



Thoughtful Investors Managing with Focused Agility

For the third quarter of 2020, the Ballast Portfolio returned **4.1%** before fees and **3.8%** net of fees, compared to 3.5% for the Russell 2500 Value. The portfolio is currently 97% invested in 50 companies.

		Periodic Returns					Annualized Returns			
		2015*	2016	2017	2018	2019	YTD 2020	1 Year	3 Year	5 Year
Ballast Portfolio¹	Gross	-7.6%	23.8%	13.5%	-2.2%	16.1%	-12.2%	-6.6%	1.4%	7.2%
	Net	-8.0%	22.6%	12.4%	-3.2%	15.0%	-12.8%	-7.5%	0.4%	6.1%
Russell 2500 Value²		-5.8%	25.2%	10.3%	-12.4%	23.5%	-18.4%	-12.6%	-2.7%	4.6%

As usual, financial markets have been tumultuous year-to-date, especially relative to current events that feel unprecedented. Our YTD absolute return is not reflective of what we expect from our strategy over time, but to the limited extent short time frames are indicative, our relative returns show it is working as intended. The evidence suggests that prevailing conditions have or are close to shifting in favor of small cap value generically, which, in our opinion, should be very favorable for our specific SMID cap implementation over the next few years at least. We discuss a few of the critical points in the body of this letter.

Portfolio Top and Bottom Performing Positions for the Third Quarter:

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
HZNP	Horizon Therapeutics	+40%	TPL	Texas Pacific Land Trust	-24%
HBI	Hanesbrands Inc	+41%	COHR	Coherent Inc	-15%
PHM	PulteGroup Inc	+36%	EPR	EPR Properties	-17%
CNXM	CNX Midstream	+45%	EAF	Graftech International	-14%
HUN	Huntsman Corp	+24%	CBNK	Capital Bancorp	-12%

Lessons Learned: A Middle School Vending Machine Venture

While in high school, I bought a used vending machine and put it in the local middle school to make money to pay for my first car. The snack machine was the first and only in the school, no competition, approximately infinite demand, the venture was a sure-fire mint. However, upfront inventory cost was a significant challenge, I didn't really *know* what demand would be and I didn't have much money to risk (that's why I went into business), so I had to start small, buying just a few of each goody (chips, chocolate bars, etc.). Sales started slowly, few people knew about it. (Marketing matters, who knew?) Over time, as students found it, word spread, the coins started rolling in and the inventory flew out. With a better sense of demand, I rolled my cash profits back into more snacks, replacing what I sold and adding more and more each time. Eventual demand justified a serious inventory investment and the two-hour round trip to the local Sam's Club for bulk discounts. Once it started to plateau, demand proved to be quite stable and I was able to save time and gas money by carrying more inventory and making fewer trips. Like I said, sure-fire! Until, that is, enough parents and teachers complained about all the sugary "junk food" students were eating, and my operation was shut down. The car note did not go away and I had a lot of snacks to get rid of. That was my first lesson in inventory cycles and leaving room for unknowns – especially events that seem to come straight out of the blue, like those parents.

Inventory and Economic Cycles

The impact of COVID-19 on production and supply-chains should help jumpstart the tangible goods economy—basically the vending machine problem in reverse. Demand has been resilient all considered, but production has not, leading to shortages and stock-outs in some cases. This is not at all similar to panic toilette paper purchases. It's been scary out there at times, but we are confident fundamentals for TP demand did not change much. Buffer inventory simply moved from stores and warehouses to private homes. While we hesitate to apply anecdotal evidence to the macro, we have witnessed an untold number of situations where parts/products are simply unavailable. There are obvious

things like workout equipment for use at home, electric drills from Home Depot and computers (mostly a spike in demand) resulting from COVID. What we are talking about are random things like

- Grill replacement parts – waited on new burners for 5-months;
- Windows – we just got a call on a replacement window we ordered in June;
- Fishing poles/Tents – very few available in Dallas;
- Cars – good luck getting a deal of any kind on a new car right now, or finding the used one you want;
- Auto Parts – took 2-weeks to get a new fuel pump;
- Insurance claims – took 2-months to have a claim processed and vehicle repaired;
- P&C rates –brokers tell us that pricing in the P&C insurance market is at multi-decade highs.

The point is, any breath of an economic recovery, which we are seeing today, raises the question around magnitude and sustainability; we believe there is going to be an outsized positive effect in production and that manufacturing based companies are poised to be some of the greatest beneficiaries.

Side Bar - History of Inventory Cycles

Until about 1990, economic downturns were usually led by a spike in inventory/sales. Demand slowed faster than factories and retailers could react. Inventory cycles get much less attention today because the relevance is much narrower and the impact on business cycles less consistent. Increasing economic weight in service and intangibles, adoption of supply-chain management and lean manufacturing, and now digitally-enhanced operational transparency and demand analytics killed the old relationship. Nonetheless, inventory cycles are still very relevant to the tangible goods economy, particularly cyclical companies with big ticket items or continuous flow manufacturing where stopping and starting (like steel and glass) is expensive and relatively slow.

The duration of the expansion, prior to COVID-19, would normally indicate inventory levels closer to the point in the cycle where high-fixed cost companies had some incentive to over-produce in order to maintain cost-absorption and hit near-term Wall Street estimates. For a while, passing inventory off to independent retail channels works. Technically, by accounting standards, selling a vehicle to a car dealer is a genuine sale even though it is disconnected from final demand. The turn in the cycle occurs when falling retail prices help to clear excess inventory, then manufacturing margins contract because the channel will not take more units without discounts, and then lower production deleverages fixed costs. Finally, the manufactures take the pain, cut production and lay people off. This was multiplied by all the related businesses and similar industries and it added up. Automotive manufacturing has been a good example in past cycles.

At the start of 2020, inventory was fairly-well balanced following rationalization that started with the economic pause in 2018. This cycle was playing different than prior ones where we have direct experience – maybe any. Grinding, slow but mostly steady real growth seemed to be facilitating well-balanced and robust domestic economic growth, even as it left average duration of prior expansions in the dust. Even the usual suspects (auto makers) had been role models of restraint this cycle – retail auto inventory/sales entered 2020 at the lowest level since 2009. Against that economic background, the automotive price/margin outlook was very favorable.

The auto industry was not alone. Homebuilders, the no-deliberation, convict-and-throw-away-the-key culprits last cycle, were another paragon of supply discipline. Inventory management looked quite rational entering 2020. Many companies were even generating positive free cash flow instead of plowing it all back into new land purchases at ever rising prices. Moreover, millennials seemed to start to buy homes, and suppliers were shifting mix to meet the demand. The last 5 to 10 years have produced some remarkable contrasts relative to the post-internet bubble recovery. We did not see any glaring

distortions from loose interest rate policy, and three rounds of Quantitative Easing (QE) did not seem to hit day-to-day prices much, if at all.

Then COVID-19 pulled the production line's emergency brake, and we got an inventory correction on steroids. \$3T of stimulus to keep people at home kept consumers' pockets full. Online retail penetration accelerated, and demand remained strong, especially relative to negative supply growth (excluding money supply [M2] which spiked nearly 30%).

Supply chains and channel partner buffer stocks evaporated. Now, despite having to work around COVID-19 as a long-term issue, jobs are slowly coming back to support demand on the consumer front.

Amazon is not the only business to experience faster technology adoption. There are many examples across the portfolio of ways companies are using technology to deal with remote work in the office, from finally automating quarter-end close, to virtual conferencing. Face-to-face will always be important, even essential in some situations, but online meetings are a much more efficient default option when you add up the wasted time, money and energy spent flying around because that's how it was always done. It will be a tricky cross-over from government stimulus to aggregate income from employment, but net, net, the backdrop seems okay.

Small Rotation

And that leads to the second consideration we will opine on in this letter – the rotation from Large Cap Growth to Small Cap Value.

We are often asked three main questions around the Large Growth versus Small Value dilemma.

- How/Why did we get here?
- What makes it change
- When will it change?

How did we get here?

At the most basic level, the value (little “v”) or worth of something, is directly tied to how much money that thing will make over a period of time. From an academic standpoint, the aggregate cash it will generate over time, discounted by some rate (i.e., the cost of capital). The two things that can affect the value of that asset, are: how fast it grows (cash) and the discount rate (annual return you require versus the risk you are taking). These two things are key in helping us compare the worth of two different assets/companies.

Here is an easy example: Netflix (NFLX) and XPO Logistics (XPO), which is a logistics/shipping company. Both are expected to generate roughly the same amount of Free Cash Flow in 2020 (\$1.25bn for Netflix versus \$1.1bn for XPO). Netflix has an Enterprise Value of ~\$225 billion, while XPO’s is \$16 billion. So, the simple math tells us that at this level of profitability, it will take 181 years to earn the currently proscribed “value” of Netflix in cash versus 15 years for XPO, and that’s without consideration of the cost of that capital/the required rate of return. However, investors expect Netflix to grow much faster than XPO, which accounts for part of the difference.

In a period when growth is hard to find, companies that are growing are increasingly prized. In addition, when interest rates are extraordinarily low, the rate at which you discount future cash flows is also low. As a result, companies that generate a lot of cash today are not as attractive as companies who are likely to generate significantly higher levels of cash tomorrow. There are some fairly simple mathematical “solves” for this, but that is inherently what starts the wheel rolling and shift to “growth” investing. After that fundamental shift, non-fundamental factors exacerbate the situation. Think momentum, liquidity, economic uncertainty.

Continuing our NFLX/XPO example, Netflix has been growing revenue at 20% to 30% for over a decade. Over the last 10 years, that level and consistency in growth has been hard to find. That scarcity is, in part, a reason for the premium valuation. Then, the global

pandemic hit, and growth was even harder to find - and companies not affected by COVID-19 were fewer still. And then, the Fed and Uncle Sam put the aforementioned \$3 trillion in the system. Much of that found its way into individuals brokerage accounts (think Robinhood), which increased the demand for stocks. While we have not been to many cocktail parties since March, I imagine the stocks that would be talked about in those circles would be Netflix, not XPO. That non-fundamental factor (liquidity, momentum, excitement) is what leads to serious disconnects (i.e., bubbles).

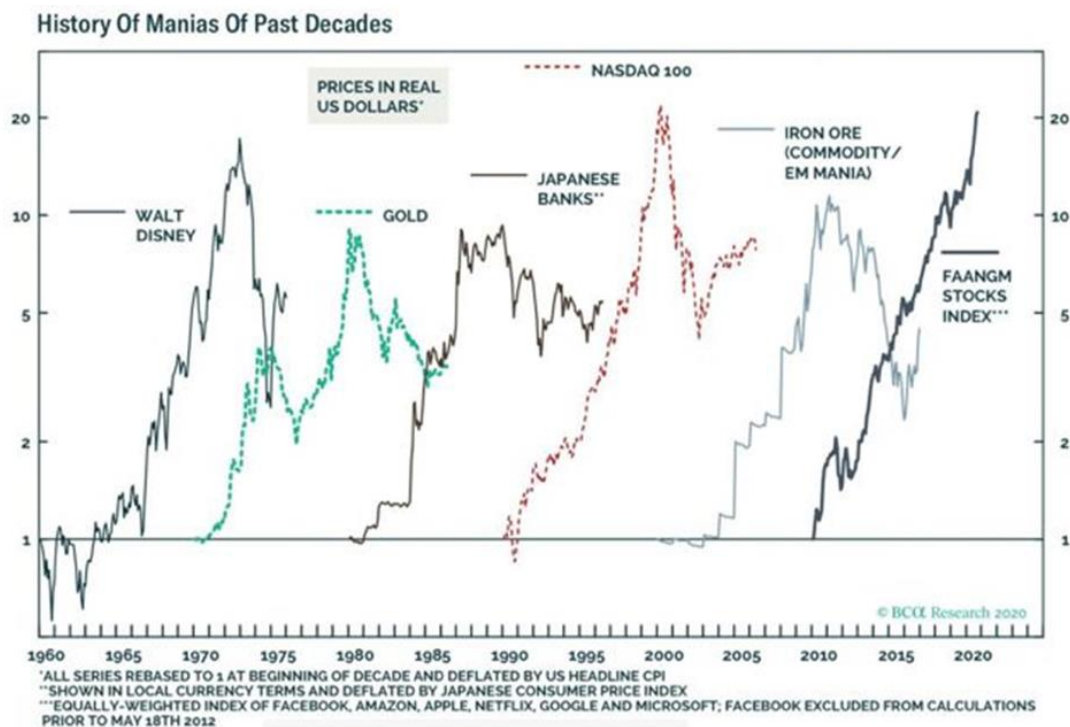
What Triggers Rotation from Growth to Value?

There are several straight-forward possibilities. First, the conditions above should at some point reverse, with more broadly distributed economic growth and/or higher interest rates, which eventually follow in consequence of broad economic recovery or in response to rising inflation expectations, with or without higher economic growth. Second, anything that changes the spectacular expectations for “can’t miss growth” stocks, that is the megacap tech and other potentially excellent business models like Tesla, that have driven large cap returns this year. A few specific risks to the “spectacular business and great stock bubble” include more political pressure, especially anti-trust, tightening liquidity, too much or too little stimulus (basically anything that changes the prevailing political or economic regime). Eventually, a point comes when valuation is so stretched that normal price fluctuation triggers a few significant market players to sell in anticipation of a change in momentum, which becomes self-fulfilling. In any case, the non-fundamental and fundamental factors combine in the same way they did on the way up, only in reverse. Following the Dot.com bubble (from the end of 1999 to the end of 2006), **the NASDAQ declined 38% while the Russell 2000 Value (small cap value stocks) appreciated 186%.**

When Will the Change Happen?

Obviously, no one knows for certain. Timing the market is notoriously difficult. However, what we can look to is history and empirically where we are today. Below is a wonderful chart we saw in a strategy piece from BCA Research that we recently read. Charts like

this send alarm bells throughout our office. Our goal is not to perfectly time markets, but to be forward thinking and prepared so that we have a chair when the music stops.



For the record, our belief is that the economic recovery in the United States will continue and accelerate in 2021 for all the reasons we wrote about in the first paragraphs. We also believe that pricing power brought about by squeezed supply chains and the dramatic influx of liquidity (that which has already happened, and that which will likely happen in the form of new stimulus), leads to higher levels of inflation than we have seen in the last decade or so. If we are right about either/both of those, we should begin to see a rotation from Growth to Value and Large Cap to Small Cap toward the end of this year and/or into 2021. That and \$1 will buy you a bag of ice at Buc-ee's (a popular convenience store in Texas).

As always, our team is available to discuss in greater detail, including portfolio changes we have made this year. Until then, our team is singularly focused on maintaining and improving our portfolio of solidly capitalized companies, with capable management and

increasing economic profits. We balance growth, quality, and favorable valuation to protect the fundamental downside, which tends to mitigate downside volatility and reliably generate excellent long-term returns.

We appreciate your continued investment and confidence in our team and strategy. Wishing you and your families continued good health during this unprecedented time.

Regards,

Ballast Asset Management

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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 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 composite. The composite performance should be the sole source of information used when evaluating past performance. Past performance does not guarantee future results.

²The 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.