BRIDGES
INVESTMENT MANAGEMENT, INC.

Market Comments

January 2, 2014

S&P 500 1848
10 Year Treasury Yield 3.03%

Stocks finished 2013 on a very positive note, as the S&P 500 closed on December 31, 2013, at an all-time high of 1848, resulting in a fourth quarter total return of 10.49% and a full year return of 32.25%, which made 2013 the best year for the S&P 500 since its 33.31% gain in 1997.

The S&P 500 closed the year 173% above the March, 9, 2009, bear market low of 667, resulting in a total return of 202.64% (25.85% annualized) between March 9, 2009, and December 31, 2013.

Despite very strong recovery returns for equities since the 2009 bear market lows, longer term returns from the 1994-2000 bull market peak remain well below historic norms; the S&P 500's annual return from March 31, 2000 through year-end 2013 is 3.49%.

We were constructive on equities at the outset of 2013 and had calculated fair value levels of 1575-1650 for the S&P 500 for 2013 (versus a year-end 2012 close of 1426) and 1725-1800 for 2014, based on earnings expectations of $110 per share in 2013 and $120 per share in 2014.

We revised our fair value ranges higher at mid-year (to 1700 for 2013 and 1920 for 2014), as corporate earnings showed strength during the year and as we felt that increasing net capital inflows to equities supported slightly higher fair value multiples for stocks than our initial valuation targets.

The strong performance of the equity market during the fourth quarter carried the S&P 500 well past our adjusted fair value level of 1700 for 2013 and toward our 1920 fair value level for 2014.

We remain constructive on the outlook for equities for 2014 and 2015 because we believe many of the factors that drove positive returns for stocks in 2012 and 2013 remain in place at present. These positive factors include: 1) continued solid corporate earnings growth; 2) reasonable valuation levels for stocks; and 3) a continuation of inflows to equities from the fixed income market.

We expect that corporate earnings growth will remain solid (5-8% average annual growth) over the next several years given: 1) U.S. companies have shown good earnings progress despite challenging aggregate economic conditions over the past five years; 2) U.S. companies have good operating leverage to any improvement in overall economic conditions going forward; 3) the cumulative effects of the Fed's quantitative easing operations over the past several years should provide some continued positive stimulus to economic growth; and 4) U.S. companies have significant excess liquidity on their balance sheets that can be used for capital spending and/or share repurchases, both of which would be accretive to earnings per share over time.

Valuation levels for stocks moved from somewhat undervalued at the start of 2013 to roughly fairly-valued by year-end 2013. We believe "fair valuation" for the S&P 500 is roughly 15-17x current year earnings (in line with the long term average P/E for the S&P 500 of about 16x); for

2014, 16x current 2014 consensus estimated earnings of $120 per share implies a fair value target of 1920, roughly 4% above year-end 2013 levels. Our initial S&P 500 fair value estimate for 2015 is 2080, based on 16x an initial 2015 earnings per share estimate of $130.

Our fair valuation estimates imply positive returns for stocks on balance over the next several years, but the S&P 500 has appreciated 46% over the past two years, well in excess of the rate of underlying earnings growth over that period, which will make it harder for stocks to continue to appreciate at similar rates for current price levels. Further, the absence of any meaningful price declines for equities in 2013 raises the probability of a material (10-15%) pullback in 2014. A 10-15% correction would significantly increase the attractiveness of stocks relative to current levels; an 8% decline to 1700 on the S&P 500 would then imply 22% upside to our 2015 fair value estimate of 2080 over a 12-24 month time horizon, versus 12-13% implied upside at present.

Stocks could move meaningfully higher than our fair value estimate in 2014 if aggregate GDP growth is better than expected. Consensus estimates are for GDP growth of about 2.5% in 2014. If GDP growth were to exceed 3% in 2014, there is likely considerable upside leverage for corporate earnings because there is so little excess cost in the system. S&P 500 earnings could approach $122-125 per share in 2014 and $132-135 per share in 2015 if GDP growth exceeded 3%; at 16x earnings, fair value for 2014 on higher earnings would be 1950-2000 and 2100-2150 for 2015.

At present, the potential for upside earnings surprises based on a better than expected economic environment developing as 2014 unfolds are clearly not priced into equities. We believe many investors are underestimating the strong positive operating leverage U.S. companies have to even slightly higher levels of GDP. This factor is why our preference in 2014 is for companies with relatively greater exposure to the economy as opposed to relatively defensive companies.

While we are still constructive on the intermediate to longer term outlook for stocks, the strong run-up in stock prices during December and resultant increase in equity valuations leads us to take a disciplined and opportunistic approach to equities at current valuation levels.

We believe that stocks are priced to provide annual average total returns in a range of 6-10% over the next decade, based on future earnings growth of 5-7% per year, a small improvement in equity valuation over time, and dividends of about 2% per year. While expected equity total returns of 7-8% annually are a bit lower than historic S&P 500 returns of 9-11% per year, high single digit absolute returns in a low inflation environment should prove to be satisfactory, and the spread between implied equity returns and implied bond returns remains in favor of stocks, given that interest rates remain well below historic average levels.

While interest rates rose on balance in 2013, prospective bond returns remain unattractive in our view. The 10-year Treasury ended 2013 at 3.03%, up from 1.76% at year-end 2012. Assuming long-term inflation is about 3% per year, the 10-year Treasury is currently priced to provide virtually zero real returns. Corporate bond spreads remain tight as investors continue to chase yield.

We expect interest rates to continue to rise on balance during 2014 as investors anticipate an eventual end to the Fed's quantitative easing activities. We remain underweighted in bonds and defensively positioned within bond portfolios in terms of interest rate exposure and duration. When and as interest rates move higher, we will look for opportunities to increase fixed income exposure and lengthen bond portfolio maturities in order to capture higher yields. We expect the 10-year Treasury yield could reach 3.75-4.00% by year-end 2014, which would materially increase the relative attractiveness of bonds, especially if stocks move to significantly higher valuation levels this year.

There are a number of salient risks for investors to consider in 2014. The federal budget deficit remains large and growing, and political discourse, already heated, could become even more hostile and polarizing as 2014 is a mid-term election year, which may lower the likelihood of any meaningful progress being made on the federal deficit and the debt ceiling. The implementation of the Affordable Care Act has been uneven, and the legislation continues to entail many uncertainties regarding its cost and its impact on the broader economy; these uncertainties could weigh on investors as 2014 unfolds. Finally, the increase in equity valuations during 2013 raises the risk of downside to equity prices in 2014 should corporate earnings disappoint in 2014 relative to consensus expectations.

These risks and the strong performance of equities over the past two years lead us to expect that 2014 will be a more challenging and volatile year than either 2012 or 2013, although we expect a continued positive price bias for stocks and negative bias for bonds during the first part of the year, and we believe that the probabilities at present favor stocks providing positive total returns on balance in 2014.

We are generally pleased with the financial performance of our companies during 2013, and we believe our companies have strong business franchises from which to generate further growth in business value in coming years and strong balance sheets which will fund that growth and provide some downside protection in the event of a significant equity market decline.

We believe our companies generally have better near and longer term total return prospects than the market as a whole, because 1) their growth rates are generally higher than the market's, and 2) their valuation metrics are generally more attractive than the market.

Our focus remains on identifying companies that we believe are well positioned to grow shareholder value at attractive rates over the long run, and we will look to capitalize on periodic broad equity market declines to increase our holdings in those companies as opportunities to do so present themselves.

In sum, 2013 was an exceptionally strong year for stocks and a difficult year for bonds. We continue to expect that stocks will outperform cash and bonds on balance both in 2014 and over the intermediate (three to five year horizon) and long term (five to ten years). We expect 2014 will be challenging, but we are very constructive on the ability of our companies to create and grow shareholder value at attractive rates in 2014 and beyond.

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