



Bridges Investment Management

Market Comments

October 15, 2008

The stock market endured its worst week since 1933 when stocks fell 18% during the week ending October 10, bringing the market's decline to 23% for the month, 38% for the year, and 41% since October 9, 2007, which marked the all time high for stocks (marginally higher than the March 11, 2000 high).

The sharp decline in stock prices was driven by worsening fears of a prolonged economic recession brought on by continued credit markets turmoil, and was exacerbated by forced selling by hedge funds and mutual funds in the face of margin calls and redemptions.

The U.S. government brought to bear a wide range of policies during September and October designed to improve credit markets liquidity in the short run, and buy time to allow for an orderly liquidation of massive amounts of impaired debt securities. The policies are unprecedented in their scope, and in addition to addressing the financial crisis directly, they were intended to send a message to the markets that all possible approaches were being taken to insure that the financial system would remain viable.

It will take time for the ultimate effects of the policies implemented in recent weeks to be known. In the interim, investors have moved from concern during the summer, to fear in September, to panic in October. It remains to be seen whether the lows of October 10, 2008, will mark the capitulation usually needed to mark a bear market low.

The sharp downdraft in equity prices and the explosion in credit spreads for most debt securities relative to Treasury yields have resulted in valuations for stocks and bonds (outside of Treasuries) that are the lowest in decades.

The three most critical issues in our view are:

- 1) How deep will the current economic deterioration be?
- 2) How long will it take before the current crisis shows signs of stabilization?
- 3) What will be the long term implications for investors on the other side of the crisis?

Predicting macro-economic outcomes is difficult if not impossible even during "normal" periods. That said, we believe that it is reasonable to expect the following factors will have a material impact on capital markets returns over the next 12 to 24 months:

- 1) The speed with which inter-bank lending reverts to more normal levels will dictate the speed with which economic activity stabilizes and eventually recovers – without normal access to credit, economic activity will decline
- 2) Unemployment – we expect unemployment to rise as businesses look to cut costs to retain profitability. Unemployment peaked at 7.8% in the 1990-92 recession. Jobs are critical for consumers to be able to continue to spend and meet their debt obligations
- 3) Dollar – commodities – inflation – our expectation is that longer term, a cost of the policies being implemented will be somewhat higher inflation

- 4) Leverage and Risk – it is reasonable to assume that investors will pay a premium for higher quality, more stable cash flow streams than was the case between 2004-07
- 5) Capitalism versus Socialism, Private versus Public – there may be significant implications on capital markets valuations if there a change from the “Ascendancy of Capitalism” from 1980-2008 toward a more interventionist government paradigm in the 2009-beyond era

While mindful of macroeconomic considerations, we believe a bottom-up approach that emphasizes individual security valuation relative to quality and growth remains the best approach to navigating difficult market conditions.

The sharp spike in credit spreads has materially increased the attractiveness of investment grade corporate bonds. Spreads versus Treasuries for A-rated 5 and 10 year corporate bonds have widened from 125-130 basis points at year end 2007 to 275 basis points today, versus long term norms of 50 to 75 basis points. The credit crisis has created a rare opportunity to buy investment grade corporate debt at well below normal prices; the high yield spreads should cushion investors somewhat if interest rates rise over the next several years as the economy recovers and demand for, and access to credit normalizes.

Equity valuations, which were attractive during the past twelve months, have fallen to once in a decade lows. As we have noted before: cheap valuations alone do not mean that stock prices cannot fall further. That said, the S&P 500 traded at its lowest level on October 10 since June, 1985, at 10.8 times trailing earnings. Importantly, yields on 10 year Treasuries in 1985 were 10%, they are 4% today, so equities are very attractive when viewed from a discounted cash flow standpoint.

Clearly, the sharp stock price decline of the past month implies that investors expect earnings to fall materially in 2009. At the bottom of the last bear market in October, 2002, the S&P 500 at its lowest level traded at 16x trailing recessionary earnings of \$48 per share. Consensus 2008 operating earnings for the S&P 500 are about \$85. The S&P 500 traded to 838 on October 10, 2008, or 11.2x trailing earnings. Assuming a trough P/E of 12x (25% less than the trough P/E of the 2000-2002 bear market/recession) and trough operating earnings of \$60 (a 33% decline from peak S&P 500 operating earnings of \$90 per share in 2007-08), the S&P 500 could have downside risk to around 700-725, which would represent a 50% decline from its October 9, 2007 peak. The last bear market (March 11, 2000 through October 9, 2002) saw a 43% decline in the S&P 500 of a 22.6% decline in earnings. Interestingly, the S&P 500 traded at 27.3x earnings at its March, 2000 peak with 10 year Treasury yields at 6%. By comparison, the S&P 500 traded at 18x earnings at its peak last October with 10 year yields at 4-4.5%. The decline in stock prices in 2008 was much more about debt, credit quality, and credit markets liquidity than about equity valuations being too high in relation to underlying long term company fundamentals.

Our portfolio currently trades at about 11.2x estimated 2008 earnings and roughly 10.5x estimated 2009 earnings versus an average P/E over the past decade of 20x. Earnings growth in 2008 is expected to be 7% over 2007, and is estimated to grow at 10-12% annually on average over the next 3-5 years. This compares favorably to the valuation metrics of the S&P 500, which trades at 10.7x estimated 2008 earnings, with earnings expected to grow at 5-7% 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.

Our companies have strong balance sheets, strong franchise characteristics (high margins and profitability), and are generally leaders in their markets. We expect that their balance sheet strength, high profitability, and strong competitive positions will allow them to grow market share vis-à-vis weaker competitors in a challenging economic environment.

Individual stock valuations are compelling. Dividend discount and/or net present value of future cash flow calculations argue strongly that our equities are significantly undervalued at present

under very conservative assumptions. For example, Capital One, using consensus earnings, growth and risk premium assumptions, has a net present value of approximately \$60 versus a current market price of \$37. If earnings growth is assumed to be 10% (versus 14% consensus growth expectations), and using a risk premium of 7% (versus 10% based on current capital asset pricing model methodology), net present value is about \$80. Alternatively, Capital One's current price implies a long term earnings growth rate of about 4%, which while possible, is unlikely.

Our stocks are also very inexpensive in view of their financial strength. Apple has net cash of about \$20 per share; adjusted for that it trades for about 15x estimated 2009 earnings. Cisco has about \$3 per share of net cash, and thus trades at about 9x estimated 2009 earnings. Roper Industries should have free cash flow of about \$4 per share in 2009, and trades at 11x free cash flow or at a 9%+ free cash flow yield. Such low valuations for companies with such strong balance sheets, high profitability, and good long term business value growth prospects are rarely seen. Again, low valuations alone are not a guarantee that prices won't decline further, but history strongly argues that over the long run, stock price and business value track fairly closely, and this gives us confidence that returns for our stocks should be very good on balance over the next few years as economic conditions stabilize and eventually improve.

We expect continued volatility for the remainder of 2008 and into 2009. There is no question that the capital markets face considerable challenges over the next several years, and it is likely that the economy, the capital markets, consumers, businesses and investors will be under pressure for a while as the damage to the system is evaluated and addressed, and as policies are implemented to enhance the recovery process. It is impossible to gauge the magnitude of the near term effects of the credit markets meltdown, or how long the recovery process will take. However, we believe that the recent stock and bond market declines probably discount a significant amount of that damage, and we believe that the damage is not irreparable; we believe that the core strengths of the U.S. economy remain intact.

We will continue to invest with a long term horizon, and emphasize companies with strong business franchises and compelling valuation characteristics.