FIRST NEBRASKA *Trust* COMPANY

First Quarter 2014

Quarterly Letter to Clients

By Scott A. Wendt, CFA

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The first quarter of 2014 will be memorable for numerous reasons. Who will forget the winter that seemed to go on and on? With the Polar Vortex that appeared to bring the Arctic to the Midwest alternating with a week or two of "Faux Spring", we were teased into thinking we could put away the winter coats and get out the summer shorts. Yet, as taxpayers put the final touches on their 2013 returns, the (hopefully final) spring snowstorm is pushing across the Midwest into the northeast.

Given additional weather related costs, it will not be a big surprise to anyone that First Quarter Real GDP growth will continue to be subpar, with economists expecting growth now to be about 2 percent. However, in spite of the poor weather, there are a number of metrics that are showing better results. Manufacturing improved in the Mid-Atlantic regions, while homebuilding held steady in February, with a small uptick in building permits. Consumer durables had a healthy gain, and consumer confidence continues to improve, implying that the rises in industrial production and capacity utilization are providing a base for inventory rebuilding to meet future demand. Retail spending remained acceptable, given the weather-related disruptions.

Job growth has been improving, with hiring picking up in the first two months of the quarter. February nonfarm payrolls increased by 175,000 and the unemployment rate ticked up to 6.7%, as more workers rejoined the workforce. After a *long* 5-year recovery, job growth is on track to replace the 8.5 million workers lost in the Great Recession. At the current rate, replacement of all jobs lost will likely occur by the end of 2014 or early in 2015. In addition, the average workweek marked its cyclical high of 34.5 hours for the nonfarm private sector in March. This should give the Federal Reserve policymakers some support in continuing their quest to taper the Quantitative Easing program on its current trajectory.

While absent in much of the current recovery, housing and autos are finally showing some more sustainable growth prospects. Auto showrooms have seen improved traffic and sales have rebounded to an annual rate of 16.3

million units. Demographic trends continue to support improved household formations, usually a leading indicator of future housing demand. As the unprecedented numbers of foreclosed homes in this cycle are absorbed into the system, the ratio of unsold new homes to the stock of single family homes should return to a more normal balance. With a little luck, and continued improvement in the job market, housing could provide that elusive "sustainable" factor to keep the recovery growing, while offsetting the negative impacts of fiscal drag caused by higher taxes and reduced government spending.

Despite expectations to the contrary, the 10-year U.S. Treasury price rallied during the quarter, bringing yields down to 2.72% from 3.03% seen at the beginning of the year. Longer maturity securities outperformed shorter ones, with the only positive performance seen in U.S. Treasury and U.S. Agency bonds with maturities of 10 years or greater. Many fixed income pundits felt that the reduced demand by the Federal Reserve would cause prices to fall and rates to increase. However, the increased tension from Russia's annexation of Crimea from the Ukraine, compounded by emerging market and European economic concerns, may have sparked a short-term flight to quality, causing the Treasury yield curve to flatten somewhat. Meanwhile, the Fed is maintaining its stimulative posture. In its most recent policy announcement, the FOMC left the Fed Funds Rate unchanged, and detailed the continued reduction in the purchases of longer-maturity U.S. Treasuries and mortgage-backed securities by $10 billion. This brings the aggregate monthly purchases to $55 billion, right in line with previous expectations.

Stocks continued to advance to new highs through early March, when the stress of the tensions in Crimea, bank stress test failures, and the Fed chair's "forward guidance" that rates could begin to be increased as soon as 2015 combined to reduce the exuberance seen in stock and bond markets. For the past couple of years, the capital markets have hung on the Federal Open Market Committee (FOMC) policy actions and the guidance from the Fed Chair to the almost exclusion of any other underlying fundamental or valuation data. However, it is becoming increasingly clear that stimulus will eventually come to an end, and rates will begin their ascent to more normal levels.

The past quarter's results were anything but uniform, as the major indices logged a wide range of results. The S&P 500 increased +1.8%, while the Dow Jones Industrial Average (DJIA) posted a decline of (0.15) % and the Nasdaq Composite increase by +0.4 percent. Take a moment to review the Morningstar Index Review Table below.

It is apparent that the divergence in index performance experienced over the past few quarters continues to dominate stock returns. Historically, such divergences in stock market performance have preceded a market inflection point, which usually is an acceleration or deceleration of an existing trend. However, like most all historical market comparisons, past results are not a guarantee of future performance.

Morningstar Index Review

As of 3-31-2014

	1st Qtr	1-Year	3-Year	5-Year
Stock Indexes				
NASDAQ Composite PR	0.54	28.51	14.72	22.40
NYSE Composite PR	1.23	15.60	7.80	16.16
Russell 2000 TR	1.12	24.90	13.18	24.31
S&P 500 TR	1.81	21.86	14.66	21.16
Bond Indexes				
Intermediate Corp Bond	1.70	1.56	5.74	8.91
Long-Term Corp Bond	5.02	1.23	8.15	12.03
Short-Term Corp Bond	0.73	1.94	3.15	5.13
Intermediate US Govt Bond	1.00	(1.92)	3.28	3.11
Long-Term US Govt Bond	5.34	(3.87)	6.79	4.50
Short-Term US Govt Bond	0.18	0.23	1.10	1.43

Source: Morningstar Website http://news.morningstar.com/index/indexReturn.html
PR = Price Return TR = Total Return

As the bull market turns five years old, stock investors have watched the Dow and S&P both advance over 150% since the market troughed on March 9, 2009. Likewise, the Nasdaq Composite index is up 242% over the same period. For stocks to continue their gains in the face of reduced Fed stimulus, corporate profits need to continue to grow to support current valuations. The obvious question at this point is whether economic growth will accelerate higher without the multitrillion-dollar stimulus that has been supplied by both federal government deficit spending and the easy money policy that the Fed has supplied to financial assets through its Quantitative Easing program.

The test is in front of us, as the Market continues to heavily discount any fundamental improvements in company earnings and cash flows by assigning a historically high multiple to earnings. FactSet reported that at the end of the quarter, the S&P 500 was trading at 16 times trailing twelve-month earnings per share, which was double its level of five years ago and nearly identical to the level which stocks peaked in October 2007.

For any additional multiple expansion to occur, companies will need to see organic earnings growth, in addition to improvements from expense reduction and share buybacks. Revenue growth, which currently appears lackluster for many companies, will be a key factor in providing companies with sustainable earnings growth for the foreseeable future.

Finally, consider the potential challenges investors might face in a world where markets are torn between relying on continued government stimulus to levitate the markets to new heights versus returning to a more normal environment. In essence, the challenge for every investor is to deal with the uncertainty of the investing environment and to apply his craft in the best way he knows how, while meeting each client's objective. In the final analysis, each portfolio is a composition of many decisions that may be synthesized down to a simple question: To buy or to sell: To make money without losing money. To be or not to be? Well, to describe the investment environment in a "tongue and cheek" manner, I've taken extensive liberty with the soliloquy from William Shakespeare's Hamlet as follows:

> To taper or not to taper, that is the question. Whether it is nobler in the mind to suffer the slings and arrows of high frequency traders, or to take arms against a sea of regulation and, by opposing, end them? To invest: to stay in cash no more, or by staying in cash, end the heart-ache of another capital market shock. To time the market: to avoid taxes, ay there's the rub, for to profit greatly, hence dreams the taxman, and with those dreams may come yet higher required profits to offset the unnatural din of political discourse. To endure the inseparable trade off of high-risk and high-return, must give us pause, for the risk never apparent in the froth of the market, whose turn is quick and unexpected, even when expected. Thus the shock must be respected, and hence avoided, to make thy retirement happy and long.[1]

(Ok – maybe it's a feeble attempt to replicate something that the Bard would have done in a much better form, but I think you get the gist of the idea).

As we've stated in the past, investor enthusiasm appears to be supporting stock market values at current levels, and they may contribute to further stock market advances. Nevertheless, finding new investment opportunities that meet our investment criteria, and that can be purchased at prices that provide us a margin-of-safety relative to our estimate of fair value, are becoming increasingly difficult to find in this environment. As such, we will continue to be disciplined in our process, purchasing those stocks that meet our investment standards, while selling those stocks that exceed our estimate of fair value, irrespective of the rotations of the general markets. Our preference continues to be constructing and maintaining a well-diversified portfolio of companies, with a history of earnings, dividends, and cash flow growth.

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[1] Adapted by Scott Wendt from Shakespeare's Hamlet – To Be Or Not To Be": Spoken by Hamlet, Act 3 Scene 1