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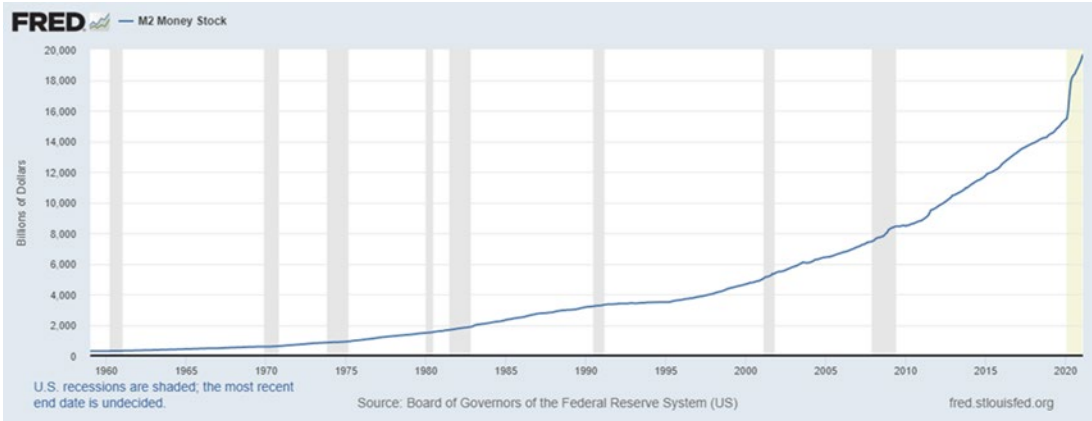
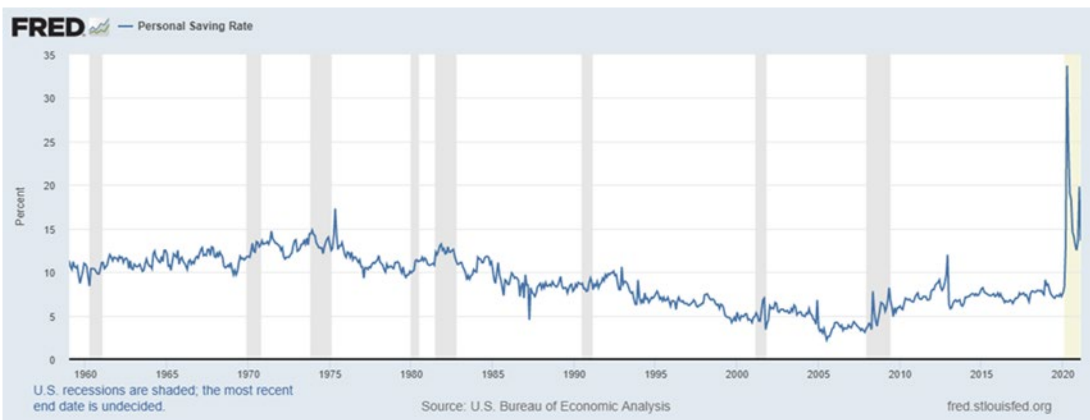
Q1 2021

Prospector Partners Quarterly Commentary

Current Market Environment

The new year began with the Georgia Senate runoff which saw both seats going to Democrats, thereby giving the Dems an effective majority in the Senate. Unshockingly, a new $1.9 trillion stimulus package was passed along party lines soon thereafter. The multi-trillions of dollars of government stimulus and additional trillions of monetary support by the Fed has left the United States awash in cash. As can be seen in the following charts, the U.S. money supply has skyrocketed, and stimulus checks have left the U.S. consumer with a considerable amount of cash in their pocketbooks.





The result of all of this has undoubtedly aided the rise in risk assets during the first few months of 2021, and has led to some speculative market actions that, to us, are reminiscent of the late-1990's dotcom bubble. By way of example:

- Leadership of loss-making companies: As readers may recall, the latter stages of the dotcom bubble were marked by nascent companies, in many cases with barely more than a business plan, coming public at multi-billion dollar market caps and with valuations being rationalized by clicks, page views, or some similar metric. Similarly, the first two months (especially) of 2021 saw loss-making companies lead the market…in many cases being up hundreds of percent through February. For example, within the Russell 3000 Index, companies that reported losses over the trailing 12 months were up, on average, over 20% for the first two months of the year, while profit-reporting companies gained on average only 9%. More striking, the top 20 gainers in the index (each one in the loss-making category) were up an average of 226% - with every one of them appreciating over 100% for the first two months of the year.

- Rise of the retail trader: In January, a group of heavily-shorted stocks (some of which being questioned as viable going concerns prior to this) saw rapid price appreciation, driven largely by investors organizing on Reddit message boards in an effort to cause short squeezes, and thus dramatic increases in the prices of those stocks. This casino-like atmosphere was seemingly made easier by the rise of commissionless trading on apps such as Robinhood – giving traders the ability to transact endlessly at zero cost. As an acquaintance of ours who works in the restaurant industry, but was engaging in this trading activity put it: "It's so easy; you log onto the message board in the morning, buy what they're pitching, and just don't get left holding the bag at the end of the day." GameStop (GME), which became the "poster child" of this movement, saw its shares rise from a price of around $20 per share to a high of $483 in a matter of days and, echoing the period of the dotcom bubble, high profile investment managers could be seen on CNBC rationalizing the head-scratching valuations of these companies.

- "Blank check" companies: More formally known as SPACs (special purpose acquisition companies), have quickly risen to prominence as a preferred way for private companies to IPO with less red tape and cost. As the "blank check" moniker implies, these are public companies which raise capital from investors with the promise to eventually find a private company to purchase with those funds. Typically, this must be done within a two-year period, or the money is returned to shareholders. In just the first three months of 2021, literally hundreds of these SPACs have raised billions of dollars from investors and most of them are still looking for private companies to purchase. This didn't stop many of them rising considerably above their IPO price, despite it being unknown what investors were really buying at the time. According to the Wall Street Journal (WSJ), at the end of March there were 430 SPACs looking for acquisition targets. Much like dotcom companies at the turn of the century seemed to fall under the weight of too much supply, as IPO after IPO came to market and 180-day lock ups expired, causing a flood of investors to look for the exits, the SPAC market risks a similar outcome. Indeed, after seeing average gains of over 5% in January and February (and 231 consecutive SPACs going public without dipping below their IPO price), the WSJ reported that SPACs rose merely 0.1% upon their debuts during March.

- Nonfungible tokens (NFTs) and digital currencies: Next on the list of hard-to-value assets that saw billions of dollars of money flow to during the first few months of 2021 are NFTs and digital currencies. While the long-term prospects of both of these types of assets could be debated, assessing a proper valuation to either of them currently comes down to "whatever the next person is willing to pay me." And, much like the aforementioned loss-making companies, these two asset classes were caught up in the speculative frenzy which marked early 2021. For example, Bitcoin, which started the year just under $30,000 rallied to just under $60,000 at quarter end. And, NFTs, which are simplistically described as files which are attached to, and verify the authenticity of any digital item such as a video or music file, a GIF or a meme, etc., were being auctioned for exorbitant sums. For example, the first tweet ever, from Twitter cofounder Jack Dorsey was sold for a whopping $2.9 million (if you don't want to dole out that sort of cash, feel free to scroll back to March 21, 2006 to see that tweet by @jack for yourself in his Twitter timeline).

As we entered March, the steam started to come out of some of these speculative assets. For example, taking a look at a broad index, loss-making companies in the Russell 3000 were down on average 3% in March in contrast to an average 5% gain for companies which posted profits over the trailing 12 months. Additionally, most of the stocks which were targeted on Reddit message boards have traded back down closer to where they were trading prior to the short squeezes (save for a handful of the more popular ones, including GME, which continue to trade much higher than before the frenzy, although significantly below their peak prices). As noted earlier, SPACs aren't being met with nearly the same fanfare as they did earlier in the year, and the foreboding supply portends a questionable future for the over 400 still looking for a partner.

Meanwhile, starting mid-February, we saw a significant rotation from growth to value stocks, with the S&P 500 Value Index rising 10.8% during the quarter, while the Growth counterpart was up only 2.1%. This value outperformance was possibly a result of the 10-year Treasury's persistent rise and increased expectations for future inflation. As we've discussed in prior letters, it's harder to justify ever-increasing valuations for fast-growing companies in an increasing interest rate environment. Will this rotation persist and be anywhere near the magnitude of what we've seen over the past 10 years+ of growth outperformance? Only time will tell, but boring as it may be in comparison to investing in tweets, we will continue with our process of searching for long-term investments in undervalued companies and will leave the investing in NFTs and the like to others.

Outlook

2021 looks to be a transitional year. We are clearly in the early stages of a new economic cycle, following the coronavirus-induced recession of 2020. Continued progress on vaccinations will allow the U.S. economy to return to more familiar footing with the resumption of dining out, air travel for business and pleasure, and large group gatherings. The recent United States elections, although closely contested, have ushered in a change in administration with attendant changes in the agenda around stimulus, spending, taxes, and trade. The razor-thin margins in Congress are likely to temper any radical policy shifts. Importantly the volatility emanating from the executive branch should ease.

While interest and mortgage rates have lifted, they are coming off historically low levels, while inflation remains below target. We see early signs of reinflation in Treasury and TIP yields from the historically high levels of government spending here and around the world. We are carefully monitoring aggregate corporate debt levels (especially BBB- debt which is a single notch above junk status), currently above pre-2008 crisis levels and loom as a potential problem absent continued aggressive Fed support. Unemployment has shown significant improvement, but continues to be an issue.

In our estimation, overall equity valuations remain at elevated levels, due to the sharp rebound in equities, which has outpaced prospective positive earnings revisions. The high valuations of a small number of enormous technology companies certainly exert upward pressure to the overall averages. Recovery in aggregate earnings will take time as certain industries such as hospitality, entertainment, and travel are tied to the success of a vaccine rollout plan, and will take longer to return to pre-coronavirus levels. Treasury and high-grade corporate bond yields look unattractive after the dramatic flight to safety rally during 2020. In any case, value investing is ripe for a continued period of outperformance. Meanwhile, we still believe equities represent a superior asset allocation alternative to bonds over the longer term.

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