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BRIDGEPORT
ASSET MANAGEMENT INC.

Q2 2021

Investment Commentary

Stocks continued to perform well in the second quarter as the economic environment steadily improves in the wake of the pandemic. Premium equity valuations in many segments of the market suggest investors see few economic risks on the horizon. Indeed, we note that economic fundamentals are strong and trending positively with no obvious sign of imminent collapse.

On balance, we remain cautiously optimistic that stocks will deliver positive returns in the second half of the year, although our positioning has been increasingly biased towards larger, more defensive businesses and situations with company-specific value drivers. We feel that the time for indiscriminate buying of so-called “re-opening” stocks (which have already rebounded sharply) is behind us.

One risk that has the attention of many is the prospect of higher-than-expected inflation. Markets generally perform best when inflation is relatively low and predictable. When inflation rises more than expected, it generally prompts central banks to raise interest rates in an effort to moderate growth and stabilize prices.

In May, the US inflation rate rose to 5% (year-over-year), the highest rate of price growth since 2008 and well ahead of the Federal Reserve’s 2% target. Expectations for inflation over the next year have risen to 4%, although the US Federal Reserve chairman (Jerome Powell) is adamant that recent inflation is “transitory” as the economy laps the most COVID-impacted months of 2020.

We suspect the recent outsized inflation figures will prove to be largely an artifact of the pandemic shutdowns. We expect inflation to revert to more normalized levels over the coming quarters as supply chains stabilize and the pandemic period moves into the rearview mirror and no longer has an outsized impact on year-over-year data. Somewhat longer term, the risks do appear tilted in favour of higher inflation rates as the post-COVID economic rebound could put pressure on wages which usually drives price increases. In addition, the eventual unwinding of Central Banks’ bond buying programs could exert upward pressure on bond yields, a somewhat separate issue from price inflation.

In any event, with higher inflation comes higher interest rates which typically have negative implications for equities, particularly for high valuation, growth stocks. Similarly, if interest rates rise to a level where they begin to stifle economic growth, cyclical value stocks will suffer as a result of deteriorating earnings potential.

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As mentioned earlier, our baseline assumption is for the inflation rate to naturally return to more reasonable, pre-pandemic levels with modest increases over time. Even if inflation turns higher for a longer period, we believe that our equity portfolios are well positioned as they are tilted towards value over growth stocks which should help to mitigate the impact of any potential contraction in valuations. In addition, our focus on investing in high quality businesses which tend to have strong customer pricing power should be beneficial as these companies are better able to maintain profitability by passing on the impact of inflationary cost pressures.

Bridgeport's three equity funds posted strong returns in the second quarter, increasing approximately 6% to 7% (with year-to-date returns between 11% and 17%). Significant contributors to performance were Alphabet (Google), Nestle and Facebook in the US Equity Fund, while Brookfield Asset Management and Onex drove performance in the Canadian Equity Fund. Trisura Insurance and Summit Industrial REIT were key contributors in Q2 to results for the Small & Mid Cap Equity Fund.

The Bridgeport High Income Fund also generated strong gains in the second quarter, increasing by approximately 4% (and over 7% on a year-to-date basis). Q2 returns in this well-diversified fund came predominantly from Canadian preferred shares and gains in a handful of dividend-paying North American common stocks.

In terms of our private asset funds, the Bridgeport Alternative Income Fund is particularly well-positioned to weather any potential increase in interest rates as it is primarily exposed to private credit strategies which invest in (i) variable interest rate loans that earn higher returns as rates rise, (ii) short term fixed rate loans where proceeds on maturity can be reinvested for higher returns in an increasing interest rate environment and (iii) special situations which tend to not be overly interest-rate sensitive since target annual investment returns are in the 10% to 20% range. The Bridgeport Alternative Income Fund continued to generate consistent performance in the second quarter, increasing approximately 1.5% (and over 3% year-to-date and 7%+ in the last 12 months).

The Bridgeport Private Equity Opportunities Fund is also off to a strong start. Launched in late 2020, the fund is up approximately 5% so far in 2021 and already has exposure to six underlying funds and hundreds of private companies managed by top US, Canadian and European private equity managers. The fund has made allocations to a diversified mix of primary, secondary and preferred private equity and venture capital strategies.

We wish you all the best for the balance of the summer. As always, please feel free to call should you have any questions.

Yours truly,

John Fisher