FIRST NEBRASKA Trust COMPANY

First Quarter 2015
Quarterly Letter to Clients
By Scott A. Wendt, CFA
April 17, 2015

When I was in graduate school, I spent almost every Friday night in front of the TV watching Wall Street Week with Louis Rukeyser on the local PBS channel. (As my kids would say, that was back before cable TV, when you had 7 channels to choose from – and two of them were the same). This long-running show featured the silver-haired Louis Rukeyser, whose years as a financial reporter had allowed him to develop a recipe for providing a wrap-up on "the week just past" using a five-minute soliloquy peppered with puns and tongue in cheek economic and financial references that had become his trademark style to entertain and inform his audience. Usually one of the "masters of investments" was a guest who would take 10 minutes of hard-hitting questions with the focus on "how to make money in today's markets". Guests included such icons as Sir John Templeton, Dr. Martin Zweig, Larry Kudlow, Mario Gabelli, Ned Davis, Abbey Joseph Coen, Bill Gross, and Wallace Weitz, to name a few. If you made it on the show, you were almost guaranteed to see an improvement in your nationwide visibility by other financial publications. These investment professionals were in the proverbial trenches of investments and finance and were making money in a world that is much different than the one we operate in today.

Never have the differences been more apparent than in the current recovery, which remains sub-par when compared to the past. Historically, Real GDP would average around 4 to 4.5% in a recovery, bolstered by rebounds in the housing and auto sectors and inventory and capacity builds to meet burgeoning demand. However, as we have pushed into the 6th year of recovery, the U.S. Economic growth continues to hover at the 2% Real GDP level, below the expected growth rate of 3% voiced by the majority of Economic forecasters and considerably below the "normal" average. As the first quarter of 2015 came to a close, the moderation of economic activity highlighted once again the challenges that provide a headwind to economic growth, despite the extraordinary policy actions taken by the world's Central Banks and pushing the fiscal policy limits, as deficits around the world are funded through ever increasing levels of sovereign debt.

The domestic **Economy** provided little support to the recovery in the first quarter of 2015, as unseasonably cold weather and the aftermath of the west coast dock strike combined to keep consumers home and delayed goods from arriving in stores in a timely manner. Likewise, the effect of the U.S. Dollar strengthening relative to other currencies had the negative effect of reducing the competitiveness of U.S. goods in the world marketplace, slowing export sales.

Despite these headwinds, there have been some pockets of improvement in a number of economic sectors. During the quarter, the Labor Department reported the 12th consecutive month of job gains in excess of 200,000, as 295,000 jobs were added to the employment roles in February. Unemployment declined to 5.5%, mostly due to the participation rate declining to 62.8%. The housing market continued to expand at a modest pace. Inventories of single family homes are at more normal levels, while sales during the quarter were below year-end 2014 levels, partially in response to the weather and partially due to the continued tight lending standards that impose an impediment to many would be home buyers.

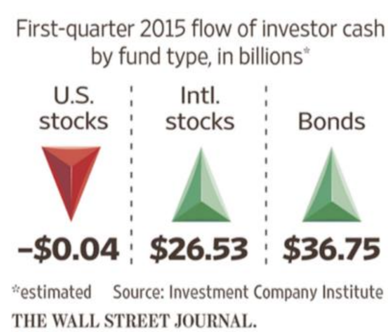
The down draft in oil prices has provided a dampening effect to the employment side of the ledger, as oil projects begin to be deferred and layoffs begin to take hold in those areas where the economics of drilling have turned unfavorable due to lower price realizations. The pain is being felt in places like Alaska, North Dakota, Oklahoma, and Texas, where rig activity has been cut nearly in half. On the flip side, consumers of refined products, including gasoline and diesel, should see their energy related costs decline, as lower cost oil makes its way through the system, providing a nice bump to their disposable income.

The **Bond Market**, almost totally fixated on anticipating the next Federal Reserve Policy move, continues to provide investors with historically low yields that persist in their downward trajectory, despite the ever-present threat of the Fed reversing its policy course. The long-awaited increase in the Fed Funds Rate, which would signal the start of rising interest rates, has been elusive. Obviously disappointing economic results have tempered the Federal Reserve Policy maker's ability to begin raising interest rates and to return the price of funds back to more normal levels. The Fed is caught in a classic "Catch-22". Rates cannot be raised until the economy shows it's improving. Yet, rates need to be raised before the onset of the next economic downturn. Without an increase in rates today, policy makers will not have the traditional tools available to lower policy rates to stimulate economic activity. But with growth at such subpar levels, a rate increase might stymie growth and encourage additional disinflationary forces to take hold, putting unwanted pressures on the areas that the Fed is trying to "jump start" in the economy. Central Banker's around the world recognize this dilemma – it's the experience of the Japanese Central Bank over the past 25 years, and one that they all are feverishly trying to avoid.

Most pundits believe that the FOMC has signaled that a rate increase is approaching due to the word "patient" being removed from the March minutes. However, the Fed has stressed that it will be the combination of the improvements in the labor markets and inflation hitting its 2 percent target level that will open the door to the rate increase. The risks associated with the timing and the method that the Fed communicates its policy change will be present for the foreseeable future, with the most likely consequence being an increasing rate of capital market volatility.

As such, we are approaching a critical juncture in the interest rate cycle. The tradeoff between reaching for coupon yield and the risks associated with those higher returns are increasing. Credit risks - the risk that the borrower will not repay principal - and longer dated maturities, are **not** paying an interest rate that adequately compensates the investor for both of these risks. Many investors are buying fixed income securities without understanding the risks associated with poor credits or credit defaults and the impact on their portfolio of interest rates moving from historically low to higher, more normal interest rate levels.

This was partially due to the huge fund inflows into the Bond market as investors reached for yield in the corporate sector and bought those funds that had higher coupons due to their above average (longer) maturities. As the graphic to the right shows, during the past quarter the bond market saw net inflows of $36.75 billion.



http://www.wsj.com/articles/u-s-stock-funds-rise-2-5-in-first-quarter-overseas-portfolios-outpace-them-1428375820?KEYWORDS=Quarterly+Monitor

As the performance of the bond market in the tables below demonstrates, riskier and long-dated securities have outperformed the less risky, shorter-duration credits. Non-investment grade securities (a.k.a. "junk bonds") also outperformed, as the speculative nature of these securities was set aside by investors as they reached for a higher cash flow alternatives.

Morningstar Bond Indexes

Broad Market	YTD	1-Year	3-Year	5-Year
Core Bond	1.6	5.9	3.3	4.5
Intermediate Core Bond	1.5	5.5	3.1	4.3
Short-Term Core Bond	0.7	1.4	1.2	1.8
Corporate				
Corp Bond	2.3	6.5	5.2	6.3
Intermediate Corp Bond	2.1	4.9	4.7	5.8
Short-Term Corp Bond	1.1	1.9	2.5	3.1
Government				
Intermediate US Govt Bond	1.7	4.6	1.9	4.0
Short-Term US Govt Bond	0.6	1.3	0.8	1.4

Source: Morningstar Index Review

The risk and return dynamics of the bond market now appear to be favoring a focused strategy of preserving capital over reaching for yield. As such, our fixed income strategy will focus on matching your risk tolerances to the investments we are making. We continue to favor a shorter-duration portfolio that is constructed with high-quality issues that can withstand the imminent changes in fixed income markets.

The **Stock Market** recorded a minor positive return in the First Quarter of 2015, with the major indices ending a roller coaster ride about where they began the year. However the results mask the enormous tug-of-war going on between many of the sectors of market that were reacting to the torrent of change occurring during the quarter. Geopolitical risks rose, oil prices fell, the U.S. dollar continued its upward trajectory and fiscal and monetary policy uncertainty increased. The large changes in currency, commodities and interest rates impacted many stock sectors differently, with utilities falling, transportation seeing some improvements, and technology rallying.

The wide variance in the first quarter returns, when compared in the Lipper Quarterly Performance Table below, shows that a number of trends experienced over the prior two quarters are still apparent. Larger capitalization stocks, especially multinational companies, lagged the overall market as they faced the negative impacts of an increasingly unfavorable foreign currency exchange environment. Smaller and riskier stocks outperformed their larger, higher-quality brethren, mainly due to the lack of significant foreign sales that allowed them to avoid the impact of the rising U.S. Dollar. The divergence most likely signals a potential change on the horizon.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, APRIL 6, 2015

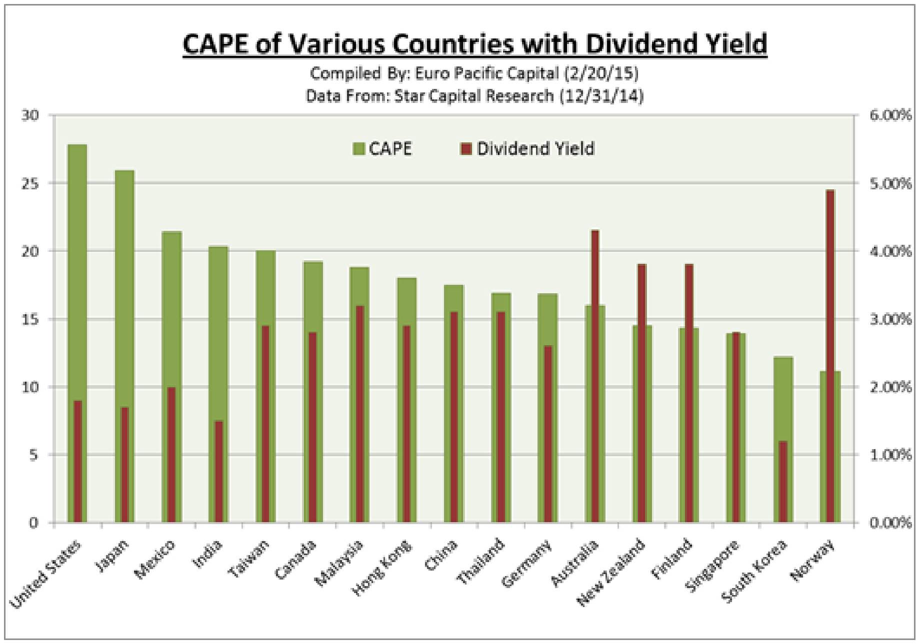
	Qtr	1 year	5 year	10 year
S&P 500	**0.8**	**12.0**	**13.8**	**7.5**
S&P 500 Index P	**0.4**	**10.4**	**12.1**	**5.8**
Dow Jones Ind. Average	**(0.3)**	**8.0**	**10.4**	**5.4**
Equity Income	**0.6**	**8.0**	**12.3**	**7.4**
Large-Cap Core	**0.9**	**10.6**	**13.0**	**7.3**
Large-Cap Growth	**3.6**	**14.5**	**14.0**	**8.5**
Large-Cap Value	**(0.0)**	**8.1**	**12.1**	**6.4**
Mid-Cap Core	**3.8**	**9.7**	**13.7**	**8.6**
Mid-Cap Growth	**5.8**	**11.6**	**14.9**	**9.4**
Mid-Cap Value	**2.8**	**9.3**	**14.1**	**8.3**
General Equity	**2.5**	**8.8**	**12.5**	**7.6**

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

On the heels of many strategists proclaiming that active management is dead, active managers reclaimed some ground, as the average mutual fund outperformed the major indices during the past 3 months. In fact, the average U.S. stock mutual fund posted a 2.5% return for the quarter, besting the results of the S&P 500 which was up 0.8% and the Dow Jones Industrial Average, which was down 0.3%. The technology laden NASDAQ index increased 3.4%, reflecting the outperformance of both the tech sector and smaller capitalization stocks.

Most valuation measures for the U.S. Equity Markets are elevated when compared to historical "normal" levels. According to Morningstar, "The S&P 500 – at a level of 2,108 – carries a Shiller price/earnings ratio of 27.7 – higher than 79% of the monthly readings since 1989."[1] Furthermore, the chart below shows that U.S. valuations are also elevated when compared to other country valuations, using a methodology similar to the Shiller price / earnings ratio.

[1] *Morningstar's* Stock Market Outlook: Proceed With Caution by Matthew Coffina, CFA 3-30-15



Other valuations indicators show comparable results. At the end of the quarter, stocks were trading at approximately 18 times their trailing 12-month earnings, and at similar levels when compared to peak operating earnings. The well-known fact that Wall Street analysts continually revise their earnings estimates downward should give investors some heartburn. The aforementioned strength in the US Dollar and declining energy prices has had a major impact on corporate top and bottom lines, which has translated into muted earnings expectations and significant downward revisions for estimated 2015 S&P 500 Earnings. At the end March, S&P Capital IQ estimated year-over-year 1st Quarter 2015 earnings would be down 3%.

The old adage, "buy low, sell high" implies that prices are high or low relative to something. When it comes to stocks, many investors look at where prices have been as their standard. We would instead focus on what an investment is worth (its value) and whether we are paying a fair or discounted price for the value we would receive in return. To maximize total return, we should try to buy at the price that is most discounted to our estimate of fair value. For investors that are chasing returns and buying today's stocks at higher valuations, the math is clear – by purchasing stocks at inflated or above average valuations, the investor will experience returns that are below the long-term average over the next decade. Thus, for those investors that have the patience and persistence to wait for more attractive buying opportunities, the potential for above average long-term returns is apparent. In addition, the patient investor will preserve capital over the long haul, by allowing cash to build during periods of market euphoria, and thus experience less of a decline in their portfolio when the inevitable market downdraft finally occurs. Finding value, without sacrificing quality, in a high and rising valuation environment is increasingly challenging. However, we will continue to be disciplined in our process, purchasing those stocks that can be bought at prices that meet our investment standards while providing an adequate margin-of-safety. Similarly, we will sell those stocks that exceed our estimate of fair value, irrespective of the gyrations of the broad markets.