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April 2006 Newsletter

Executive Summary

Market Value Versus Intrinsic Value – Bridges' investment philosophy is that, over the long run, stock prices are primarily driven by underlying corporate financial performance in terms of growth in earnings, dividends, and free cash flow. However, the stock prices of many companies under-performed the increase in their respective estimated intrinsic value in 2005. A review of Bridges Core Growth Model Portfolio showed that book values increased an average 11.4%, and earnings per share increased an average 14.6% during 2005, while the average stock price increased only 3.7%. We believe eventually stock prices will reflect long-term intrinsic value.

Avoiding Train Wrecks – While there are risks and costs associated with the Federal Reserve's current tightening policy, slowing consumer demand, federal budget deficits and trade deficits, we don't believe they will derail the economy over the next 12 to 18 months.

Investment Strategy - The price/earnings ratio of the S&P 500 is currently less than 16 times the estimated 2006 earnings per share, which is near the historical average. We continue to believe stocks are under-valued relative to bonds although the gap is narrowing. We recommend over-weighting select companies in the Health Care and Energy sectors, and underweighting investments in the Utility and Telecommunications sectors. In fixed-income portfolios, we are starting to shift our purchases from short-term maturities to intermediate maturities.

Market Value Versus Intrinsic Value

Bridges' investment philosophy is that, over the long run, stock prices are primarily driven by underlying corporate financial performance in terms of growth in earnings, dividends, and free cash flow. In other words, stock prices tend to reflect the economic or "intrinsic" value of the company over the long term. If a company can increase its earnings at a 15% compounded annual rate resulting in a doubling of the earnings level of the company in five years, then our best estimate of the company's stock price in five years would be approximately twice the current stock price. Of course there are other fundamental factors that can influence a stock price such as: investor perceptions of whether future growth will be accelerating or decelerating, the level of interest rates and market average price/earnings ratios, and changes in the financial strength of the company.

There is also a plethora of non-fundamental factors that can influence a stock price such as: if the stock is being "touted" or "panned" by analysts on Wall Street or in the media, if the stock is being bought or sold by short-term traders (e.g. hedge funds), or if investors are enthusiastic or concerned about short-term events potentially facing a company (e.g. a company reports quarterly earnings that missed the Street estimates by a few cents per share). We believe that we have a much higher probability of accurately forecasting the fundamental factors (except for maybe future levels of interest rates and price/earnings ratios) compared to the non-fundamental factors.

Benjamin Graham, the father of securities analysis and the mentor of Warren Buffett, once said, "In the short run the market acts like a voting machine, but in the long run it acts like a weighing machine." In other words, in the short run, stocks tend to reflect current popularity among investors, but in the long run, stock prices tend to reflect the economic or intrinsic value of the corporation. Warren Buffett once stated that he was a "market agnostic", meaning that he didn't spend time on the impossible task of trying to predict where the market was going; he spent his time on analyzing the business economics of each company he owned or wanted to buy. This philosophy enables him to be patient with a stock that has underperformed the market indices for one or more years, while the underlying company has continued to out-perform the average company in terms of return on investment, growth in earnings and generation of free cash flow.

We apply this same philosophy at Bridges. We recognize that in the short run, stock prices vary far more widely than underlying business value. Many stocks frequently will have annual trading ranges that vary by 50% around their average price during a year every year, while their underlying earnings stream varies by a few percentage points around the average long term growth rate. Wide short term fluctuations in stock prices that are driven by non-fundamental or transient factors create opportunities for long term investors to enhance investment returns, although this opportunistic approach sometimes means that our annual returns may vary significantly from market index returns.

We eschew stocks that are "popular" in favor of owning stocks that we determine are under-valued based on our estimate of long term intrinsic value. There may be some years, such as 2005, when the companies we own perform well from a financial standpoint, growing earnings and free cash flow nicely, but underperform in stock price terms because they are not in sync with whatever sector of the market is "popular" in the short run. We believe it is far more important to get the analysis of the likely growth of a business and its valuation right, because we know that eventually, the market will accurately reflect long term corporate financial performance in the stock price.

While 2005 was a year in which the Bridges Investment Fund, Inc. and our average equity portfolio did better than the Standard & Poor's 500 Average ("S&P 500"), we believe that most of the stock prices of our portfolio companies lagged behind the increases in their respective intrinsic values. To demonstrate this point we have presented certain fundamental data on the stocks included in our Core Growth Model Portfolio during 2005. The Core Growth Model Portfolio is a hypothetical

portfolio that we use internally to communicate our portfolio strategy. Since the determination of a stock's intrinsic value can be subjective, we decided to use data on growth in book value and growth in earnings per share as proxies for the growth in intrinsic value. The use of book value has been validated by Warren Buffett, who has used growth in book value as a measurement of Berkshire Hathaway's annual return. While most of Berkshire's publicly traded holdings are marked-to-market in the calculation of book value, all of Berkshire's private holdings are not. The use of growth in earnings per share can be defended because a commonly used valuation metric for stocks is the price/earnings ratio. If a stock's earnings per share increase by 10% and the price/earnings ratio remains unchanged, then mathematically the price or value should have increased 10%. Of course as we discussed above, there are other fundamental factors that could cause the price/earnings ratio to change, but over a portfolio of more than 20 stocks, these factors probably would balance each other out. In Exhibit 1, attached, we have summarized the percent change in book values and earnings per share during 2005 of stocks that were held in Bridges Core Growth Model Portfolio for the entire year.

As you can see, the average book value of these stocks increased 11.4% during 2005 and the earnings per share increased an average 14.6%, while the average stock price increased only 3.7%. Using Best Buy as an example, we see that both its book value and earnings per share increased by 20%. However, Best Buy's stock price increased only 9.8% in 2005. As a result, the price/earnings ratio contracted from 20.9 times the trailing 12 months' earnings at the beginning of 2005 to 19.1 times the trailing 12 months' earnings at the end of 2005. While we are disappointed that investors didn't fully "reward" Best Buy's stock price for the Company's apparent increase in intrinsic value in 2005, we are very pleased with Best Buy's management and business model because it delivered what we expected and more. If Best Buy continues to increase its intrinsic value, it can only be a matter of time before the stock price should catch up. Thus, in our minds, Best Buy was a better value at the end of 2005 than it was at the beginning of the year. This belief is true of many of the stocks that we own and is one of the reasons that we are constructive on the potential future returns from these stocks over the next several years. In the case of Best Buy, we were promptly rewarded in the first quarter of 2006 when its stock price increased over 28%.

Avoiding Train Wrecks

After reading the previous section, one might ask, "If the probability of predicting stock prices and interest rates in the short run is relatively low, then how can you have an investment strategy?" The answer is: we don't have a strategy for the next quarter or next two quarters; we have a strategy for the next three to five years. Our strategy is based on our evaluation of each of the sectors and companies in those sectors to determine where we can find the best potential growth in intrinsic value for the largest discount to intrinsic value. Of course we can't be totally agnostic about the market. We need to be alert to possible "train wrecks" in the markets, such as the grossly extended stock valuations that were reached in 1999-2000, or a worldwide recession, or accelerating inflation. However, some train wrecks, such as the terrorist attacks on 9/11, are impossible to prepare for.

At the present time, we don't see any probable train wrecks. There is some risk that the Federal Reserve Board will stay on their current tightening policy of raising short-term interest rates too long and trigger a recession. However, we think the probability of that scenario is relatively low for two reasons. First, interest rates are still at relatively low levels compared to the average of the past 30 years. Some market pundants have argued that since the 1970's, an inverted interest rate curve (i.e. when short-term interest rates are higher than long-term rates) has accurately predicted nearly every recession. This is being discussed now because the interest rate curve is very flat and was briefly inverted during the first quarter. Some economists are concerned that if the Federal Reserve keeps raising the short-term rates, it will eventually cause an inversion of the interest rate curve. However, the recessions since the 1970's all occurred when interest rates were well above the average historical rate. In our opinion, an interest rate move from 6% to 8% is more crippling (and potentially recession causing) than a interest rate move from 3.5% to 5.5%. Second, the Federal Reserve Board members and staff hopefully have learned from past mistakes. The causes of the Great Depression of the 1930's, the runaway inflation of the 1970's and the speculation in financial assets in the 1990's have been intensely studied and valuable lessons have been learned. The Federal Reserve Board officially meets approximately every six to seven weeks, and their staffs are studying the economy every day. This doesn't mean they are now infallible, but their track record has definitely improved.

There are legitimate concerns about the health of U.S. consumers, who, as a group, have been spending approximately 100% of their after-tax income with the assistance of mortgage refinancings and home equity loans. Rising interest rates and slowing appreciation of real estate assets have already had a slowing effect on the real estate market. Baby Boomers have the additional need to step up their savings as they approach retirement. Another important determinant of consumer spending is growth in real wages, and here the data is mixed. On the one hand, you have low cost competition for labor from developing countries in many manufacturing and some service jobs as witnessed by the wage concessions demanded by Delphi and other auto-related companies. On the other hand, economists are worried that the U.S. unemployment rate has declined to 4.7%, which is a level that many consider full employment and where wage inflation could become a risk. Another factor to consider is the growing consumer demand from developing countries such as China and some developed countries such as Japan, whose populations are experiencing significant increases in wages and/or have accumulated large pools of savings, which many are increasingly spending on consumer goods. Many of the U.S.-based international companies are seeing significant growth in their foreign sales that in some cases can offset sluggish sales in the U.S. The companies that seem to be the most at risk are those that depend largely on lower wage earners in the U.S.

Another potential train wreck is the large U.S. federal budget and trade deficits, for which there appears to be no movement on the part of our political leaders to find a solution. The solution to the federal budget requires a combination of spending cuts (e.g., Social Security) and tax increases, neither of which is currently politically palatable. However, we think all tax payers and investors should plan on both higher taxes and lower growth in government benefits over the next 10 years.

The solution to the trade deficit is tougher to tackle from a policy level, but fortunately, it should be largely self-correcting in an open global economy. The U.S. trade deficit is being “financed” largely by the recycling of savings from Japan, China, Europe and the Middle Eastern countries through the purchase of our government and corporate securities. The foreign investors are not buying our securities because they feel sorry for us. They are buying them because they can get a higher risk-adjusted return in the U.S. than they can in other markets. They will most likely continue to buy our securities as long as they offer an attractive return. This “accommodation” comes to the U.S. at a cost of course, through higher interest rates.

The good news is that the seeds for an improving trade balance have already been sown. During the past 15 years, with Japan in a depression and much of Europe in an economic funk, the U.S. consumer has been the buyer of last resort in the global economy. Demand from the U.S. has been largely credited with enabling the rapid growth of many developing countries and helping to minimize the fallout from the economic crises in many Asian and South America countries in the 1990’s.
Now there is evidence that growing demand from these developing countries and economic improvement in Japan may be the engines of demand for the global economy in the future. Meanwhile in the U.S., the Baby Boomers are approaching the age where they begin to plan (save) for retirement and in many cases, curtail discretionary spending. These trends coupled with fluid foreign currency markets (i.e. a declining value of the U. S. dollar) should narrow the magnitude of the trade deficit over time. Thus, while we believe there will be some pain to the U.S. economy in the form of higher interest rates, higher taxes, lower government benefits, and higher costs of imported goods, we don’t believe the budget and trade deficits will cause an economic train wreck.

Investment Strategy

Thus far in 2006, the economy appears to be tracking as expected; economic growth has rebounded from the hurricane-impacted fourth quarter, housing and autos have slowed, but other consumer spending remains relatively healthy. Inflation outside of energy has been modest, short-term interest rates have increased one-half percentage point and capital spending by corporations appears to be improving. On the negative side, the situation in Iraq is improving more slowly than expected, and President Bush’s popularity as measured by polls has deteriorated to new lows.

Despite rising interest rates, Iraq and the President’s political problems, the stock market indices experienced a solid advance in the first quarter. Corporations have just started reporting earnings for the first quarter, and earnings estimates for the S&P 500 average are forecasting a solid 11% increase over last year’s first quarter. Despite the recent price appreciation, the S&P 500 still is trading at only 15.8 times the estimated earnings for 2006, which is very near the average price/earnings ratio for the past 50 years. Thus, we are not concerned that stocks are over-valued. In fact, compared to prior periods with similarly low interest rates, one could argue that stocks today on average are under-valued. While rising interest rates could adversely affect stock valuations, we believe interest rates would have to move above 5.5% before current stock valuations would appear to be over-valued relative to bonds.

We continue to recommend an over-weighting in our health care stocks. While this sector wasn't rewarded by investors in the first quarter, we believe the long-term fundamentals remain intact and the valuations are attractive. We continue to add to our energy positions on any temporary price weakness. We also favor select stocks in the Information Technology sector. We are under-weighting investments in the Utility and Telecommunications sectors, because we believe the valuations are expensive relative to the expected long-term growth in earnings.

After three and one-half years of the 10-year Treasury bond yielding well below 5%, we are finally seeing investment grade corporate bonds in the 5.5%-6.5% range. As a result, in our fixed-income portfolios we have started to shift some money from short-term (less than five years) to intermediate-term maturities (five to twelve years). We believe inflation will remain in the 3% range, and we don't think intermediate yields will increase materially higher from current levels. However, to reduce the risk in case interest rates do increase materially, we continue to minimize our investments in long-term maturity bonds (over 15 years).

The investment strategies described above are general in nature and are usually modified to fit the unique investment objectives of your accounts. If you have any questions regarding the investment strategy in your account, please contact your account officer.

A Special Thank You

We want to thank those clients who have referred other investors to the Firm over time. Historically, the Firm has grown mostly by referrals. We have no formal marketing effort, as we believe our top priority is to focus on managing the assets of our client base. We appreciate your continued support of the Firm, and we would encourage you to recommend us to anyone that you think might be a good fit for our services, as we have found that the best clients over time are those that have been recommended to us by people that they trust and respect. Also, we would encourage you to let us know what we can do to improve our service. Thanks again for your continued support of the Firm.

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Exhibit 1
Growth in Earnings and Book Values in 2005
of Companies in Bridges Core Growth Model

Company	12/31/04 Book Value	12/31/05 Book Value	% Change	2004 EPS	2005 EPS	% Change	2005 Price Change
Altria	$14.91	$17.13	14.9%	$4.65	$5.10	9.7%	22.3%
American Int'l Group	$31.05	$34.40	10.8%	$3.87	$3.30	-14.7%	3.9%
Anadarko	$38.37	$47.27	23.2%	$7.22	$10.91	51.1%	46.2%
Apache	$24.75	$31.63	27.8%	$5.10	$7.83	53.5%	35.5%
Bank of America	$24.56	$25.32	3.1%	$3.84	$4.22	9.9%	-1.8%
Berkshire Hathaway	$305.67	$315.83	3.3%	$114.93	$103.07	-10.3%	0.0%
Best Buy	$9.91	$11.89	20.0%	$1.90	$2.28	20.0%	9.8%
Capital One	$33.98	$46.98	38.3%	$6.23	$6.80	9.1%	2.6%
Cisco	$3.48	$3.73	7.2%	$0.76	$0.92	21.1%	-11.4%
Citigroup	$20.82	$22.37	7.4%	$3.91	$3.88	-0.8%	0.7%
First Data	$11.05	$11.09	0.4%	$2.15	$2.25	4.7%	1.1%
GE	$10.42	$10.43	0.1%	$1.61	$1.81	12.4%	-4.0%
Home Depot	$12.14	$12.67	4.4%	$2.26	$2.71	19.9%	-5.3%
Johnson & Johnson	$10.71	$12.73	18.9%	$3.10	$3.50	12.9%	-5.2%
Lowes	$17.44	$20.71	18.8%	$2.76	$3.46	25.4%	15.7%
Medtronic	$8.64	$9.73	12.6%	$1.63	$1.86	14.1%	15.9%
Microsoft	$4.26	$4.74	11.3%	$1.26	$1.30	3.2%	-2.1%
Pepsico	$8.08	$8.65	7.1%	$2.31	$2.66	15.2%	13.2%
Qualcomm	$7.26	$7.56	4.1%	$1.14	$1.17	2.6%	1.6%
State Street	$18.46	$19.08	3.4%	$2.47	$2.82	14.2%	12.9%
Stryker	$6.84	$8.03	17.4%	$1.43	$1.75	22.4%	-7.9%
Sysco	$4.47	$4.38	-2.0%	$1.37	$1.47	7.3%	-18.7%
Target	$15.42	$17.77	15.2%	$2.13	$2.71	27.2%	5.9%
Tyco International	$16.13	$16.42	1.8%	$1.70	$1.86	9.4%	-19.3%
Wells Fargo	$22.19	$24.04	8.3%	$4.09	$4.56	11.5%	1.1%
Zimmer Holdings	$16.06	$18.90	17.7%	$2.41	$3.10	28.6%	-15.8%
AVERAGE			11.4%			14.6%	3.7%

Note: This list includes all securities owned in the Bridges Core Growth Model Portfolio for the entire period. Securites that were purchased or sold during the period have been excluded.

Source: Thomson Baseline