## Bridges Investment Management

## Market Comments

March 1, 2008

As we discussed in market comments last fall, we entered 2008 expecting the year to be challenging, for a variety of reasons, including: 1) continued uncertainty surrounding the breadth and depth of the economic fallout from the subprime mortgage debacle in terms of its effects on the financial services sector, the capital markets, the U.S. consumer, and U.S. GDP; 2) the effects of a persistently weak U.S. dollar; 3) inflationary risks posed by the Fed's continued interest rate cuts and significant increases in many commodity prices over the past 18 months; and 4) uncertainty regarding the outcome of elections later in the year and the risk of significant changes in U.S. economic, tax, and foreign policies.

Equity prices peaked on October 11 when the S&P 500 reached 1576. The market subsequently declined to an intra-day low of 1270 on January 23, a decline of 19.4%. The S&P 500 has since recovered to 1381 on February 26, an 8.7% improvement, but the market remains 12.4% below its October 2007 high.

We did not feel last fall that equity valuations were sufficiently high that a significant correction was needed to bring valuations back toward fair value, which we pegged at 1600 on the S&P 500 (using a fair value P/E of 17-18x and earnings of $90). In 2007, corporate earnings growth was solid versus 2006, especially outside of the financial services sector. In the fourth quarter, excluding financial service companies' write-offs and write-downs, corporate earnings growth averaged 6.3% year-over-year, and was up 23% on a market-cap weighted basis. Clearly, larger companies, outside of financial services, showed good earnings progress in 2007.

Interest rates declined materially in the second half of 2007 as bond investors sought a safe haven in Treasuries as turmoil in the bond market reached crisis proportions in August, and as the Fed more aggressively cut rates in the fall to provide liquidity to the credit market.

In our view, the current weakness in the equity market is a function of investors worrying about what might happen in 2008-09, and trying to discount what the intermediate term implications are for corporate profits in the wake of the unwinding of the subprime mortgage morass and the weakness in the housing market that it has caused.

The key issue for equity investors is whether current valuations adequately discount the potential negative effects on U.S. GDP and corporate earnings of the unwinding of the financial services and housing market problems. While the answer to that issue will only be known in hindsight, we can get a feel for what is likely to happen beyond 2008 by examining how assets are currently valued, and what we think likely outcomes might be for corporate earnings over the longer term (next three to five years).

At present, consensus earnings per share for the S&P 500 are $92-93; the S&P 500 trades at approximately 15 times estimated 2008 profits. When viewed against the last 50 years of market valuations, and with 10 year Treasury yields slightly under 4%, equity valuations are extremely attractive for investors with a time horizon longer than a year.

Historically, the combination of P/Es at 15x or less, and interest rates below 4%, has resulted in mid-double digit annual returns for stocks over subsequent 3 year periods when this valuation relationship has occurred. Consequently, despite the considerable level of market volatility over the past year, the recent correction, and the litany of risks we outline above, we are optimistic regarding the potential for equity returns on balance over the next three years.

That said, cheap valuations alone do not make a market bottom; just because something is "cheap" does not mean that its valuation cannot go lower before it returns to "fair value." Our expectation is that the market will retest the low that was reached in late January at some point this year. We expect that stock price volatility will remain high during 2008 as investors react to unfolding events over the next several months, particularly data surrounding the strength of the economy, signs of a bottom in the housing market, further write-downs in the financial services sectors, first quarter earnings results (and, importantly, management comments regarding earnings guidance for the rest of 2008), the performance of the dollar, and the level and direction of energy prices. How these factors play out in the next several quarters will be determinative of the short term direction of stock prices.

Again, time horizon is critical. For investors with a multi-year investment horizon, equities are priced to provide significantly better returns than bonds over the next 3 to 5 years, assuming normalized earnings of 6-8% on average over that time frame, and if stock prices move lower in the short run, that will only improve their relative and absolute attractiveness.

We are more optimistic about our portfolio than the broad market. In 2006 and for the first three quarters of 2007, relatively risky stocks (companies with leveraged balance sheets, small cap companies, companies with relatively variable cash flow streams, companies with relatively higher leverage to changes GDP (commodity cyclicals, for example) significantly outperformed relatively higher quality companies (larger companies with stronger balance sheets and relatively more consistent cash flow growth).

This trend began to change in the fourth quarter of 2007 as equity investors began to reduce their exposure to riskier companies. Larger, higher quality companies offered both lower valuations (having lagged considerably in the 2006-07 time frame) and the prospects of more stable cash flows in the event of an overall slowdown in the economy.

At present, our portfolio is valued at approximately 16.0x estimated 2008 earnings. Earnings are expected to be 8% higher in 2008 than in 2007, and are projected to grow at 15% per year over the next 3 to 5 years. This compares favorably to the valuation metrics of the S&P 500, which trades at 15.0x estimated 2008 earnings, with earnings expected to grow at 6-8% per year over the next 3 to 5 years. Our companies generally trade at valuations well below long term averages, despite solid financial performance over the past five years, and solid financial performance expected going forward.

We would expect that our companies over time will experience price change that is roughly equivalent to the growth in their underlying business value (which has been approximately 15% a year over the 2003-07 time frame, so a 15% annualized growth rate going forward is consistent with historical financial performance); further, it is reasonable to expect that "normal" valuation for companies that are growing their underlying business value consistently in the range of 10-15% per year is higher than 14-17x earnings when interest rates are in the range of 4-5%.

Our financial services companies appear to be extremely undervalued assuming a normal recovery over the next few years in credit quality. Goldman Sachs trades at a P/E of 9x, Capital One trades at 9x, and Wells Fargo trades at 12x; we expect they will see good earnings growth over the next five years and will see their P/E's expand accordingly. Consumer discretionary stocks such as Target, Lowes, and Best Buy are also very undervalued both in absolute terms and relative to normalized valuation levels.

We anticipate that as overall corporate earnings growth slows, valuation multiples will expand for those companies that have strong business franchises and the ability to grow earnings and free cash flow even during periods of weaker GDP growth. Given the relative underperformance of high quality, consistent growth companies (compared to those companies with relatively higher sensitivity to changes in GDP) over the past several years, we believe our companies are both significantly undervalued and likely to see an improvement in their absolute and relative valuations over the next few years.

We expect that during the 2008-2012 time frame, our portfolio companies should experience total returns (price change plus dividends) that approximate their growth in business value from current levels. While the consensus earnings growth rate for our companies going forward is 15%, even a 10% aggregate annual growth rate over the next 5 years would provide a return significantly higher than the 10 year Treasury over the same period of time.

We don't need any valuation improvement going forward to generate solid returns assuming stock prices for our companies follow a conservative estimate (10% per year on average, well below what they have done in the past) of business value growth. However, the average P/E for our companies over the past 5 years is 23x. If the 10% growth over 5 years is accompanied by a valuation improvement halfway back to the long term valuation average of 23x (i.e., to 19-20x from the 16x level at present), then equity returns will approximate mid double digits per year on average.

By contrast, even if the 10 year Treasury yield were to fall from its current 3.9% yield to 2% over the next 5 years, the total return would only be 30% (4.96% annualized) between yield and price change, well below the returns that seem reasonably likely to be generated from stocks over the same period under the assumptions we outlined above.

It is difficult to predict with any degree of certainty how events will play out in 2008. Our sense is that it will be a difficult and challenging year as investors grapple with the risks that we outlined above. That said, we believe that the current level of stock valuations suggests that a material amount of risk is already priced into stock prices.

Further, we believe valuation relationships between stocks and bonds tend to revert toward long term averages. Over the long run, stocks return about 10% per year, bonds 5%. Between December 31, 1982, and January 31, 2008, the S&P 500 returned 12.68% per year, the Lehman Aggregate Bond Index returned 9.59%. Both asset classes had much higher than normal returns, but bonds far outperformed stocks on a risk-adjusted basis, and relative to historic norms. This outperformance was driven by a huge decline in interest rates over the 25 year period, from low double digit levels in 1982 to under 4% today. That rate decline also enhanced equity returns as well, as investors received not only price growth due to underlying earnings growth, but an expansion in price-earnings multiples from 8-10x at the end of 1982 to 14-15x at present. However, currently bonds are very expensive relative to historic levels (low yields = high price), while equity valuations are moderate relative to historic valuation levels, and unlike bonds, offer the potential of growth on balance over time (at the cost of materially higher short term price volatility). Looking forward, we believe stocks and bonds are valued currently such that the odds favor stocks providing better returns on balance over the next five years than bonds.

We remain focused on owning companies with strong business franchises, solid prospects for long term growth, and compelling valuation characteristics, and while we believe 2008 will continue to be a volatile and challenging year, we are very constructive regarding the prospect for the portfolio's returns over the next three to five years because current valuations are so low, both absolutely, and relative to long term historical norms and relative to interest rates.