February 23, 2004

Dear Client:

THE DEFICITS, THE DOLLAR, AND EMPLOYMENT

Executive Summary

Fourth Quarter Earnings Shine -- Approximately two-thirds of the S&P 500 companies that have reported have beat analysts' earnings estimates, and the average increase for 2003 over 2002 fourth quarter earnings was 25%.

Stocks Start 2004 on a Positive Note -- The S&P 500 index increased 1.7% in January and was up 3% through mid-February. Market leadership appears to be shifting to the Telecommunications, Financials, Health Care, and Energy sectors from last years' leaders, the Information Technology, Materials, Consumer Discretion, and Industrials sectors.

The Federal Budget Deficits -- The $500 billion estimated Federal budget deficit for fiscal 2004 is a record in dollars, but this result is in the historical range as a percent of GDP. The bull market in stocks during President Reagan's deficits in the 1980's is evidence that deficits don't harm the value of financial assets. We believe that Federal revenues growth from an improving economy and disciplined legislative action will narrow the deficit over time.

The Trade Deficit -- The U.S. has had a trade deficit for over 20 years, but it is at a record high in terms of dollars and at a historical high in terms of percent of GDP. We expect the trade deficit to narrow over the next several years due to expanded exports, the lower value of the dollar, and improving world economic growth. However, we expect the U.S. to continue to experience significant trade deficits for the foreseeable future.

The Dollar -- The large U.S. trade deficit has created a surplus of dollars abroad, which has caused the dollar to decline 44% against the euro over the last three and a half years and 20% against the yen over the past two years. Fortunately, many of these dollars have been invested back into U.S. securities, which has helped interest rates to remain at low levels. International economic and political pressures will most likely allow this recycling of dollars to continue. A narrowing trade deficit and freely floating currency exchange rates should alleviate these currency imbalances over time. However, these pressures could cause interest rates in the U.S. to rise this year and for several years into the future.

Employment -- The Labor Department's statistics provide conflicting assessments for total U.S. employment, which is firm, and structural unemployment, that is stubborn to reduce. However, by either measure, it appears that job growth has been slower in this economic recovery than in previous cycles. It appears that many of the jobs lost in manufacturing and some service industries will not be returning to the U.S. economy and that newly defined jobs will need to be created. However, the current unemployment rate is still better than the average of the past 30 years. We believe that the U.S. continues to be among the most entrepreneurial countries in the world, and that our economy will eventually generate the new jobs needed. However, our leaders may need to be more proactive in ensuring that U.S. employees are educated and trained sufficiently to be qualified for the increasingly more technical requirements of many new jobs.

Investment Strategy -- We continue to believe stocks offer better value than fixed income securities at current prices. Given the significant increases in stock prices over the past year, it wouldn't surprise us if the stock market indices experienced a temporary decline of 10% to 20% sometime during 2004. However, we expect stock prices to move above year-end 2003 levels over the next several years in line with growth in earnings for the companies that achieve such improvements.

Fourth Quarter Earnings Shine

Most of the publicly traded corporations have reported their results for the fourth quarter of 2003, and most have met or exceeded analysts' estimates. Through February 13, 2004, 87% of the Standard & Poor's 500 Index companies had reported fourth quarter results, and 68% of those companies exceeded earnings estimates, 20% met estimates, and only 12% were below estimates. The average earnings increase over the 2002 fourth quarter results was 25%. The stocks that Bridges follows had a similar experience. Out of the 69 companies that had reported through February 16, 64% reported earnings that exceeded analysts' estimates, 17% met estimates, and 19% were below estimates. A sampling of the fourth quarter earnings results from Bridges-followed companies are shown in Exhibit A on the following page:

Exhibit A

FOURTH QUARTER EARNINGS RESULTS

Company Name	Actual EPS	EPS Est.	Q4 EPS 2002	% Chg 03 Vs 02
Altria Group	1.06	1.06	0.93	14%
Anadarko Petroleum	1.17	1.18	1.21	-3%
Apache	0.87	0.84	0.62	40%
Capital One Financial	1.11	1.00	1.05	6%
Cardinal Health	0.86	0.86	0.77	12%
Chevron Texaco	1.70	1.59	1.07	59%
Cisco Systems	0.18	0.17	0.15	20%
Colgate-Palmolive	0.65	0.63	0.59	10%
Dow Chemical	0.50	0.29	-0.18	378%
Exxon Mobil	0.68	0.58	0.56	21%
Fair Isaac	0.59	0.56	0.40	48%
First Data	0.50	0.54	0.48	4%
Fiserv	0.42	0.42	0.35	20%
General Electric	0.45	0.45	0.31	45%
Intel	0.33	0.25	0.16	106%
Johnson & Johnson	0.57	0.56	0.46	24%
Marsh & McLennan	0.70	0.65	0.57	23%
MBNA	0.54	0.53	0.41	32%
Microsoft	0.34	0.30	0.27	26%
Omnicom Group	1.17	1.18	1.08	8%
PepsiCo	0.51	0.52	0.50	2%
Pfizer	0.53	0.52	0.45	18%
State Street	0.71	0.66	0.56	27%
Tyco International	0.34	0.32	0.32	6%
Wells Fargo	0.95	0.95	0.86	10%

Source: Baseline

Stocks Start 2004 on a Positive Note

The stock market indices started the year on a positive note with the Standard & Poor's 500 Index advancing 1.8% in the first five trading days of January and 1.7% for the month of January. This cheered the bulls because there is a saying on Wall Street that "as January goes, so goes the year". This is because, more often than not, when the stock market indices have a positive return in January (and especially in the first week of January), they have historically had a positive return for the ensuing year. This trend continued into February, bringing the year-to-date advance to 3.0% through February 13.

Based on the year-to-date returns, it appears that the market leadership has shifted away from many of the leaders in 2003. Last year the four highest performing sectors in descending order were Information Technology, Materials, Consumer Discretion, and Industrials. Thus far in 2004, these sectors have lagged behind the S&P 500, and the new leading sectors are Telecommunications, Financials, Health Care, and Energy as shown in Exhibit B shown below:

Exhibit B

STANDARD & POOR'S 500
SECTOR PERFORMANCE

Sector	Price % Chg '03	Price % Chg YTD*
Consumer Discretion	35.5%	+0.7%
Consumer Staples	18.8%	+2.8%
Energy	23.0%	+3.9%
Financials	27.9%	+5.3%
Health Care	13.7%	+4.7%
Industrials	30.8%	+1.4%
Information Tech.	45.7%	+2.3%
Materials	35.4%	-1.6%
Telecommunication	3.6%	+6.2%
Utilities	21.3%	+1.3%
S&P 500	26.4%	+3.0%

*Through February 13, 2004

Source: Baseline

Deficits, the Dollar, and Employment

By most measures, the current economic environment looks as positive as any time since1999. Real growth in Gross Domestic Product (GDP) has improved to a 4.0% annual rate in the fourth quarter of 2003 (8.2% in the third quarter) from less than 3% in 2002, and economists' forecasts for 2004 are in the 4% to 5% range. Operating earnings for the companies in the S&P 500 Index have recovered from their nadir in the fourth quarter of 2001 and are estimated to have reached a new record high in the fourth quarter of 2003, surpassing the previous record high in second quarter of 2000. Inflation and interest rates are near 45-year lows. The stock indices have recovered sharply from their bear market lows, with the S&P 500 Index up about 48% from its October 2002 low, and now it is within 25% of its record high in 2000. Investors' confidence has improved markedly, and mutual funds are witnessing sharply higher sales in recent months.

However, there are four economic measures that are still troubling to some investors and are becoming political fodder in this election year -- the record budget and trade

deficits, the falling value of the dollar, and stubbornly slow growth in employment. Since some economists believe these measures could be the economy's and the stock market's undoing, we thought it prudent to study these issues and to put them into perspective.

The Federal Budget Deficit

Much has been made about the record Federal budget deficits, which are forecast to exceed $500 billion in 2004. We agree that running large deficits over a long period of time would be a poor economic policy and could eventually undermine the economy. However, history does not support the hypothesis that budget deficits for multiple year periods are harmful to the economy or the financial markets. In fact, a similar hue and cry arose in the 1980's when then President Reagan slashed tax rates and ran large deficits for nearly the entire eight years of his Presidency. However, instead of negatively impacting the economy and the financial markets, a major bull market began in 1982 that lasted until the recession and first Gulf War in 1990. Growth in real GDP increased at an average annual rate of 4.3% during this period. While it is true that the dollar amount of the deficits under President Reagan was only in the $150 to $200 billion range versus $500 billion now, as a percent of GDP, it was about the same as now, 4% to 5% of GDP. The deficit swelled to about $300 billion in 1992 due to the recession and the cost of the first Gulf War under the first President Bush. Once again the 1992 deficit was between 4 % and 5% of GDP. It is interesting to note that much of the budget surplus enjoyed in 1999 and 2000 was due to taxes received by the Federal government related to capital gains and stock options generated from the stock market bubble. Will we be concerned if the Federal government is allowing the deficit to continue to run at 5% or higher over the next ten years? The answer to that question is definitely yes. Are we concerned that the deficit may remain at these levels for the next several years as the U.S. pays for fighting terrorism and rebuilding Iraq and Afghanistan? The answer to that question is no.

The Trade Deficit

The U.S. has been importing more than it exports for more than 20 years. The trade deficit on goods and services remained below $150 billion until 1997, but since then it has increased sharply to over a $485 billion annualized rate in the third quarter of 2003. The biggest contributor to the increase was consumer goods excluding autos, which nearly doubled its trade deficit since 1997 to $237 billion. Close behind was petroleum, which, primarily due to higher oil prices, increased from a deficit of less than $75 billion in 1997 to $137 billion. The other major contributor was autos, which doubled its trade deficit since 1997 to $125 billion. The 2003 trade deficit will be the largest ever in dollars and the largest since World War II as a percent of GDP (5%). We believe the trade deficit will stabilize or even narrow somewhat over the next few years as improving economic growth abroad, coupled with the lower value of the dollar, creates more demand for U.S. exports. At the same time, the growth rate of U.S. imports should moderate as the declining value of the dollar makes imported products more expensive. However, given the U.S. consumers' proclivity to spend rather than save money, our dependency on foreign oil, and the continuing movement of manufacturing to lower-cost foreign countries, a sizable U.S. trade

deficit is likely for the foreseeable future. This has implications for both the value of the dollar and growth in employment.

The Dollar

As Americans purchase $500 billion more in goods from foreign countries than they sell to them, a surplus of dollars accumulates at foreign central banks. As these banks attempt to convert the dollars to their own or another currency, it puts pressure on the dollar exchange rate, causing the dollar to decline versus other currencies. One of the largest dollar value declines has been against the euro. Since bottoming at $0.83 per euro in October of 2000, the euro has risen 44% to $1.28 per euro. The Japanese yen has had a more modest rise against the dollar, rising 20% from $74 per 10,000 yen in February of 2002 to $94 per 10,000 yen recently.

Economists are divided on how big a problem this is. A lower dollar gives U.S. industry a competitive advantage over foreign companies because it reduces the price of U.S.-made goods. However, a cheap dollar makes foreign-produced products and foreign travel more expensive for U.S. consumers and eventually puts upward pressure on inflation. Economic theory suggests that these currency imbalances are self-correcting if exchange rates are allowed to be set by the market. As a currency declines, exports become more price competitive and imports become less, so the trade gap should naturally narrow. This appears to be the policy of the Bush administration. However, countries that depend significantly on trade with the U.S., such as Japan and China, want to keep their exports growing. Their primary method for dealing with this problem is to intervene in the currency markets and buy up dollars in an attempt to slow its decline against their respective currencies.

Actually, the Chinese have pegged their currency to the dollar, which has exacerbated the trade deficit between China and the U.S (estimated to be $120 billion in 2003). As a result, the U.S., Japan, and other countries have been trying to put political pressure on China to revalue their currency at a higher level versus the dollar. China is also experiencing economic pressures. The combination of increasing currency reserves (up $160 billion in 2003 to $450 billion), rapid economic growth, expansion of credit, and a high savings rate is flooding the Chinese economy with too much money. This is causing inflation to increase (up 6% in December versus November) and potential speculative bubbles in real estate and commodities such as steel and cement.

The dollars that Japan, China, and other counties accumulate are often invested in U.S. securities in order to earn a return on the dollars they are holding. The most popular investment vehicle for these dollars is U.S. Government securities. In 2003, Japan purchased $172 billion of U.S. dollars and invested much of that ($104 billion between January and October) in U.S. debt. That represented about one-third of the new debt issued by the U.S. government during that period. Of course, this benefited the U.S. as it finances record budget deficits. A senior strategist at Japan's largest bank estimated that the yield on the benchmark U.S. 10-year note would be closer to 6% instead of 4% had it not been for Japan's purchases. In December, total foreign net purchases of U.S. securities

were $75.7 billion, down from $87.5 billion in November. Out of this total, $29.8 billion went into U.S. Government securities, $20.4 billion went into corporate bonds and $13.3 billion went into U.S. stocks. At year-end 2003, Japan was the largest holder of U.S. Government securities with $545.2 billion, followed by China and the U.K.

The question for other investors and us is whether there is a danger to the values of U.S. securities from these trade imbalances and the weak dollar. Here again, economists are divided in their opinion. On the one hand it is unsettling that central banks and investors in Japan, China, and Europe are largely financing our currency imbalances and our federal budget deficit. If they were to suddenly withdraw, we would expect interest rates in the U.S. to increase significantly and risk choking off the economic recovery. On the other hand, economic and political pressures on these foreign countries make their withdrawal highly unlikely. The Chinese are rumored to be considering a modest 3% to 6% upward revaluation of their currency. Japan is nursing along a fragile economic recovery and is unlikely to embrace any significant changes. Germany and several other European countries are also experiencing stagnant economic growth. The other investors in currencies and U.S. securities are private investors such as financial institutions and hedge funds that are primarily motivated by currency trends and rates of return. However, if foreign investors reduced their purchases of dollars and U.S. securities, interest rates in the U.S. would rise, which would eventually halt the slide of the dollar and make U.S. securities more attractive to foreign investors.

Our synthesis of all this information is that there are currency imbalances building that will have to be corrected, which will most likely cause upward pressure on interest rates in the U.S. However, it is in nearly everyone's interest that this correction occur in a gradual and orderly manner. Thus, we believe that the odds of a sudden or significant shift in exchange rates and/or interest rates are relatively low over the next year. However, this is something we intend to watch very carefully.

Employment

The one economic measure that identifies an improving economy that has yet to meaningfully recover is employment. However, there is conflicting data from the Department of Labor as to how many people are employed. The Department conducts two surveys of employment from two different sources: household interviews (household series) and reports from employers (establishment series). Seasonally adjusted total nonfarm payrolls in the U.S. based on the establishment series peaked in March 2001 at 132.5 million, and they were at 130.0 million in December 2003, for a loss of 2.5 million jobs or 1.9%. This is the statistic that critics of the Administration's economic policy have quoted. However, based on the Labor Department's household series, seasonally adjusted employment peaked at 137.8 million in January of 2001, declined to a low of 135.7 million in January 2002, and then recovered to a new record high of 138.6 million in January 2004! The Department of Labor has not successfully rectified the difference between these two series. Some economists have suggested that the establishment series does not include self-employed individuals and employees of more recently established businesses, and therefore understates the true employment picture. This argument would be especially valid

if a higher than average number of individuals who were laid-off or took early retirement packages in the last few years has established or joined new businesses. There is some anecdotal evidence that this is true.

By either measure of employment, the percent of jobs lost and the peak unemployment rate in this recession were no worse than that during previous recessions. In fact, January's unemployment rate of 5.6% was lower than the average unemployment rate during the last 30 years. However, what has been disappointing and alarming is the stubbornly slow recovery in jobs this time. After the same number of months from the peak in employment in 1990, about 400,000 jobs had been added. Economists, basing their forecasts on past experience, were too optimistic in their estimates of new jobs created in 11 out of the past 14 months.

Some economists now believe that a large portion of the jobs lost during this recession may not be coming back. A combination of increased use of technology, more efficient operating processes, and moving or outsourcing production to lower-cost countries have caused some jobs to be lost permanently. Manufacturing jobs have been the hardest hit with a loss of 5.5% over the past three years. The information sector was next with a loss of 4.1% over the past three years. The manufacturing sector has been lagging behind the services sector for more than 20 years, and now represents only 11% of all non-farm jobs compared to 83% of the total contributed by service sector jobs. The remaining 6% of jobs comes from the construction and natural resources/mining sectors. The best job growth in services in the past three years has been 2.9% growth in education and health services (15% of total jobs), 1.1% in government (20% of total jobs), 0.9% in financial activities (7% of total jobs), and 0.7% in other services (5% of total jobs). Other major categories include professional and business services (15% of total jobs, down 1.3% during the past three years), retail trade (14% of jobs, down 1.0%), and leisure and hospitality (11% of jobs, up 0.4%).

The key question in the long term is whether the U.S. economy can create enough service jobs to replace the manufacturing and other jobs lost and employ the new entrants into the job market each year. The key question in the short term is how much this stagnant job growth will limit growth in total personal income and therefore, growth in GDP. Of course, there are a host of social and political questions raised by this problem, which our political leaders will need to address. One of the most important issues is the need for retraining of laid-off employees in declining industries so they can gain meaningful employment in growing industries that are able to compete in the world marketplace. We believe that the U.S. continues to be one of the most entrepreneurial countries in the world and that our economy will eventually generate the new jobs needed. However, our leaders may need to be more proactive in ensuring that U.S. employees are educated and trained sufficiently to be qualified for the increasingly more technical requirements of many new jobs.

Investment Strategy

The investment strategy for our advisory and discretionary clients remains the same. We continue to believe stocks offer better value than fixed income securities at current prices. However, the stock market indices have recovered sharply from their March 2003 lows without as much as a pause. Thus, it wouldn't surprise us if the stock market indices experienced a temporary decline of 10% to 20% sometime during 2004. However, we expect stock prices to move higher over the next several years in line with growth in earnings. We remain focused on owning companies that we believe have the best combination of good long-term earnings growth prospects and attractive valuation characteristics.

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