Market Comments

February 24, 2009

Dear Shareholder,

On February 23, the S&P 500 traded down to 742.27, marginally above the current bear market low of 741.02 set on November 21, 2008. This represented a 53% decline from the October 9, 2007 high of 1576.09, and a 17% decline since the start of 2009 (the worst start to a year for the stock market since 1931).

The stock market's most recent leg down was driven by a combination of disappointing fourth quarter earnings results, investor frustration over a lack of clarity regarding policy initiatives of the Obama administration regarding the financial crisis, fears of an impending nationalization of one or more major banks and the possible bankruptcy of AIG (the world's largest insurer), and growing concern regarding the depth and length of the current recession and the strength of the subsequent recovery and expansion.

Prior market comments have outlined our sense that 2009 will be a challenging and volatile year for the stock market. That has certainly been the case during the first seven weeks of the year.

There are many issues for investors to weigh, and the risks and challenges that the economy and the capital markets have to address are material.

However, the large decline in stock prices over the past 18 months appears to discount, at least to some extent, many of the risks facing the market. We believe investors should focus on two key considerations. First, time horizon is critical at all times, but especially when market conditions are more volatile than usual. For investors that have time horizons that are measured in weeks and months, greater levels of market volatility and declining stock prices are more problematic, because there is less time for stock prices to recover from declines. However, for investors that have time horizons measured in years, negative price performance is an annoyance, but time remains an investor's ally.

The second consideration is the relationship between price and underlying value. Historically, stock prices are far more variable than underlying business value. In the current environment, a portion of the market's decline is a function of investors re-pricing stocks to reflect the lower level of near term corporate profits relative to expectations that existed in early 2008. Investors may also be extrapolating the current environment well into the future (on the theory that many of the current economic problems are either permanent, or at a minimum will take years to rectify), and are consequently revaluing equities lower to reflect diminished levels of corporate profitability longer term.

However, we believe that a significant portion of the market's current decline is a re-pricing of the inherent risk in equities (both broad market risk and company-specific risk) that has always been there, but that was less evident over the past 20 years in an era of persistently rising stock prices. This expansion of risk premiums for stocks is essentially a proxy for fear – as investors' fears rise, they demand higher returns to compensate them for the risks inherent in holding equities, and stock prices decline as risk premiums expand.

While this response is rational in the very short run, it can create excellent long term opportunities for investors willing to bear the risk of short term price declines and increased price volatility in exchange for realizing the returns created by the wider gap created between current price and true underlying business value viewed from a longer term (say 3 to 5 to 7 years). As the economy recovers, corporate profitability improves, and investor fears recede, risk premiums will revert to more normal levels, and stock returns from current levels should be outstanding.

As we have noted repeatedly over the past year: cheap valuations alone do not mean that stock prices stop going down. However, current valuations for stocks are extremely cheap relative to historic levels, and history argues strongly that over time, valuations tend to move toward "normal," and as they do, stock returns are by definition better than normal.

Our valuation work shows that many very strong companies currently have valuations that imply flat to negative earnings growth going forward. While a long stretch of flattish or even negative corporate profits is a possibility, we think it is a very low probability, and that eventually, as earnings stabilize and then recover, stock prices will appreciate significantly as investors re-price their long term expectations regarding normalized levels of corporate profitability that resemble levels that U.S. companies have achieved in the past.

It is important to differentiate between stock price changes and a company's ability to deliver good underlying corporate financial performance over time, and that distinction is especially important during periods of extreme duress in the stock market. As we analyze companies, particularly in the current environment, we ask ourselves whether a company's balance sheet will allow it to survive the current recession (i.e., is the underlying business self-financing, or is it dependent on ever higher levels of debt to be sustained), and we assess how strong a company's business franchise is in terms of being able to grow shareholder value at an acceptable rate over the long run.

In the current environment, many of our companies are valued as if they will be able to achieve very little, if any, growth in business value in the future. While profits in 2009 will be difficult to come by, we believe that the extreme negativity currently expressed by investors in stock price valuations will likely prove to be overdone looking back several years from now once corporate profitability improves over the next cycle.

To put the current negativity surrounding stock valuations in perspective, consider PepsiCo. Despite more than doubling its revenues and almost quadrupling its net income over the past decade, PepsiCo currently trades at its lowest valuation level since 1989, at 13.7x estimated 2009 earnings. At a recent price of $50, Pepsico trades slightly below its average price of $51.72 over the past decade, and well below its all time high of $79.79, despite earning a record level of revenues and profits in the third quarter of 2008. The current price of $50 would appear to assume PepsiCo's earnings will grow at somewhere between 3-6% annually going forward, well below both current consensus estimates and the company's demonstrated ability to grow its earnings at a much higher rate over time. We believe fair value for PepsiCo is well above $70 assuming the company can grow its business value more or less in line with rates it has achieved in the past.

As always, we review our core portfolio holdings thoroughly at the start of each year. This comprehensive process, which essentially entails our investment group reviewing every company that the Firm owns, or that we may be interested in possibly owning, is undertaken with the objective of establishing that 1) the core fundamental reasons for owning a company in the first place are still valid; 2) the stock is priced at a level that will allow us to earn an attractive risk-adjusted return over the long run; and 3) we have an appropriate mix of companies within client portfolios based on our assessment of expected return relative to risk.

We establish both a one year out and a long term target price for every stock we examine. We spend a lot of time analyzing what the optimal mix within portfolios is between companies with 1) lower (more attractive) valuations, higher earnings growth rates, higher expected returns, lower certainty (higher risk), and 2) companies with higher, less attractive (but still good) valuations,

lower earnings growth rates, lower expected returns, but higher predictability and certainty (we use terms like "predictability" and "certainty" advisedly, especially in the current environment).

The process was somewhat more difficult (albeit every bit as rigorous) this January than most years, for several reasons. First, earnings estimates, which drive our valuation process, are coming down quickly as analysts try to ballpark how well companies can manage through the current economic downturn, the magnitude and duration of which both appear to be the worst since the early 1970's, and perhaps the 1930's. Second, many company managements are reluctant to give much if any guidance for 2009 (who can blame them). These factors make pinning down specific valuations even more difficult than usual.

That said, we came away from our work with several themes. First, almost regardless of how earnings play out, valuations for stocks generally, and our names specifically, appear to be very attractive both on a one year, but especially over a 3-5 year horizon, assuming that we get a stabilization and eventual economic recovery over the next 24 months, which we believe is a reasonable assumption. So while our estimates of 2009 earnings could end up being too optimistic, it may not matter too much because valuations already appear to price in a very pessimistic year, and if the year is bad but not disastrous, stock prices could rally even without a huge upturn initially in headlines.

Second, we can categorize most of our holdings into one of two buckets: stocks that will do relatively well if the world gets worse (companies that are somewhat less Gross Domestic Product (GDP)-sensitive such as consumer staples and health care), and stocks that will do better if the world starts to stabilize and improve (relatively more economically sensitive names that benefit from an improvement in consumer spending, capital spending, and an improved credit market environment). Our expectation is that stocks in the latter group will gain ascendancy as the year wears on and we get closer to the market discounting an eventual economic improvement that will result from the various stimulus packages that have been brought to bear since last fall, but we will remain flexible in our approach as the economic data during the year unfolds.

Most importantly, our work shows that our companies appear to be very undervalued assuming some improvement in the economy and a normalization of valuations for stocks over time (which will result as investors gradually move from "fear" to "caution" to "expectation of better times"). A return to only the bottom end of the range of "average" valuations over the past twenty years will result in very good stock returns, and a move back to average valuations combined with normalized earnings, if it occurs over the next five years, will result in outstanding stock price returns.

Despite the economic challenges and risks apparent at present, we believe our holdings are well positioned for the long term. Our companies have strong balance sheets, long track records of generating above average financial performance for shareholders, attractive valuation characteristics, and good prospects for growing their business value in the future. We will continue to focus on owning those companies with the best combination of strong business franchises, good growth prospects and attractive valuation metrics, and we anticipate using interim periods of market weakness to upgrade portfolio quality and exposure to companies that can show solid financial performance over the course of the economic cycle.

Opinions expressed are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Past performance does not guarantee future results.

Mutual fund investing involves risk. Principal loss is possible.

Fund holdings and sector allocations are subject to change at any time and are not recommendations to by or sell any security. *Current and future portfolio holdings are subject to risk* Please **click here** for fund holdings.

The S&P 500 Index is a broadly based unmanaged composite of 500 stocks which is widely recognized as representative of price changes for the U.S. equity market in general. It is not possible to invest directly in a specific index. Earnings per share (EPS) is calculated by taking the total earnings divided by the number of shares outstanding.

Must be preceded or accompanied by a current prospectus.

The Bridges Investment Fund is distributed by Quasar Distributors, LLC (2/09).

Sincerely,

Edson L. Bridges III, CFA
President and Chief Executive Officer