



## **Bridges Investment Management**

### **Market Comments**

December 15, 2009

November saw a continuation of a strong rebound in stock prices that began on March 9, 2009. After declining 57% from its all time high on October 9, 2007 to the March 9, 2009 low, the S&P 500 has subsequently rallied 64% through December 15, 2009. The S&P 500 is 28% higher than it was one year ago (December 15, 2008).

The market's recovery has been based on several factors, the most important of which are investors anticipating 1) an eventual recovery in the economy, and 2) an improvement in the credit markets.

We remain constructive on the outlook for the stock market for several reasons.

First, while equity valuations are not as grossly undervalued as they were coincident with the market's lows in March, stocks still appear to be undervalued from a number of valuation approaches, especially relative to longer term norms. While we anticipate that the economy's recovery from the current recession will be slower than most post-war recoveries, we do expect that economic conditions will improve on balance over the next several years, which should lead to higher corporate earnings over time. We expect that S&P 500 earnings could approach \$75-80 per share in 2010, and if interest rates stay in the neighborhood of 4-4.5%, we believe fair value for the S&P in 2010 could approach 1250-1300 (which would imply a market P/E of roughly 16x 2010 earnings).

Second, money market fund assets remain high, and bond mutual fund purchases remain brisk, indicating that substantial capital is available to buy equities over time if and when investors' appetite for higher earning assets recovers. If interest rates remain low, and if the equity market continues to advance, it is possible that capital could flow back to the equity market from money market funds and bond funds as investors seek higher returns.

Third, investor sentiment, despite the large run-up in stock prices since March, remains muted. Many investors do not seem to trust the rally, and are skeptical of the sustainability of the gains. We believe that the best gains in the equity market often come against a backdrop that is less than favorable, in part because when many of the fundamental factors that affect stocks are ostensibly negative, those negatives can be discounted in equity valuations, which sets the stage for better equity returns from that point as the fundamentals begin to turn positive and equity valuations improve.

Specifically, the current period can be contrasted with the late 1990's; then, most fundamentals (strength of the economy, employment, strength in the dollar, easy access to credit, etc.) were positive, but equity valuations reflected the positives, and as those positives gave way to negatives in the 2000-2002 period, equity valuations and stock prices declined accordingly as the market discounted the sequence of negative developments (collapse of technology bubble, recession, 9/11) at the margin. Conversely, at present, there is no shortage of negatives, but we believe that many of the risks are pretty well known and discounted in equity valuations, leaving room for improving valuations as the economic environment stabilizes and eventually moderates and improves.

Finally, the past decade has been miserable on balance for equity investors. The S&P 500 has provided a negative return over the past 10 years: down 23% on a price basis, -7.86% on a total return basis, which equates to an annualized negative total return of 0.86% over the past decade, the

worst ten year stretch for stock investors since 1938. We believe reversion to the mean is one of the most powerful forces in investing. Equity returns have averaged about 10% per year over the past seven decades (although rarely providing 10% per year returns in any one decade); stock returns have generally tracked U.S. GDP growth of 3-4% per year and corporate earnings growth of 7-8% per year, on average. While the next economic recovery could be less robust given the need for consumers and companies to deleverage, we believe that the U.S. economy, despite the challenges it faces at present, remains the most innovative and productive in the world, and current valuations do not reflect this.

It strikes us that equity investors can win in two ways over the next 3-5 years, as corporate earnings recover (significant cost cutting over the past year creates the opportunity for companies to realize good earnings progress even if revenue growth is tepid) and as valuations of that earnings growth return to average historical levels. It is interesting to note that aggregate corporate earnings in the U.S. are about double the level of the past recession (2002-2003), while the S&P 500 Index, even after the large advance since March, is only about 30% above the lows of the 2002-2003 bear market, indicating that at present, stocks are conservatively valued from a long term perspective.

While we remain constructive on the longer term outlook for stocks, we are not unmindful of the long list of risks facing investors at present, which includes a recessionary economy, high unemployment, a difficult credit market (even for borrowers with solid credit histories), burgeoning budget and trade deficits, a dollar that has been under intense pressure this year, and the risk of inflation that comes with the reflationary monetary and fiscal policies implemented over the past year. Investors also appear to face more than the usual level of uncertainty on the legislative front as the new administration seems intent on effectuating a very activist legislative agenda, that could include (and would likely have to be paid for) tax increases on the most vibrant segments of the private sector of the economy.

That said, we believe that over time, the combination of relatively modest equity valuations and the potential for material earnings improvement should lead to positive returns for stocks in 2010.

We continue to view our portfolio companies relative to our expectations of the impact of a better or worse economy on their ability to grow shareholder value. Given our expectation that time is an ally of economic recovery, we would expect that those companies that have relatively greater economic sensitivity should be better stock market performers than relatively more defensive companies in 2010. This has been the case in 2009, which has created a bit of a dichotomy: the cheapest stocks appear to be ones with higher balance sheet quality and less economic sensitivity (consumer staples and health care), but those companies will likely lag as the recovery gains momentum and capital flows toward companies with greater operating leverage; that group (technology, industrials, and commodity-related) has generally done better in 2009 as investors have been willing to bid up stock prices in the expectation of better earnings down the road, leading to higher valuations (and the need for those companies to actually deliver the higher earnings expected over the next several quarters).

We expect the market environment to remain volatile and choppy as the next several quarters unfold. Short terms risks seem relatively high given the sharp run up in stock prices since March, but longer term valuations remain reasonable, and many of our companies still seem materially undervalued when viewed from a longer term perspective even under conservative assumptions regarding business value growth and valuations.

We remain focused on owning companies with strong business franchises, solid prospects for long-term growth, and compelling valuation characteristics, and we are confident that equity returns on balance over the next few years will be good.