BRIDGES | INVESTMENT MANAGEMENT

Think Forward

Market Comments
September 2, 2014

S&P 500	2000
10 year Treasury	2.40%

On August 26, 2014, the S&P 500 closed above 2000 for the first time ever. The financial media has covered this historic event, but we believe it is important to briefly discuss the stock market's push to all-time high levels in terms of its implications for investors going forward.

Our key takeaways are summarized below:

1. The valuation level of stocks is more important than the price level of stocks. While the S&P 500 is up about 8% through the first eight months of 2014 and about 40% since the beginning of 2013, valuations for stocks are currently about in line with long-term historical averages, at 16.5x estimated 2014 earnings, and 15.4x estimated 2015 earnings. While stocks are no longer cheap, they are near our estimate of fair value, which implies that returns for equities going forward should approximate corporate financial performance (growth in earnings, dividends, and/or free cash flow). We estimate growth to be in a range of 6-8% per year on average over the next three to five years.

2. It is important to recognize how far the stock market has advanced in recent years, because the market's strong upward move does increase the probability of an interim correction (the timing, depth, and duration of which is impossible to predict). The S&P 500 is up 48% since mid-November 2012 without experiencing a pullback of more than 7% along the way. The S&P 500 is up 196% since the last bear market low of early March, 2009, with only two 10%+ corrections (spring of 2010, summer of 2011) along the way. We remain constructive on stocks going forward, but the essentially uninterrupted advance in stocks over the past five and a half years argues for a vigilant and selective approach to equities.

3. The large move in stocks has been supported by strong corporate earnings growth over the past five years. Second quarter 2014 S&P 500 earnings advanced 11% year-over-year on an unweighted basis. As stock valuations have expanded from undervalued in 2011-12 to fair value at present, it will become more important to identify companies that can differentiate their earnings growth in a still sluggish economic environment. Our investment focus in the second half of 2014 will be on identifying those companies that we believe can generate above average business value growth and which trade at valuations that will allow for solid long-term total returns. We believe organic revenue growth is a key metric to identify those companies that are achieving differentiated business value growth.

4. In addition to earnings, stocks have been supported by strong net capital flows into the equity market since early 2013. We expect this to continue for the foreseeable future, even if interest rates reverse course and begin to rise, because implied returns for stocks remain much better than the expected returns for cash and bonds. The eventual end of the Fed's quantitative easing operations (likely in 2015) does not necessarily mean the end of the stock market's advance, because interest rates are well below a level at which bonds can provide returns that are competitive with stocks.

Summary

In sum, we continue to believe stock returns are likely to be better than bond returns on balance over the next few years, because 1) equity valuations are close to our estimate of fair value, 2) corporate earnings are strong, 3) cash levels are high on corporate balance sheets (which provides companies with the flexibility to invest in their businesses for growth, and/or buy back stock and increase dividends), and 4) capital flows to stocks are positive. We believe the equity market is long overdue for a meaningful (10+%) correction, but stock valuations would become much more attractive in the event of a 10% correction, which we would view as an opportunity to increase our exposure to companies with truly outstanding business franchises and long-term growth prospects.

Edson L. Bridges III, CFA
President