



Market Comments

January 9, 2012

S&P 500 1281
10 Year Treasury Yield 1.97%

Review of 2011

U.S. equities finished 2011 virtually unchanged after a year that was notable for its extreme volatility. The S&P 500 started the year at 1257.64 and ended it at 1257.60, the smallest calendar year change in history.

The Index's modest change for the year belied a wild ride for investors. Stocks enjoyed a sharp rally during the first third of the year, reaching the year's high of 1370 on May 2, a gain of 9% which was driven by solid first quarter corporate earnings.

Stocks then traded sideways for several months, before plunging sharply in early August as concerns regarding the solvency of European sovereign debt intensified. Stocks fell from 1345 on July 22 to an intraday low of 1070 on October 3, a drop of 20%.

Equities stabilized and then moved 17% higher over the last three months of the year, rallying from 1070 to finish at 1257.60, essentially where they started the year.

The three risks we felt posed the biggest challenges for investors at the outset of 2011 included 1) European financial deterioration, 2) a sluggish U.S. economy, and 3) a rancorous political climate, and all three risks impacted stocks negatively at various times during the year, which was enough to offset 2011's most positive outcome: the continued strong performance of corporate earnings growth, which appears to be on track to result in earnings gains of about 17% over 2010, well ahead of the consensus' 10% growth expectation at the outset of 2011.

Fixed income investors generally fared better than equity investors in 2011. Treasury yields dropped sharply during the year as investors sought "safety" and chased yield, even though yields were very low relative to historic norms. The yield on the 10 year Treasury dropped from 3.30% to 1.89% during the year, driving large total returns for holders of intermediate and long dated Treasuries. Corporate bonds also did well; the Citigroup 7-10 year corporate bond index had a total return of 9.37%, although corporate spreads widened in the second half of the year coincident with rising European crisis concerns.

2011 was notable for the ostensibly insatiable appetite of investors for yield, both in the fixed income and equity markets. "Yield" oriented assets, already fairly full-priced entering 2011, reached higher valuation levels by year end 2011, in stark contrast to "growth" assets, which ended the year at historically low absolute and relative valuation levels.

Mutual fund flows in 2011 saw huge inflows into bond funds, and large net redemptions from equity funds over the course of the year, continuing a trend that has been in place since 2007.

Outlook for 2012

We believe investors face many of the same risks at the outset of 2012 that they faced one year ago. Europe remains the largest obstacle for the equity market, which could remain mired in a trading range until it becomes apparent that meaningful progress is being made toward addressing and remedying the significant credit problems of some EU members.

With Europe in recession, it becomes more difficult for U.S. companies to maintain earnings growth rates both due to reduced demand from the Euro zone, and because the dollar could continue to strengthen versus other world currencies given the U.S.'s relative economic stability, making goods and services priced in dollars relatively more expensive in the global marketplace.

The U.S. economy's recovery remains below trend, unemployment remains high, and consumers continue to pay down debt loads incurred in the 2004-2007 time frame, reducing consumption (two thirds of the U.S economy is consumer-based).

Finally, the political climate remains highly charged and divisive, and some investors may opt to stay on the sidelines until the November elections afford more clarity about the future direction of the country and the relative roles of the private and public sectors in the domestic economy.

Notwithstanding the risks, we remain very constructive on the intermediate to longer term outlook for equities, and neutral to negative on the outlook for returns from fixed income assets.

Our valuation work is at the heart of these conclusions, and we believe the valuation metrics paint a compelling picture in favor of equities relative to bonds.

Bond yields are at historic lows, and offer virtually no margin for error against an eventual rise in inflation expectations and increases in interest rates. The 10 year Treasury at or below 2% implies a zero real return over the next decade, assuming an average annual inflation rate of 2%; real returns on Treasuries could easily become negative should inflation exceed 2% on average over the next ten years.

We believe corporate credits offer slightly better returns, as spreads have widened coincident European debt fears and recessionary conditions in the EU. Corporate bonds in the five to ten year maturity range offer yields around 3% (A rated credits) to 4% (BBB credits). Other yield oriented areas such as preferred stocks, REITs, and master limited partnerships, offer incrementally better yields, but valuations are stretched relative to historic norms and provide little margin of safety should interest rates rise at some point over the next few years.

High quality companies with solid equity dividends in many cases offer higher yields than their corporate debt issues. In the second half of 2011, investors chased dividend yield, and these companies saw their valuations move to high relative levels, although absolute valuations remain reasonable against long term averages. For example, Abbott Labs' stock yields 3.4% at present, versus a 2% yield for its 2017 maturity debt. Investors seem willing to exchange a yield pick-up with some upside appreciation potential for the interim price risk inherent in the equity relative to the debt.

Conversely, growth-oriented companies appear to be extremely undervalued for investors with a longer term time horizon. As of January 9th the S&P 500 traded at about 12x estimated 2012 earnings of \$105 (up from an estimated \$98 per share of earnings for 2011), versus a long term average P/E of 15-16x (the 12x P/E seems especially cheap in a 2-3% interest rate environment). The S&P 500's 2012 earnings yield is 8.2% (\$105 earnings in 2012 divided by the current 1280 Index price), the highest earnings yield since 1988. The implied risk premium is 6%+ (earnings yield of 8.2% minus 10 year Treasury yield of 2%); this metric is also high relative to a historic average of around 4-5%, and many high quality growth companies have implied risk premiums of 8-10%.

We believe fair value for the S&P 500 in 2012 is between 1550-1600, assuming 14-15x estimated earnings of \$105-108 implying potential upside. The long term average P/E for the

S&P 500 is about 15-16x, and we could make the case that if interest rates remain in a range of 2-4%, the P/E for equities could be even higher than 15-16x.

Portfolio

We believe high quality companies that are able to generate good growth in revenues, earnings, and free cash flow are very attractive at present.

Many of our companies appear to be significantly undervalued, and have shown strong growth in business value over the past several years despite extremely challenging business conditions.

We continue to emphasize companies that fit three broad themes.

First, for investors interested in both growth and income, high quality companies with solid and growing earnings and dividend streams seem attractive, and priced to provide high single digit to low double digit total returns over the next several years. Examples include Abbott Labs, Accenture, Blackrock, Chevron, General Electric, J. P. Morgan, McDonalds, Microsoft, PepsiCo, Philip Morris International, and UPS. These companies have dividend yields well above the S&P 500's 2% yield, solid earnings growth prospects, and histories of increasing their dividend payments roughly in line with their earnings over time. While their valuations are not as compelling on a relative basis given their strong second half 2011 performance, they still appear reasonable on an absolute basis.

Second, there are a number of strong business franchise companies with 10%+ annual earnings growth prospects that trade at very low absolute and relative valuations. These companies include Apple, Disney, EMC, Express Scripts, Google, MasterCard, Priceline, and Qualcomm. Many of these companies appear to trade at levels that imply upside appreciation potential, based on their demonstrated ability to grow earnings at well above average rates, and the potential for their valuations to expand to levels that are more reasonable (and closer to their historic average valuation metrics) given their longer term earnings and business value growth prospects.

Third, we believe many strong companies with relatively higher sensitivity to aggregate economic growth trade at very attractive valuations. This is the riskiest group of companies, because in a slow growth environment, their earnings growth is less assured; however, they appear to trade at very low valuations relative to normalized earnings growth over the economic cycle. Companies in this group include Apache, BHP Billiton, Capital One, Caterpillar, Chicago Bridge and Iron, Eaton, FedEx, Roper, and Union Pacific.

Finally, small and midcap companies, and emerging markets equities, which showed outstanding price appreciation in 2010, struggled in 2011, and now appear to offer the prospects for upside potential over the next several years.

We do not know what the catalyst will be to result in improved valuations for U.S. equities, but history strongly argues that valuations eventually return toward long term averages.

We will continue to focus on identifying and owning companies with strong balance sheets, demonstrated records of growing business value in difficult economic conditions, reasonable prospects for above average future growth, and attractive absolute and relative valuation metrics.

Equity returns over the past decade have been far below long term norms. We believe that the next decade has the potential to provide patient investors the opportunity for solid equity returns as premier companies continue to show good business value growth, and as valuations eventually move toward levels that we feel more accurately discount true underlying shareholder value given reasonable growth rates and normal interest rate levels.

Stocks are generally perceived to have more financial risk than bonds in that bond holders have a claim on firm operations or assets that is senior to that of equity holders. In addition, stock prices are generally more volatile than bond prices. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. A stock may trade with more or less liquidity than a bond depending on the number of shares and bonds outstanding, the size of the company, and the demand for the securities.

Similarly, the transaction costs involved in trading a stock may be more or less than a particular bond depending on the factors mentioned above and whether the stock or bond trades upon an exchange. Depending on the entity issuing the bond, it may or may not afford additional protections to the investor, such as a guarantee of return of principal by a government or bond insurance company. There is typically no guarantee of any kind associated with the purchase of an individual stock. Bonds are often owned by individuals interested in current income while stocks are generally owned by individuals seeking price appreciation with income a secondary concern. The tax treatment of returns of bonds and stocks also differs given differential tax treatment of income versus capital gain.

The Citigroup 7-10 Year Corporate Bond Index is a diversified index of corporate bonds with maturities between 7 and 10 years.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. FCF is important because it allows a company to pursue opportunities that enhance shareholder value. Without cash, it's tough to develop new products, make acquisitions, pay dividends and reduce debt.

FCF is calculated as:

$$\text{EBIT}(1-\text{Tax Rate}) + \text{Depreciation \& Amortization} - \text{Change in Net Working Capital} - \text{Capital Expenditure}$$

It can also be calculated by taking operating cash flow and subtracting capital expenditures.

Opinions expressed are those of Edson L. Bridges III and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Past performance does not guarantee future results.

Mutual fund investing involves risk. Principal loss is possible. Small and medium capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies. Investments in debt securities typically decrease in value when interest rates rise.

This risk is usually greater for longer-term debt securities. Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

CLICK HERE for the funds top ten holdings.

Fund holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

S&P 500 Index is a broadly based unmanaged composite of 500 stocks which is widely recognized as representative of price changes for the U.S. equity market in general. One cannot invest directly in an index.

Earnings Growth is a measure of growth in a company's net income over a specific period, often one year.

Earnings growth for a Fund holding does not guarantee a corresponding increase in the market value of the holding or the Fund.

The Price to Earnings (P/E) Ratio reflects the multiple of earnings at which a stock sells and is calculated by dividing current price of the stock by the company's trailing or forward 12 months' earnings per share.

Earnings per share (EPS) is calculated by taking the total earnings divided by the number of shares outstanding.

Must be preceded or accompanied by a current prospectus.

Bridges Investment Fund, Inc. is distributed by Quasar Distributors, LLC.