BRIDGES
INVESTMENT MANAGEMENT, INC.

## Market Comment Notes

January 19, 2009

**Where are we?**

1. 2008 was the worst year for the stock market since 1931
2. Equity returns are now negative on a trailing 10 year basis – worst 10 year stretch since the 1930's
3. Most major economic and capital markets indicators are at huge spreads from long term averages

    SPX P/E
    Credit Spreads
    Energy Prices
    U.S. Treasury yields
    VIX - volatility

4. Valuations appear to be pricing in worst recession since 1930's – SPX earnings are 2x 2002 recession lows, SPX is near 2002 bear market lows

**How did we get here?**

1. Excessive leverage
2. Underpricing of risk

**Where do we go from here?**

1. Reversion to the mean remains the most powerful force in investing
2. Current situation for equities is opposite of late 1999-early 2000
3. Common sense strategies are appropriate and have compelling risk-reward characteristics
4. "Safety" is priced expensively, "Risk" is priced dirt cheap – opposite of 2006
5. Smart money bet is that major economic relationships move materially back toward long term averages on balance over next two years – halfway back to average will result in very good returns, back to average will result in outstanding returns

**Risks**

1. Uncertainty, always higher than we think, is unusually high given "uncharted waters" aspect of current environment
2. Move toward greater government intervention / socialist policies / taxes – implications on equity valuations are negative
3. Deleveraging is painful – and risk aversion will likely mean recovery is slower than usual
4. Volatility is likely to remain high for a while given level of uncertainties, still high debt levels, and perceived risks
5. Are traditional notions of risk and return expectations for the capital markets still valid?

**Opportunities**

1. Equity valuations are exceedingly cheap, especially for 3-5 year horizon

2. “High Quality” is especially cheap given valuation compression across quality and growth spectrum
3. Timing – equities discount recovery before headlines show economic improvement
4. Investors have a rare opportunity to own the best companies at historically low valuations, both absolutely and relative to all other companies and asset classes, with relatively low valuation risk and execution/business/economic risk
5. Investors can win 2 ways --- stabilization and eventual recovery leads to higher corporate profits several years out, PLUS reversion to “normal” valuation metrics as investor sentiment moves from panic to caution to relieved driving P/Es from 8-12x to 12-20x