H.M. Payson & Co.

QUARTERLY INVESTMENT PUBLICATION—SUMMER 2010

PERSPECTIVES

In publishing *Perspectives* we have a straightforward editorial guideline: *ensure the narrative and opinions relate to our investment philosophy, our process and/or our portfolios; and depending on the topic, give our readers actionable take-aways.* Our goal is to shed some light on how and why we come to our conclusions, and hopefully impart a sense of our consistent analytical framework. This letter is a "Special Issue," of sorts, in so far as we cast a wide net over a number of topics - each of which we could expound into an entire newsletter. We shall continue to share with you our thoughts on these topics as developments unfold.

A Wall of Worry or a Mountain of Uncertainty?

These are unsettling times. Many individual investors have chosen to quit the game rather than suffer gut wrenching volatility or bear the prospect of experiencing losses they may never recover. Much of the world is on the investment defensive; but we think now is the time to get ahead of consensus thinking and to take advantage of opportunities available to those able to adapt their long-term view, and stick with it. But, before we introduce some of our recent long -term thinking, we'll briefly discuss the current market and what our observations might mean to our client portfolios.

Even though our work led us to conclude the S&P 500 was somewhat overvalued and clearly overbought by the end of April, we didn't expect the vociferousness of the market correction in May, which contributed to an otherwise miserable quarter. The familiar worries about the housing market and unemployment continue to loom over investor psychology. The employment numbers have disappointed and the housing data remains below expectations, even factoring in the end of the huge incentives extended to new home buyers. These data have shaken the market's fading confidence in the vitality of the economic recovery, and for the most part finally disabused the notion of a full, V-shaped earnings recovery. Of course, we have long-maintained the view that the housing inventory overhang and so-far intractable unemployment pose real long term impediments to a recovery anywhere near approaching "trendline" growth - and these assumptions are incorporated in our expected return models.[1] So, we weren't as surprised by the data as the market seemed to be.

Still, in terms of market sentiment there is a big difference between worry and uncertainty. Worries are issues investors and the market can already recognize; whereas uncertainty is far more insipid since by its nature it's difficult or impossible to quantify. Investors and businesses continue to grapple with a wide range of political uncertainties - each potentially a significant variable in their investment equation - and in the aggregate certain to raise their cost of doing business. "Reforms" around taxes, financial regulation and healthcare are steeped in political rhetoric, but for the most part short on detail. Quite rationally, investors and businesses have been sitting on their hands rather than risking new investments without knowing all the rules of the new game – which we believe exacerbated the spring correction and contributed to the choppy and volatile market action in the second quarter.

1. http://hmpayson.com/docs/49.HMPExpectedReturns-June2010.pdf.

For us, the immediate issue this year has been the notably high correlation among individual stocks in the index - that is, the market action has frustrated our efforts to distinguish and diversify our best ideas from overall market returns. Probably the best explanation for this phenomenon is the growing trading presence of exchange traded funds (ETFs) designed to mimic the S&P 500 or other indexes, which investors can use to get inexpensive and liquid market exposure to all the stocks in the index. Whatever the reasons, we recognize these trading dynamics to be "technical"; that is, *not* related to underlying company fundamentals. While frustrating to us in our efforts to outperform the market, in the second quarter especially, we believe any short-term, technical influence on stock prices creates more pricing inefficiencies we can exploit longer-term - which suits us fine.

Cutting Cards with the Market

One investment metric we have found to be pretty darned efficient is "yield" - that is, seldom is there a "free lunch" when it comes to earning interest and dividend income. Stocks and bonds with higher relative yields are consistently priced to accurately reflect the fundamentals behind the stream of payments. A company with a high-yielding stock typically has low growth prospects. A stock with an exceptionally high yield reflects the market's expectation that the dividend is in jeopardy of being reduced or eliminated. The "market" gets this right virtually every time - which is why buying or holding a stock for its high yield alone can be very dangerous to the health of your principal. The bond market is similarly efficient in this regard.

This year we have been struck by the fact that stocks of many high-quality companies yield significantly ***more*** than bonds issued by the same company! (*Please see the table below.*) Clearly the dividends of these companies are not under any duress; and, in fact, many have continued to raise their dividends. So, what's going on here? Well, bonds have done very well over the last decade - perhaps investors are chasing good performance as they often do. Or, maybe the tiny return on cash has induced investors to pursue yield by piling into bonds and bond funds, driving down yields in the process.

We keep a framed quotation in our office, courtesy of Mark Twain, which reads *"Whenever you find yourself on the side of the majority, it is time to pause and reflect."* For the last several years we have been in a crowded camp of investors convinced the Fed's massive expansion of the money supply would axiomatically result in accelerating inflation, sooner than later. But, even to *us* the story seemed too pat. We were very uncomfortable subscribing to such a widely-held consensus view. So far, it's obvious we were more than a little early on our accelerating-

Many Quality Stocks Yield More Than Their Bonds

	5 Yr Bond Yld	Dividend Yield	Spread
MCD	2.4%	3.1%	-0.6%
KFT	2.9%	4.0%	-1.1%
PG	2.5%	2.9%	-0.4%
XOM	2.5%	2.9%	-0.4%
GD	2.2%	2.7%	-0.4%
ABT	2.6%	3.9%	-1.3%

Source: Bloomberg

	Times Dividend Covered*	5 Year Dividend Growth	Consensus LT Earnings Growth
MCD	2.0	32%	10%
KFT	2.2	7%	8%
PG	2.7	12%	9%
XOM	2.6	9%	9%
GD	4.1	16%	8%
ABT	2.1	10%	10%

Source: Capital IQ

* Times Dividend Covered = Last 12 months Net Income/Last 12 months Dividends

inflation call! Perhaps we were *so* early that….we were wrong!

Well, we should have recognized the market has correctly priced yield levels, again. The answer is that stock and bond yields are both missing an inflation component they have almost always embodied; and they corroborate a forecast of little to no inflation for a long time – with at least some probability of actual deflation. Here is how we look at it:

The 6% long-term growth of "nominal" earnings (including inflation) for the S&P 500 is comprised roughly of 3% inflation and 3% actual, or "real" growth (adjusting for inflation). The ability of corporations to pass higher costs thru to the price of their products and services – and hence their earnings - is the primary mechanism through which equities provide some inflation protection over time. Dividends are paid out of corporate earnings, so they grow with earnings. The high dividend yields afforded by the market are an indication that earnings and dividend growth probably won't include any inflation "pass-through" at all. So it's reasonable to expect lower *nominal* earnings growth, which goes a long way to explain today's low price multiples of earnings and dividends.

Interest rates on bonds typically include a component of return to compensate the bond holder for the deleterious effects inflation has on the purchasing power of their principal. Today's very low interest rates would appear not to embody any inflation expectation whatsoever. In fact, just as inflation lowers the real return on a bond investment, deflation *increases* the purchasing power of the bond principal over time and thereby increases the real return. Indeed, the market for US government bonds would appear to be discounting some probability of deflation, given the exceptionally low long-term yields at which US bonds now trade.

We're "Trapped"

In retrospect, disinflationary forces have been at work for almost a decade, which explains, among other things, the strong relative performance of bonds over stocks during this period. The de-leveraging of the housing market in the ongoing mortgage meltdown and a retrenched consumer are powerful and persistent disinflationary forces. We've seen signs of true deflationary pressure in falling real labor costs in the US and low factory utilization rates. The yearly change in the Core CPI through June was 0.9%, the lowest reading since 1961![2]

With interest rates almost as low as they can go, the Fed finds itself in a classic "liquidity trap" - an environment in which neither lower rates nor higher money growth will have any effect on economic growth or inflation. With core US inflation running as low as it has been in almost 50 years, we are approaching a tipping point on actual deflation.

Clearly, for US investors it is hardly "business as usual". We need to construct portfolios to serve at least two possible masters: long-term inflation, and no/low inflation or even deflation. Diversification, as hard as it has been to come by within and across asset classes, will be the key. But, critically, asset allocation strategies that might have worked well in the past seem unlikely to provide adequate diversification or returns in the current environment. Specifically, we expect a period of very slow growth in the US, continued deterioration in US government finances and future fallout from sovereign debt problems among other developed countries. These are not inputs we've had to factor into our policy work before. We must adapt our thinking and evolve strategies to traverse a new investment landscape.

In particular, high levels of public and private debt present greater systemic risk. There is still plenty of leverage in the system. Therefore, it's prudent to plan for a wider array of possible

2. Ned Davis Research, NBER

economic and market outcomes than we've experienced in times of more manageable debt levels. We think a sensible investment strategy begins with a less US-based, dollar-centric premise. The world *will* continue to grow economically; but emerging economies will likely enjoy faster growth. Investing in countries on the other side of the dollar's fundamentals[3] makes good, long-term sense, too. The currencies of emerging markets should eventually outperform the dollar, providing a tailwind to investment returns. We think the dollar's problems (i.e., there are too many dollars being printed) will get worse before they get better - which buttresses a case for maintaining portfolio exposures to industrial commodities and precious metals. This is not a strategy we have actively pursued before. Even cash can play a new role in a portfolio as part of a hedge against deflation.

Below we outline our view of a number of asset classes and make the case for an expanded perspective on asset allocation in the context of traditional solutions.

Equities

Equities are the beating heart of every long-term portfolio. Notwithstanding low US economic growth, we continue to favor many large US stocks. We especially favor stocks of companies with high and stable margins, strong and liquid balance sheets and plenty of free cash flow. Many stocks on our Working List derive significant revenue from foreign countries which diversifies away an element of currency risk. Strong companies can take advantage of weaker competitors in tough times, so we see an embedded optionality with real value in the strength of some of these franchises. By our calculations, many of these stocks are startlingly cheap. They trade at prices which already reflect extremely low expectations of future growth - which means any growth they might realize could translate into meaningfully higher stock prices. Also, these leading companies are well-positioned to buy back their own stock by issuing lower-yielding debt – lowering their cost of capital and *improving* cash flow![4]

We can build portfolios of these very attractive stocks that stand to perform well whatever the macroeconomic environment.

Stocks for a Deflationary Environment

Some firms can still grow in a deflationary environment. Firms with patents or very high economic or technological barriers to prevent new competitors from entering their markets typically have captive customers. Therefore they may not have to lower prices to fend off competition. Companies that can increase volumes when the pricing environment is flat can drive revenues higher. Important drivers of unit volume growth include taking market share from competitors, developing innovative products and effecting a sensible and opportunistic acquisition strategy. Great examples of companies currently on our Working List that have the ability to increase market share in a low-growth environment include Google, Philip Morris, Laboratory Corp. of America, Tyler and Unit Corp., to name a few. Google continues to take ad revenue from companies operating in the traditional media outlets; Phillip Morris has a captive overseas customer base; Laboratory Corp. operates in a duopoly where lower prices will knock out smaller competitors; Tyler continues to gain share in a very fragmented market for software used by states and municipalities; and Unit has a long and successful record of making synergistic acquisitions of natural gas assets.

Stocks for an Inflationary Environment

Companies with large intangible capital bases (such as brands, patents, etc.) are well positioned to maintain margins and pass higher costs through to their customers. They don't need to constantly replace plant and equipment at higher

3. Countries with lower debt/GDP, and surpluses in some combination of trade, current account and/or budgets

4. As we go to press, IBM raised $1.5B thru the sale of 3-year notes at the *lowest* interest rate on record, 1.0%, compared to its dividend yield of 2%

and higher prices as does a company with more tangible productive assets that wear out. So, companies with great brands such as Procter & Gamble or Pepsi, whose physical assets represent a small portion of their overall capital (and who also have good leverage over their customers by virtue of their size and product mix) can maintain their profit margins by passing through cost increases without having to make offsetting investments in physical plant and equipment. Another good example of a franchise company with good margin protection is Oracle. They have a sizable captive customer base due to the high cost their customers would incur to change enterprise software.

Foreign Equity

In view of the dollar's long-term problems, we believe the time has come to rethink the proper *strategic* policy allocation to foreign stocks, perhaps in the range of 50%; and, why not? The NYSE and NASDAQ account for only about a third of the world's investable market capitalization.[5] Foreign investing is nothing new to us; but we are building upon our capabilities in this area – looking for solid companies across a broader range of domiciles.

	Percent of Total Capitalization	Percent of Total Tradable Issues
NYSE/NASDAQ	32%	12%
Americas Ex-US	8%	11%
Asia Pacific	30%	46%
Europe/Mideast/Africa	30%	31%
	100%	100%

Source: World Federation of Exchanges

We regularly invest in the stocks of large, high-quality foreign companies using American Depository Receipts (ADRs) which are US-registered securities held to certain US accounting standards which are the beneficial owners of shares in a specific foreign company. We apply the same rigorous analysis and valuation work to these shares as we do any US company. Our focus everywhere is on revenue growth, margins, balance sheet strength and attractive valuations.

We've done well managing tactical allocations around the volatile Emerging Market Index - and we see reasonable value and expected returns in the index currently.

Currently we are expanding our research coverage into two of the so-called BRIC countries (Brazil, Russia, India and China). We are attracted to the prospects for India and Brazil for their comparative advantage in educated labor and natural resources, respectively. In particular, India is also possessed of large foreign reserves, which could provide support for its currency versus the dollar.

Our latest research initiatives are focused on developing a country- and stock-specific approach to Brazil, India and emerging markets using exchange traded funds (ETFs) and ADRs. We see a greatly expanded role for allocations to these strategies to enhance growth and to garner further currency diversification for our clients.

Bonds

We've been wrong about U.S. Treasury bonds over the last three years; but we really couldn't have predicted the panicked "flight-to-quality" surge of capital into treasuries once the financial crisis was in full bloom. In mid-2007, before the mortgage market meltdown, the yield curve was flat and yields seemed unexciting to us (5%-6%) compared to our expected returns for other asset classes. We kept our portfolio maturities short and we were underweighted in US bonds.

The U.S. Treasury market is unique in the world for its depth and liquidity, so it is considered a haven in times of market or political turmoil and uncertainty. Today's very low yields are the result of lots of capital from all over the globe looking for the *relative* safety of the U.S. Treasury market. The financial woes of Greece

5. World Federation of Exchanges (http://www.world-exchanges.org/statistics/key-market-figures)

and the rest of the so-called PIIGS (Portugal, Italy, Ireland, Greece and Spain) have wracked the market for their sovereign debt and currencies - driving capital into the US dollar and treasury market causing them to rally sharply. We believe both these markets are overbought; and it is certainly not the time to turn bullish on either!

Today our total-return bond portfolios are "barbelled": roughly half our bond portfolios are invested in very short-term bonds or cash, and we are moving to invest the other portion of our bond portfolios into intermediate-term, high-yield bond funds yielding about 8% to maturity. This results in a bond portfolio with an average maturity of about 3.5 years, yielding about 3.6% or roughly 2.5% over the three-year Treasury note. This barbell structure serves as a hedge, of sorts, as the cash would perform well in a disinflationary environment, or could be used to invest in more bonds should interest rates move higher, for whatever reason. The reasonably short average maturity protects the total portfolio somewhat from undue interest-rate risk - while the high-yield bonds provide a valuable stream of income. This cash and fund strategy is also very liquid - which means we can move quickly should market conditions change, as they inevitably will.

The market for US government debt faces a large overhang of future supply as the treasury must sell new bonds to fund our enormous budget deficits, support the mortgage market and refinance maturing bonds. Even the Chinese won't be able to sop up all our new issuance; and eventually it will cost the US more, perhaps much more, to borrow. In fact, we think it's likely many of our most creditworthy corporations will eventually be able to borrow at rates *lower* than the US government - a true paradigm shift. But, the government's need for funding will raise everyone's cost of capital, reducing new investment and depressing equity valuations in the future. As our government debt approaches 100% of GDP, the economic policy choices narrow; and the combination of further monetary and fiscal efforts to stimulate growth will only exacerbate the debt and funding equation.

Gold/US Dollar

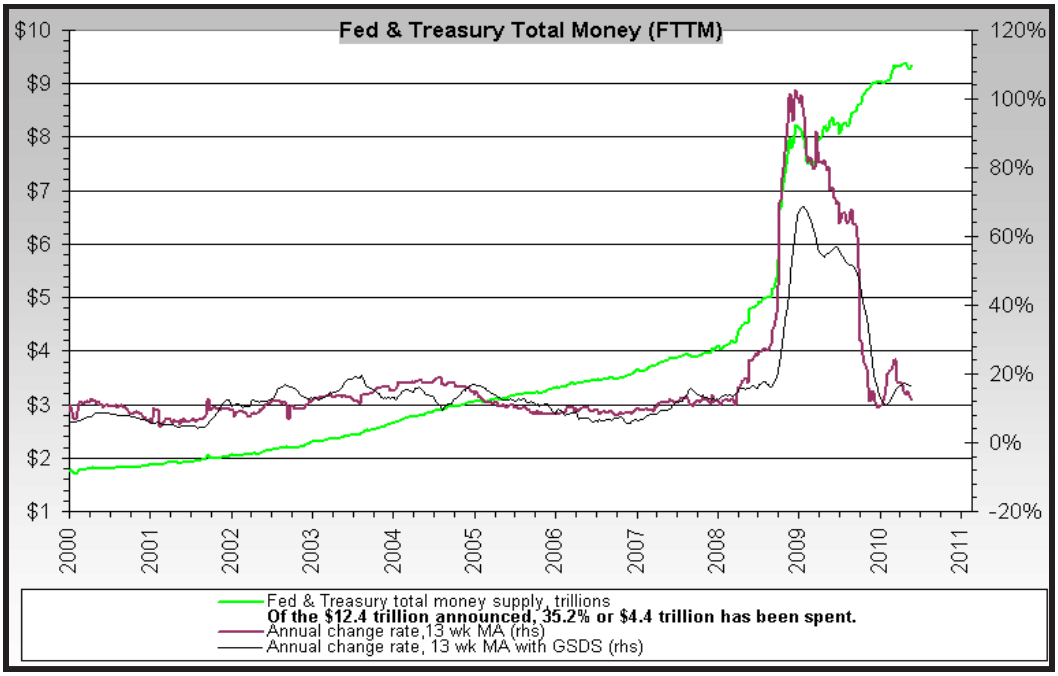
In a dollar-centric investment world US investors haven't had to give currency considerations much thought. Under the Bretton Woods agreement, the US was effectively the world's central bank. Since the demise of that agreement in 1971, the US dollar has maintained its status as a "reserve currency" due to the size of our economy, the depth and liquidity of our markets and our stable political system. However, the fundamentals underlying our currency have badly deteriorated. Instead of surpluses in trade, budgets and current accounts, the US runs large and growing deficits. Instead of being the world's largest creditor nation, we emerged as the world's largest debtor nation. We are creating too many new dollars compared to the real growth of our economy - and an oversupply of anything drives down its value.

On the other hand, the supply of gold grows slowly compared to all the gold that exists in the world today - so aggregate supply is quite stable. Gold performs well in times of uncertainty as investors seek haven; but, gold also serves as a sensitive barometer to the rate of change in the supply of US dollars (Please refer to the graphs on the next page).

In this regard we believe two dynamics will support gold over the intermediate term. First, if the rate of core inflation continues to decline or turns negative, Fed chairman Bernanke will do as he's promised to do: create even more liquidity. He probably never thought it would actually come to this when he contemplated the possibility of deflation in several speeches; but increasing the money supply would be the only tool available to the Fed to divert deflation - and certainly gold would continue to find favor in this scenario.

Second, if and when the day comes when the U.S. Treasury begins having difficulty finding ready buyers for massive amounts of new US debt, resulting in higher interest rates, the Fed would likely step in to mop up some of this new supply, further bloating its balance sheet. This "open-market" action would be tantamount to pumping more money into the system which would also serve to support gold prices. Of course, some portfolio exposure to gold would also provide a short-term hedge against a sovereign financial or political "accident" which could send investors fleeing to the relative stability of gold.

All major Fed operations, showing the running total of all Fed and Treasury-controlled money creation or destruction actions:



Source: www.nowandfutures.com

Source: www.finviz.com

Some argue that it is inconsistent to think gold might do well in a deflationary environment, despite the fact that gold and long U.S. Treasury's have both been in a strong rally for over a year. Though gold experienced a significant correction in 2008 when fear of deflation arose, the Fed and Treasury moved aggressively to expand money growth, which kick started the current rally.[6] This will be the standard policy response to deflation, actual or anticipated.

We think gold's role in the investment world is shifting from a speculative hedge to more of a monetary asset as the dollar's role as a reserve currency diminishes. Therefore, we see gold not so much as an inflation hedge but as a hedge against the inevitable debasement of the US dollar stemming from massive new supply. Indeed, we believe the time is fast approaching when any discussion of investment policy in the US will start with currency considerations – much as foreign investors have long approached cross-border investments.

For now, the most practical way for us to garner exposure to gold is by owning the miners and producers whose earnings will benefit from strong demand and high prices, many of which pay dividends.

6. The green line in the upper graph indicates the cumulative effect of Fed and Treasury money creation – which reflects in the trend and level of gold (in the lower graph).

Conclusion

Investment opportunities and risks always exist - and most often they are two sides of the same coin. Overall portfolio risk is a function of the "quality" and valuation of the securities it contains. Our view of quality pertains to things fundamental, such as balance sheet strength and corporate performance metrics. Valuation connotes a "hurdle rate" that the fundamental performance of the portfolio must exceed to provide competitive returns going forward. Today's precarious macroeconomic backdrop, and the high systemic risk it embodies, *compounds* portfolio risk and underscores the importance of owning fundamentally sound securities. Therefore, it is imperative to take a broader view of asset allocation and investment policy issues than a traditional approach might afford.

Specifically, our approach seeks to provide diversification beyond simply allocating across asset classes. We believe portfolios will do well to diversify away from the shaky US dollar, as well as to gain exposure to countries possessed of balanced export and consumer economies, such as Brazil and India. We are committed to a global approach of finding strong companies that can compete successfully in a low-growth environment among the developed countries and/or have a presence in faster-growing markets.

Broadly, today we see much more value in equities than bonds - with much *less* market and fundamental risk commensurate with our expected returns for both asset classes. This speaks to the need to adopt a more fluid approach in the formulation of investment policies so asset allocation is guided by the return/risk outlook rather than traditional allocation ranges. This approach makes particularly good sense in light of the growing degree of correlation among many asset classes.

Finally, we want to save room in our policies and portfolios for less-traditional ideas that might provide diversification and return as market conditions warrant. Gold is hardly a non-traditional asset; although it typically is not considered an *asset class*. Today we see a role for gold exposure in portfolios as an additional hedge against the potential loss of purchasing power that would result if the dollar were to decline over time. Maintaining the purchasing power of the income and principal of our clients' portfolios is a paramount investment objective for us, as clients and long-time readers of *Perspectives* know.

The tenets of our research-intensive, fundamental and patient investment process won't change; but we believe maintaining an eclectic, adaptable, fluid - yet disciplined - approach to asset allocation will be critical to achieving investment success for our clients.

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