Bridgeport Asset Management Inc.
Tel: 416-849-2225 x 103
info@bridgeportasset.com
www.bridgeportasset.com

BRIDGEPORT
ASSET MANAGEMENT INC.

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Investment Commentary

Bond markets dominated the news in the second quarter as income-oriented investments suffered losses in response to Bernanke's comments that the US Federal Reserve might shortly begin to taper its Treasury and mortgage-backed bond purchases.

Market reaction to the idea of a "tapering" was swift. The price of ten year US treasury bonds declined about 3.5% in the days after the Fed Chairman's remarks.

Our view is that markets overreacted to the news as economic growth is still tepid and the Fed does not appear to be rushing to raise rates any time soon. And when it does begin the rate rising process, it will likely do so in a careful and gradual way.

That being said, rising rates will ultimately be negative for fixed income investments, although some sectors will fare better than others. For example, we expect government bonds to perform the worst as they are generally the most sensitive to interest rate increases. Corporate bonds (especially those with lower credit ratings) should perform better as they offer a total return to investors based on an interest rate spread over and above government bond yields based on the credit worthiness of the issuer. It is this interest rate spread which can offer a measure of protection from rising rates, particularly if the credit worthiness of a corporate borrower improves over time.

Notwithstanding the the volatility caused by the tapering threat, the second quarter was mixed for equity investors with the S&P 500 advancing 2.4% and the TSX Composite declining 4.9% on continued weakness in the materials sector.

The US stock market has obviously had a good run of late. It is hard to believe that it was only a few years ago that investors were lamenting the disappointing returns generated by equities in the wake of the crash of '08. Indeed, as many media outlets pointed out at the time, the S&P500 had generated a ten year annualized return of -1.4% (including dividends) as of the end of 2008.

What a difference a few years makes though! As of the end of June 2013, the ten year S&P 500 annualized return had increased to +7.3% which is more in line with historical levels.

So what is to be learned from all this? We think the main lesson is that equity investing is a long term endeavor. The short term is impossible to predict and can sometimes be exhilarating or terrifying as movements are often driven by the twin evils of investor fear and greed.

In contrast, the very long term is often boring as the market typically moves along an upward trajectory based on fundamentals such as earnings and cash flow.

As we have noted in past letters, there have been very few ten year periods over the last century where the stock market has returned zero or declined. In the rare ten year periods when equities have not generated positive returns, there is almost always a subsequent period of outperformance to bring long term rates of returns closer to historical averages.

In terms of investment activity during the period, the second quarter saw a number of changes to our High Income Portfolios as a few new bonds were purchased, while others were redeemed early by issuers to take advantage of refinancing opportunities at lower rates. New bonds added to the portfolio include Frontier Communications and Canadian Satellite Radio Holdings (CSR). Frontier provides internet and wireline telephone services to thousands of business and residential customers in 27 US states, while CSR offers XM and Sirius radio to subscribers in Canada.

We also acquired new US bonds issued by Revlon and Vector Group which replaced bonds we previously owned from the same issuers that were redeemed at the end of the first quarter.

Please feel free to call should you have any questions about your portfolio. We wish you all the best for the balance of the summer!

Yours truly,

John Fisher, CPA, CFA