Bridges Investment Management

Market Comments

August 19, 2011

Stocks ended the second quarter of 2011 essentially unchanged despite volatility during the quarter. After reaching a recovery high of 1370 on May 2 (representing a year to date gain of 9% and gain of 105% from the March 9, 2009, lows), the S&P 500 declined to an intra-quarter low of 1268 on June 16. The pullback was driven by renewed concerns of European debt defaults and signs of slowing economic growth in the U.S. Stocks rallied sharply during the last week of June to finish about flat for the quarter, and up about 5% for the first half of 2011.

Despite indications of some economic slowing in the U.S, we believe that GDP will continue to show growth during the second half of 2011 and into 2012. Corporate profits remained strong in the second quarter of 2011, and we expect continued solid profit growth during the second half of this year. S&P 500 earnings rose 31% year over year in the second quarter on a market-cap weighted basis, and 17% on an equal-weighted basis, with 71% of companies reporting positive earnings surprises (down from 75% in the first quarter of 2011, but still a very solid number). Index earnings were $25 per share in the second quarter, indicating a $100 per share annual run-rate of earnings for the S&P 500.

On July 22, the equity market began a sharp decline that resulted in a 17% drop in 13 trading days (S&P 500 fell from 1345 to 1120, and touched 1100 intraday on August 10). While the decline was coincident with the rancorous Congressional debt ceiling proceedings and the August 5th Standard and Poor's downgrade of U.S. Treasury debt, we believe the real catalyst for the sell-off was increased investor concern about debt defaults in Europe.

After a snap-back rally between August 8 and August 15, the U.S. equity market is again testing its 2011 lows around 1100 as equity investors are looking to de-risk portfolios in the face of the European sovereign debt uncertainty, and a rapid round of cuts in estimates of GDP growth in the face of that uncertainty.

Clearly, equity investors face many risks at all times; however, at some junctures, events coalesce and focus investors on the negatives. This is one of those times. While the macroeconomic risks are material, in our view they are not new, and equities appear to discount much of the bad news, because the U.S. equity market trades at 10-12x earnings during a period of very solid earnings growth and historically low interest rates (which normally should result in higher equity valuations, all things being equal).

At present, stock valuations are discounting little if any future earnings growth, and valuations have essentially retreated to the valuation lows seen in late 2008-early 2009 (the S&P 500 remains about 70% above the March 2009 lows, and has increased in price essentially in line with corporate earnings growth over the March 2009-June 30 time frame).

Rarely have investors had the opportunity to own the highest quality companies and the strongest business franchises at such low valuations. As we noted in late 2008, cheap valuations alone do not mean that stock prices will stop going down, but for investors with time horizons measured in years, and assuming that economic conditions eventually stabilize and improve, equities should provide very solid returns over the next 3-5 years from current levels.

Economy and Capital Markets

The following bullet points summarize what we believe are the most salient factors in our assessment of the current economic and capital markets environment:

- S&P 500 fair value for 2011 is 1400-1450 – 14-15x $95-100 EPS
- S&P 500 fair value for 2012 is 1600 -- 15x $105-110 EPS
- 5 year S&P 500 target is 1900-2100 – 6-7% earnings growth, P/E of 15-16x (long term average)
- Interest rates are at all time lows; bonds appear very unattractive relative to historic valuation metrics – we are at the opposite end of bond-stock valuation spectrum relative to 1999-2000, when stocks were valued at historically high levels both absolutely and relative to bonds
- We expect continued higher than normal market volatility to persist, possibly through the November 2012 elections. Political gridlock until the elections could put a lid on stock valuations (similar to the July-November 2010 period)
- Key risks – European credit, slow/slowing global growth, political gridlock
- The "E" (earnings) side of the P/E equation is critical – if E comes through over the next several quarters, stocks are very undervalued, but the concerns regarding Europe at present are forcing investors to question what earnings will be going forward, and earnings estimates are being slashed (although analysts generally were behind the curve relative to positive earnings surprises over the past six to eight quarters)
- High quality growth stocks remain the most undervalued, most attractive segment of the U.S. equity market; the recent market decline improved the relative valuation of small and midcap sectors, but they remain priced 30-40% higher than larger companies. We believe high quality companies will provide the best equity market returns on balance over the next several years because of disparity between their low valuation and their intrinsic business value and ability to grow business value and generate free cash flow going forward
- In a challenging economic environment, companies that can show strong revenue, earnings, and free cash flow growth are scarce; this sector remains quantitatively attractive. If interest rates remain persistently low, investors will gravitate toward companies that have strong balance sheets and the ability to grow business value in challenging economic conditions in order to earn returns that are higher than available in the fixed income market; the tradeoff is the acceptance of the short term volatility inherent in the equity market
- The most underappreciated aspect of the positive case for equities is the reality of a persistently low interest rate environment, and its implications on investors seeking returns
- A detailed knowledge of the long term investment value of the companies we own and a long term time horizon provide a compass during extremely turbulent market conditions

Portfolio

Despite difficult equity market conditions, our stock selection focus remains consistent.

We remain focused on identifying companies that have:

- A demonstrated ability to grow business value and cash flow in a difficult economic environment
- Dominant market share / new product growth
- Strong balance sheets/financial flexibility to grow shareholder value
- Exposure to emerging markets
- High margins and high ROE
- Track record of superior dividend growth / capital allocation
- Rising earnings estimates / beating estimates
- Low absolute and relative valuation
- We look to Increase beta during/after periods of stock market weakness
- We will utilize periods of extreme negative volatility to upgrade our exposure to growth and sensitivity to economic recovery

Valuations for our companies remain very attractive viewed from an intermediate to longer term perspective. Most of our companies reported positive earnings surprises during the second quarter (some of which were very large earnings beats – Apple, MasterCard), and year over year results were solid within the context of a sluggish economic environment. We will continue to use periods of extreme market weakness to upgrade portfolios in terms of valuation/growth potential. Our companies currently trade at about 13x estimated 2011 earnings and about 11x 2012 earnings, with long term earnings projected to grow at 12-15%. By comparison, the S&P 500 trades at similar P/E multiples, but with lower earnings growth, lower margins, and higher average debt levels. We believe our holdings are very well-positioned from a qualitative and quantitative standpoint for the next several years.

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