



Bridges Investment Management

Market Comments

May 21, 2008

The five months of 2008 have been marked by significant equity market volatility driven by continued revelations of significant asset write-downs in the financial services sector stemming from sub-prime mortgage defaults. Investors were troubled by concerns that the weakness in the housing and financial services sectors would result in a significant slowing in the U.S. economy during 2008 (and perhaps beyond). Rising commodity prices have rekindled inflationary fears (spot oil prices are up 37% year to date through May 21), and the dollar has continued to be weak relative to other major currencies (the dollar is down 8% versus the Euro year to date).

Rarely in the past 25 years have so many asset classes seen such wide variations in price and value from their long term averages and such significant short term price volatility.

Bond yields are near multi-decade lows. The 10 year Treasury yield is 3.85% at present, compared with an average yield of 5.98% over the past 20 years. Further, with inflation moving higher, real yields on bonds (yield on the 10 year Treasury minus CPI) have recently turned negative.

Oil prices also trade at historic highs, surpassing \$130 per barrel, double the average price of \$60 per barrel over the past 5 years, and more than four times the average price per barrel of \$30 over the past 20 years.

The wide disparities in valuations of so many asset classes relative to their historic norms create both volatility and opportunity. Short term price volatility is increased the further price moves away from fair value, and it is magnified by the large increase in leverage in the system in recent years coincident with the proliferation of hedge funds, and by increased speculation as capital chases recent price trends.

Given the current environment, we think it will continue to make sense to focus on and allocate capital to those asset classes and sectors that are undervalued relative to historic valuation norms, and we expect higher quality assets to weather the volatility better than companies with lower quality balance sheets and/or greater exposure to changes at the margin in the pace of the economy. We also think it will pay over the next several years to remember that reversion to the mean, over the long run, is a powerful force in the capital markets; we would expect many of the wide valuation divergences that exist at present to moderate on balance over time.

We think stocks are priced to outperform bonds materially on balance over the next 5 years, assuming a reasonably normal economic recovery. Over the past 8 years, bonds have materially outperformed stocks, as interest rates have fallen from 6.5% at year end 1999 to 3.8% at present, while P/E's for the S&P 500 have been roughly cut in half, falling from 30x in late 1999-early 2000 to 15x at present. Over the past 8 years, intermediate term corporate bonds have returned 76%, or 7.3% per year to investors (versus a long term expected return of 5-6%), while the S&P 500 had a total return of 9.2%, equal to a compound annual return of 1.1%, versus long term expected returns of 8-10% annually. Given current valuations (bond prices high, with yields under 4%, and equity valuations lower than average, at around 15x current year earnings),

and the tendency for capital markets returns to revert toward their averages over time, we are more constructive on stocks than bonds at present.

Equity valuations appear attractive from a longer term perspective, although stocks face significant challenges in the near term. At present, the S&P 500, at 1390, trades at about 14.0x consensus 2008 earnings estimates of \$93. Actual earnings for 2008 could end up being much higher or lower, depending on the amount of additional asset write-downs by financial services companies, how much consumer spending is hurt by fallout from the housing crisis and higher energy prices, and by how sustainable higher commodity prices end up being throughout the year. Historically, stock prices have done well over the three year periods where P/Es are 15x or less, and interest rates are in the 4-5% range. However, as inflation picks up, there will be upward pressure on interest rates, which may slow P/E multiple expansion back toward the 17-18x level, which we believe to be an area of long term fair value.

At present, our portfolio is valued at about 16.5x estimated 2008 earnings. Earnings are expected to be 9% 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 14.0x estimated 2008 earnings, with earnings expected to grow at 6-8% per year over the next 3 to 5 years. We have included a spreadsheet that outlines the valuation and growth inputs for all of the portfolio's equities, the portfolio as a whole, and the S&P 500. The data indicates that 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.

At present, the portfolio has over-weightings in financial services, energy, and health care, and is roughly market-weight technology and industrials. We are underweight utilities, materials, and consumer staples. We believe financial services are extremely undervalued relative to their long term fair value. Energy, despite its strong move over the past two years, remains undervalued relative to energy spot prices, and we believe the current imbalance between supply and demand will persist for the foreseeable future. Technology should continue to see above average earnings growth over the next five years, and valuations are very low relative to historic norms. As investors have sought defensive areas of the market in recent months, consumer staples and utilities appear to be at best fairly valued, and in some cases, over-valued, and we are underweight those sectors.

We continue to expect 2008 to be a challenging year, marked by larger than normal equity market volatility. However, we remain constructive longer term because valuations are reasonable, and our companies have strong business franchises with exceptional records of growing shareholder value through a wide range of economic conditions over the long term.