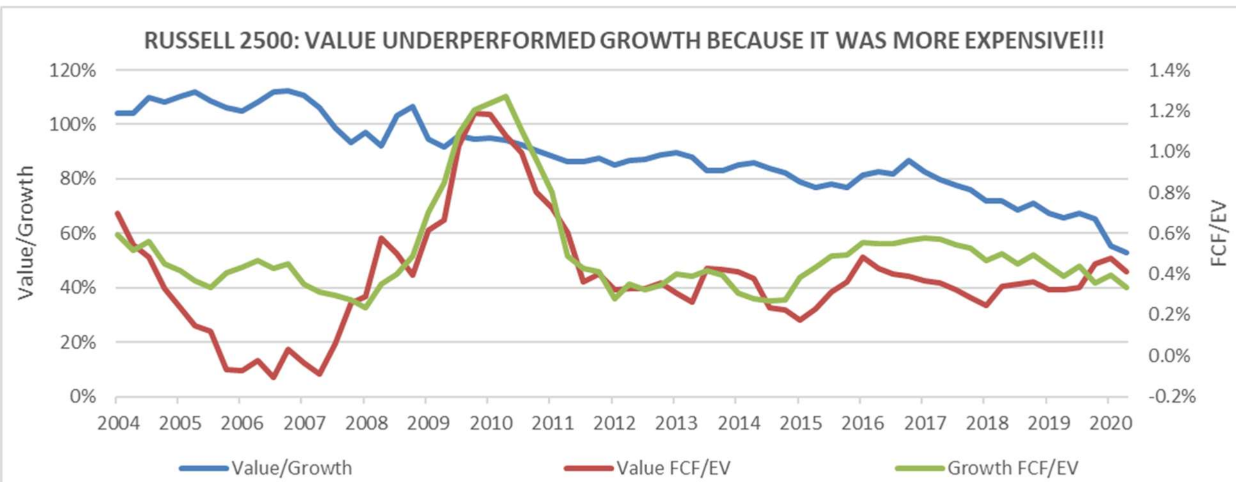
Thoughtful Investors Managing with Focused Agility

In our view, the value/growth distinction is a narrow academic construct of much less economic use today than when Fama-French first introduced High Minus Low (HML). Before widespread computing, sorting stocks based on Market/Book was a mathematically tractable way to prove the commonsense hypothesis that cheap "value" stocks outperformed expensive "glamour" stocks. It worked for a long time until automated investing arbitraged cognitive/behavior biases out of the short-term excess return pool, but it was always just a proxy. Evidence from the Russell 2500 Value and Growth indexes suggests that this naïve value is permanently impaired. Value underperformed growth because it was more expensive on the metrics that matter, for instance, free cash flow. Moreover, as the economy has grown more intangible, naïve value tends to concentrate in capital intense, asset-heavy businesses because those investments are capitalized to book value. In contrast, competitive-advantage-sustaining investments (like R&D, digitization, and branding) are expensed and do not show up in book value.



Source: Bloomberg, Ballast computations

In contrast to naïve value, our "valuation investing" process boils down to:

1. Estimating the growth of cash flow ROI over three years,
2. Forecasting valuation multiples for multiple scenarios,
3. Investing when base case reward is three times greater than losses in the risk case,
4. Subject to a maximum downside of 30% and a strong balance sheet, and
5. Selling if our investment thesis is violated or the target valuation has been met.

Our investment process is designed to mitigate cognitive biases, including team-based decision making with individual position accountability. Our research combines independent thinking, proprietary research, data-driven analysis, and qualitative business judgement to identify companies capable of internally compounding at above-market rates that are trading at unwarranted discounts.

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