Bridges Investment Management

Market Comments

January 4, 2011

After a strong recovery year in 2009 from the depths of the financial crisis of 2008, stocks in 2010 built on their 2009 gains. The S&P 500 posted a 15% total return in 2010, while the S&P Midcap Index and S&P Small Cap Index both realized total returns of 26%.

The bulk of 2010's returns came during the fourth quarter of the year. The S&P 500 had a fourth quarter total return of 10.76%, the S&P Midcap Index had a total return of 13.50%, and the S&P Small Cap Index had a fourth quarter return of 16.24%.

The positive equity market returns for the year were largely driven by two factors. First, corporate earnings showed very strong earnings growth throughout the year. Earnings for the S&P 500 companies were up 23% during the four quarters ending in September on both a market-cap weighted and equal-weighted basis, indicating that the profit recovery in 2010 was broadly based. We expect fourth quarter earnings to be reported this January to show continued solid progress in corporate profit growth.

The second factor bolstering fourth quarter equity returns was the effect of the Federal Reserve's massive quantitative easing operations. The Fed began to aggressively purchase U.S. Treasury securities in the second half of 2010, with the intent of driving investors toward riskier assets and driving the value of financial assets higher in order to stimulate the economy. We believe that so far the Fed's approach has been successful in pushing financial asset prices higher, but we are concerned about the longer term consequences of the strategy, especially when the Fed's marginal demand for Treasuries declines. This will be a key factor to monitor in 2011.

We are constructive on the outlook for equities in 2011. Our positive outlook is based on several factors.

First, we expect corporate earnings growth to continue in 2011. At present, consensus earnings estimates for the S&P 500 are $92 per share for 2011. Corporate earnings growth has consistently exceeded analysts' expectations over the past six quarters, and we believe there is still room for upside surprises in earnings in 2011; we anticipate actual earnings for the S&P 500 in 2011 could be as high as $95. Continued solid corporate earnings momentum should support higher stock prices on balance over the course of 2011.

Second, equity valuations remain modest despite the strong earnings recovery of 2009-2010. At present, the S&P 500 trades at 13.8x the current consensus 2011 earnings estimate of $92 per share (1275 / 92 = 13.8x). The current market P/E multiple is well below the long-term average P/E for the S&P 500 (which is about 17x), especially given that earnings growth is likely to be solid in 2011, and given that interest rates remain well below long-term average levels.

Third, valuations for many companies are understated because balance sheets have excess cash. This cash provides the flexibility for companies to create incremental shareholder value through increased research and development, capital spending, dividend increases, and or share repurchases.

Fourth, despite the large recovery in stock prices since March of 2009 (the S&P 500 rallied 86% between the market low on March 9, 2009, and December 31, 2010), U.S. equity mutual funds experienced net outflows of approximately $50 billion in 2010, while investors flocked to bond funds (net inflows of about $500 billion) even though interest rates were at or near record low levels in 2010. We believe that if interest rates continue to rise (the yield on the 10 year Treasury

rallied sharply during the last three months of 2010, rising from 2.39% at its lowest point during 2010 on October 7 to finish the year at 3.36%), investors who chased low yields in bond funds could reverse course and return to the stock market.

We believe fair value for 2011 for the S&P 500 is approximately 1425, or about 12% above current levels. Our fair value estimate is based on a 15x P/E for the market and an estimate of 2011 earnings of about $95. Should investors be willing to accord higher valuations to equities over the course of the year, an upside target of 1500 for the S&P 500 would be reasonable. For perspective, the all-time high level for the S&P 500 was reached in October of 2007 at 1575, which was about 17x 2007 earnings.

It is interesting to note that despite the challenging economic conditions of 2008-2010, S&P 500 earnings could reach all-time high levels in 2011, and yet the index trades about 20% below its all-time high. Clearly, investor psyche has not recovered as well as actual corporate profits and this is reflected in current equity valuations, which we believe creates an attractive long-term valuation opportunity for equity investors.

Against the backdrop of our generally positive outlook for equities in 2011, it is important to note that material corrections are likely (and would be healthy) in 2011. The S&P 500 is up 22% from its July 1, 2010, low, and up 86% from the bear market low of March 9, 2009.

Small and midcap stocks led the market in 2010. As the market moved higher in the second half of the year, and the Fed's quantitative easing signaled that every possible policy approach would be brought to bear to stimulate the U.S. economy, smaller and midcap stocks surged higher, as investors gravitated toward companies with relatively higher levels of 1) leverage to an improving economy, 2) operating leverage, and 3) balance sheet leverage. Stock price performance during 2010 was generally inversely correlated with "quality", as lower quality and smaller companies outperformed larger and higher quality companies.

We believe the cheapest sector of the U.S. equity market is the large capitalization, high quality segment: companies with market caps larger than $20 billion, with high levels of profitability and low levels of balance sheet debt. Many of these companies source large portions of their revenues outside of the U.S. and they should benefit from the decline in the value of the dollar.

We believe that small and midcap stocks are still attractive longer term, but their torrid advance over the last four months of 2010 raises the odds of a material correction in the first half of 2011. Small and midcap equities appear to be at rough parity with larger cap stocks on a P/E to earnings growth basis. At present, small cap stocks have a P/E to growth rate ratio of 1.49x, midcap stocks are at 1.45x, and large cap stocks are at 1.40x. Small and midcap stocks will have greater short-term volatility but should do well if the economy continues to show improvement over the course of 2011 and 2012.

We believe that many technology, consumer discretion, industrials, energy, and financial service companies are well-positioned at the outset of 2011, but we expect that an eclectic, company-centric approach in 2011 will be important.

We suspect that 2011 could be marked by higher volatility than 2010, because the capital markets appear to be at an inflection point, with several key markets at or near significant highs (gold and other commodities) or lows (interest rates). We will continue to focus on identifying those companies which we believe are capable of growing shareholder value over time and which are valued at levels which should allow for good returns over the long-run.

Our capital markets expectations for 2011 and 2012 are attached, along with the key assumptions that relate to those expectations.

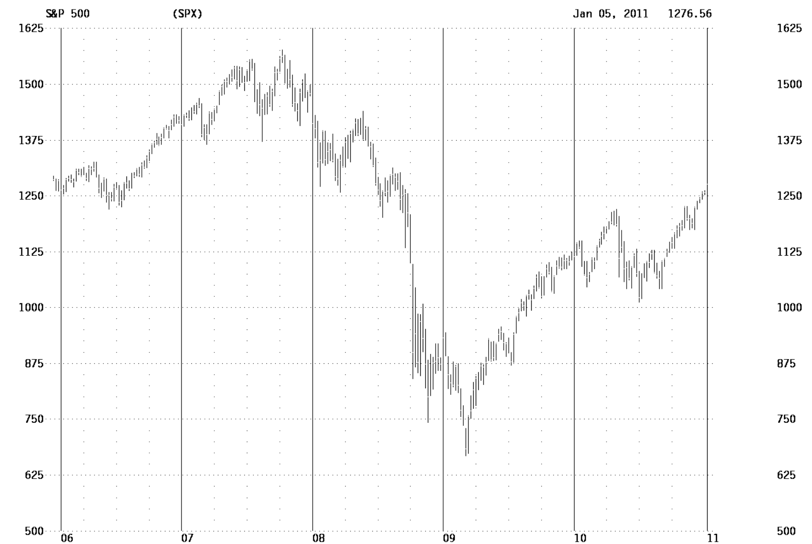
Edson L. Bridges III, CFA

Capital Markets Expectations

Current Levels:	*S&P 500*	1258	*Ten Year Treasury*	2.65%	*Inflation:*	0.70%

Long Term Total Return Expectations:

Asset Class	**Current**	**Historic Range**
Cash	1-2%	3-4%
Treasuries	2-3%	4-6%
Corporates	4-5%	6-7%
Preferred Stocks	5-6%	7-8%
U.S. Equities	7-10%	9-11%
EAFE Equities	6-10%	9-11%
U.S. Small-Midcap Equities	8-10%	9-12%
Emerging Market Equities	8-12%	9-12%



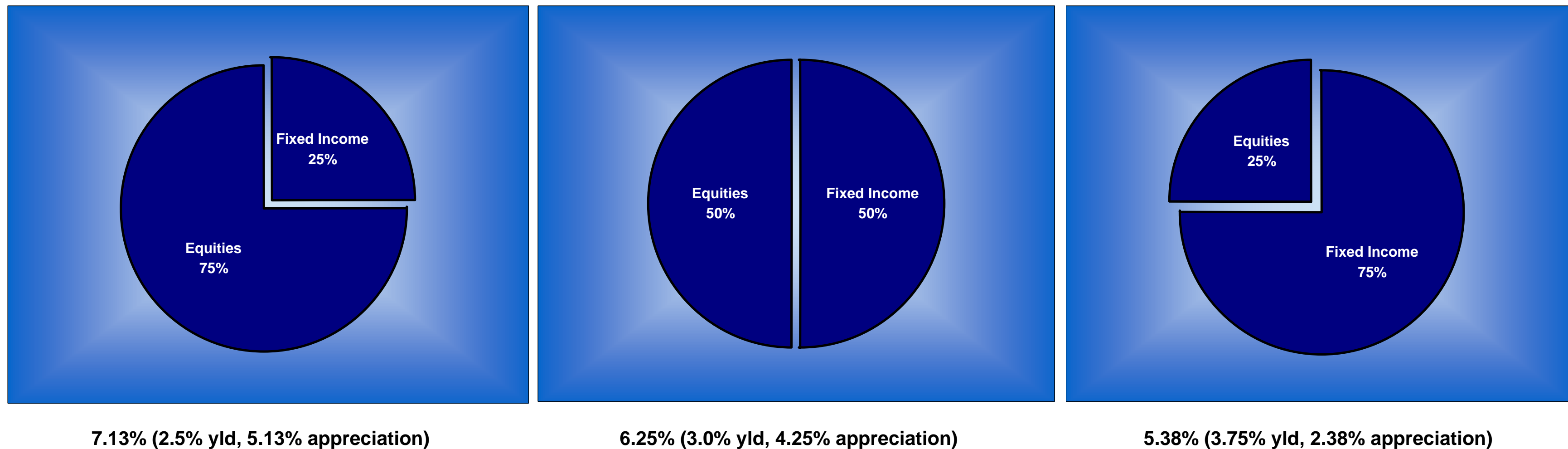
Long Term Capital Markets Characteristics

	Current	**Historic Range**
U.S. Investment Grade Credit Spread	50-100 bps	50-100 bps
U.S. Equity Risk Premium	4-7%	4-6%
U.S. Equity Dividend Yield	2.0-2.5%	3.0-3.5%
S&P 500 Long Term Earnings Growth	5-8%	7-8%
Fair Value P/E	15-16x	15-16x

Capital Markets Forecasts

S&P 500 (2011)	Earnings	$92-95	Year End Target	1400-1450
S&P 500 (2012)	Earnings	$102-105	Year End Target	1550-1600
Ten Year Treasury	Range	2.75-4.5%	Year End Target	4.00%

Long Term Expected Returns by Asset Allocation



7.13% (2.5% yld, 5.13% appreciation) | **6.25% (3.0% yld, 4.25% appreciation)** | **5.38% (3.75% yld, 2.38% appreciation)**

Return assumptions for charts: Equities 6.5% appreciation, 1.5% yld; Fixed Income: 4.5% yld

Key Assumptions:

* U.S. Economy continues to show growth in 2011 around 3% annual rate.
* Inflation expectations rise during 2011 toward long term levels.
* Corporate profit growth continues to be good although comparisons become more difficult throughout the 2011
* Fixed Income remains relatively less attractive than Equities in rising inflation and interest rate environment
* Large cap and high quality equities are most attractive U.S. sectors given cheapest absolute and relative valuations
* Small and mid-cap may outperform in first half of 2011 given earnings and price momentum