Bridges Investment Management

Market Comments

November 20, 2008

November 20, 2008, was a historic day for both bonds and stocks. As concerns about the depth and length of the recession grew, investors sought a safe haven in U.S Treasuries, driving yields on the 10 year note to 3.01%, an all-time low. Similarly, the 30 year Treasury bond traded to 3.47%, also an all-time low. The yield on the 2 year Treasury fell below 1%, at 0.98%, as investors clamored for safety and fled assets with greater levels of risk.

The S&P 500 breached the 2000-2003 bear market lows, which were set on October 9, 2002 at 768.63. On November 20, 2008, the S&P 500 traded to 747.78 intraday, and set a new bear market closing low of 752.44, down 48.76% yea-to-date, and down 51.93% from the all-time high set on October 9, 2007. This marks 2008 as the worst year for U.S. equities since the S&P 500 fell 47% in 1931. Despite an additional 15% drop in 1932, the S&P finished 111% higher in 1936 than its 1931 close, resulting in a 5 year compound annualized return of 16% over the 1931-36 time frame.

Clearly, investors are pricing in a significant decline in corporate profits in 2009. Key issues include: 1) how much aggregate corporate earnings may decline over the course of the current recession; 2) how quickly earnings recover; and 3) what current valuations imply for longer term corporate financial performance.

The media is focused on reporting on changes in stock prices. While stock price change is important, we believe what is more important is the valuation of stocks. Despite the current price volatility for stocks, we believe that the long-term underlying fundamentals for U.S. stocks remain solid. There are several reasons for this.

First, the U.S. economy remains the most vibrant in the world in terms of creating and marketing leading brands and products across a wide range of economic sectors around the globe. Second, outside of the financial services sector, U.S. corporations are entering this recession with very strong balance sheets, as aggregate debt levels and interest payments as a percentage of corporate cash flows are both well below long-term historical averages. Third, valuation levels of equities are compelling. Many companies have seen their stock prices decline from near all-time highs to below 2002 bear market lows in the last 90 days, even though their revenue, earnings, free cash flow and dividend levels are 50-100% higher than 2002 levels. Even assuming material declines in 2009 (and perhaps 2010) in financial performance, the enduring quality of strong business franchises will drive an eventual return to normalized growth and profitability levels, and as that occurs, valuation levels will also return to more normal levels. In broad terms, that could be anywhere from 1200 to 1500 on the S&P 500 over the next 18 to 24 months.

Valuation levels in October, 2007, coincident with the equity market's peak, were not excessive, at about 16x estimated 2008 earnings of $95. Actual operating earnings (exclusive of write-downs against reported earnings of financial companies) will probably be in the range of $85, as the economy has slowed in 2008, and oil prices have dropped precipitously in the second half of the year, which will lower energy company earnings from peak levels earlier in the year.

At its November 20, 2008 close of 752, the S&P traded at 8.8x 2008 operating earnings. Assuming S&P 500 operating earnings decline to $60 in 2009, the S&P now trades at 12.5x recession level earnings, compared to a 15.5x multiple on four quarter forward earnings in July, 2002. Clearly, the stock market is discounting a substantial operating earnings decline in 2009, and/or an extended period of weak profit growth.

That said, equity valuations when viewed from a longer term perspective appear to be incredibly cheap. At a level of 750 on the S&P 500, stocks are in the lowest 20% of all observed historical stock market valuation levels. Current valuations give little or no credit for an eventual recovery in profitability to normalized levels. Many individual company valuations at present imply little or no earnings growth for a period of years. While it is possible that the profitability of U.S. companies could be stalled at current levels for many years, history would argue that such an outcome is very unlikely, and that corporate profitability and earnings growth will move to new, higher levels at some point during the next phase of economic expansion. While ongoing deleveraging across the economy and the capital markets will be painful and will be dampen growth for a while, we believe that longer term nothing has changed structurally in the U.S. economy in terms of the ability of stronger corporations to earn competitive returns for shareholders.

Further, the current level of market volatility is one that has historically been associated with important market bottoms. The VIX Index, which measures equity market volatility, is at all-time highs, and all previous highs have been coincident with major equity market lows. The average level of the VIX over the past 20 years is 20; it currently trades at 80, indicating that equity market activity has been and is implied to be four times more volatile than normal, and implying price change of around 25-30% over the next 30 days. Credit spreads on bonds and risk premiums for equities are at the widest levels in decades, indicating that investors, in a 180-degree turnaround from 2006-early 2007, are shunning "risk" and pricing "safety" at literally all-time high levels. While we expect volatility to remain high for the foreseeable future, it will eventually decline, but if volatility is a proxy for fear, it indicates that fear at present is at truly historic levels in both the credit and equity markets.

Stock prices do not stop going down just because stock valuations are cheap, as evidenced by the events of the past few weeks. However, the vast weight of economic and market history argues strongly that the probabilities are likely that stock returns will be very good on balance over the next five years, given the current combination of depressed equity valuations and excessive investor pessimism. Further, it is likely that stock prices will recover well before the headlines indicate that economic conditions have improved. In the 2000-2003 bear market, unemployment peaked at 8.5% in June of 2003, but stock prices bottomed for the last of three times in March of 2003, and by June the S&P 500 was 25% higher. By June of 2005 the S&P 500 was 50% higher. The S&P 500 is currently down about 20% in value over the trailing 10 years, one of the worst decades in market history, despite the period being marked by solid aggregate corporate financial performance (the S&P 500 earned about $45 per share in 1998; it will earn almost twice that in 2008). Notions of mean reversion argue that stock returns over the next decade will be much better.

Our companies generally have low, or at least manageable debt levels, leading positions in their industries, high levels of profitability, strong free cash flow characteristics, and experienced management teams that have good track records for growing business value for their shareholders over time, and through a wide range of economic conditions.

Earnings estimates are never precise, and in the current environment they are somewhat less useful than usual given the rapid deceleration in the economy, and the difficulty in pinpointing how deep and long the recession will be. That said, the huge drop in stock prices clearly discounts substantial earnings weakness and uncertainty in 2009. We have used prior bear market low valuations to derive implied earnings estimates for our companies for 2009. Generally, our work shows that earnings estimates could come down another 15-20%. Regardless, our companies trade far below reasonable and conservative estimates of fair value even if 2009 earnings come in materially below current expectations.

Our companies have generally grown earnings faster than the S&P 500 over the past five years, and in the currently challenging economic environment, we believe they are better positioned to show relatively strong earnings progress over the next several years than most companies given their strong balance sheets and leading competitive positions in their industries. As was the case in the 2002-2004 time frame, we believe that higher quality companies will outperform into and through the recession, and during the early stages of eventual economic recovery, as capital gravitates toward those companies that are best-positioned to weather the difficult environment. This effect could be magnified during this cycle because the valuations for the highest quality companies are so depressed, both in absolute terms, and relative to the broader equity universe. Rarely have investors had the opportunity to own the best companies at such low absolute and relative valuation levels.

We continue to expect that the next several quarters will be extremely challenging for investors given the long litany of economic problems and uncertainties at present. There is no question that the risks facing investors are both real and significant in the short run. However, it is likely that the historically large stock price declines during the second half of 2008 have gone a long way toward discounting a major recession, and it is likely that stock prices will begin to improve well before economic conditions do. We believe equities are extremely attractive for those investors whose time horizons are measured in years as opposed to weeks or months.

We remain focused on owning companies with strong business franchises, solid prospects for long-term growth, and compelling valuation characteristics, and we are very confident that equity returns on balance over the next five years will be good.