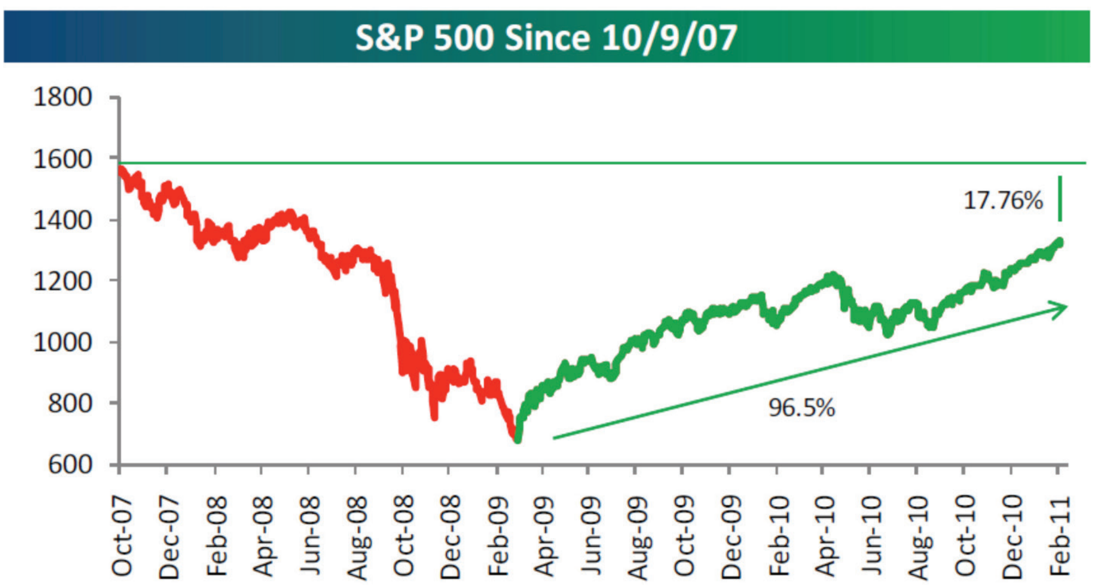
H.M. Payson & Co.

Winter 2011

PERSPECTIVES

Looking Up

"It's tough to make predictions, especially about the future." Yogi Berra's wry observation enjoyed particular resonance in 2010 as the strength of the equity markets' advance far exceeded consensus expectations. Annual market forecasts are challenging enough under normal circumstances, to say nothing of the unique environment of the past few years. The roller coaster market of 2008-2010 is a vivid reminder that near-term economic forecasts are unreliable predictors of investment returns, because of the market's ability to anticipate changing economic conditions well before they are widely evident. As we look ahead the economy is strengthening, but the major indices have nearly doubled from their 2009 lows; dutifully anticipating the rebound in the U.S. and global economies. While some are beginning to question the remaining potential stocks might hold after such an advance, our disciplined selection process is still indicating an ample number of worthy total return opportunities.



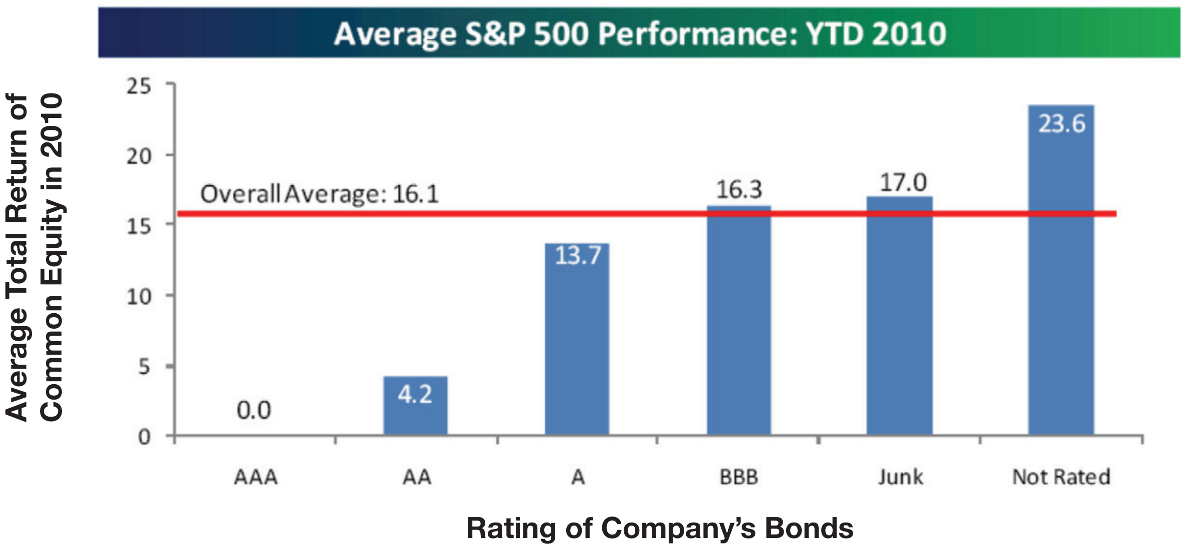
Source: Bespoke Investment Group, LLC
www.bespokeinvest.com

2010 Ends on a Strong Note

Despite the uncertain economic outlook entering 2010, equities turned in generous returns for the second year in a row. Through the spring and summer, concerns about the European debt crisis and fears of a "double dip" recession erased early gains. But the market rebounded sharply in the final months, aided by an accommodative Federal Reserve and a growing array of economic indicators signaling a strengthening recovery. The end result was an unanticipated 15% total return for the S&P 500. After a strong start this year, the S&P 500 index is now within 17% of its all time high in October of 2007.

Small-Caps Lead

As is usually the case, the gains were not uniform for equity investors last year. As shown in the chart below, smaller-capitalization, lower-quality companies – particularly those in highly cyclical commodity-related industries – posted the largest returns. Our portfolio emphasis was in larger higher-quality issues, where we saw attractive valuations, superior financial strength and excellent dividend growth. For much of the year, this segment of the market trailed the broader indices, but displayed some robust relative performance in the closing months.



Data as of 12/7/10

© 2010, Bespoke Investment Group, LLC
www.bespokeinvest.com

Quality Equities for Peace of Mind and Income

Although our equity models trailed the S&P slightly, we sacrificed very little return in exchange for the comfort of owning companies with solid balance sheets and robust cash flows. Further, by emphasizing stocks and underweighting bonds, we positioned our clients to fully participate in the market recovery. Because record low bond yields presented significant interest-rate risk, we undertook a creative interim approach to conventional investment policy constraints. By substituting higher-yielding stocks (examples in the table below) for bonds, our portfolios generated ample current returns with less risk.

	5 Yr Bond Yld	Dividend Yield	Spread
McDonalds	2.6%	3.1%	-0.5%
Kraft	2.6%	3.8%	-1.2%
Procter & Gamble	1.9%	3.0%	-1.1%
Exxon	2.0%	2.5%	-0.5%
General Dynamics	1.9%	2.5%	-0.6%
Abbott	2.0%	3.8%	-1.7%

Source: Bloomberg 11/22/2010

	Times Dividend Covered*	5 Year Dividend Growth	Consensus LT Earnings Growth
McDonalds	2.0	27%	10%
Kraft	2.2	7%	8%
Procter & Gamble	2.2	12%	9%
Exxon	3.3	9%	15%
General Dynamics	4.0	16%	8%
Abbott	1.8	10%	10%

Source: Bloomberg

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

Will Deleveraging Impose a "New Normal"?

In the wake of the financial crisis, a "New Normal" school of thought arose, judging that massive public and private debt burdens would force a prolonged period of lower spending and borrowing by both consumers and governments. This forced austerity would present a long-term headwind for economic growth, potentially redefining a "normal" recovery. The large developed economies of the U.S., Japan and Europe are particularly vulnerable, with structural retirement and health care liabilities, high taxes and aging populations. So, with the markets marching higher and economic data gaining momentum, the question at this juncture is: was the "New Normal" crowd wrong, or just early? Only time will tell, of course; for the moment the markets are focused on improving economic data.

Data Turning Positive, Raising Expectations

Until recently, the primary fuel for the market's strength had been surging corporate profits engineered primarily through cost cutting, rather than improved demand for goods and services. Although the global recovery relied on healthier emerging market economies in the early stages, a broader range of indicators in the U.S. have now turned solidly positive. For the fourth quarter of 2010, GDP expanded at a healthy 3.2% annualized rate. Thanks to an aggressive Federal Reserve, money is as cheap as it gets – and plentiful on corporate balance sheets. Managements are moving to increase investment in capital expenditures, technology, and other productivity-enhancing assets. Unemployment remains high – but recent data indicates an improving trend, and consumer confidence is solidly positive. Wall Street analysts are busily revising their earnings estimates upward in response to some genuinely good earnings reports and bullish guidance from corporate managements. A growing number of strategists are citing strong forward-looking S&P 500 earnings estimates as the basis for double-digit return predictions for the year.

Guarding Against Complacency

Despite an increasingly bullish economic outlook, investors would be wise to remain vigilant. Just as gloomy forecasts in 2009 preceded a sharp rebound in the index, this year's increasingly optimistic outlook does not guarantee generous returns. Among the potential obstacles:

- Macroeconomic headwinds from deleveraging (discussed above) could serve as a moderating factor to the recent surge in GDP growth.
- If interest rates begin to rise significantly, the discount rate (required rate of return) on future earnings and dividends will also rise, pressuring equity valuations.
- Analysts will be challenged to gauge and value highly variable future profits driven by operating leverage.
- Profit margins are again at all-time highs, leaving them vulnerable to mean-reversion over time.
- Earnings comparisons to year-ago results will become more challenging without a broad, sustained demand recovery.

By some measures, the market as a whole is becoming expensive. The trailing P/E (based on the last twelve month's earnings) on the S&P 500 stands at 16, slightly above its long-term average. On a "forward earnings" basis, the P/E is a more reasonable 14, though we are always reluctant to bank on above-average future earnings growth. At moments like this, adherence to a disciplined selection process is increasingly important. The good news is while our outlook for the market as a whole is tempered by some valuation measures, we have little difficulty identifying companies boasting sound balance sheets and strong cash flows, trading at very reasonable valuations.

Broader Strategies – A Deliberate Approach

As we discussed in our previous newsletter, global investment opportunities will play a larger role for our clients in the coming months and years. To date, we have effectively incorporated strategic international exposure through a limited selection of index-based exchange-traded funds. Currently, we are examining a variety of more tactical strategies but will not stray from our valuation discipline for the sake of diversification alone. Further, in a world of expensive investment "products", we are adamant about maintaining the lowest possible cost to the client, and are being very selective as we research potential vehicles for more targeted asset class exposure.

We also spent some time discussing gold in the last Perspectives. However, as we weighed the potential diversification benefits against the increasingly steep price, gold (and gold mining shares) simply showed all the characteristics of a "crowded trade" with high potential to disappoint. In fact, both the bullion and the gold ETF have been in a sharply corrective mode as the dollar has strengthened in recent months. At some price, we may determine that gold deserves a place in our portfolios as a hedge against global currency debasement – but for the time being we will focus on more quantifiable opportunities.

Stocks Over Bonds, For Now

With the five-year Treasury yield at 2.3%, we see significant inflation and interest rate risk to bond portfolios. Considering the large number of high quality equities that have demonstrated a propensity to raise dividends at a rate surpassing inflation, equities look compelling as a source of real income, at least compared to the alternatives. Therefore, we continue to maintain maximum equity weightings in our portfolios, for both income and total return potential.

Given the sustained advance since last August without a significant pullback, we would not be surprised to see the market retrench and consolidate some gains at any point. In the long run, disciplined security selection is more important than month-to-month index levels. We're comfortable with what we own, and confident that our forward-looking asset allocation work and emphasis on quality will serve our clients well as the global economic recovery continues to progress.

Market Log

Publication Date: 3/3/11
S&P 500: 1330.97
5 year T-note: 2.28
Crude Oil: 101.91
Gold: 1416.00