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Prospector Partners Quarterly Commentary

Current Market Environment

First and foremost, we hope this writing finds you and your families healthy. It's been a long twelve months and no one could be criticized for being happy to see the end of 2020. So much changed so quickly at the beginning of the year, as COVID-19 rapidly spread around the world, creating the first global pandemic of our lifetimes. Unfortunately, we all had to quickly learn to live in a "new normal" environment and lives were turned upside down. As most of us went into quarantine in March, quickly entering the lexicon were terms like: social distancing, herd immunity, flatten the curve, pantry loading, and distance learning… to name a handful.

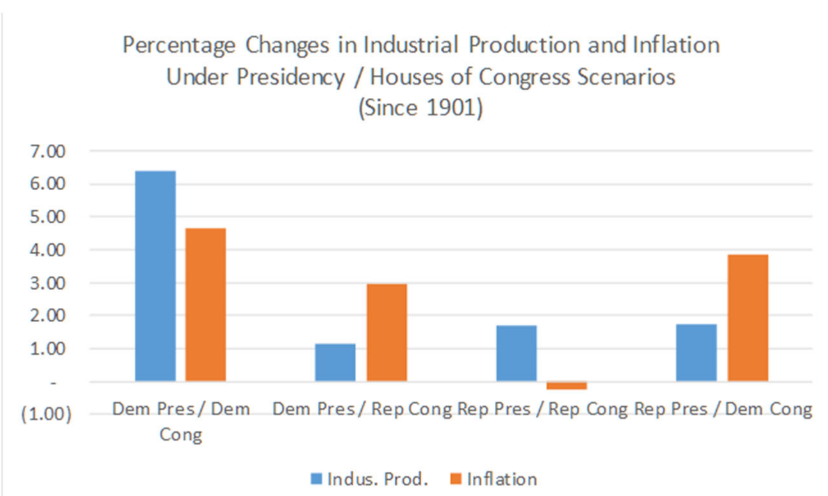
For those of us in the investment management business, the information flow related to Covid-19 (spread of the virus, therapeutics, vaccines, etc.) was akin to drinking from a fire hose. The stock market that had already begun discounting news more rapidly in recent years accelerated from "warp speed to ludicrous speed" (forgive us for the "Space Balls" reference). Indeed, as the multitrillion dollar stimulus plan started taking shape in the spring, and vaccine candidates entered Phase 1 trials, the market, which entered a bear market in record speed, quickly made a V-shaped bottom, charging higher and never looking back.

As referenced in our last writing, growth stocks dominated over their value brethren during 2020. This is contrary to history, where value stocks typically lead in the early years of an economic recovery. While we mentioned several potential catalysts which we felt could cause a rotation to value stocks (including the potential for increased inflation, rising interest rates and additional economic expansion) our conviction has only grown given the results of the recent U.S. elections. In the paragraphs to follow, we delve into why this is the case, and what we feel are the broader implications of the election.

Implications of the Blue "Ripple"

In November, a deeply divided nation went to the polls and voted to change administrations. Subsequently on January 5, 2021, the Georgia Senate runoff elections resulted in the Democrats taking control of the Senate, in addition to the Presidency and the House. This can have many implications on the economy and investing climate in the coming years. We believe this outcome, on the margin, will lead to a more rapid economic expansion, higher interest rates and inflation expectations, and a steeper yield curve. We regard this environment as constructive for value stocks in general, including cyclical companies and beaten down financial stocks. We expand on these thoughts below.

First off, as you could see in the following table, which includes data provided by Ned Davis Research (NDR), history would indicate that both industrial production and inflation run higher when we have both a Democrat president and control of Congress. Additionally, according to NDR, when the incumbent president loses office, this is typically a precursor for cyclical stocks outperforming. Their reason is logical - most often, a sputtering economy is the reason behind an incumbent losing out on a second term. Therefore, the new administration often makes that their number one priority and enacts legislation to boost the economy, which in turn, benefits cyclically-exposed companies.



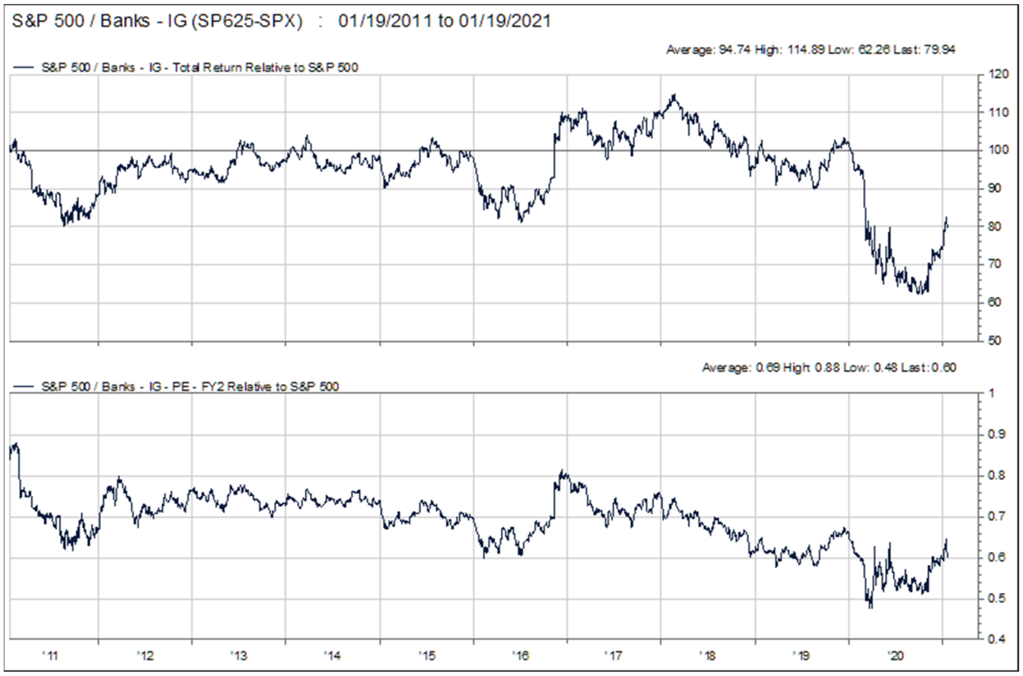
Source: Ned Davis Research

While, undoubtedly, there are many factors that went into the current change in administrations, the state of the pandemic-impacted economy likely weighed heavily. And given that backdrop, we expect the incoming Biden administration to deliver an additional large stimulus package to bolster the economy as we attempt to bridge from the COVID-19 pandemic towards a "new normal" economy.

We also anticipate the Biden administration will push a $1 trillion+ infrastructure package early in his administration, given this was a top priority during his candidacy. While the slim majority Democrats hold in the Senate (a 50-50 tie with vice president Harris the tie-breaking vote) offers hurdles to getting an infrastructure bill passed, we expect that they will either be able to get it done (at least partially) via budget reconciliation, or as part of a stimulus package.

Trillions in additional stimulus dollars and/or infrastructure bill, both of which (in our view) have a better chance of getting done under a scenario where the White House and both Houses of Congress are held by the same party, would add inflationary fuel to an already expanding economy and would likely lead to rising interest rates. A countervailing force under a Democratic administration could be higher taxes. However, in our opinion, with such a tight margin in the Senate, significant tax increases will be difficult to achieve…especially while we are still impacted by the pandemic. We don't discount the potential for a rise in the corporate tax rate at some point - especially as part of a negotiation for a large infrastructure bill - however the threat of higher taxes in our minds is outweighed by the near term impact of additional stimulus. Both parties also seem willing to let the deficit rise, and seem less worried than ever about "paying for" stimulus packages.

What does this all mean to us? While we did not make wholesale changes to our portfolios in anticipation of, or in reaction to the election outcome, we feel we are positioned well for the current environment. Increasing spending and deficits by the U.S. government should lead to rising inflation expectations and interest rates. We also expect a continued steepening in the yield curve given the Fed has indicated a willingness to keep short-term interest rates low until inflation goes above 2%. This should benefit financial service companies, including long out-of-favor banks which could see improving net interest margins. The economic expansion mitigates credit risk for the regional banks whose balance sheets are solid, both in terms of capital levels and ratios as well as a maintaining a strong reserving position. . While many of our bank holdings have rallied recently from bottom decile to bottom quintile absolute valuations, we still see significant upside. By way of reference, below we show the S&P 500 Bank Index's relative performance and relative valuation over the past ten years (as of January 19, 2021).



Source: FactSet

The nascent recovery also portends good results out of the industrial, more cyclical, companies in our portfolios, especially those with exposure to COVID-depressed end markets such as commercial aerospace, auto, and energy where the prices remain depressed. These and other industrial companies could be significant beneficiaries of a large infrastructure bill, which is a pressing need and high priority of the incoming Biden administration. Recall that our criteria for investing in these companies includes a solid, low-leverage balance sheet, dependable free cash flow generation, an owner-oriented management team, and participating in an industry with active merger & acquisition activity.

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. The rollout of efficacious Covid-19 vaccines during 2021 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.

Interest and mortgage rates continue near 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 improvement, but continues to be an issue.

In our estimation, overall equity valuations remain at elevated levels, due to the sharp decline in expected earnings for the rest of 2020 and into 2021, and the sharp rebound in equities. 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 strong period of outperformance, and the bargains inherent in our portfolios should attract acquirers and other investors over time. Meanwhile, we still believe equities represent a superior asset allocation alternative to bonds over the longer term.

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