BRIDGES
INVESTMENT MANAGEMENT, INC.

Market Comments

October 11, 2011

Four years ago today, the S&P 500 traded at an all-time high of 1576. Today, the S&P 500 closed at 1196, down 24% from the October 11, 2007 high. The S&P 500's all-time high prior to October 11, 2007, was 1553 on March 24, 2000, which was reached at the height of the 1994-2000 bull market. The S&P 500's total return from the 2000 peak through today is -6%.

Many question whether investing in stocks is worth the risk, given the lack of return over the past decade, and given the extreme volatility experienced in the equity market over the past several years. A number of articles and commentators question the wisdom of "buy and hold" investment approaches. Investors have voted with their feet over the past year, as bond mutual fund inflows have reached record levels (despite very low interest rates and unattractive bond valuations), while equity mutual funds have seen significant net redemptions.

The risks facing equity investors are both numerous and widely publicized: a slowing U.S. economy that has been far less vibrant than prior post-War recoveries; rising risk of European sovereign debt defaults and the collateral financial damage that could affect global financial institutions; and a rancorous political environment in the U.S. where "leadership" consistently seems to be sublimated to "political expedience." Prominent market commentators warn of "the New Normal" – calling for years of subpar economic growth because of the lingering effects of the financial collapse of 2007-09, where asset values imploded but the excessive debt that was created remains, along with oppressive levels of regulatory legislation enacted in the backlash.

In this environment, equity investors have been skittish and the equity market has been volatile, with a negative bias this year despite solid underlying corporate earnings growth.

Despite the preponderance of bad news, we remain very constructive on the intermediate and long-term outlook for U.S. equities.

The core components of our positive outlook include:

Valuation: Stocks reached peak price levels in 2000, and again in 2007. In 2000, the S&P 500 traded as high as 28x earnings of $56, an all-time valuation level high. In 2007, the peak valuation level was 19x earnings of $83. At present, the S&P 500 trades at about 12x estimated 2011 earnings of $98 (the S&P 500's earnings in 2011 will be almost double the level of 2000, and about 18% above the level of 2007). The current S&P 500 P/E multiple is well below its long-term average P/E of 15-16x, despite solid earnings growth over the past nine quarters, despite consensus estimates of continued earnings growth in 2012, and despite record low interest rates.

The S&P 500's earnings yield (earnings divided by price) is 7.9%, the highest (most attractive) level since 1988's 8.7% level.

Stock valuation metrics are affected by three primary components: the expected rate of growth in earnings; interest rates; and investor sentiment. Earnings have grown substantially over the past several years despite challenging economic conditions, and consensus expectations at present call for 5-10% growth in 2012. Interest rates are at historically low levels, which should favorably affect equity valuations. Sentiment is the problem; despite the solid recovery in earnings since early 2009, investors worry that stagnant economic conditions will stifle future earnings growth, and have accorded equities with very low valuations, especially in view of the exceptionally low level of current interest rates.

Valuations have drifted back toward the levels experienced at the bear market lows of March, 2009 – even though earnings momentum and balance sheet strength are much better at present than in early 2009. At current levels, investors appear to be discounting long-term corporate earnings growth of about 3-4%, well below the average of 7-8% annually since World War II. While earnings growth will remain a challenge in a slow growth economy, we believe the probabilities are that corporate earnings growth will be better than 3-4% over the next 3-5 years, as U.S. companies have proven to be adept at delivering solid financial performance in the face of difficult aggregate economic conditions over the past three years.

The market's recent decline of roughly 11% since mid-July has been indiscriminate, driving higher quality companies down to the point where valuation spreads between the highest and lowest quality companies are unusually tight, and investors now pay little premium to own the highest quality companies in terms of balance sheet strength, earnings growth, and consistency of financial performance. We continue to believe that large, high quality companies are the most undervalued segment of the U.S. equity market.

We believe that fair value for the S&P 500 is about 1400-1450 for 2011, and about 1600 for 2012, based a P/E of 15x estimated 2011 earnings of $95-98 and estimated 2012 earnings of $105-108.

Sentiment: Investor sentiment levels are (understandably) negative, which over the long run has been a reliable contrary indicator. The risks, while material, are well-known and should be pretty well discounted into equity prices at present. There is considerable room for sentiment to improve if and when the outlook brightens, and better investor sentiment should eventually translate into better equity market performance.

Low Interest Rates: Investors have driven interest rates to all-time low levels, as they have chased yield and sought "safety" in a volatile environment. We believe that eventually interest rates will rise as economic activity improves, demand for credit increases, and investors begin to worry about an uptick in inflation. Higher interest rates will result in flat or negative bond returns, and should result in some capital returning to equities. Longer term, investors that require higher returns than those currently afforded by the yield curve will be forced to accept equity market risk in search of higher returns.

We believe that, despite a decade plus of subpar equity returns, and despite a wide array of risks facing investors at present, the outlook for good returns for stocks over the next several years is positive, because valuations are compelling and sentiment toward equities is largely negative.

We expect continued volatility in the capital markets through the end of this year and into 2012, but we will continue to use that volatility to upgrade portfolio holdings toward those companies which have the best combination of balance sheet strength, prospects for superior business value growth, and attractive valuation metrics.

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