H.M. Payson & Co.

QUARTERLY INVESTMENT PUBLICATION · WINTER 2010

PERSPECTIVES

Rebound vs. Recovery – Time for Vigilance

Market Indices—February 18, 2010

S&P 500: 1,106.75

90-day T-Bill: 0.09%

10 year Treasury Note: 3.81%

The markets have come a very long way from their lowest levels set back in the dark, desperate days of March 2009, erasing earlier losses and leaving the indices ahead by a substantial amount for the year. That's the good news/bad news story of this newsletter, for as we predicted in our spring newsletter last year the markets have performed much better than the economy.[1] The dramatic appreciation in the stock and bond markets leaves them both overvalued – and the bond market especially so - in our opinion; and against a backdrop of still very shaky economic conditions, we think it is a time to err well on the side of caution in our portfolios.

As bullish as we were last spring about the prospects for high returns, and after the market then made significant advances from the very depressed lows, we encouraged our clients to "recalibrate their psychological threshold" to the fear and uncertainty that might lie ahead. To clients who rely heavily on the income and principal value of their portfolios to defray living expenses, we recommended they maintain 2-3 years worth of liquidity, even if it meant earning paltry returns on short-term reserves.

Now that valuations have gone from extremely undervalued to arguably overvalued levels, *we are strongly recommending our clients revisit the psychological/liquidity recalibration process with their H.M. Payson & Co. Portfolio Manager to properly gauge their exposure to any possibility of another severe market downturn.*

Today, in our view, stock and bond prices are discounting a strong and sustained earnings recovery. Even if such an earnings recovery materialized, we see few opportunities to earn a high enough investment return from current valuations to warrant taking a risk the economy and the markets won't reflect a sundry of fundamental problems. We can't remember the last time macroeconomic considerations played such a role in our outlook. We never thought we would say this, but this time it just might actually be different! – meaning the economy and corporate earnings might not track a "normal" rate of recovery.

Recognizing, as the late-great Peter Bernstein was fond of saying, "more things *can* go wrong than *will* go wrong", and freely admitting we have no real idea where the economy might go, this time there are structural, or systemic, issues our economy has never faced on such a scale, which we believe demand special consideration in our outlook. Specifically, problems within the housing market and its effect on consumer behavior, as well as a severe unemployment situation, seem likely to exacerbate the recession and mitigate the effect of the government's economic stimulus.

In addition, there are practical limits to the Fed's and Treasury's capacity to affect economic stimulus through lower interest rates, as we are beginning to see. Central banks, and notably China's, have begun to divert some of their foreign reserves away from our government bonds in favor of gold and other investments - and in China's case into direct domestic infrastructure investments, recognizing the

[1] H.M. Payson & Co. Perspectives, Spring 2009 — *http://www.hmpayson.com/docs/38.Spring2009-H.pdf*

dubious value proposition US sovereign debt now represents.

We view the rally in gold as an important sign there are serious structural risks the bond and equity markets seem to be ignoring. In particular, gold does well when fiscal and monetary policies are applied in ways that may have unhealthy longer-term implications for the US dollar.

Additionally, we think the record steepness in the yield curve for US government securities indicates several things: mainly that the Fed understands how fragile our economy remains, and so it has committed to anchoring short-term interest rates (those it directly controls) at virtually 0% for "an extended period"; and further, the higher yield levels for longer-dated bonds reflect the stimulative effect of these low interest rates, the inflationary implications of further monetary growth, and/or the crushing overhang of new Treasury issuance in the offing. The yield curve is obviously predicting higher interest rates ahead – which, no matter how well the fundamentals might be doing in the future, will prove to be a drag on the economy and the markets.

We recognize the issues of housing, employment, deficits, inflation and the dollar could each themselves be the subject of an entire newsletter, and then some. While we unapologetically admit we have no special insight as to how these factors will impact the economy, corporate earnings or security valuations, we are quite confident the scale of these problems is both under-reported and would appear to be underappreciated in the markets. Even on the face of the reported data, our economy has never faced such a confluence of macroeconomic challenges. Therefore, our simple conclusion is that uncertainty and the risks associated with all of Peter Bernstein's "things that *can* go wrong" are high.

On the other hand, our work suggests expected market returns are much too low (please see table below), especially given the shaky and uncertain fundamental backdrop. What if, as we've been saying, the more encouraging economic data turns out to be merely the result of a "rebound" rather than evidence of a turn towards real recovery? It's still quite possible we are in the grips of a recession. Clearly, then, the S&P 500 would be even more overvalued than it appears. Also, the enormous rally in corporate bonds would appear overdone, as we believe it now is.

Indeed, we think the bond market is significantly overvalued today given the very low yields and the prospects of higher rates in the relatively near future. According to Morningstar, $330 billion mi-

Estimated 5 Year Annualized Returns*

	Expected Total Return 3/31/2009	Expected Total Return 6/30/2009	Expected Total Return 9/30/2009	Expected Total Return 12/31/2009	Current HMP Risk Rating
Equities					
H.M. Payson Core Strategy**	**14.5%**	**11.0%**	**8.6%**	**7.5%**	**Medium**
Small Cap	**8.5%**	**8.0%**	**7.0%**	**7.0%**	**High**
International Developed	**12.0%**	**10.0%**	**7.0%**	**6.0%**	**Medium**
Emerging Markets	**15.0%**	**9.0%**	**6.0%**	**5.0%**	**High**
REITs	**12.0%**	**11.6%**	**3.7%**	**1.2%**	**High**
Fixed Income					
High Yield Bonds	**23.5%**	**11.0%**	**8.0%**	**6.0%**	**High**
Investment Grade	**10.0%**	**4.6%**	**-1.3%**	**-2.0%**	**Medium**
Government Bonds	**-3.0%**	**-2.0%**	**-2.0%**	**-1.7%**	**Low**
Municipal Bonds	**8.0%**	**-2.0%**	**-4.0%**	**-4.7%**	**Medium**
Cash	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**Low**

* H.M. Payson & Co. Research Dept. Projections

** S&P 500 Expected Return 12/31/09: 5.5%

grated out of money market funds into bond mutual funds in 2009 in an attempt to escape the negligible yields on cash. We view today's rush into the bond market much like the stampede into stock index funds at the beginning of the last decade - investors are chasing past performance and dangerously underestimating the risks of the underlying fund holdings.

For yield, we find more compelling income-producing opportunities in the equity market today. Despite our opinion the stock market is currently overvalued, we believe carefully selected equities can offer long-term potential relative to other asset classes. The S&P 500 itself yields 2.2%, just shy of the yield on a *five-year* U.S. Treasury note. Compared to government bonds, in particular, two of our portfolio favorites offer good examples of the significantly more attractive total return opportunity in high-quality, dividend-paying stocks. Johnson & Johnson yields 3.1%, roughly equivalent to a *seven-year* government security, and J&J's dividend is growing at around 6% annually. McDonald's yields 3.5%, about what a *ten-year* treasury note is yielding; and we believe McDonald's can continue to grow its dividend at close to 10% annually. In addition, we view McDonald's ability to quickly pass through cost increases (in many different currencies) as particularly effective inflation protection, whereas the real principal of a government bond is eroded at the exact rate of inflation.

Last year the stocks of companies that otherwise would have financing issues or are more exposed to the economic cycle did far better than their stronger brethren since they rebounded off lower lows. In any case, we believe these stocks for the most part have come too far too fast, and their current valuations discount much of the sanguine outlook for a rebound in earnings. At this point, we believe careful security selection will dominate equity returns in 2010 - and consistent with our cautious outlook we shall continue to focus on financial strength as our top investment criterion.

We insist that all companies in our equity portfolios be generating free cash flow with ample balance sheet strength to weather even the toughest economic environment. The companies we own that are not currently paying dividends are possessed of the same kind of financial flexibility as those that do, and are in a position to continue investing very profitably and/or return cash to shareholders through stock buybacks.

Now is not the time to reach for return and *definitely* not the time to chase yields. It is a time to raise needed liquidity and to reduce risk – meanwhile accepting lower returns until the opportunities improve. If the markets perform better than we now expect and our defensive portfolio stance turns out to be too conservative, we are confident the returns we might miss will cost us less sleep than the losses we could otherwise avoid if our outlook turns out to be correct.

In Case You Missed It

"From Irrational Exuberance to the Great Recession: Framing a Forecast" was presented by Chief Investment Strategist Peter Robbins to an attentive audience at the Portland Country Club on January 28th. We would encourage all readers to view the presentation, which can be found on our website. *http://www.hmpayson.com/info.php?info_id=29*

Notes on the Decade

The decade just concluded was one of the worst on record for investors. While recognizing the very real distress this has caused, we are proud to report that our clients generally fared significantly better than the major indices, finishing on a strong note in 2009. For the ten years ended 12/31/09, the S&P 500 index showed a cumulative total return (including dividends) of -9.1%. By comparison, the H.M. Payson & Co. Taxable and Tax-Exempt Equity Composites posted gains of 21.3% and 33.5% respectively.[2] We wish to express our sincere appreciation for the loyalty our clients have shown throughout this challenging period.

[2] Composites consist of actual managed fee paying accounts. Explanatory notes available upon request.

New Damariscotta Office

We are pleased to announce an exciting new chapter in the 156-year history of H.M. Payson & Co.: the opening of our new branch office, located in downtown Damariscotta! Mike Currie, President of the firm, comments "We've been well known in southern Maine for six generations, and the Damariscotta presence represents both a commitment to our mid-coast client base and an important source of future growth for the firm. We believe H.M. Payson & Co. will be viewed as a compelling alternative for investors in the mid-coast area." The office will be staffed by our relationship team of Kent Whitaker, Portfolio Manager, and Margaret Wilder, Investment Assistant. The office is located at 10 Bristol Road; local phone: 207-563-1854. Kent and Margaret welcome any calls or inquiries.

H.M. Payson & Co.

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