March 30, 2020

Dear Fellow Investors,

Above all, we hope you and your family members remain safe and healthy. Events and information flows are moving fast, in ways unprecedented in our lifetimes. We wanted to share some of our thoughts about managing the uncertainty and how we are responding from an investment viewpoint.

Key Takeaways

- Despite the Federal Reserve's financial backstop, some companies will be permanently impaired and will not survive when increased leverage and thin margins meet the economic impact of Covid-19 (C-19), whether it lasts one quarter or six.

- Passive Investment Funds (including ETFs) cannot discriminate between permanently impaired stocks, potentially failing companies, and those businesses that will survive and thrive. Passive investors are exposed to the entire basket of stocks, a particular problem in small caps.

- Active management driven by in-depth research on business fundamentals can identify companies with the financial wherewithal to manage through the C-19 economic impact and come out with stronger competitive positions.

- Stocks of many high-quality, high-return businesses have plunged to levels that fit our discipline of avoiding new investments with more than 30% downside. Measuredly, we are selectively adding stable, long-term compounders that were previously out of reach.

Where we are

For the past few years, we positioned the portfolio to benefit from the strength in the real economy, while being patient and selective when adding higher-quality companies that could defend against an eventual market rout. We are now in the midst of a Black Swan Event; the C-19 virus. Vulnerabilities that have been present for some time, are now fully exposed. In the context of investing, that is excessive risk-taking, too much debt, too little savings, and over-optimization of financial strategies.

The rally in the markets last week was largely a response to the Fed's historic net $2.5 trillion-plus liquidity backstop, along with the passage of another $2.2 trillion in fiscal stimulus. We believe the Fed's response mitigates the possibility of the financial system seizing, causing a cascade of insolvent companies to fail, dragging solvent companies and the economy down with them. We do not know how much of the market

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rout is attributable to that fear and forced selling, but certainly a sizable portion. Fiscal stimulus, notably absent from the response to the Great Financial Crisis (GFC), should mitigate damage to the real economy from C-19.

Calling the bottom

Calling the bottom is not in our circle of competence. However, share prices have declined sufficiently to create lots of value-oriented opportunities. Some of these companies represent real value and we are devoting significant time to research. Narrowing credit spreads will be an important indicator for the bottom, but not until the actual impact of C-19 is more predictable. The news cycle lags the actual spread of the disease by 10-14 days, and it is sure to get far worse before it gets better, leading to increasingly dire expectations for the real economy and more emotional reactions by market participants.

Time to get active

Many companies remain too levered to withstand the analytical uncertainty in the range of C-19 outcomes, not to mention the swoon in energy prices. These are reasons to be active and discriminating when selecting stocks and not simply reallocate to equities via indexes. Quantitative investing might do better than passive, but it is limited by the lack of historical precedent for C-19—what worked in the GFC following the Fed's injections of liquidity will not work as well this time around. We believe fundamental, bottom-up analysis is the best way to sort the winners from the mere survivors and losers.

What we are doing

We are researching companies from the bottom-up, estimating trajectories under various C-19 outcomes, actively looking for safe value, ideally in long term compounders. We are shifting from a quality and stability bias to gradually positioning for an eventual rebound in the hardest-hit stocks, though only in cases where we have confidence in the business model's returns and some visibility on fundamental stability over the next few quarters. As always, we look to limit the downside in any position we initiate to less than 30% with at least 3x the upside.

We see many opportunities that have 4-5x upside or more, but fewer meet the 30% downside. Our goal is to capture as much value as is prudently possible, not to call the bottom or swing for the fence by loading up on the riskiest stocks that will rip if they are still around when the bottom is apparent. Most importantly, we remain disciplined with our investment process throughout these volatile periods. History has shown that markets will eventually recover and reward patient investors.

If we can provide further information or be of any assistance, please contact us. Continue to stay safe.

Best Regards,

Ballast Asset Management