BALLAST
ASSET MANAGEMENT

FIRST QUARTER 2019 LETTER

For the first quarter of 2019, the Ballast Composite returned 11.6% before fees and 11.3% net of fees, compared to 15.8% for the Russell 2500 and 13.1% for the Russell 2500 Value.

		Periodic Returns					Annualized Returns	
		2015*	2016	2017	2018	2019 YTD	1 Year	3 Years
Ballast Composite[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	11.6%	5.3%	14.8%
	Net	-8.0%	22.6%	12.4%	-3.2%	11.3%	4.3%	13.6%
Russell 2500[2]		-6.9%	17.6%	16.8%	-10.0%	15.8%	4.5%	12.5%
Russell 2500 Value[3]		-5.8%	25.2%	10.3%	-12.4%	13.1%	1.8%	9.8%

Performance (as of 3.31.2019) *2015 performance from 8.11.2015 through 12.31.2015

For those that have not had the pleasure of reading our previous letters, I grew up on a farm/ranch, and many of the experiences/lessons learned from that upbringing I still remember and apply in my personal and professional life today. One of those lessons comes from a rule that my father had when operating heavy equipment, like a tractor. I first started driving tractors at a much too young age in order to help our family plow, sow and ultimately harvest rice. The first and most important rule I was taught prior to climbing on that tractor for the first time was this – if anything ever happens, turn off the key. The rule was simple, but the lesson profound. That is, when something goes wrong, the first thing to do is stop the action and prevent the situation from getting worse. Once you do that (ideally prior to making too big of a mess), you have time to think, reevaluate the situation and proceed with caution.

In a business where we are paid to take in a significant volume of information and make quick decisions in the best interest of the client, simply "turning off the key" is sometimes hard to do. It is particularly challenging when volatility spikes and the market values of companies move quickly and dramatically. However, our belief is that the priority is to protect our clients from a permanent loss of capital (which is how we ultimately define risk). That is our version of the physician axiom "first do no harm." It is one of the reasons we have a strict rule around selling stocks that violate our original investment thesis. It is also why we have historically had a difficult time keeping up with the type of market we experienced in the first quarter. More on that below.

First Quarter Performance

The first quarter was a great example of an environment in which we would expect to underperform – more market-driven than fundamental. To explain, we will use the table of below. Factors that produced positive returns over seven and fifteen years are printed in green. Factors that produced negative returns over seven and fifteen years are in red. The list is sorted from highest to lowest first quarter return – a quick glance reveals that what worked in 1Q19 was opposite of what has historically worked in the long term. High volatility, high beta, and high trading activity reflect far more about market participants than business fundamentals; a so-called FOMO market (Fear Of Missing Out). By contrast, the underperforming factors are what work in the long run – the sorts of fundamental factors a businessperson would use to assess the value and performance of a company.

Style	Factor/Driver	YTD Ret	1Y Ret	7Y CAGR	15Y CAGR
Market Sensitivity	90 Day Beta	15.7%	4.0%	-6.5%	-3.5%
Volatility	1Y Volatility	12.9%	-7.2%	-10.4%	-7.8%
Trade Activity	Volume to Share Count	12.1%	2.8%	-6.5%	-5.7%
Growth	2Y Fwd Sales Growth (FY) %	8.1%	0.7%	-6.0%	-6.3%
Variability	5Y Sales Variability	7.1%	-5.0%	-7.2%	-6.6%
Leverage	Net Debt/EBITDA LTM	2.8%	-5.7%	-2.6%	-4.0%
Fundamental	3M EPS Revision % (FY1)	1.6%	-1.9%	6.6%	7.9%
Fundamental	3M Sales Revision % (FQ1)	-3.0%	0.9%	11.5%	8.6%
Growth	3Y Net Income CAGR	-4.2%	-3.6%	1.5%	2.2%
Value	Earnings Yield (E/P)	-8.6%	-0.9%	7.5%	8.0%
Value	FCF/Enterprise Value	-9.1%	5.4%	6.7%	10.0%
Profitability	Net Profit Margin %	-13.0%	-5.5%	2.3%	3.3%

Source: Bloomberg

This is a situation that can persist awhile. In times like this, we stick to our fundamental, valuation-oriented, risk-managed strategy because the data and our experience demonstrate that it works reliably over longer periods of time, and especially in down markets. We remain confident in our processes and in the inherent value in our portfolio, with average three-year upside of 85% to our target prices (versus average downside risk of 32%).

What are factors and what do they mean?

Each month, Bloomberg constructs an arbitrage portfolio for each factor by sorting the Russell 3000 stocks from high to low values, buying the top 20% and shorting the bottom 20%, tracking the return over the next month, and repeating. Positive returns indicate the top 20% outperformed the bottom 20%, and vice versa. For instance, higher FCF/EV is better value than lower, so buying the top 20% and selling the bottom 20% ought to produce positive returns over time and, in fact, it has returned 6.7% and 10% per annum over the last 7 and 15 years, respectively. Conversely, high Net-Debt-to-EBITDA increases a firm's risk of bankruptcy, so buying the 20% highest (riskiest) and selling the 20% lowest (safest) ought to produce negative returns and, in fact, this factor portfolio has lost 2.6% and 4% per annum over the last 7 and 15 years, respectively. Lower sales variability tends to indicate a slower growth, less cyclical businesses. The negative long-term performance of 2-year forward sales growth reflects how often expectations for growth stocks get ahead of reality. The 3-month EPS Revision and 3-month Sales Revision indicate how the market is responding to underappreciated or unanticipated favorable fundamental developments.

Economic Backdrop

We are generally sanguine about the US economy, anticipating slower growth than 2018 and would put the chances of recession in the next 12 months at only about one in four. However, we also believe we are closer to the end of an economic cycle than the beginning. The Fed seems to have come around to our view that performing $600b/year in Quantitative Tightening, while also raising rates, was overdoing it. Its current policy stance seems to be data dependent, which we appreciate given our bias toward making decisions based on evidence.

Leveraged loan and high yield credit was too loose into the second half 2018, but issuance ground to a halt in 4Q18. It is slowly recovering, but seems to have self-corrected somewhat, perhaps in part due to weaker economics behind creating CLOs. Otherwise, we have not seen the sorts of broad-based, credit-fueled imbalances that preceded the last two recessions and are inclined to think the sluggishness of this cycle promotes its longevity.

Globally, European weakness could be offset if China stabilizes its growth, which evidence seems to suggest is happening. For instance, the developing market composite purchasing managers index has ticked up into expansion range for the last two months, indicating demand for raw materials of which China is the marginal consumer. Since the start of the year, commodity prices in general are up (CRB +3.7%) while industrially sensitive copper and oil prices are up 13% and 40%, respectively. This may also, in part, reflect India's increasing importance to global economic growth. Standard Charter projects that India's economy will be second only to China by 2030, with the US in third place.

Although we think market predictions should be treated mostly as entertainment, we continue to believe the risk of higher volatility across asset classes is elevated. As for stocks, we remain, as ever, agnostic and data dependent, trusting our "downside first" discipline to mitigate drawdown risk while simultaneously investing in good businesses with strong cash flows, attractive valuations and upside optionality that are positioned to fully participate in a rising market over time.

New Positions Initiated

XPO Logistics Inc. (XPO)

In March, we established a position in XPO, a transportation and logistics company we have followed off and on since 2012. It is the largest third-party logistics (3PL) company in North America, although Amazon's 3PL businesses, which are not reported separately, may be larger. Logistics, its largest line of business, accounts for about 1/3 of its $17b revenue in 2018. The balance is reported as Transportation, which includes the largest North American less-than-truckload (LTL) system, the second-largest US freight broker, and European truckload and LTL businesses, principally in France and the UK. Freight and logistics are a trillion-dollar industry growing at about 2x GDP, mainly due to supply-chain outsourcing and globalization and ecommerce.

The CEO, Brad Jacobs, has built XPO through a series of acquisitions, organic growth initiatives and technology investments aimed at building economies of scale in a fragmented industry while also driving digitization and automation of transportation and logistics. Jacobs, who owns about 16% of the stock, has twice before built leading companies in fragmented industries: first rolling up garbage companies with United Waste and then consolidating equipment rentals with United Rentals. The commonality is fragmented growing markets, scale leverage, technology/analytics and operations management.

Last fall, the confluence of a truthy but misinformed short-seller attack (including a fallacious report from Spruce Point), two reductions in EBITDA guidance, and growth investors' disappointment with the CEO's decision to buy back up to $2.5b of stock rather than chase acquisitions drove the share price from $113 in October 2018 to $45 in December 2018 (which it revisited in March 2019). Absent fraud, which there is no reason to suspect, the valuation makes no sense given the current performance of the business, let alone the potential upside from scaling its investments toward the industry average 20% ROE. Ultimately, we believe a combination of its high returns, the asset light nature of the business, significant revenue growth opportunity and rerating of the stock upon disproval of the short thesis will lead the stock to more than double over the next years.

Exited Positions

We exited several positions in the quarter. Two positions were sold because of a thesis violation – Edgewell Personal Care (EPC) and Roan Resources (ROAN). Perkin Elmer (PKI) and Teleflex (TFX) hit our price targets. Finally, we sold Penn Virginia (PVAC) following an acquisition bid by Denbury Resources (DNR – not owned).

Edgewell (EPC)

Central to our Edgewell (EPC) thesis was that the razor price reset that took place in late 2017, led by Procter & Gamble (parent company of Gillette) in response to competitive pressure from Harry's, would stabilize market share. Under this assumption, we believed Edgewell's Schick brand, with a value price-point, would be able to maintain and possibly grow market share through online sales over time. In contrast, we have seen market share continue to trend negatively as Harry's pushes into the retail shelves, a space traditionally reserved for incumbent players. A second component of our thesis was a near-term margin benefit in the feminine care division driven by consolidating manufacturing capacity into a single facility. As expected, this benefit to margins played out over the last several quarters. However, this benefit was more one-time in nature, and we now see heightened risk to overall margins going forward as a result of continued pressure in razor market share. While the valuation remains reasonable, we determined that our thesis had been violated, and we exited the position in February for a 24% loss.

Roan Resources (ROAN)

We originally purchased Linn Energy (formerly LINN), which ultimately became Roan Resources, in September 2017 for an average price of around $37. Our original thesis on Linn was that it was an underlevered energy company (upstream and midstream assets) with a disciplined board of directors resulting from previous debt holders exchanging their debt position in the bankrupt entity for equity. The company was in the process of shedding non-core assets to further reduce debt and fund rapid production growth in a nascent, promising area (SCOOP/STACK/MERGE in Oklahoma), coupled with an underappreciated growth opportunity in its natural gas gathering midstream assets. Over the course of the next couple years, there were a number of corporate actions (two tender offers, a merger and a spin-off) that made the story much more complicated. All the while, we expected the streamlining process to unlock the underappreciated value of the individual parts. While we benefited from some of the corporate actions along the way, ultimately Roan suffered a production stumble in the core upstream business. That constituted a violation of our investment thesis and we sold the stock. Including the initial purchase, tender offer, spin-off, sale of Riviera Resources and trading around the positions, we ended up realizing a 28% loss on the position.

Teleflex (TFX) and Perkin Elmer (PKI)

We sold positions in both Teleflex (TFX) and Perkin Elmer (PKI) during the quarter. Both health care companies had performed well for us over several years of ownership and subsequently approached their respective price targets. We reduced our position in Teleflex along the way, but ultimately the price more than doubled (up 115%) from our original purchase price in August of 2015. Similar story with Perkin Elmer – we originally purchased the stock in August 2015 and sold the final (albeit reduced) position in February for an 82% gain.

Penn Virginia (PVAC)

We originally purchased Penn Virginia in April of 2018. Our original thesis was that Penn was a dramatically undervalued, oily E&P with a rock-solid balance sheet and significant growth prospects in a region (Eagle Ford shale) that had a structural pricing advantage in the oil that it sold. That pricing advantage was a result of Penn selling oil in the category of Louisiana Light Sweet (LLS) due to its location near the Gulf of Mexico rather than West Texas Intermediate (WTI). Due in part to production growth in the Permian combined with limited pipeline takeaway capacity, LLS crude was selling at a ~$10 premium to WTI. While our original investment in Penn looked like a home run (it doubled from April to July), softening oil prices coupled with the October announcement that overlevered small cap E&P Denbury Resources would acquire Penn in a stock deal spoiled our winnings. The deal was ultimately called off due to shareholder displeasure with the deal, but the damage had already been done. Ultimately, we were concerned that the deal may still go through (and we did not want to own Denbury), and thus we sold the position. We realized a 15% profit on the initial purchase.

1Q 2019 Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	**Total Return**		**Name**	**Total Return**
COHR	Coherent Inc	34%	**ROAN**	Roan Resources Inc	-27%
HBI	Hanesbrands Inc	44%	**CRTO**	Criteo SA	-12%
SOI	Solaris Oilfield	37%	**GME**	GameStop Corp	-17%
EXP	Eagle Materials	38%	**DOX**	Amdocs Ltd	-7%
CRMT	America’s Car-Mart	26%	**DBI**	Designer Brands Inc	-9%

Top 5 Contributors

Coherent (COHR) was a leading performer in 1Q19. The company announced mixed quarterly results and outlook, but better prospects for OLED adoption in the display industry boosted share performance over the near term. While the timing is unclear, a move by Chinese display manufacturers to challenge Korea’s dominance in OLED-type displays could produce significant earnings potential for Coherent.

Hanesbrands (HBI) was a solid performer in the quarter, bouncing back from a difficult December. Fourth quarter operating results proved better than expected, driven by double-digit growth in the Champion brand. We are very encouraged by management’s focus on reducing debt, as they make progress toward 2-3x leverage target.

In January, **Solaris (SOI)** reported strong top- and bottom-line results and initiated a dividend. Notably, this relatively undiscovered company has outstanding growth opportunities and a great balance sheet. During the quarter, sell side analysts from Goldman Sachs and B. Riley FBR initiated coverage, as visibility continues to trend positively.

Eagle Materials (EXP) stronger housing data and continued infrastructure spending was a tailwind, but the primary driver was a one-day gain of 15% on news that activist fund Sachem Head Capital acquired a 9% stake. SHC urged Eagle’s board and management to undertake a strategic review of breaking up and selling its three divisions. Sale of its underperforming proppant business could lead to a rerating.

Following a strong year in 2018, **America’s Car-Mart (CRMT)** was again a top contributor in 1Q19. Car-Mart continues to execute well and benefit from a normalizing competitive environment, in which its business model’s competitive advantage is once again producing strong ROIC and resuming growth.

Bottom 5 Detractors

Roan Resources (ROAN) underperformed on rising concerns over lower-than-expected pressure on wells drilled from pad sites, which would undermine expected returns in the SCOOP/STACK play. As we discussed in the ‘Trades’ section above, we exited Roan Resources because our thesis was violated.

Criteo (CRTO) sold off due to an article published on March 22 by *Adweek* discussing Google’s plans to make sweeping changes to Chrome’s advertiser-facing tools. Although the article acknowledges that the “conversations are still just internal discussions at Google,” several sell-side analysts downgraded their ratings on Criteo. We believe it is too early to make such a call, and even under sweeping changes, we think potential workarounds for third-party advertisers seems plausible.

GameStop (GME) was down 17% after abandoning plans to sell the company. GameStop’s timing for shopping the company couldn’t have been worse. Shortly after announcing their strategic review, the market for new high-yield credit evaporated. Whether or not they would have successfully sold the company under different circumstances is not clear, but access to credit would have been imperative to GameStop as an LBO target. The prospects were dimmed further by new streaming video game announcements by industry players, including Google’s entry into the market with Stadia.

Amdocs (DOX) traded lower in January after a short report published by Spruce Point criticized many facets of Amdocs’ disclosure and accounting and drew, in our opinion, faulty conclusions. Our team discussed the report in detail. We believe many of the assertions made by Spruce Point have reasonable explanations and were made without deep-enough understanding of the nature of Amdocs’ business and past acquisitions. More importantly, Amdocs has weathered a very difficult cyclical period for telecom spending and managed to grow organically last year, even when the AT&T account (Amdocs’ largest customer) was down 15%. We believe this underappreciated growth is a direct result of integrating strategic acquisitions made over several preceding years.

Designer Brands (DBI), formerly known as **Designer Shoe Warehouse (DSW)**, sold off after a 4Q earnings miss added to confusion related to the vertical acquisition of Camuto. We expect these misunderstandings will be alleviated in coming quarters, contingent upon management’s ability to deliver on its strategy outlined in the Investor Day in March.

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.

Thanks,

Ragen Stienke

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 SMID Composite represents the performance of a composite of accounts invested in the firm's model strategy that was launched on August 11, 2015. Gross Performance represents the returns of the composite 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. In April 2019, Ballast transitioned from calculating performance based on a proprietary account to a composite of all accounts employing the strategy. The Ballast SMID Composite should be the sole source of information used when evaluating past performance of the strategy. 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.