BRIDGES
INVESTMENT MANAGEMENT, INC.

Bridges Investment Management

Market Comments

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The second quarter of 2010 was the worst quarter for equity investors since the fourth quarter of 2008. The S&P 500 had a total return of -11.41% during the second quarter, bringing its total return to -6.64% for the first 6 months of 2010, and 14.43% over the past 12 months. The S&P 500 is up 52% from the March 9, 2009 low, but remains down 34% from the all time high level reached on October 9, 2007.

The second quarter started off reasonably well, and the S&P 500 made a recovery high of 1217 on April 23, buoyed by solid first quarter corporate earnings results, which saw year over year earnings gains of 52% and 77% of S&P 500 companies report positive earnings surprises.

From April 23, the market declined in 30 of the last 47 trading days of the quarter and fell 13% to finish the second quarter at 1030.71.

We believe there are 4 primary reasons for the market's selloff in May and June.

First, given the large rally from the lows of March, 2009, the market was ripe for some type of correction, especially with the emergence of any type of news catalyst that would give investors a reason to take profits.

Second, in late April, Greece's economic problems came to the forefront and provided that catalyst for investors to sell stocks. Investors quickly connected the dots, and assumed that if Greece was nearing default on its sovereign debt, it was possible that some of the other larger European Union countries, particularly Spain, Portugal and Italy, might not be far behind. The specter of a series of sovereign debt defaults roiled both the credit and equity markets world-wide – clearly, investors remain skittish in the aftermath of the events of 2008 and early 2009.

While the economic difficulties of the EU are problematic in their own right, U.S. investors are now questioning what the impact will be on the still fragile economic recovery domestically. First, the economic weakness in Europe impacts U.S. multinationals that sell into the EU. Second, as EU problems have worsened, the Euro has weakened relative to the dollar, which makes dollar-denominated goods and services more expensive. So, not only is demand weak in the EU, but it has become harder for EU countries to pay for U.S. products. These concerns have raised worries about the sustainability of the economic recovery in the U.S.

Third, the oil spill in the Gulf has weighed on market. Energy stocks have been negatively impacted and that has been a drag on both the market and investor sentiment.

Fourth, investors seem to have increasing concerns regarding the breadth and depth of new regulation and legislation initiatives across a wide front, particularly financial services reform. Our take on the pending financial services legislation is that it will significantly increase compliance costs for most financial services companies, and may have a number of unintended consequences that actually make it harder for consumers and businesses to get credit. Investors seem concerned that a more activist federal government both raises the cost of doing business and increases uncertainty because "the rules of the game" seem to change frequently, making it harder for businesses to make informed capital allocation decisions and harder for investors to assess risk and value securities.

Consequently, in our view, the mid-term elections in November are taking on greater significance than usual. We believe the elections will be a referendum on the politics, policies and leadership of the Obama administration. Historically, we have felt that "politics and government" have not been a primary focus within our investment process, because for the most part over the past thirty years, the impact of government on business in the U.S. has been both relatively small compared to other factors. The events of the past two years call that position into question, because of the significantly greater incursion of government into the economy, and the vastly greater politicization of the governmental and legislative process.

In essence, the greater proportion government is of the overall economy, the lower the economy's long term growth rate (and the lower the eventual standard of living for its citizens). And as government expands in size relative to the private sector, the greater the level of uncertainty, because policies become politically driven (and therefore harder to predict) as opposed to being disciplined by the competitive forces and profit motive that "govern" the private sector.

Against the backdrop of an increasingly activist government, investors have acted predictably, by increasing risk premiums (demanding higher returns on "risky" assets such as equities and real estate) and fleeing to "safety" buy buying U.S Treasuries which are viewed as a safe haven (for now). We believe the implied risk premium for U.S. equities is now about 7% (versus 5-6% historically), and Treasury yields are probing to new all time lows. The yield on the 2 year Treasury is 0.60%, and the yield on the 10 year Treasury is 2.96%.

We believe the two biggest issues/risks facing investors for the remainder of 2010 and into 2011 are: 1) what the pace of the economy will be over the next several years, and 2) what U.S. voters determine is the appropriate role of government in society and the economy, particularly in terms of deciding how to address the large and growing budget deficits in terms of monetary, fiscal and tax policy, and also in the area of government's regulation of private enterprise.

The outcome of the second issue should be more clear after the elections this November; we believe a reaffirmation of the directions taken by the Obama administration over the past two years would have negative implications for the capital markets, particularly equities, while a significant shift toward a more centrist approach (similar to what occurred in the 1994 mid-term elections during Clinton's first term) would be viewed as positive by the capital markets.

The two issues are inextricably linked. As government's role in the economy expands, higher taxes are needed to fund government programs and pay down government debt. Higher taxes reduce the return earned on capital and result in lower rates of aggregate economic growth and lower equity valuations.

The key question surrounding the first issue (trajectory and sustainability of the current economic recovery) is: "how much lasting impact will the credit crisis and the subsequent policy responses to the crisis have on the long term secular growth rate of the U.S. economy?"

Our sense is that it will be material, and might lead to core GDP growth of 2.0-2.5% over the next decade, compared to 3.0-3.5% over the past decade.

Traditional economic theory would argue that the monetary and fiscal policies brought to bear on the financial crisis in late 2008 eventually should result in higher levels of inflation. Because the credit crisis was largely the result of the excessive creation and use of (very low credit quality) debt, higher inflation over the next few years would help debtors.

Veteran investors have a saying that "the most dangerous words in investing are 'this time it is different'." However, this time it may really be different, because the unprecedented enormity of the debt build-up over the past decade may mean that the de-leveraging process now underway could take a long time, and as long as consumers, companies and countries are using capital to pay down debt, it is hard for them to also spend. Lower spending rates make inflation hard to sustain, because businesses in a slow growth environment are very willing to compete on price, which effectively keeps inflation in check.

The rub is that, if we are heading into an extended deflationary period, interest rates are already low, which means that bond prices are high and bond valuations are stretched, and which leaves little margin for error for bond investors should inflation return to even the normal (3% annual) levels that have characterized the last 2 or 3 decades. Despite low interest rates and unattractive bond valuations, investors have been stampeding toward yield in recent weeks, buying bonds with yields that two or three years ago would have seemed very unattractive. This headlong rush to "safety" in Treasuries, and "yield" across the fixed income market, is reminiscent of the bull market in technology stocks in the late 1990's, when investors were undeterred by historically high valuations and unsustainable rates of growth.

The irony is that many of the leading technology companies in fact delivered outstanding earnings growth between 2000-2010, but returns for their investors were disappointing because the valuations at the start of the period were so high. Bond investors face a much more difficult proposition today – unless interest rates stay at historically low levels (a long shot bet when viewed against a long term historical perspective) or go even lower, and unless inflation stays well below historical levels (again, a perusal of the variability of the rate of inflation over the past century in the U.S. would argue that this is a long shot bet as well), investors buying bonds at current levels will have a difficult time earning a decent return on their capital, just as the equity investors buying technology companies in late 1999 had a tough time doing well over the subsequent decade because valuations at the outset were so elevated.

It is a different story at present for equities, where, despite solid first quarter earnings, and a good stretch of earnings recovery over the past 5 quarters, valuations remain low relative to long term norms. At present, the S&P 500 trades at about 12x estimated 2010 earnings, a very low valuation multiple given the current low interest rate environment.

We believe stock market valuation levels are low for two reasons. First, as noted above, economic uncertainty, legislative uncertainty, and market turmoil in Europe has caused investors to increase risk premiums and demand higher returns for capital committed to stocks. This has caused valuations to languish despite good earnings performance in recent quarters. Second, investor sentiment is poor; investors are skittish, and uncertainty is high (not so much higher than it usually is, more that investors recognize that things are very uncertain). Investors are more worried about participating in the next decline than missing the next rally. The low valuation of equities strongly implies that investors don't believe that the earnings recovery of the past 5 quarters is sustainable.

As we noted in the fall of 2008, cheapness alone does not mean stock prices will necessarily stop going down in the short run. But low valuation does, over the long run, create the opportunity for investors to earn returns from both 1) growth of a company's underlying business value driven by its financial performance (i.e. growth in its revenues, earnings, dividends, and free cash flow), and 2) an improvement in the market's valuation of the company based on that financial performance and a more normalized view of a company's long term business prospects. Based on current valuations levels, and the likelihood that over the next 5 to 10 years corporate profitability levels will improve toward something approaching "average" or "normal", the potential for good returns to equity investors appears to be solid.

At present, we believe valuations for many companies indicate that investors 1) have a very short term time horizon (they are not willing to pay for intermediate or longer term business growth), and/or 2) do not believe that companies are capable of generating growth in business value at anything remotely close to the levels seen on average over the past several decades, presumably because their outlook for aggregate global economic growth is pessimistic in view of the problems and risks we outlined above.

The next several quarters should provide us with good insight into both the trajectory and the sustainability of the economic recovery. While there is some downside risk to stock prices in the short run if corporate earnings slow from the pace of the past several quarters, we believe current valuations make that risk acceptable, and probably discount a slowing in the rate of earnings recovery to some degree.

Longer term, we believe high quality companies with strong balance sheets, dominant business franchises, a demonstrable ability to manage through challenging economic conditions, and the ability to grow business value over the long run, should be rewarding investments from current levels. We will remain focused on identifying and owning companies with superior operating, profitability, and valuation metrics.

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. It is not possible to invest directly in an index.

Cash flow refers to the movement of cash into or out of a business, a project, or a financial product. It is usually measured during a specified, finite period of time. Earnings per share (EPS) is calculated by taking the total earnings divided by the number of shares outstanding.