Thoughtful Investors Managing with Focused Agility

It is hard to believe the S&P 500 is exactly where it was a year ago, but it is true, we have been running in place. Back then, the market had just recovered from the Stealth QT-induced 4Q18 drawdown of 20%. Now, QE plus fiscal stimulus have shot the market 28% higher after the insanely quick Covid-19 induced 34% sell-off; talk about volatility. Of greater concern, the S&P 500 is still 15% below the February peak thanks to the dark magic of compounding on the downside, which brings us to the first principle: manage downside risk. We do this in two primary ways.

First, our Fundamental Risk Model (FRM) helps us manage aggregate exposures. Frankly, the FRM did not help us much with CV-19; it does not explicitly model pandemics. It did, however, accelerate our ability to position away from industries and companies it showed were most at risk in terms of revenue, geography, and supply chain and helped guide our decisions on the seventeen new stocks now in the portfolio. We added a mix of companies: great businesses that usually trade at prohibitive valuations, solid businesses at great values, and a few run-of-the-mill businesses that were priced for chapter 11. Active high grading resulted in 30% turnover for the quarter—quite a record compared to our normal 20-30% annual turnover.

Second, downside risk management is embedded in our stock selection process. We analyze a range of possible fundamental and valuation outcomes over one and three-year horizons and only invest in the stocks that have at least three times as much upside in the base case as we estimate potentially losing on the downside. Notably, each of the new names we added had reward-to-risk between 6-10x, which is slightly better than the portfolio's overall 6x reward to risk.

Our normal process helps us manage through periods of "low visibility". We do not rely on company guidance for the next quarter or year, instead we build our theses on proprietary bottom-up analysis. We use business judgement to cut through the haze, preferring approximately correct long term estimates to the false precision of a series of precise short term estimates.

As a result, the current portfolio has favorable fundamental characteristics relative to both the Russell 2500 and the S&P 500, with faster sales growth, comparable ROA, and similar leverage. Although BAM's SMID portfolio ROE is lower than the S&P 500's, without going into the math (and we are happy to dive into this further if you would like), this is more than offset by lower valuations.

We currently own 51 businesses with sound fundamentals, which, regardless of short-term market action and with about a 30-40% reinvestment rate, have the potential to compound intrinsic value over time at roughly 15%.

Key Metrics	**BAM SMID**	**R2500**	**S&P 500**
Net Margin	15%	4%	18%
Asset Turns	0.6x	0.5x	0.5x
ROA	9%	2%	9%
Assets/Equity	2.7x	5.6x	3.6x
ROE	**24%**	**11%**	**34%**
EBIT/Interest	3.4x	2.6x	7.7x
Net Debt/EBITDA	**1.3x**	**3.2x**	**1.3x**
Debt/Assets	30%	32%	31%
P/E	9.9x	23.7x	19.1x
NTM P/E	16.4x	21.4x	20.1x
FCF Yield	**5.8%**	**2.9%**	**5.2%**
P/B	1.2x	3.4x	6.2x
Dividend Yield	1.5%	1.6%	1.9%
5Y Sales CAGR	13%	13%	10%

Source: Bloomberg, Ballast computations
Note: weighted by market cap or position size, missing data points omitted from numerator and denominator

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