Bridges Investment Management
Market Comments
April 12, 2011

The first quarter of 2011 showed strong equity returns. It was the best first quarter for stocks since the first quarter of 1998. The S&P 500 had a total return of 5.92% during the first quarter, bringing its gain to 30.98% since the market's July 1, 2010 low. The S&P Midcap Index returned 9.36% in the first quarter and is up 41.25% since the 2010 low, and the S&P Small Cap Index returned 7.71% in the first quarter and is up 38.29% since the July 2010 low.

The market is now a little more than two years past the March 9, 2009 bear market lows, and the returns off those lows have been extremely strong, with the S&P 500 advancing 96%, the S&P MidCap Index rallying 144%, and the S&P Small Cap Index rising 146%.

Clearly, investors have been willing to increase their exposure to risk, given the magnitude of the outperformance of smaller and lower quality companies over larger and higher quality companies off the market bottom.

The outperformance of smaller and mid-sized companies relative to larger companies accelerated in the second half of 2010 coincident with the Fed's QE2 operations, and smaller companies have continued to lead the market during the first part of 2011, as QE2 has incentivized investors to move out along the risk spectrum.

Despite the strong returns for stocks both during the first quarter of 2011 and over the past two years, we remain constructive on the outlook for equity returns both for the remainder of 2011 and over the next three to five years.

Our positive thesis rests on these factors:

1) we believe that the strong recovery in stock prices has been supported by the recovery in corporate profits over the past two years

2) we expect corporate profits to continue to show good progress over the next several years as the economic recovery continues to unfold

3) valuations for equities, despite the strong upward move in stock prices, remain reasonable – the S&P 500 currently trades at about 14x consensus 2010 earnings estimates, somewhat below its long term average P/E

4) interest rates, although likely to rise over the remainder of 2011, remain well below long term norms

5) investors and corporations have considerable excess liquidity, which currently provides little real return; that liquidity could fuel higher stock valuations over time

We continue to believe that fair value for the S&P 500 is around 1450-1500 for 2011, and 1575-1625 for 2012, based on our expectation that S&P 500 earnings will approximate $95-96 in 2011, and $105-108 in 2012.

Investors do face a number of risks. Rising commodity prices raise the risk of inflation. The U.S. continues to face large budget deficits and political uncertainty as those deficits are addressed. While the economy is improving, recovery has been uneven and unemployment remains stubbornly high. Stock prices have had a large run, and while that has been largely supported by earnings recovery, it is reasonable to assume that the market is overdue for a material correction at some point during 2011.

We continue to focus on two primary themes within the equity market. First, large capitalization, higher quality stocks have generally lagged the broader market since the beginning of 2010, and consequently are cheap on both an absolute basis, and relative to small and lower quality companies. We believe that over time, those valuation disparities will

be narrowed, although it is difficult at present to know what the catalyst will be that will ignite a period of better relative performance for larger, higher quality companies.

Second, companies with exposure to an improving economy should continue to show above average earnings growth, and we are focused on identifying companies that are well-positioned to benefit from ongoing economic growth both in the U.S. and abroad.

We are less constructive on bonds than stocks. We expect interest rates to rise on balance during 2011 as inflation expectations increase, economic activity improves and demand for credit rises.

First quarter earnings season will provide an important window into the expectations of company managements regarding their sense of profit growth for the remainder of the year.

We remain positive on the prospects for equity returns for the remainder of 2011 and into 2012 given our expectation of continued corporate earnings growth and given modest equity valuations.