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BRIDGEPORT
ASSET MANAGEMENT INC.

Q2 2020

Investment Commentary

While theme parks around the world have been closed due to COVID-19, investors have experienced a different type of roller coaster ride so far in 2020. As quickly as both bonds and stocks sunk in late February and March as the reality of the pandemic's economic impact became clear, markets rallied back in the second quarter, partially recovering earlier losses. We are pleased to report that Bridgeport's Equity and Income Funds participated in this rebound and were generally up between 8% and 16% during the quarter.

The biggest question on investors' minds is why markets have entered into recovery mode while global economic activity has collapsed due to COVID. Of course, the exact answer to this question is unknowable but there are several potential explanations.

First, as we pointed out in an earlier note, the average stock is not the stock market average. By this, we refer to the fact that certain U.S. stock market indices like the S&P500 have mostly or fully recovered, although the average stock in the S&P500 remained down 12% from January 1 through June 30. This disparity has occurred because a handful of technology stocks represent a large proportion of the S&P500 and they are viewed favorably despite the pandemic due to belief in their online business models. This solid performance has masked the fact that many other stocks in the S&P500 as well as small and mid-sized public companies and large segments of the Canadian stock market are still down significantly in price since the start of the year.

Second, history tells us that stock markets do not always move in tandem with the economy. Markets are forward looking and anticipate events well in advance of their occurrence. This is but one reason why the stock market can appear at times to be untethered from actual economic conditions. It is also what makes market timing so difficult, despite how seductive it can be to attempt to sell to avoid losses when things look bleak and "get back in when they look better". For whatever reason, no one ever discusses that by the time "things look better" that fact is generally known to all investors and the stock market will have already reacted.

Third, the government's fiscal and monetary response to COVID has provided huge support to markets. In particular, monetary stimulus has lowered interest rates to rock bottom levels. The ten-year government of Canada bond yield is now at 0.5%. In a sign of the times, investors are so desperate to earn income yields they snapped up two billion Euros worth of 100-year bonds issued by the government of Austria in exchange for an annual return of 0.88% in late June (that is not a typo, these investors have accepted an annual rate of return of less than 1% until 2120!).

With rates expected to remain low for the foreseeable future, many investors have concluded that "there is no alternative" (TINA) to investing in assets with some level of risk as there is no point in investing in riskless assets like government bonds and GICs with rates near zero.

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Low risk-free rates, however, does not mean investors should abandon caution. Before COVID, the list of risks for investors to fret about included concerns about the upcoming US election, China's increasingly aggressive foreign policy and waning interest in free trade as nationalist tendencies take hold around the world. Today, COVID is clearly the primary investor concern. After widespread improvement through May, re-opening measures have resulted in accelerating daily new cases, particularly in areas which have been more "laissez faire" when it comes to safety protocols. Already, we have seen upwards of 40% of US cities (by population) tightening or outright postponing re-opening policies. Thankfully, accelerating case-counts have not yet translated into increased mortality, but it will be important to watch those statistics carefully as the continued re-opening of the economy is key to a sustainable recovery.

So, with risks acknowledged, our general outlook is that a return to March lows in the equity markets is unlikely for two reasons. First, unless COVID related deaths start to accelerate significantly across the US, we do not believe there will be broad-based "stay-at-home" orders. There are also daily reports emerging about vaccine trials and there are over 150 studies/trials going on worldwide in this regard.

Second, there is record amount of cash sitting in money market funds (peaking at an estimated $4.7 trillion in late May) waiting to be deployed into riskier assets like equities. This is in addition to the enormous amount of "dry powder" built up by private equity firms to invest in both public and private companies. All of this suggests there is a wall of money waiting on the sidelines to take advantage of the many dislocations caused by the pandemic which we believe is bullish for those with a time horizon that extends beyond the next few months and quarters.

In terms of Bridgeport's portfolios, we too are taking advantage of investment opportunities as a result of the market disruption. For example, we recently added Park Lawn Corp. (PLC) to our Small & Mid Cap Equity Fund. The company is one of North America's largest death care service providers, earning more than 70% of their revenue from funeral services, a relatively recession resistant business. PLC has been able to grow consistently via acquisition, new development and margin expansion, all while generating strong free cash flow. Because of the pandemic, we have been able to accumulate a position in the stock at a price which is approximately 40% lower than pre-COVID levels, despite the fact that there has been no material long term impact to its business.

We also invested in two companies during the quarter related to US housing, NVR and First American Financial (FAF). We expect the housing sector to experience strong long-term growth as the U.S. birth rate peaked in 1990 which means that we are now beginning to seeing a record number of people entering their peak years for household formation.

NVR is a unique regional home-builder which relies on a capital-light business model to produce above average returns on capital, while mitigating balance sheet risk during cyclical downturns. FAF provides title insurance to homebuyers and is part of an effective duopoly in its market. Title insurance risk is based not on uncertain future events but rather past events that require due-diligence, something that FAF's dominant position and access to data allows them to execute with minimal risk.

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Our Alternative Income Fund has held its value well during the pandemic and has thus far proven to be a good portfolio diversifier for our clients. We have recently committed capital from this fund to two new investment strategies to provide added diversification. We have partnered with an established New York-based asset manager which specializes in the acquisition of music publishing rights and collects royalties from various sources including downloads and use in different types of media. The other partner is a London-based asset manager which has pioneered the use of providing preferred equity backed by private-equity portfolios to earn structured rates of return.

We wish you all a safe, healthy and happy rest of summer. As always, please feel free to reach out with any questions about your portfolio.

Yours truly,

John Fisher