HM Payson

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Q2 Market Update and CEO Chat

Pete Robbins CFA
CEO, Chief Investment Officer

In This Note:

- Will large-cap tech continue to lead the market?
- Are we on the verge of the next bubble?
- How has the HM Payson research process changed over time?
- What keeps Pete up at night?

Q2 Returns, at a Glance:

INDEX	Q2 2024	YTD 2024	TRAILING 12 MOS.
S&P 500	4.3%	15.3%	24.6%
Russell 2000 Small Cap	-3.3%	1.7%	10.1%
MSCI EAFE - International	-0.4%	5.3%	11.5%
MSCI Emerging Markets	5.0%	7.5%	12.5%
Bloomberg US Aggregate Bond	0.1%	-0.7%	2.6%

SOURCE: BLOOMBERG

This quarter, we are changing up the format of our traditional market update, aiming to shed more light not just on the movements of the market, which are reported in the Q2 returns table below, but on how we view the larger dynamics at work from the research, analysis, and portfolio management perspectives. We hope you enjoy this series of seven questions with CEO and Chief Investment Officer Pete Robbins, and we welcome your follow-up questions on any of the topics explored below.

Has the concentration of large-cap technology stocks driving the US stock market affected your portfolio management approach?

It's a relative impact. As the stock market has become more concentrated in fewer very large companies, so too have our portfolios — but in a very deliberate and calculated way.

Our portfolios have always been more concentrated than the market. We tend to concentrate portfolios in sectors and stocks of high-quality companies - companies with great margins (as a function of their competitive positions), growing earnings and cash flows and with superior balance sheets. Also, we specifically look for companies that we consider "capital-efficient" — which means they can generate strong revenue growth with relatively lower capital investment than the average company.

These large companies are big because they possess the attributes we want in our portfolios and do a great job growing profitably and compounding returns — and the concentration of the stocks in the market gives us leeway to maintain larger positions in the companies we find most attractive.

And, like the market, our portfolios have grown on their own to become more concentrated since we owned these high-quality companies as they've appreciated nicely, providing us great returns in the process.

Is there a bubble in mega-cap technology stocks linked to AI growth? Is AI as disruptive as past innovations, and how do you manage portfolios in such disruptive periods?

"Bubble" is a strong word! No, we don't see anywhere near the type of speculation in stock prices that accompanied the advent of the Internet, for example. For sure valuations are climbing; and certainly some of this is related to the excitement around AI. But, as the research outfit, Strategas, and others have pointed out, the top 10 largest stocks make up almost 40% of the market — but they also generate over 30% of net income. So I say, to a great extent you're getting what you pay for in the S&P 500 index today.

To be sure, at some point the largest companies will face the "law of large numbers", and they will have a harder time maintaining revenue and earnings growth off such a large base — certainly we've seen this in Apple, for example.

Have the fundamental drivers of stock performance changed over time?

No. The primary driver of long-term equity returns remains and will always be the growth of company earnings (and the cash flows derived from them). Importantly, the real (above inflation) growth of these cash flows is the mechanism through which equities provide protection against inflation over time. Yes, our economy has transitioned away from bricks and mortar, plant and equipment-type of businesses to more service-oriented, intellectual property focused businesses. But at the end of the day, current and future cash flows are the foundation upon which to ascribe value to a company's stock and the stock market as a whole.

How has research and stock selection at HM Payson evolved in the past decade?

Our economy has evolved from heavy-industrial (old economy) businesses requiring ongoing capital investments of plant and equipment into an economy built on research and development (R&D) of technologies and intellectual properties. Generally accepted accounting principles (GAAP) don't do a good job reflecting the true economics of R&D investments since these investments pay off over time — whereas GAAP calls for expensing these outlays immediately which depresses net income.

When I started at HM Payson over 40 years ago, the aggregate balance sheet of stocks comprising the S&P 500 was comprised of 90% 'hard' assets such as plant and equipment, inventory, cash and receivables, etc., and 10% 'intangible assets' which arise primarily from goodwill, copyrights, trademarks, patents and other non-monetary assets. Today, that ratio is reversed!

We were early adopters of a construct known as Economic Value Added (EVA) which makes adjustments to GAAP accounting to present a more realistic economic picture of an enterprise. For example EVA capitalizes R&D investments (treats them like an asset to be depreciated over time) rather than charging them immediately against income.

Further, using the EVA model, we levy a hypothetical cost to the company for all their capital — shareholders and lenders expect a return on their investments. Companies that can produce a profit after this capital charge are 'economically' profitable. This distinction has become a central tenet of our approach to analyzing and valuing companies.

As a result, over the years we pivoted away from companies that require larger amounts of extra capital to grow, and we now favor the 'capital-efficient' companies we talked about earlier which are better able to earn an 'economic' return.

This shift in our approach has made all the difference in the strong performance of our portfolios.

What advice would you give less seasoned Portfolio Managers during difficult times?

Time horizon is the key. I tell young portfolio managers to keep their eyes on the time horizon. If you have a long time horizon, the worst thing you can do is try to trade in and out of the market because you risk being out of the market when it inevitably moves higher. Empirically it is all but impossible to succeed at timing the market this way.

Lower prices today mean higher returns in the future. If you're a net saver, lower prices should be a welcome opportunity to add to positions. Unfortunately, the typical investor buys high — after prices have risen and they feel like they are missing out — and sells low, when the market is down and they get scared things'll get worse. It's pretty hard to make money this way! We believe sometimes we can add the most value for our clients at market extremes by keeping them calm and unemotional during periods of inevitable volatility.

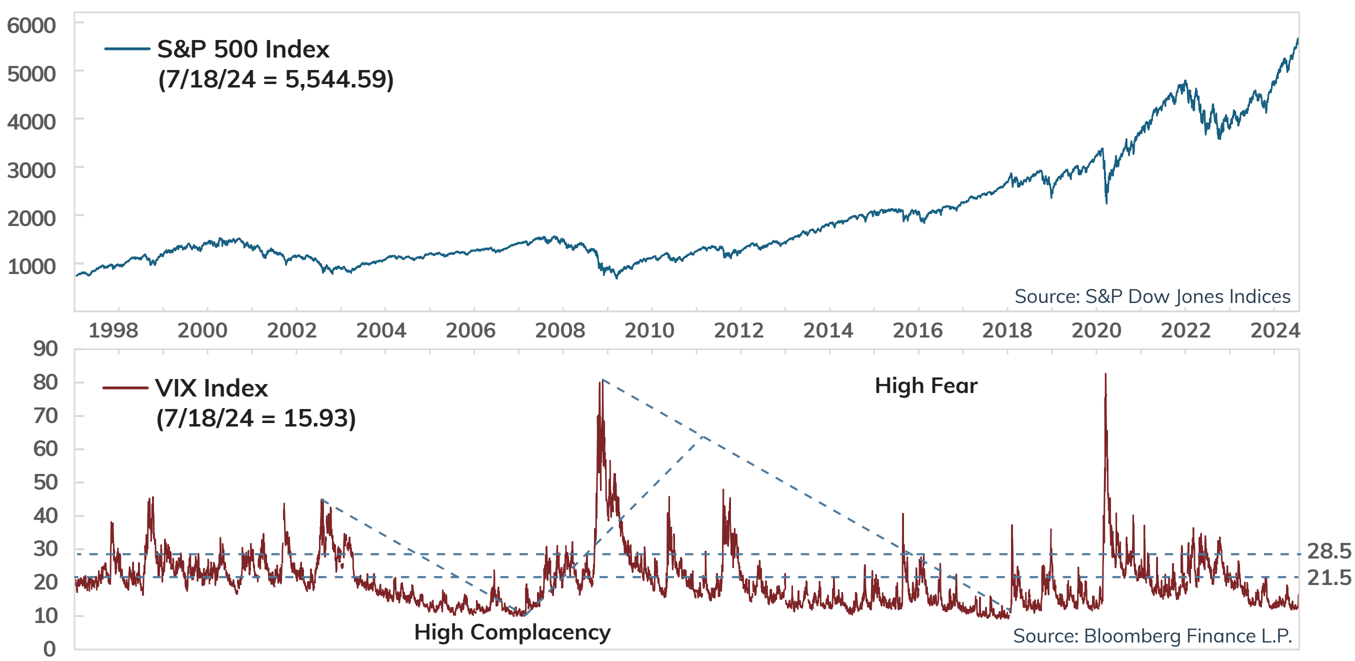
I really like the chart and table below. The VIX, or volatility index, is mathematically derived from option prices and is a measure of what investors are willing to pay as essentially insurance premiums to mitigate volatility in their portfolios. Typically, when prices are declining and/or market volatility is high, the VIX will move higher.

To my point about trying to time the market, I think the stats in the box below are pretty amazing. Going back to 1996, except for periods when the 'Fear Index' (VIX) is at a relatively escalated 28.5 (only 12.2% of the time), annualized returns for the S&P 500 are way below the index returns of 7.6% per year! So, to turn a phrase, the best time to invest new cash is when others are downright fearful. It can be hard to do if portfolio management is new to you.

What trends or recent developments draw your attention as an investor?

After a decade of negative real yields in bonds (meaning yields offering returns below the prevailing rate of inflation), we are ready to consider bonds an asset class again. For most of the last 10-12 years we would invest in only extremely

S&P 500 VS. VIX INDEX, DAILY DATA 1996-12-31 TO 2024-07-18



S&P 500 INDEX PERFORMANCE, FULL HISTORY: 12/31/1996 to 07/18/2024

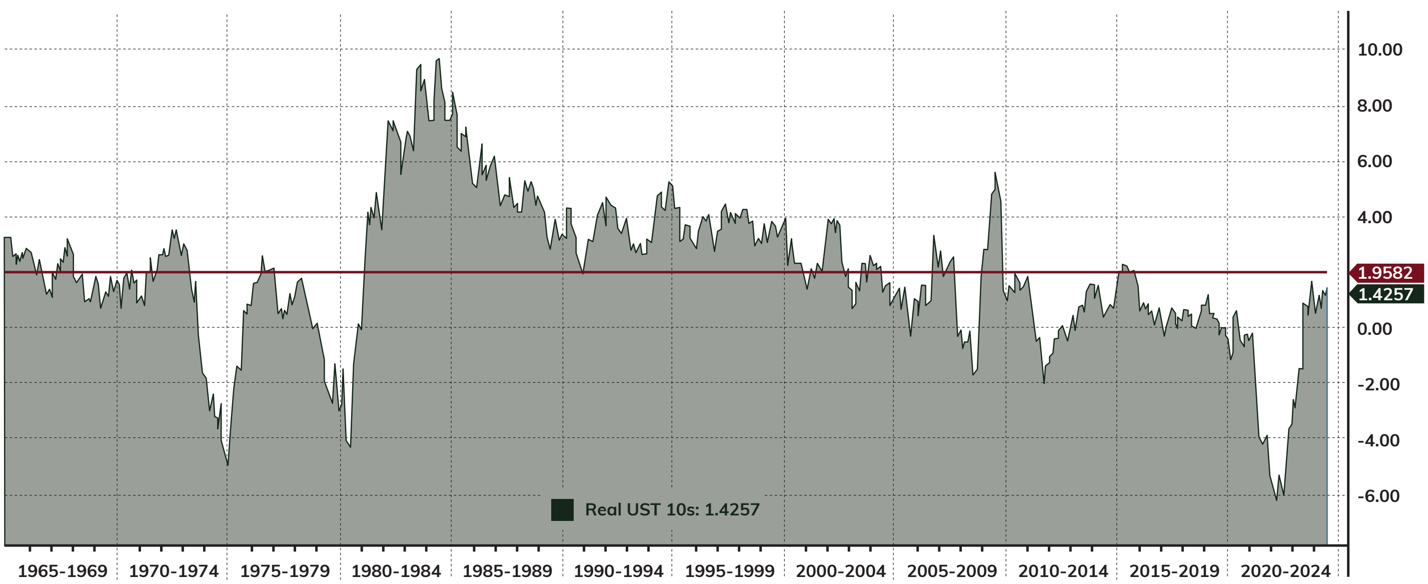
VIX INDEX IS	% GAIN/ANNUM	% OF TIME
Above 28.5	50.59	12.17
21.5 - 28.5	0.97	23.55
Below 21.5	3.31	64.29
BUY/HOLD = 7.58% GAIN/ANNUM		

short bonds as a store of liquidity since cash was earning virtually 0%. This is somewhat of a big deal. But we make the case that even though interest rates have come up pretty far and fast from their lows, they are still arguably below "normal" in terms of the return they should provide above inflation.

Today, our bond portfolios are still invested in very short-term bonds and cash, which now earns around 5%. Bonds, as an asset class, are still best for a store of liquidity — but at least short bonds are yielding something above inflation today.

It's a recurring concern of bond investors over the decades, but today the large US fiscal deficits and the government borrowing that funding those deficits requires may finally pose a risk to bond yields. Simply put, there is a lot of new supply of government bonds to fund the US deficit; and the question is, when might the demand for newly issued bonds fall short of the increased supply? When that day comes, obviously bonds need to get cheaper to be attractive — which means the yields they offer will have to go higher. Higher interest rates can disrupt the economy and negatively impact stock market valuations.

REAL 10-YEAR US TREASURY YIELD 10Y - YOY CPI INFLATION | RED LINE: AVERAGE SINCE 1965



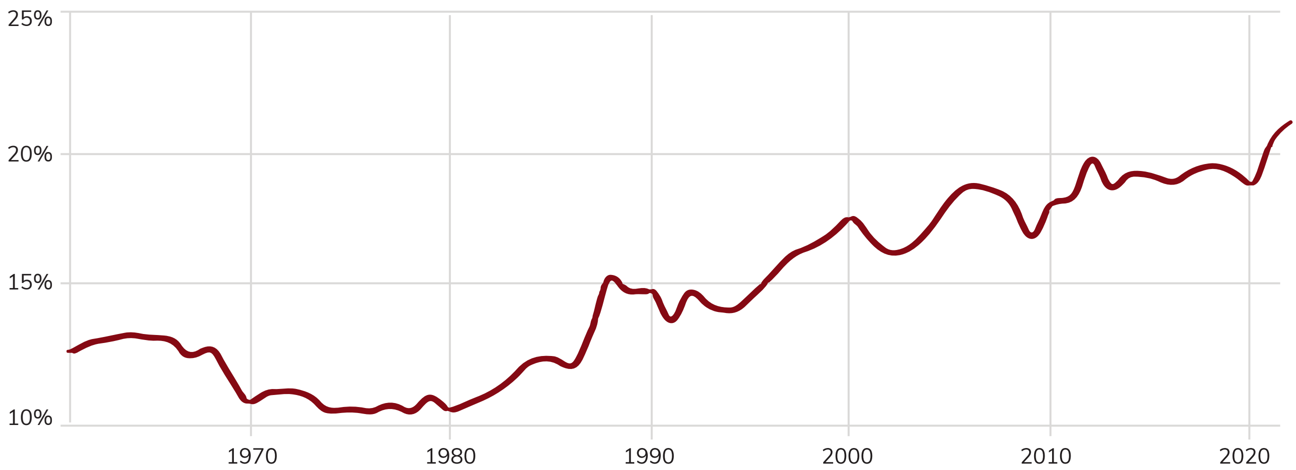
91282CKQ Govt Real 10s Monthly 31Dec1964-30Jun2024. Source: Bloomberg

What keeps you up at night?

I get this question a lot; and while I don't really know how best to qualify my answer or quantify the risks, my answer has been the same for over a decade.

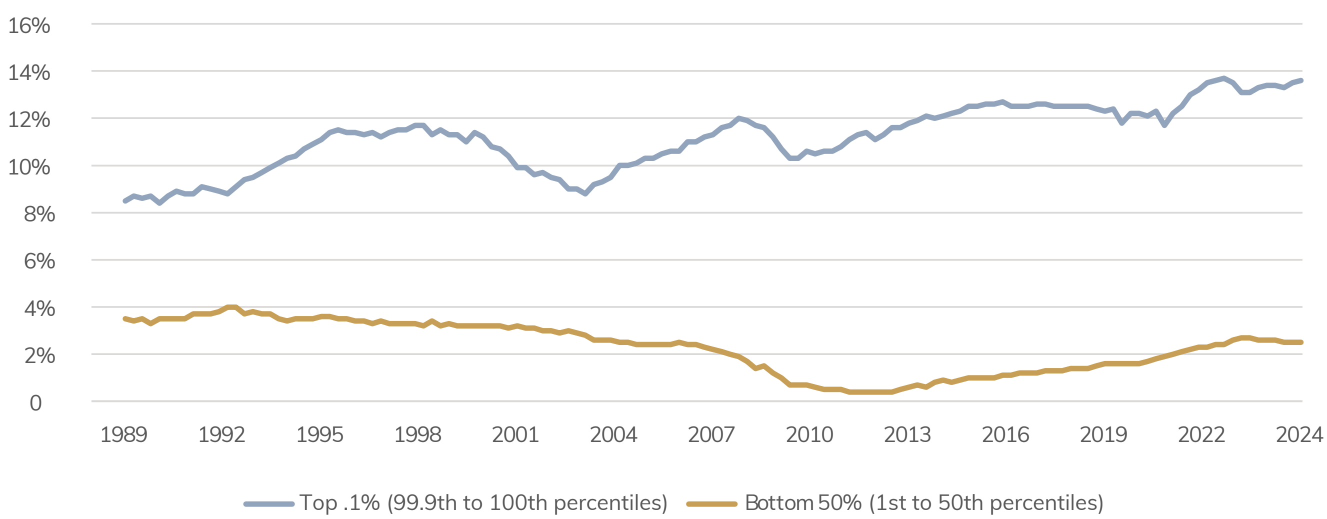
Eventually, ever-growing income- and wealth-inequality are likely to catalyze some form of social dislocation and unrest. Who knows what form it might take, or what our government might have to do to stave off the risks and effects of this imbalance. I cheer good policy intended to address this — but good intentions and policy only go so far. With essentially 'free money,' it's cheaper to substitute capital investment (robotics, machinery, etc.) in lieu of additional labor — so labor has become relatively cheap and abundant. The aggregate labor market forces are much more complicated than that, of course; but the net result has been that real (again, after-inflation) wage inequality has continued to rise as real wages at the low-end trend lower. Also, not surprisingly given the appreciation of virtually every asset class since the peak in real interest rates going all the way back to 1981, those with assets

TOP 1% NATIONAL INCOME SHARE IN THE UNITED STATES



Source: World Inequality Database (WID.world)

SHARES OF WEALTH IN THE UNITED STATES BY WEALTH PERCENTILES, 1989-2024



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

have become much more relatively wealthy. The wealth gap among the Haves, the Middles, and the Have-Nots has gotten much worse. To me, these trends pose increasing socioeconomic risks that might not have obvious market impacts. The ironic policy response is likely to be more like throwing gas on a fire: more money printing and transfer payments to the less wealthy and lower real wage-earning populace — paid for to some extent by pressure to raise taxes, which hurts future investment and economic growth. There are no simple policy responses — but it will be crucial to promote real wage growth by increasing labor productivity through investments in education and perhaps through tax incentives that reduce the after-tax cost of labor.

We hope you found Pete's insights interesting and helpful. If you have questions, please feel free to contact Pete at 207-518-6209 or PER@hmpayson.com.