy Dose of Skepticism

In our last issue of *Perspectives*, amid the abject gloom of the first quarter, we offered the following words of encouragement from the great John Templeton: *"Bull Markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."* The meaningful second quarter market rebound suggests that the extreme pessimism has faded. Although last month's pullback caused renewed apprehension, it had been widely anticipated after such a rapid advance. Whether this "baby bull" continues to grow on skepticism remains to be seen, as recent data have raised doubts about the pace of economic recovery. The investment profession can be humbling, and it is in this spirit we maintain our constructive outlook for equities despite the dismal state of the economy and the sobering voices of credible skeptics.

The 40% rally in the major indices from the early March lows to the June peak was described as everything from a "bear market rally" doomed to imminent failure, to the start of a new bull market ushering in an extended period of more generous returns. While investor sentiment has improved significantly since March, skepticism remains firmly entrenched. The early evidence of economic recovery – popularly coined "green shoots" – has been derided by skeptics as mere weeds in an economy struggling to emerge from the bursting of an unprecedented credit bubble. The current conversation among pundits includes the extremes of both inflation and deflation – very different problems posing very different risks for investors. While we will watch developments closely, we suspect incremental economic progress will allow the equity markets to move moderately higher in the short to intermediate term. Moreover, we believe our close attention to valuations and willingness to take advantage of security and asset class mispricing will continue to produce above-average portfolio returns.

Although evidence of economic weakness abounds, there have been notable improvements in some important data over the past few months, helping to assuage investor psychology. The credit markets have emerged from the crisis phase, as evidenced by several indicators including the three month LIBOR rate (a widely followed global inter-bank lending rate) plunging from near 5% at the height of the crisis to around 0.50% today. Yield spreads between Treasury securities and other segments of the bond market have contracted dramatically, as investors have returned to riskier assets. Meanwhile, as we anticipated, yields on Treasuries have begun to rise as the vast supply of additional government debt begins to come to market, and as investors weigh the absolute safety of Treasuries versus their paltry yields. For example, the yield on the 10 year Treasury Note has ballooned from 2.21% at year-end to 3.57% currently – causing an 11% decline in price. Other measures of investor psychology, such as the Volatility Index (VIX), have improved to levels not seen since before the failure of Lehman Brothers.

Some economic data have shown real improvement, while others have at least begun to look "less bad."

The Consumer Confidence Index has rebounded from a low of 25 to a recent reading of 49. The Index of Leading Economic Indicators has shown improvement for three consecutive months, with seven of the ten indicators improving in May and June. While continuing weakness in the housing market and ever-higher unemployment figures are serious concerns, more sanguine data elements are getting little attention in the press. Existing home sales have been picking up as excess inventory is cleared (a necessary step toward eventual stability). Although the monthly jobless figures are undeniably disturbing, unemployment is typically considered a lagging economic indicator. Hence, it is possible to have what initially appears to be a "jobless recovery" with unemployment remaining stubbornly high. Meanwhile, the full impact of the unprecedented government stimulus effort is yet to be realized. Because of the media focus on housing and employment, we expect the nascent economic recovery to be met with continued skepticism.

There is a tendency among market forecasters to draw parallels to the past in predicting what may lie ahead. Since last year's market downturn was the most severe since the Great Depression, are we destined for a repeat of the 1930s, with dramatic swings and numerous false starts? Or are we headed for a repeat of the 1970s, with stagnant growth and high inflation… or, will an anemic global economy produce flat or negative equity returns for years to come? Of course we don't know for sure, but we do respect the importance of market levels as a determinant of investment returns and risk. The extraordinary returns of the 1980's and 1990's caused valuations to run to extremes, setting the stage for the current decade of disappointing returns. Today, with the major indices still some 35% below their 2007 peak and valuations reasonable by most measures, we believe equities have the potential to pleasantly surprise the current generation of beleaguered investors.

The heightened economic uncertainty and accompanying market volatility present unique challenges for investment managers. In this rapidly changing environment, decision time frames are compressed. As a result of the second quarter's market advance, investors may have already earned a good portion of the generous equity returns we foresaw earlier this

Estimated 5 Year Annualized Returns*

	Expected Total Return	Expected Income Yield	HMP Risk Rating	Tactical Weighting
Equities				
H.M. Payson Core Strategy**	**11.0%**	**3.0%**	**Medium**	***Over***
Small Cap	**8.0%**	**1.8%**	**High**	***Under***
International Developed	**10.0%**	**2.6%**	**Medium**	***Over***
Emerging Markets	**9.0%**	**2.6%**	**High**	***Under***
REITs	**11.6%**	**6.8%**	**High**	***Neutral***
Fixed Income				
High Yield Bonds	**11.0%**	**8.8%**	**High**	***Neutral***
Investment Grade	**4.6%**	**6.0%**	**Medium**	***Over***
Government Bonds	**-2.0%**	**3.5%**	**Low**	***Under***
Municipal Bonds	**-2.0%**	**4.5%**	**Medium**	***Under***
Cash	**0.0%**	**0.0%**	**Low**	***Under***

*H.M. Payson & Co. Research Dept.
** S&P 500 Expected Return: 9.1%

year (as reflected in our most recent expected returns work, shown on the previous page). We exploited the opportunities we saw in March (high yield bonds, commodities, emerging markets, equities in general), but now observe an altered landscape offering different – and less obvious - potential. As we go to press, the majority of second quarter earnings announcements are providing positive support for stock prices, but are driven primarily by cost cutting rather than an improved revenue picture. The fluidity of the current situation may persist, and requires that we remain disciplined and nimble in translating our valuation work into portfolio action.

Although we are generally optimistic about the ability of the economy and the markets to adjust to changing conditions, we acknowledge that a full recovery may be slow in coming. Systemic risks which did not exist prior to last year are of real concern today: excessive regulation, ballooning deficits and higher taxes may serve to diminish the vigor of any expansion. While our equity return expectations in general have been tempered in the wake of the spring rally, the rapidly-changing leadership between sub-asset classes and equity sectors continues to create trading opportunities. In every instance, however, we have made a concerted effort to ensure that the companies in our equity portfolios are of superb quality, offer excellent balance sheet strength, generate strong positive cash flows and display compelling valuations.

Large and sudden price swings may tempt investors to embrace market timing strategies, but their ineffectiveness over any length of time is well documented (with this week's positive market response to better-than-expected corporate earnings serving as a case in point). However, during this period of relative calm, while we await more tangible signs of recovery, we advise our clients to review their individual investment objectives and strategic asset allocations. We encourage them to re-examine their liquidity needs, risk tolerances, income needs and other factors with their portfolio manager. We are emerging from a crisis unlike any of us have seen, and it is virtually impossible to anticipate short-term market movements.

As Mr. Templeton reminded us all, the best environments for equity returns are often characterized by doubt and worry, making it difficult to enjoy the ride. The fact that skepticism abounds is – in terms of market cycles and investor psychology – a good thing; but that does not reduce the need for hard work and discipline. We will remain vigilant in our research efforts and active in our portfolio work as we strive to position our clients for the best possible outcome as this extraordinary period in investing history continues.

H.M. Payson & Co. and the Financial Crisis

We appreciate the positive feedback we have received in response to our communications describing our investment process and tactical strategies throughout the recent turmoil. A number of clients have expressed their appreciation for our dedication to our core disciplines and avoidance of gimmicky investment "products" which caused trouble for so many investors. While our portfolios were not immune from the market declines of the past year, we have been pleased to report favorable investment performance relative to the indices for the past year and for much of the current decade.

Although it has not been pleasant, the turbulence of the past year has engendered a renewed appreciation for institutional stability and an independent perspective in an investment advisor. We are especially grateful for the opportunity to serve a large number of new clients, which we continue to welcome.

It is with great pleasure we announce that David R. Hines, CFA, has been named a Managing Director of the firm. Since joining H.M. Payson & Co. in 2003, David has quickly become an integral member of our research and portfolio management team, where his work has gained universal respect and admiration. Please join us in congratulating David.

H.M. Payson & Co.

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