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BRIDGEPORT
ASSET MANAGEMENT INC.

Q3 2008 was one of the most dismal periods in recent memory for stock market investors. In our second quarter investment letter, we wrote that fear had supplanted greed in the capital markets. That fear reached a crescendo in September and October, causing investors to head for the exits as it became clear that governments and central banking authorities around the world were struggling to contain the global credit crisis.

On a year-to-date basis to September 30, 2008, the S&P 500 declined 26% and the TSX Composite dropped 36%. From their 52 week highs, the S&P 500 and TSX Composite had both declined by approximately 45% by mid October.

The drop in the TSX is particularly stunning given it was actually up about 5% for the year through June 30, 2008 before going into free fall over the summer with the bursting of the commodity bubble. We wrote in Bridgeport's Q1 2008 investment letter about our decision to avoid commodity stocks altogether as a result of our aversion to investing in cyclical businesses which have no control over the selling price of their products and earn low long term rates of return on invested capital. Our lack of exposure to the energy and material sectors hurt our investment performance in early 2008 as commodity prices soared, but has allowed us to mitigate losses in the latter half of the year as these sectors have been among the worst performers. From its high in May 2008 to its present low in mid October, the S&P TSX Capped Energy index lost about 60% of its value.

Circle of Greed

So how did we go from what many thought was a vibrant growing economy to the present mess? Our economic problems can be traced back to an overinflated housing market (particularly in the U.S.), caused by a perfect circle of greed. At every step in the home buying process, market participants had financial incentives to act recklessly to enrich themselves. Mortgage brokers recommended homeowners accept mortgages which were, in many cases, unaffordable over the long term. Many of these mortgages were offered with temporary low "teaser" rates which increased after an initial period, causing monthly payments to rise significantly. Mortgage brokers advised homeowners to accept these mortgages as brokers are paid on commission, not based on whether the mortgage is suitable for a homeowner or likely to be repaid.

We can only conjecture as to why homeowners took out mortgages they could not afford, but there appears to be several reasons including the age old compulsion to live beyond one's means. Other buyers were engaged in pure speculation and bought into the notion that home prices would continue to rise indefinitely and that they would get rich owning multiple homes and continuously flipping them at a profit. Given that many lenders required little or no equity down for home purchases, speculators were able to engage in this game with minimal investment. And sadly, many homebuyers were undoubtedly taken advantage of by unscrupulous mortgage brokers and lenders who encouraged them to take out mortgages, the terms of which they clearly did not understand.

Various financial intermediaries (such as banks and mortgage companies) were willing to fund these mortgages as they planned to pool them together and sell them at a profit to third party investors. This process allowed intermediaries to reap big gains, while relieving them of any long term investment exposure.

The ultimate owners of these mortgages were various retail and institutional investors who bought them on a pooled basis in the form of mortgage backed securities from intermediaries. It was very difficult for these investors to investigate the quality of the mortgages underlying these securities as thousands of mortgages were typically pooled together. Instead, investors relied on credit ratings supplied by firms such as Moody's and S&P which were supposed to indicate the likelihood that homeowners would default. As it turns out, those credit ratings were often based on faulty assumptions (such as the notion that house prices would not decline significantly) and were poor indicators of the quality of the mortgage pools. Perhaps if the rating agencies were paid for their work by the mortgage pool investors as opposed to the financial intermediaries, they might have had a greater incentive to be more diligent in performing their credit analysis.

This circle of greed worked for everyone's financial benefit until investors began to question whether home prices would go up forever given that the housing supply was increasing rapidly and borrowers were beginning to default. The unraveling of this mess will take some time and the effects have now clearly spilled over into other areas, causing a severe tightening of global business and consumer credit. We expect the situation will stabilize once home prices bottom out in the U.S., perhaps in Q1 or Q2 2009. While Canada's housing market has gone through a boom as well, lending practices are generally stricter here as compared to the U.S. so Canada's situation is less dire. Still, we believe that Canadian should be prepared for the possibility of residential house price declines of approximately 10% to 20% over the next year or two.

Recession All But Confirmed

Economists agree that many western countries have already entered into recessionary territory by most practical measures, although few are yet technically in recession. We expect unemployment rates to rise over the next few quarters, while inflation should lessen with the decline in commodity prices, allowing central banks to continue to lower interest rates. Assuming governments stay the course and are successful in stabilizing the banking system, we do not expect that the economy will descend into a full fledge depression, despite what some of the more grim forecasters are suggesting.

Valuations Inexpensive

From our discussion, we might have given the impression that we are gloomy about future stock market returns. This is certainly not the case. In fact, we are more bullish now than we have been at any time in the last 18 months. Valuations for solid publicly traded businesses are cheaper now than they have been for some time relative to underlying earnings and operating cash flow. We have been steadily deploying excess cash in our equity portfolios and expect to be fully invested shortly.

Many publicly traded stocks we own have continued to perform well on a fundamental basis over the last 12 months, despite in some cases declining in price. For example, we remain enthusiastic about our position in Shaw Communications, a communications company which provides cable, internet, digital phone and direct-to-home (DTH) satellite services primarily in Western Canada. The company has over 1.5 million Internet customers, 3 million cable customers, 600,000 digital phone lines and 900,000 DTH subscribers who pay monthly fees for services, generating tremendous recurring revenue and stable and growing earnings. The Shaw family owns $1 billion worth of common shares in the company and is well aligned with public shareholders in terms of creating value. Despite challenging economic conditions, in its fiscal year ended August 31, 2008, Shaw increased revenue by 12% and operating earnings by 14% compared to 2007. The company's shares are currently trading for approximately 8.5x EBITDA which we believe is inexpensive given the company's dominant market position and strong growth profile.

We will continue to seek out solid businesses with inexpensive share prices in the coming months. The opportunities for value investors have not been this numerous for some time. We plan to take advantage of the current environment so that we are well positioned when market sentiment inevitably turns more optimistic.

We wish you all the best for the upcoming holiday season and encourage you to call should you have any questions.

Yours truly,

John Fisher, CPA, CFA