BALLAST
ASSET MANAGEMENT

For second quarter 2018, the Ballast Portfolio returned 9.2% before fees and 9.0% net of fees, compared to 5.7% for the Russell 2500 and 5.8% for the Russell 2500 Value.

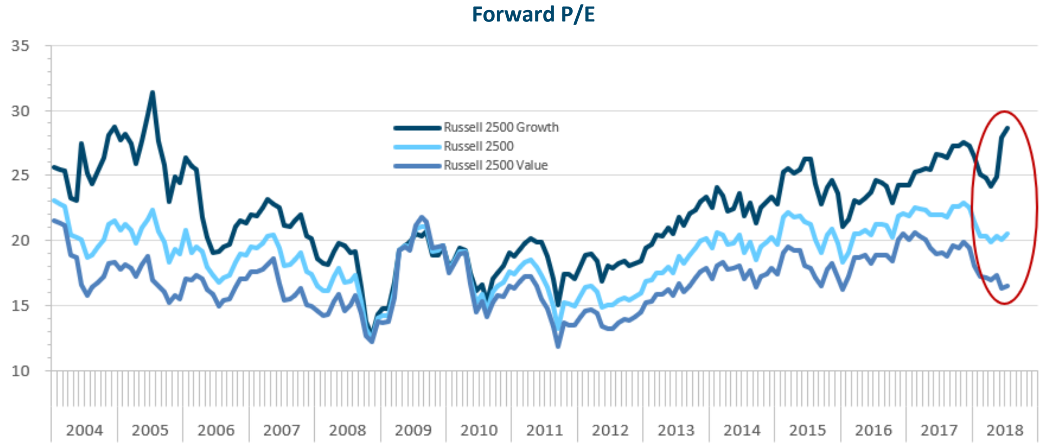
Net Performance as of 6/30/2018												
Periodic Returns		2015*	2016	1Q 2017	2Q 2017	3Q 2017	4Q 2017	2017	1Q 2018	2Q 2018	YTD 2018
Ballast Portfolio [1]	Gross	-7.6%	23.7%	2.1%	2.1%	4.2%	4.5%	13.5%	3.6%	9.2%	13.1%
	Net	-8.0%	22.9%	1.9%	1.9%	4.1%	4.3%	12.7%	3.4%	9.0%	12.8%
Russell 2500 [2]		-6.9%	17.6%	3.8%	2.1%	4.8%	5.2%	16.8%	-0.2%	5.7%	5.4%
Russell 2500 Value [3]		-5.8%	25.2%	1.6%	0.3%	3.8%	4.2%	10.3%	-2.6%	5.8%	3.0%

* 2015 performance from 8/11/2015 through 12/31/2015

Growing up the son of a farmer, I had many unique experiences at a young age. One of those was driving a tractor to pull implements – discs, spring-tooth harrows, planters, etc. When pulling the planter, for example, I'd first drive around the perimeter of the field and then move over so that subsequent passes would not overlap what had already been done to avoid proverbially "replowing the same ground." Back then, tractors didn't have GPS guidance systems, we eye-balled distances and drove them by hand. To complicate matters, the steering often had slack in it. Sometimes, I'd turn the wheel a quarter- or halfway before the front wheels responded. If I focused too closely on the last path or looked back too long to make sure the planter wasn't leaving gaps with all the jolting around, I'd invariably make too many, too large, and/or badly timed adjustments. Over time, I learned to look far forward and make a series of small corrections. These are lessons we still apply today.

Although primary index valuations aren't especially attractive, and despite an unusually long list of high-level crosscurrents (discussed below), we are finding as many or more opportunities than usual in small- and mid-cap stocks. The increasing differentiation between individual stocks, for instance as in the divergence between value and growth mid-cap P/Es in the chart below, has at least three causes: (1) declining liquidity, (2) passive strategies (usually market cap weighted) accounting for 45% of investment in U.S. equites, more than twice as much as a decade ago, and (3) differing exposure to global factors, particularly favoring small- and mid-cap stocks. In other words, it is a stock pickers' market.

Forward P/E



Price divided by next 12-month forward consensus expected Earnings Per Share provided by Bloomberg Estimates
Source: Bloomberg

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Despite the rich opportunity set, we think it is important for you to understand our approach to risk management, especially with the growing list of uncertainties and the prevalence of an uneasy feeling that the expansion and bull market have gone on too long. At Ballast, risk management is a question, not an answer. We treat it as a dynamic process, continuously reassessing our exposure to unknowns and unknowables as they unfold over time, staying focused on what we can control, and consistently executing the same bottom-up investment processes that have driven our results in the past.

Our first safeguard is at the security level. Every position has a clearly defined investment thesis, which if violated results in immediate exit. The thesis also explicitly defines a valuation-based reward-to-risk estimate for each stock, which guides our tactical buy and sell decisions. Portfolio construction, sizing positions by individual reward-to-risk adjusted for interactions and overall portfolio exposures, is the second level. Our proprietary Fundamental Risk Model guides portfolio construction and is central to the third level, which is ongoing management of macroeconomic and other high-level unknowns, for equities generally and for fundamental profit drivers at the company and portfolio level.

I'll use trade friction, a hot topic in investment circles in Q2, as an example. To be candid, we do not have any great insight into whether tariff tit-for-tat will escalate to full-blown trade war, or at least no greater than the media parade of Wall Street strategists, political operatives, and TV pundits. For now, we withhold judgment on that big question. We watch it closely, but no amount of research into such an unknowable dynamic will generate enough evidence to act based on facts, and our time is better spent on understanding the direct impact of tariffs and company research.

When the first round of tariffs was announced, we quickly scoped the impact with our Fundamental Risk Model. It measures each company's exposure to factors such as geography, end markets, cyclical and macro indicators, and so on. It is not a quant model that calculates risk based on historical stock price correlations (looking back at already plowed ground), but instead measures actual revenue and earnings exposures bottom-up, in real time, aggregated to the portfolio level. After setting aside the unknowable trade war question, our tariff analysis boiled down to two simple questions: 1) Do we have exposure to any of the announced product categories? and 2) How much? Using the model, we immediately calculated the Ballast portfolio's gross exposure was 16%. Deeper analysis led to second order adjustment due to reduced competition and/or ability to pass input cost increases through by raising prices. In moments, we determined our net exposure was only 3.5%. The tractor jolted, but we avoided overcorrecting.

That's just one example of how the Fundamental Risk Model works with our downside analysis discipline to make quick, appropriately tuned adjustments to real-world risks. We routinely use this model for risks such as inflation, oil and other commodity prices, consumer spending, interest rates, excess supply of natural gas liquids, exposure to China, the topics we enumerate below, and more.

Before turning to the crosscurrents, a word of caution: Our risk management process ensures consistency and moderates, but does not eliminate, downside. To be completely clear, Ballast's strategy is long-only – we are not hedged, and market-related drawdowns are an unavoidable part of our process for generating strong returns over a market cycle. Our goal is to dig a smaller hole and empirically we have seen our investment discipline do just that when volatility has spiked in the past, including most recently in February.

High-Level Crosscurrents

As in the last few quarters, we continue to expect higher financial volatility amidst this lengthening list and what feels like a nervous but risk-complacent market. We expect sustained, moderate domestic and global economic growth as a working hypothesis. Issues that will decide the course of events include:

- Domestic final demand continues to grow, in part due to a tax cut-related fiscal stimulus equal to about ~2% of GDP this year and next. We expect tightening labor markets to drive personal income growth and higher personal consumption expenditures, which will help support resurging capital investment.

- The 10yr-Fed Funds and 10yr-2yr yield curves are only 50bps and 25bps away from inverting. Inversion has preceded every recession since the 1960s by approximately 6-18 months. With recent inflation data points slightly exceeding the Fed's 2% target, it seems inevitable that short-term rates will rise another 50bps this year. The long end is more difficult to predict.

- Liquidity (M2/GDP) is declining, the first real change in trend since the post-crisis recovery began. The immediate cause is tighter monetary policy via Fed Funds increases and shrinking the Fed's Quantitative Easing (QE) bloated balance sheet. Declining liquidity is a risk to the real economy but may be necessary to avoid worse risks of too much inflation and destabilized inflation expectations. If overdone, falling liquidity may reverse the tailwind QE gave financial asset valuations.

- Oil prices continue to rise, as do commodity prices more generally. Oil seems more of a sign of global economic growth meeting underinvestment (capex averaged only about half the 2014 level over the last 3.5 years) than a sign of ramping inflation. Domestically, trucking and rail capacity was widely reported as tight and getting more expensive in the second quarter.

- Tariffs on steel and other products will filter through the economy, generally resulting in higher prices and/or lower margins, especially in manufacturing.

- Home price appreciation has rebuilt homeowners' equity, setting up the possibility of a wave of mortgage equity withdrawals stimulating the economy at some point over the next few years.

- The foreign exchange value of the U.S. Dollar typically moves inversely with commodity prices, but so far not this year. The dollar's strength makes sense in the context of relatively faster U.S. economic growth and tighter monetary policy (higher real interest rates) compared to other economies. Cheaper import prices benefit U.S. consumers but decrease pricing power for U.S. producers of globally traded goods.

- Historically high levels of global indebtedness and seemingly overindulgent risk appetites in financial markets are akin to a dry forest awaiting an errant spark. Fire is far from certain but impossible to rule out.

- Tariffs, while only one-fifth the size of the tax cut stimulus, could degrade into outright trade war, which would reduce global economic efficiency, slow growth potential, and promote inflation.

- Short term, in every U.S. midterm election year since the 1940s, stocks drew down into the November elections. Historically, it's been a good time for opportunistic portfolio additions; in every case since 1962, the market was up 12 months later, about 30% on average.

Although we can't predict precisely how our portfolio will perform, given the wide range of scenarios, we are confident in the unrealized fundamental value of the companies in our Ballast portfolio.

Portfolio Additions/Deletions

New positions initiated during the second quarter included Penn Virginia, Coherent, and Patterson Companies.

Penn Virginia (PVAC) is an oil and gas company with assets in the Eagle Ford Shale. After restructuring its debt in 2016, the stock had a reasonable balance sheet and rock-bottom valuation. Despite plans to grow 2018 oil production in excess of 100% plus improving well economics and efficiency, the company traded at a notable discount, both relative to peers and to its forward production rates.

Coherent (COHR) has a long history of supplying laser-based photonic systems for a wide variety of applications including materials processing, semiconductor manufacturing, medical instrumentation, and scientific research. More recently, the company has become the leader in lasers used for manufacturing OLED display technology, a new, lucrative market for the company's dominant technology. In early 2018, lackluster reception of the new iPhone X raised doubts about the uptake of OLED screen technology, sending Coherent's stock price down significantly. We initiated a position after the OLED sell-off based on Coherent's limited downside and significant upside from its other businesses, with any future value from the OLED business pure upside.

Patterson Companies (PDCO) is a distributor and service provider to dental and animal health offices. Over the last several years, it faced a painful combination of challenges on three fronts. First, the company undertook a large-scale ERP system implementation, which predictably disrupted internal processes, elevated inventory, ran significantly over budget, and ultimately cost the CEO his job. Second, Patterson ended a long-term, differentiating, exclusive distribution agreement with a maker of high-end dental equipment and terminated 600 salespeople. These were tough business decisions with significant short-term costs, which exacerbated the market's reaction to the third challenge, Amazon's entry into the medical and dental distribution markets. Challenges aside, Patterson has essential and defensible businesses that are undervalued at recent prices. With ERP implementation largely complete and sales force productivity rebuilding, operating results should improve. There is further upside if the market reassesses Amazon or the ended distribution exclusivity.

We exited one position during the quarter: our remaining shares in **XL Group (XL)**, which announced a pending acquisition by AXA Insurance in February.

Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
XOXO	XO Group Inc	54%	COHR	Coherent Inc	-11%
PVAC	Penn Virginia Corp	83%	OSK	Oshkosh Corp	-9%
CRTO	Criteo SA	27%	WRK	Natural Gas Services Group Inc	-10%
NTAP	NetApp Inc	28%	ARRS	ARRIS International PLC	-8%
CRMT	America's Car-Mart Inc/TX	23%	ON	ON Semiconductor Corp	-9%

Top 5 Contributors

XO Group (XOXO) provides soon-to-be brides and new parents with resources through its online platforms, The Knot and The Bump. Strong 1Q18 results highlighted the company's progress toward achieving its long-term objectives, including better than expected margins and solid momentum with its localized sales efforts. Even after the recent price move, we continue to view reward-to-risk attractively. XO Group is a unique asset with outstanding internal reinvestment opportunities and an undervalued core business with TheKnot.com.

Penn Virginia (PVAC) was a recent purchase which performed extraordinarily well right out of the gate. The company develops oil and gas properties primarily in the Eagle Ford Shale of South Texas. When we purchased the stock, it was trading at an unwarranted discount to peers and shared plans to grow production in excess of 100% in 2018. While Permian names have been constrained lately by limited takeaway capacity, Penn Virginia in the Eagle Ford has enjoyed wider spread between Louisiana Light Sweet and West Texas Intermediate.

Criteo (CRTO) is an undervalued growth story we initially purchased earlier this year. The company assists traditional retailers with their online marketing efforts. Through unique data algorithms and bidding capabilities, they are able to offer targeted advertisements that improve ROI for advertisers and relevance for shoppers. Fears about Apple's browser policy changes and Europe's passing of the General Data Protection Regulation (GDPR) have weighed heavily on the stock prior to our purchase, but we view the reward-to-risk ratio favorably for this market-leading technology company.

NetApp (NTAP) has been a long-term holding and continues to be an outstanding performer. We first purchased the stock when fears pervaded that the cloud would render NetApp's storage technology obsolete. NetApp has demonstrated a recurring theme in the technology space, that disruptive new technologies are often additive to existing demands rather than substitutive. The company has managed to reposition its technology and return to top-line growth while boosting profitability and generating substantial free cash flow.

America's Car-Mart (CRMT) sells and finances older used vehicles in small and rural markets in the southern United States, primarily to deep subprime and lower customers. We first acquired shares of America's Car-Mart several years ago at cyclically depressed levels after a rush of new entrants, unfamiliar with the market, aggressively lent without regard to borrowers' ability to repay. America's Car-Mart accepted slower growth to protect its lending standards and took steps to restore its excellent rates of return. Now, as others' losses mount, competition is normalizing. Returns are excellent again and growth, with its proven lending discipline and high prioritization of customer success, is resuming.

Bottom 5 Detractors

Coherent (COHR) builds laser-based photonic systems used in manufacturing and instrumentation applications. We initiated a position in the stock after a substantial sell-off was triggered in January by lower anticipated sales to the OLED screen manufacturing industry. While uncertainty has persisted for OLED investment and the uptake of Apple's iPhone X, we continue to see significant long-term value and a favorable reward-to-risk for the company's leading advanced manufacturing solutions and laser applications.

Oshkosh (OSK) is a specialty truck, access equipment, and defense vehicle manufacturer. After significant outperformance in 2016 and 2017, the stock has lagged so far in 2018. Execution has been solid, but the valuation faces late-cycle multiple compression and concerns of rising steel and aluminum costs, which are primary inputs to their truck and vehicle products. While the stock has been under pressure, the company enjoys attractive long-term opportunities in its defense vehicles and market-leading truck and equipment portfolios.

WestRock (WRK) is a leader in consumer and corrugated packaging solutions. Earlier this year, they announced the pending acquisition of another large producer and competitor, KapStone. Like Oshkosh, the stock has faced some late-cycle multiple compression and rising costs, specifically in transportation in both North and South America. The long-term prospects are supported by attractive and consolidating industry fundamentals, solid demand for paperboard packaging, and a favorable price environment.

Arris (ARRS) supplies network equipment to service providers and, more recently, enterprises through its acquisition of Ruckus Wireless from Brocade. Sentiment on this stock is highly sensitive to the near-term prospect of set-top boxes, the death of which has been predicted for years. Still, the company has continued to generate steady free cash flow across its businesses, which it stewards through reinvestment and stock repurchases. Most recently, the stock has been shunned as pay-TV subscribers showed incremental negative trends in 1Q18.

ON Semiconductor (ON) supplies semiconductors for a very diverse base of data and power management applications including autos, industrial, computing, and others. Along with auto and analog semiconductors peers, recent stock performance has been subdued. However, longer-term secular trends for data and power management solutions in autos, industrials, and consumer electronics are very favorable for ON Semiconductor.

Conclusion

Thanks again for your interest in Ballast. If you have any questions about our firm, our People, or our Process, please feel free to reach out.

Best regards,

Ballast Asset Management

Important Notes and Disclosures

The investment decisions we make for clients' accounts are subject to various market, economic, and other risks, and there is no guarantee that those investment decisions will always be profitable. Clients are reminded that investing in any security entails risk of loss, which they should be willing to bear. The past performance of the firm or its principal is no guarantee of future results.

Some information contained in this communication was obtained from third-party sources. While these sources are believed to be accurate, that information has not been independently verified.

1. The Ballast Portfolio represents the performance of a proprietary account managed in the firm's model strategy that was launched on August 11, 2015. Gross Performance represents the returns of the account after all expenses, but before deduction of management fees. An individual client's account would be subject to the deduction of management fees in accordance with the Ballast fee schedule. Net Performance represents returns net of all expenses and the highest management fee rate (1%) in the firm's fee schedule. The returns achieved by an individual client's account may vary from those reported for various reasons, including management fee rate, timing of cash flows, frequency of rebalancing of individual accounts, and an individual client's restrictions. Past performance does not guarantee future results.

2. The Russell 2500 Index is a market capitalization weighted index of the 2,500 smallest companies in the Russell 3000 universe of United States equities. Returns shown include the reinvestment of dividends and are based on data obtained from FTSE Russell.

3. The Russell 2500 Value Index measures the performance of those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. Returns shown include the reinvestment of dividends and are based on data obtained from FTSE Russell.