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Prospector Partners Quarterly Commentary

Coronavirus Pandemic

These are uncharted waters for all of us. The COVID-19 virus pandemic is first and foremost a health crisis with associated economic and financial fallout. The health data relative to testing is spotty and poor. Our leaders are trying to manage a crisis without the ability to adequately measure the scope and spread of the disease. We have no idea what the denominator is, so all estimates of infection, serious illness and mortality rates are suspect. The Federal Reserve, under the able leadership of Jerome Powell, along with other global central banks have moved decisively with lower short-term rates and massive quantitative easing programs to cushion the liquidity crunch and soften the financial aspects of the crisis. The U.S. Congress then moved quickly and decisively with unprecedented fiscal stimulus through the CARES Act and Paycheck Protection Program to absorb some of the near term economic damage from the abrupt economic crash and unemployment spike. We expect more stimulus to come as the federal government uses its balance sheet and borrowing power to keep the economy afloat.

The management of the health crisis is paramount and will be the most critical determinant of the length, depth, and breadth of the economic downturn that is upon us. The success or failure of aggressive mitigation efforts such as social distancing and sheltering in place strategies implemented by many states will dictate the intermediate future. Ultimately, we will need widespread and effective testing and contact tracing capabilities to control the pandemic. Questions abound regarding the economic recession; will there be a V-shaped recovery? Unlikely… U-shaped? Or L-shaped? Will the virus fade with warmer weather conditions and reoccur next fall like the seasonal flu virus? Will therapeutic treatments emerge in the short or medium term? Will a vaccine be discovered in a year or two? How quickly might billions of doses of said vaccine be available?

Will there be long lasting behavioral changes as a result of COVID-19? Will we ever shake hands again? Is remote working at scale here to stay? How long will it take for certain percentages of the population to overcome anxiety regarding eating out, attending a concert or sporting event, staying overnight in a hotel room, riding mass transit or shoe-horning onto an airplane to visit a tourist destination? Surely e-commerce, technology, and healthcare will continue to grow. Global supply chains of strategically important goods will redomesticate. How and where we work and live will experience some level of permanent change at the margin. The scope and scale of those changes depends on the management of the pandemic from this point forward. A shorter decisive resolution might trigger a shorter collective memory...

Our Stock Market Distress Playbook

During the 23-year history of Prospector Partners, we have experienced three significant equity market sell offs, including the burst of the internet bubble in 2000, the Great Financial Crisis of 2008, and now this Coronavirus pandemic. Each time, we return to a few key strategic portfolio management actions:

- First, we upgrade the quality of the balance sheets in our portfolios. We are chronically "allergic" to leverage and debt in our positions. That said, there is always room for improvement when the music stops and a market crisis erupts. Generally this reunderwriting process leads us to hold larger balance sheets with more staying power.

- Second, we reduce the gross exposure in long/short strategies to reduce overall risk during the heightened uncertainty.

- We reduce cyclicality in the portfolios at the margin. We are typically underweight cyclical sectors of the market such as industrials, materials, technology, and consumer discretionary. This time is no different. When we start to see through the severity of the economic downturn we would begin to reintroduce cyclicality into our portfolios through investments in quality balance sheets in these same areas.

- Finally, we actively and aggressively manage our tax position. We are loathe to deliver a taxable gain at the same time as a total return loss to our customers. A significant portion of the assets under management consists of internal money invested in Prospector's strategies. As such we pay close attention to maximizing after tax returns for our clients.

Financial Services Outlook

Property and casualty underwriter stocks have been harshly punished by the market over concerns of potentially having to pay COVID-19 related claims under business interruption clauses in their commercial property policies as well as plummeting yields on fixed income investments hurting reinvestment rates and slowing book value growth. While there is truth to the latter concern, we feel that the first one, which is the more material, immediate concern, is unfounded. Our property and casualty holdings generally consist of personal lines insurers who have little commercial property exposure, or main street carriers who write small commercial policies largely using Insurance Service Office (ISO) standard forms which specifically exclude coverage for a pandemic. While not unusual for politicians to propose legislation in the aftermath of a large loss to extend insurance policies to respond to events specifically excluded (e.g. Hurricane Sandy, World Trade Center, et al), the U.S. judicial system has always ultimately enforced the principles of contract law. We feel strongly that this will remain the case. Reinsurance industry exposure to Covid-19 is difficult to handicap, and it could affect several reinsurance companies negatively.

Insurance intermediaries, another area we like, stand to benefit from dramatically higher future rates for insurance which are in the offing. These capital-light businesses charge commissions and fees and bear no underwriting risk. We expect organic growth to dip in the next couple of quarters as the headcount-related premium lines such as workers compensation contract with rising unemployment, before reaccelerating into an economic recovery as insurance rates accelerate.

On the bank side, we trimmed exposure due to a decent rally in bank stocks during the fourth quarter of 2019 combined with twin concerns about an overdue credit cycle and a persistent low interest rate outlook. Today, banks in the U.S. are better prepared to handle this crisis than in 2008. They have significantly higher capital levels and liquidity, plus many of the higher risk loan categories are now held by non-bank lenders, hedge funds, etc. In other words, the capital ratios relative to risk assets are double where they were prior to the Great Financial Crisis, and the loan underwriting standards are significantly more stringent than 12 years ago. They also hold fewer exotic instruments and engage in significantly less proprietary trading. Their digital capabilities, built through large consistent investing in technology over the past decade, allow them to service customers seamlessly and remotely, which is currently essential. Finally bank stocks are historically inexpensive on a price to tangible book value basis and have robust 5% dividend yields that look sustainable unless the downturn becomes materially worse, or the Fed reverses their current stance and forces banks to cut dividends in an effort to accrete capital. Regulators and legislators are using the banking infrastructure to deliver stimulus to small businesses, i.e. they are part of the solution, not the epicenter of the problem as during the Great Financial Crisis.

That said, there are few safe haven loan categories this time around; especially at risk are: energy, hospitality, restaurants, retail, travel, leveraged loans, etc. Also, buybacks are suspended for the time being, and M&A activity has halted as well, both of which are core elements of the book value growth thesis for owning bank stocks.

Outlook

The range of outcomes in the short to intermediate term is wide and hinges on the imminent outcome of the "bending the curve" effort to curtail the COVID-19 pandemic. Economic contraction, trade and geopolitical concerns weigh heavily. The upcoming United States presidential election is right around the corner and a shift in power could prolong market volatility.

Interest and mortgage rates continue near historically low levels, inflation is non-existent, and a recession is here. We are carefully monitoring aggregate corporate debt levels (especially BBB- debt which is a single notch above junk status), which now sit above pre-2008 crisis levels and loom as a problem without aggressive Fed buying through the latest quantitative easing program. Unemployment has also spiked to double digit levels and has not yet stabilized.

In our estimation, equity valuations remain at elevated levels, even after the first quarter sell off, due to the sharp decline in expected earnings for the rest of 2020 and into 2021. Recovery in aggregate earnings will be slow as certain industries such as hospitality, entertainment, banking, and travel will take much longer to return to pre-Coronavirus levels. Treasury and high-grade corporate bond yields look unattractive after the dramatic flight to safety rally during the current health crisis. In any case, we feel the values inherent in our portfolios should attract acquirers and other investors over time. Meanwhile, we still believe equities are a superior asset allocation alternative to bonds over the longer term.

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