Thoughtful Investors Managing with Focused Agility

For the first quarter 2021, the Ballast Portfolio returned **25.8%** before fees and **25.6%** net of fees, compared to 16.8% for the Russell 2500 Value. The portfolio is currently 97% invested in 51 companies.

		Periodic Returns							Annualized Returns		
		2015*	2016	2017	2018	2019	2020	1Q 2021	1 Year	3 Year	5 Year
Ballast Portfolio[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	16.1%	12.5%	25.8%	112.5%	15.8%	17.4%
	Net	-8.0%	22.6%	12.4%	-3.2%	15.0%	11.4%	25.6%	110.5%	14.6%	16.2%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	16.8%	87.4%	10.8%	12.1%
Russell 2500[3]		-6.9%	17.6%	16.8%	-10.0%	27.7%	20.0%	10.9%	89.4%	15.3%	15.9%

Performance (as of 3.31.2021) *2015 performance from 8.11.2015 through 12.31.2015

One question we have gotten quite a bit recently is: Has the easy money already been made in stocks? It is a simple and perhaps even fair question. Our initial and candid response was that it did not seem all that easy back in March, April, and May 2020. Of course, what that question is really getting at is: Can the rally continue? Can the nearly vertical V-shaped recovery continue? How much equity upside remains? What about the economy, stimulus, national debt and inflation? We all innately prefer to avoid uncertainty, especially after a shock followed by a statistically possible yet intuitively staggering average six-year total return CAGR packed into just 12 months – while much of the world is still in more than normal disarray. So, will it continue?

We think the short answer is “Yes,” and we think Ballast’s current SMid portfolio has more than 100% upside based on our fundamental business estimates and prevailing assumptions baked into equities in general. While equity markets are no better at forecasting than people, the historical record is quite clear: The current outlook is extremely favorable for smaller value stocks. Prospects for our SMid value strategy are even more promising given recent extreme underperformance of “quality” small caps and the increasing problem of naïve, academic value methodology stocking small cap value indexes chock full of zombie companies.

Our strategy should also benefit as the recovery matures, which historically leads to quality outperforming. Given just how much quality has lagged the zombies and lottery tickets, we were pleased to see our individual stock selections enabled us to overcome the headwind. Our process remains focused on finding well-run companies with good prospects, solid balance sheets and sustainable returns at attractive valuations. The obvious aim of these criteria is downside risk mitigation coupled with finding stocks that offer asymmetric reward-to-risk profiles.

The point of a downside-first framework, and our entire portfolio "manufacturing process" for that matter, is to mitigate downside risk. To date, outperforming in market drawdowns has come without sacrificing long-term upside. More subtly perhaps, downside-first makes the tough questions confronted in a drawdown just a bit easier. It reduces emotional reactivity within the team and puts distance between distracting, unpredictable short-term price movements and making consistent, informed business judgements on the issues that will drive the stock prices of our companies over time. Our buy/sell decision process, which is empirically validated by over a 15-year record of each and every decision, lets us hold positions with confidence by forcing us to quickly accept and fix the mistakes. The impact is hard to quantify, but even a tiny amount of consistent behavioral alpha has an exponential impact on the CAGR potential of compounding both valuation and business fundamentals over time.

With that, the rest of the content of this letter contemplates several new risks and opportunities that have sprouted up over the last year. Those include:

- The crisis-bred zombie companies
- Value Indexes catch zombies better than ever
- Inflation
- The Outlook for Small Cap Value and Quality

Fear the Zombies

Now that the first big move is out of the way, we believe it is the time to fear the zombies – companies who may still exist, but for which the equity value is impaired. These companies' operations may look unchanged, and most of their employees still have jobs and pension plans, but the equity value is left to wander around aimlessly.

More formally, zombies are not sufficiently profitable to service debt and make investments for the future at the same time. A zombie company might have a high ROE, but it will reflect too much debt leverage relative to the earnings power of its assets. Even with great management, these types of businesses are often terminal, at least as independent companies. The stocks usually trade at low price-to-book multiples, reflecting low returns and mediocre prospects or a dearth of intangible assets – or both, as it amounts to the same thing.

Here is an example. Coming out of the Great Financial Crisis of 2008, General Motors was in crisis and near potential extinction. The business eventually survived, due to a liquidity injection from Uncle Sam, and a reorganization that wiped out prior equity owners. The new stock was at about $37 at the end of 2010. Guess where it was at the end of 2019? Yes, still at $37. The total return was 27% through dividends, etc., while the S&P returned 210% and the Russell 2500 Value returned 133%. It was a zombie.

A second example is the KBW bank index. The index peaked at roughly $118 at the end of 2006. Sixteen short years later, it finally got back there. In fairness, there was a nice trade there if you picked it up on the bottom, in which case you would have realized about an 86% return in the next

12 months (the easy money). How about Homebuilders? Same thing – nice bounce off the bottom, then zombies.

This time is NOT different. There are a number of companies and industries who, through no fault of their own, saw their businesses decimated last year. Thanks to Uncle Sam and Aunt Fed stepping in, many more survived than would have otherwise. However, their balance sheets are now stretched/decimated, and they are still losing money, even while hope springs eternal for a recovery from Covid shutdowns. The market is full of zombies.

Here again are some examples:

- Airlines
- Cruise Lines
- Office REITs
- Theaters
- Theme Parks
- And on, and on

So, let's look at the four major publicly traded airlines in the US – Southwest, Delta, United and American. Collectively, they took on over $16 billion in Net debt in 2020 to survive, along with a bunch of help from the government. In aggregate, the Street thinks they will lose another $11 billion or so in 2021. In 2019, before the downturn, they collectively generated about $12 billion in earnings. So, if we assume that 2022 will be a "normal" year and those four airlines return to historical levels of profitability, it will take until 2024 for the real equity value to be the same as it was at the end of 2019. Said differently, they have three years of focusing on balance sheet repair (not to mention deferred maintenance) before equity holders will begin to benefit. Yet collectively the stocks have recovered to within 15% or so of their pre-pandemic levels. Said plainly, we believe the Airlines are zombies.

How about cruise lines? Worse story – they too took on over $16 billion in Net debt and are also expected to lose over $11 billion in 2021. Based on the same analysis, you are looking at 2027 before getting back to previous equity values. And yet those stocks too have recovered dramatically off the bottom.

Zombies Flock to Passive Value Metrics

Low-multiple-value inspired the ancient epithet "value trap" – a stock that looks cheap for good reason. It has always been an issue for value indexes, but digitization has made it much worse.

The financial theories used to justify passive investing were developed long before inexpensive computing and relied on assumptions to make the math tractable. One kludge was using Book-to-Market (which compares accounting and market estimates of owners' equity, e.g., P/B inverted) as a screen for value, which was reasonable at the time because the economy was driven much more by physical assets than intangibles. It was never really that simple, but the ratio of gems/zombies was high enough that it worked well enough for large portfolios.

Today, any company that wants to compete long-term needs to be a tech company. Physical assets are still important, but more and more economic value derives from information and analytics. And unlike a factory, digitally derived assets are hard to discern. Much of the cost is expensed as incurred and disappears from the balance sheet, basically the same accounting Coke and Nike have always used for brand investments. Brand equity is not reported on the balance sheet or in book value, but it still contributes to the sort of abnormally high accounting returns that justify high price-to-book multiples.

Said plainly, we believe passive ETFs and index funds, especially value indexes, have hidden risk of exposure to zombie stocks. So, if one simply bought a basket of stocks in March 2020 (say, a Russell small cap index) then you enjoyed a tremendous beta rally. Now, you own as basket of really good companies, decent businesses, and zombies.

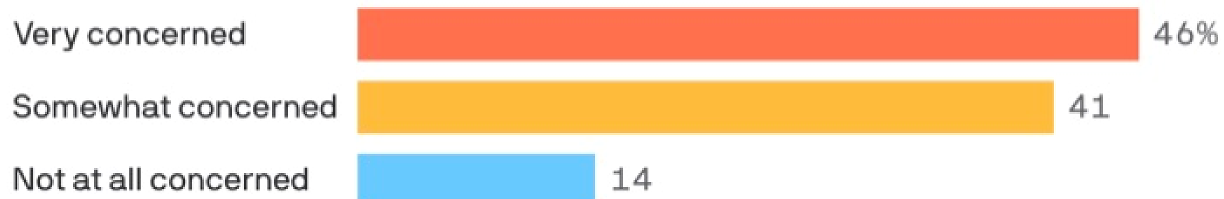
We believe now more than ever is the right time to employ active managers to help you avoid those zombies. Are we talking our own book? Absolutely we are – just like we were coming out of the Great Financial Crisis, and before that, the Dot.Com recession.

Inflation

As the world emerges from lockdown, rebuilding of supply chains along with slower capacity expansion across many industries are causing prices for many tangible goods to rise. The earnings impact varies company by company, depending on the industry, competition, and location in the value chain. Where output capacity is constrained and inputs are readily available, prices and margins will expand, and vice versa. It is basic economic supply and demand. Is that inflation or a price signal? Hard to say, but if it creates the perception of inflation risk, the probability of higher actual inflation rises. And surveys suggest that Americans are increasingly worried about it.

How concerned are you about increased costs of household expenses?

From a poll of 3,276 American adults, April 16-21, 2021



Data: CivicScience; Chart: Will Chase/Axios

There is a strong case for the view that unsustainable global macroeconomic imbalances, if not proactively resolved by global policy makers, will unwind in a disorderly manner akin to the end of Bretton Woods over the course of the late 1960s into the early 1980s. However, the unsustainable is often sustained far longer than seems possible and it does not automatically translate to immediate, inevitable declining purchasing power of US dollars. The inflation debate is heating up, but there are simply too many moving pieces and variables to make an evidence-based call at the moment. We are watching carefully, but our research and analysis amounts mostly to "it's complicated."

The last bout of serious inflation in the US came in consequence of global economic imbalances and geopolitics, which necessitated changes to the gold-backed US Dollar-anchored global monetary system (e.g., Bretton Woods). While we are skeptical that Bitcoin has a future beyond digital gold, if that, the imbalances contribute a least a kernel of truth necessary to start a speculative frenzy.

History clearly shows that inflation is as much a question of confidence as it is of economics. But beyond that, even considering centuries, the sample size is not big enough to rule out, as yet unknown x-factors. Easy analogies, like DC is Rome and McCain was Cato, are unlikely to pay off other than by luck. We try not to lose sight of the fact that economics is a branch of sociology, not physics. So, we watch the evidence and stay wary of "logical inevitabilities" derived from 20th century economics. People may not change, but the way they organize does. The global financial and monetary system is quite different today than in the times when frequently invoked economists like Fisher, Keynes, Friedman, Hayek and Mises wrote. Technology, globalization, financialization, population density, belief systems and many other factors impact how the system behaves.

We are not banking on higher-than-expected inflation, but the portfolio is prepared. We have assigned more weight to companies with competitively positioned real assets and, as always, our

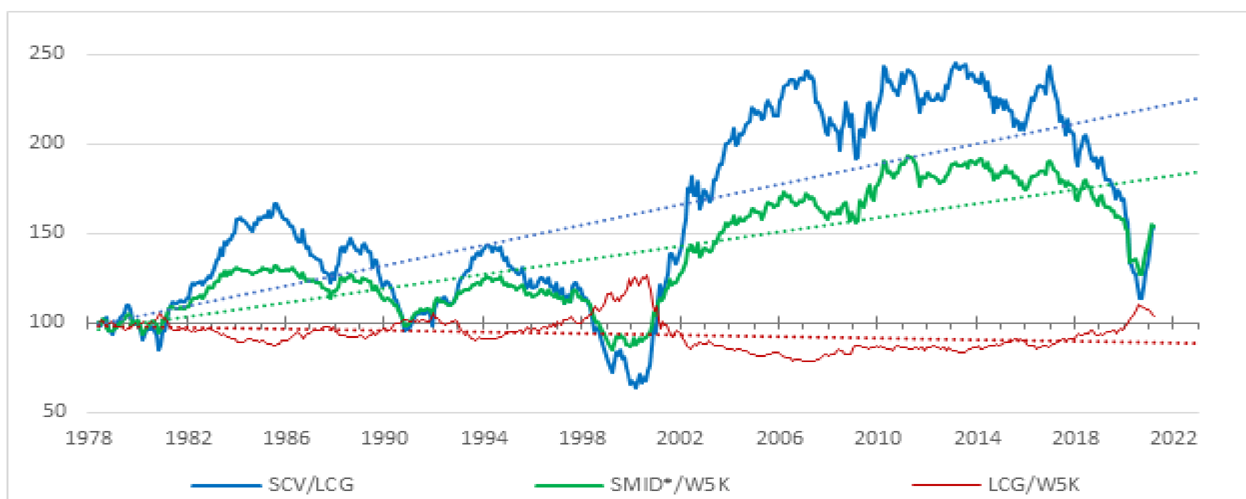
business analysis aims to cut through accounting and monetary distortions to focus on the real economics, especially pricing power.

The Outlook for Small Cap Value and Quality

Judging by historical performance and confirmed by recent evidence from the companies and industries we follow, small cap value is just getting going. With adaptation and vaccination progressing, an economically significant part of the world is getting back to business somewhat-as-usual. US consumers, flush with pent-up savings and job prospects turbocharged by stimulus, appear more than ready to do their part for the demand surge markets expect. Companies and their supply chains are refilling, we saw relatively modest capacity expansion since 2017 pockets of tight pricing environment, and demand is buoyed by $7 trillion in stimulus and counting.

That, and given how quality has lagged in the current recovery, we believe the Ballast strategy has significant fundamental and market upside. In fact, it is more appropriate to say that the magnitude of Ballast's SMid outperformance since November (and the April lows) is a bit surprising.

Small Cap Value Kept Its Lead



Source: Bloomberg, Wilshire 5000 Total Return Indexes, June 1978 through April 2021

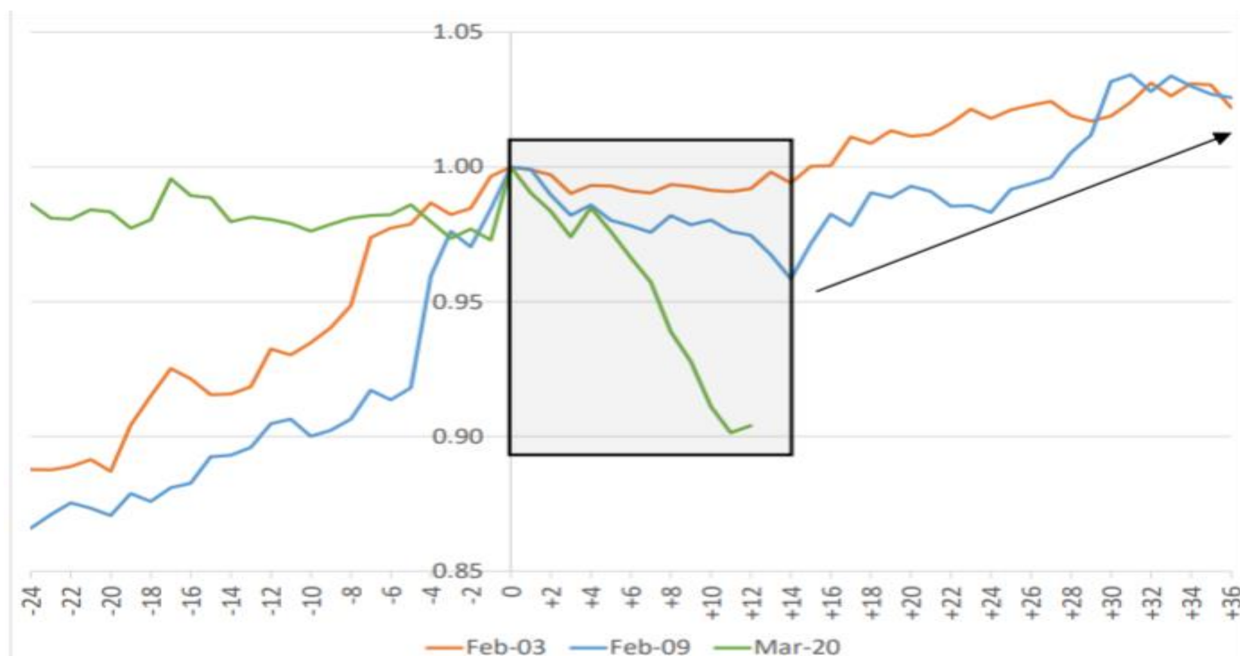
Small Quality Is Also Primed

We normally expect quality to trail the initial phase of a recovery, because it tends go down less in the sell-off and then, as capital rushes back in, ponzi-financed zombies tend to outperform as the market assesses a lower chance of bankruptcy. Once the business cycle matures, stocks with "quality" attributes like good management, competitive advantage, a decent balance sheet and

attractive reinvestment opportunities for growth become increasingly fashionable and short-term relative performance takes off.

Given the portfolio's solid returns since November and the absolute low in March 2020, we were a bit surprised to learn R2000 Quality stocks have lagged the broader stock market recovery by an unprecedented amount. The chart below plots R2000 Quality relative to the entire R2000 for the current sell-off and recovery (in green) and the two prior drawdowns centered on the date of the market bottom.

Quality lagged the rest of R2000's recovery by an extraordinary amount



Source: FRP, FactSet

Obviously, this sell-off was different, triggered by natural disaster rather than the typical recession and related economic factors. Stocks of many high-quality companies with historically stable businesses were dislocated by an abrupt economic halt necessitated by the global pandemic. Ironically, while these stocks felt similar pain during the Covid drawdown, they have not kept up with their lower-quality brethren during the reopening trade. We believe therein lies the opportunity going forward.

Performance

Top 5 Contributors

Texas Pacific Land Corp (TPL), formerly known as Texas Pacific Land Trust, returned 119% during the quarter. The 132-year-old trust completed its tax-free reorganization into a Delaware corporation in January. West Texas Intermediate Crude rose 22% during the quarter to close

above $59, and rising inflation expectations increased investor demand for real assets and commodities, both of which also favored Texas Pacific's properties.

Coherent (COHR) returned 69% during the quarter. In January, another one of our holdings, Lumentum (LITE), announced intention to acquire Coherent for $5.7 billion, sending the stock 30% higher. Twenty days later, MKS Instruments came in with a $6 billion value, shortly followed by an unsolicited offer from II-VI. A series of bids between Lumentum and II-IV ultimately resulted in termination of the Lumentum deal (including payment of a $200 million + break-up fee) and the acceptance of II-IV's offer for $220 cash and 0.91 II-IV shares for each share of Coherent.

Teradata (TDC) rose 71% during the quarter after reporting a strong beat and raise on public cloud revenue growth of more than 100%. In a three-day period, the stock more than doubled as high short interest drove a sudden short squeeze. Through the end of 2019, the business had suffered headwinds and missteps, prompting executive changes and an urgent focus on stabilizing the business. Now, with 3 consecutive quarters of strong results, the company has been rebuilding both the business and investor confidence under the leadership of the new CEO, Steve McMillan.

TripAdvisor (TRIP) was up 87% during 1Q21, concluding a 175% rally that began early in 4Q20 set off by news of successful vaccine trials. While TripAdvisor.com website traffic declined sharply through April of 2020, visits substantially recovered through the balance of the year. As the vaccines make air travel more feasible and tourist destinations more accessible, pent-up demand for trips in 2021 and 2022 bodes very with for the travel sector, positioning TripAdvisor for strong growth in earnings and cash flow.

Northern Technologies (NTIC) rose 45% during 1Q. A significant portion of the company's compostable plastic products are sold to closed loop facilities including corporate campuses, schools, and event venues. While adoption of compostable plastic continues, the existing businesses have naturally taken a little longer to recover due to their direct impact by remote work, learning and events. In other businesses, Zerust Industrial and a collection of highly profitable joint ventures are correlated to industrial activity and auto production. As these industries began ramping up in 2H20, their suppliers experienced strong demand to replenish inventories.

Bottom 5 Detractors

Amdocs (DOX) In the last two days of the quarter, this position traded down almost 15% on a short report by Jehosaphat Research. Publicly launching a sensational short report at the end of a quarter can be a highly lucrative way for short-sellers to exploit a sudden sell-off. We have seen other instances over the years in which a well-timed and artfully worded short report can spook complacent shareholders into selling until they find time to sort through the accusations. We view short reports opportunistically and welcome their often-opposing view (especially when based on rigorous research), but in this case, we quickly increased our position after the sell-off as the report lacked substance.

Lumentum (LITE) As mentioned in our comments on Coherent (COHR), Lumentum was involved in a bidding war during the quarter. Due largely to investor concern (ours included) that they would overpay for Coherent and issue more stock to get the deal done, Lumentum traded from a high

of $109 in mid-January to a low of around $79 in March. Upon termination of the deal, Coherent agreed to pay $217.6 million to Lumentum, and in the final days of the quarter, Lumentum rallied about 14% to close the quarter above $91.

Goodrich Petroleum (GDP) generated a negative 6% return during the quarter, slightly lagging a modest 2.7% gain in the price of natural gas. Notwithstanding the very long-term headwinds to the oil & gas industry, natural gas remains a crucial fuel for power generation, industrial production, and home heating. We believe natural gas will continue to play an important transitory role in our nation's long-term energy reform. Additionally, the fundamentals for natural gas are shaping up extraordinarily well for 2021. In 2020, industrial and commercial demand for natural gas were down 1.8% and 10.4%, respectively, with production down 1.6%. In 2021, as the economy reopens and industrial production picks up, demand is likely to grow 2% to 5%. The exit rate of production was down 4.7% in 2020, and understandably, very little growth capital has been deployed year to date.

Eagle Bulk Shipping (EGLE) and **Collegium Pharmaceuticals (COLL)** Due to the broad strength in performance across the portfolio, our two bottom contributors were held for the shortest period. **Both investments** were added in March. Eagle Bulk traded down almost 8% between the time of our initial purchase and the end of the quarter, while Collegium traded down 4% from the time of our initial purchase through the end of the quarter. Subsequent to the quarter, Eagle Bulk is up nearly 20% while Collegium remains about even. We do not initiate new positions expecting the stock to move in our favor on such short time frames, nor do we become concerned about short-term drawdowns so long as our thesis remains intact.

Thanks again for your interest in Ballast. If you have any questions about our firm, our team, or our strategy, please reach out to us. www.ballastam.com.

Regards,

Ragen Stienke

Ballast Asset Management

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 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.

[2]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.

[3]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.