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BRIDGEPORT
ASSET MANAGEMENT INC.

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Investment Commentary

Most major stock indexes declined in the second quarter as the Greek debt crisis and fears of a double dip recession spooked investors. The S&P 500 dropped 11.9% and the TSX Composite decreased 6.2% in the second quarter. On a year-to-date basis through June 30, the S&P 500 and TSX Composite were down 7.6% and 3.8%, respectively. Market volatility has increased significantly as investors are particularly jittery and highly reactive to virtually any news item.

We originally outlined our investment philosophy for our investors in our inaugural investment letter in January 2008. Given the recent market turmoil and the fact that many of you have become investors more recently, we thought it might be useful to revisit our strategy as originally outlined.

First, we view equity investing as being about the acquisition of ownership stakes in companies, as opposed to the buying and selling of mere pieces of paper. This idea strongly guides our investment approach as we view the former as requiring a thorough assessment of a company's future prospects and the relative risk and reward of business ownership. We view the latter approach (buying and selling paper) as nothing more than gambling as it is not rooted in any form of rational analysis.

Second, we are value investors, meaning that we like to buy ownership positions in companies when current market prices are significantly less than our estimate of a business' fundamental value. Generally, we determine fundamental value by estimating the discounted value of the future annual cash flows available for distributions to the owners of a business. Basically, we believe the worth of a business (whether it is private or public) is based on the amount of cash flow its owners can extract from it over time.

In terms of the types of businesses in which we like to invest, we tend to favour companies which exhibit high barriers to entry and are not easily eliminated or marginalized by competition. We are most enthusiastic about businesses which generate recurring revenue and serve a large number of customers as it is easier to estimate their future revenue and cash flow and such companies are not as likely to be held hostage to the negotiating power of significant customers. Overall, we focus our research efforts on understanding the customer bases of the companies in which we invest as customers are the lifeblood of any business. We are attracted to companies that have "sticky" customer relationships which prevent easy switching to competitors or termination of service.

Companies have a choice as to whether they should distribute the cash flow they generate to shareholders or reinvest it in their operations to fuel growth. As value investors, we like owning shares of businesses which distribute a reasonable proportion of their annual earnings to shareholders either in the form of dividends or share repurchases as we believe such businesses are forced to manage their operations more efficiently and generate higher shareholder returns over the long term. At the same time, we also believe it is important to invest in businesses which generate high returns on invested capital as this ensures that to the extent that cash flow is reinvested in the business it will be deployed productively to generate above average shareholder returns.

We believe that fear and greed drive the markets in the short term, creating inefficiency and opportunity for those investors willing to take a longer term, disciplined approach. As the father of value investing Benjamin Graham once said, "in the short run, the market is a voting machine, but in the long run it is a weighing machine."

Our task is to analyze a company's fundamentals (more specifically its earnings and cash flow generating ability) to determine if we can acquire ownership of that future cash flow at an inexpensive price. For example, most investors would obviously jump at the chance to buy a stable privately held business which produces $100,000 of annual cash flow if the purchase price were, say, $200,000. As long as the cash flow does not decrease in the future, an investor could recover their investment on a pre-tax basis in two years and all the cash flow earned thereafter would be pure profit.

If the purchase price for the same business was $500,000 however, the decision might be more difficult and depend on a number of factors such as the likelihood that the annual cash flow of the business could be maintained or the possibility that the cash flow might even be increased. At a $1 million purchase price, an investor's interest in acquiring the business might decrease unless they were certain the annual cash flow was going to increase substantially from its current level. Otherwise, the investor would have to wait ten years just to recover his investment on a pre-tax basis before earning a profit.

Bridgeport's decision to buy or sell individual publicly traded stocks is based on a similar type of methodology as discussed in our example above. The only difference is that in reality the mathematics are usually a bit more complicated and significant judgment is required to estimate and value the future cash flow produced by a large publicly traded business.

As public market investors, we also strive to focus on what we call "absolute or intrinsic value" and to ignore "relative value". Absolute value, in our view, is the value of a business based on its estimated future cash flow and the rate of return on investment implied by that future cash flow.

Relative value, on the other hand, is the value of a business determined in relation to the value of another business, irrespective of whether the other business is valued accurately. Because relative value does not measure the value of an asset based on its future cash flow, it may lead investors to acquire assets at prices which will not necessarily yield a satisfactory investment return based on future cash flows alone.

The overuse of relative value in determining housing prices was a major factor in creating the housing bubble in the US over the last decade. Home buyers developed an unhealthy focus on the value of one home relative to the value of other homes in a neighborhood. Very few home buyers ever thought to compare a given home's price with the earnings that it could potentially generate from rental income (which is a measure of absolute value). If homebuyers and other housing market participants would have focused more on intrinsic value, they could have more readily concluded that many (if not most) homes in America were significantly overvalued.

Similarly, the use of relative value to evaluate publicly traded stocks is rampant on Bay Street and Wall Street. Research analysts often compare the price-earnings ratios of various companies within an industry, sometimes suggesting that the companies with lower price-to-earnings ratios may be undervalued. Less often do they suggest that all the companies in an industry are overvalued on a price-to-earnings ratio basis and that it would be difficult based on current prices and earnings estimates for any of the companies to offer investors a reasonable rate of return.

We strive at Bridgeport to identify securities which are undervalued as compared to our assessment of their absolute or intrinsic value, while doing our best to ignore the often temporary appeal of relative value. To assist with this task, Bridgeport has recently hired Adam Ferguson as an Investment Analyst from the private equity division of OMERS (one of the largest pension funds in Canada). Adam's private equity experience is similar to mine in that he has an extensive background in analyzing the value of businesses based on their fundamentals. Adam has already become a valuable member of the team and he looks forward to meeting many of you in the coming months.

As always, please feel free to call should you have any questions or wish to discuss anything about your portfolio.

Thanks for your continued support.

Yours truly,

John Fisher, CPA, CFA