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

BRIDGEPORT
ASSET MANAGEMENT INC.

THE CURIOUS CASE OF 2008

2008 could not have drawn to a close sooner for investors. The stock market seemed to consistently move in reverse during the year, much like the age of the main character in the recent movie “The Curious Case of Benjamin Button.”

The year was among the worst for equity performance in the last century. The U.S. Dow Jones Industrial Average suffered its most dramatic loss since 1931, falling approximately 34% over the year. 2008 returns for other major benchmark indexes were even lower: S&P 500 (-39%), S&P/TSX Composite (-35%), Nasdaq (-41%) and S&P/TSX Small Cap (-48%). Most major stock indexes have now declined between 40% and 50% from their past highs in 2007 and 2008.

Many investors have completely abandoned the stock market despite believing until recently that they were committed to equities for the “long haul.” Unable to face the possibility of further losses, many just decided to get out. Frankly, some are right to get out or at least reduce their allocation to equities as they were far too exposed in the first place given their investment time horizon. Others have sold based on pure emotion which is exactly the basis upon which they invested in the first place.

Emotional investors never understood the value of their equity holdings when they were making money and they still don’t understand the value now during these difficult times. These investors basically view stocks as pieces of paper and only believe they are valuable when they rise in price. Now that share prices are in decline, emotional investors have bailed out en masse.

The value of stocks, of course, is based on the fact that they represent corporate ownership. In turn, ownership is valuable because it entitles one to share in a company’s future profits. While this is plainly obvious to any entrepreneur who owns shares of a privately held company and lives off the profits of his or her business, stock market investors routinely lose sight of this fact, particularly during troubling times like these.

The current difference in behavior between owners of private companies and owners (or shareholders) of public companies is telling. Private company owners primarily focus on the level of profits their business generates. They do not have the luxury (nor perhaps the misfortune!) of other people telling them every day what the shares of their business are worth as there is no liquid market for their equity. Their view on the value of their business is mainly linked to the profits they believe they can earn and potentially distribute.

For example, it would be unusual for an entrepreneur to sell a high quality, stable and growing business for a purchase price equal to only a few years worth of her expected annual profit. Why would the owner of such a business sell (assuming no personal issues compel her to exit)? Instead of selling, in just a few years, she would recoup the amount of the proposed purchase price by simply paying herself the profits from her business.

BRIDGEPORT
ASSET MANAGEMENT INC.

Would she sell her business for a meager price just because other owners of similar businesses were willing to sell for low prices or because potential buyers repeatedly approached her, but offered insufficient prices relative to her company's future earnings? Clearly, the answer is no. What others in the marketplace believe about the value of her business would be of secondary importance compared to the amount of profit she expected to earn in relation to her business investment.

While the private business owner's approach to equity value is both simple and logical, stock market investors don't always view the world from the same perspective. The publicly traded equity investor understands the link between valuation and future profits, but must contend with the reality that the market prices his equity holdings on a minute by minute basis. This process of continuous market feedback is dizzying to say the least and often causes stock market investors to abandon their focus on fundamental value.

The fact that publicly traded stock prices can at times become decoupled from corporate earnings presents public equity investors with both tremendous investment opportunities and challenges. The opportunity is to buy future profits for low prices today, but the difficulty is that those opportunities often present themselves when others are selling. Everyone aspires to buy low and sell high, but yet finds it difficult to buy when everyone else is selling! It is often said that stocks are perhaps the only item that people are less interested in buying as prices decline. Retailers wouldn't last a minute if their customers behaved like this!

While we have little to offer in terms of predicting the short term direction of the market, we continue to view stocks as historically inexpensive on a fundamental basis. Share prices for many high quality companies are so low that if these businesses were privately held, few owners would consider selling at current levels as the sale proceeds would represent only a few years worth of future earnings.

We expect that the economic news will continue to be grim for the better part of 2009 with employee layoffs, bankruptcies and credit issues dominating the headlines. Despite this, there is room for optimism over the longer term given the current lack of inflation, low interest rates, low commodity prices and government's continued maneuvers to pump liquidity into the system and improve access to credit. Our main longer term concerns revolve around the possibility of significant inflation in the future as a result of the amount of money being printed and government's apparent bias to undertaking massive spending projects of dubious economic benefit.

While we wait for the recovery, we will continue to invest cautiously in inexpensive, high quality securities which offer attractive income yields as compensation while we wait for capital appreciation.

We wish you all the best in 2009 and encourage you to call should you have any questions.

Yours truly,

John Fisher, CPA, CFA