BALLAST
ASSET MANAGEMENT

Real People, Real World, Real Businesses, Real Values

For the second quarter of 2021, the Ballast Portfolio returned 7.4% before fees and 7.2% net of fees, compared to 5% for the Russell 2500 Value.

Performance

		Periodic Returns							Annualized Returns		
		2015†	2016	2017	2018	2019	2020	2021 YTD	1 Year	3 Years	5 Years
Ballast Portfolio[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	16.1%	12.5%	35.2%	80.3%	15.1%	18.6%
	Net	-8.0%	22.6%	12.4%	-3.2%	15.0%	11.4%	34.6%	78.6%	14.0%	17.4%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	22.7%	63.2%	10.6%	12.3%

Performance (as of 6/30/2021)

†2015 Performance from 8/11/2015 through 12/31/2015

The equity bull market off the March 2020 bottom kicked off with a liquidity-driven "reflation trade" that handed off to the "reopening trade," which now seems played out reading into broad market price action and increasingly cautious financial commentary. Aside from financial markets fluctuating, which is normal, the world has not changed all that much over the last three months – the future is still uncertain and uncertainty still makes people uncomfortable. The world is still dealing with COVID, but outside the echo chamber, people, communities, businesses and governments are adapting to tough times, consumer and corporate balance sheets are in good shape and the earnings outlook, supported by deferred demand, is still far better than two years ago.

The idea that equities are somewhere between valued-to-perfection and overvalued by historical norms is broadly fair on current market fundamentals. For brevity, we leave aside the questions of inflation, whether historical multiples are precedent or misrepresentative, and whether or not stocks are really real assets worth a significant premium to tiny treasury yields and tight credit spreads.

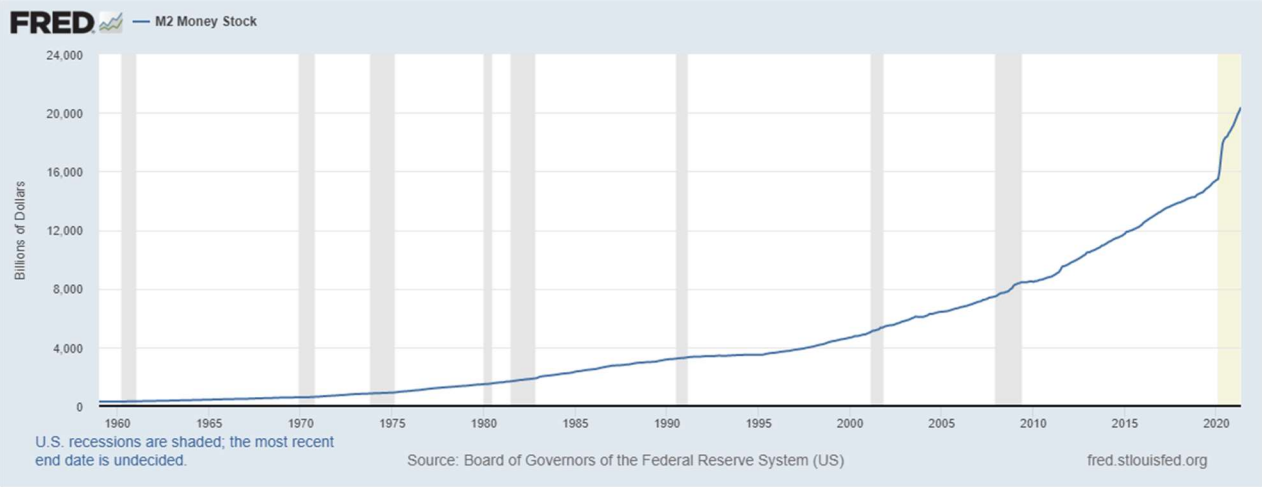
Here's the bottom line: We think the earnings acceleration, especially for economically sensitive companies, is just getting started. The driver? Good old-fashioned US consumer spending. Plus, Uncle Sam is likely in for another trillion or two, just for belt-and-suspenders. If Delta (or Lambda or Zeta) starts to threaten the US reopening, he's probably good for closer to four – in for a penny, in for a pound.

Driven by Cash

The idea of a "roaring '20s" scenario does not just stem from the emotional effect of being cooped up for a year, but because in aggregate we have saved a boatload of money and dramatically increased our wealth. Unless the American consumer changes patterns exhibited over the last 60 years or so, that savings will be spent. The timing is likely a function of two things. The first of which is the continued opening of the economy – services. The second is the availability of goods to buy (cars, boats, houses).

While many industries will likely use the ramp in sales and earnings to shore up their balance sheets, others will experience top-line torque, margin expansion and a cash build. Decision-making on how to deploy that capital will likely determine long-term value/valuation – we get into that in the next section.

What gives us this confidence in the next leg up? Frankly put, a massive jump in money supply not seen in the United States since – well, ever. Or at least since the St. Louis Fed started tracking the data back in the '50s. From February 2020 to February 2021, M2 jumped 27%.



Historical shifts in savings rates and inputs of stimulus were measured in billions of dollars. During COVID-19, that was ramped to trillions. These are absolutely massive numbers, and frankly make velocity a moot point in the money supply argument.

- Personal Savings grew $2.3 trillion in 2020, about 2x a normal year over the last decade.

- The Money Supply (M2) has increased roughly $5 trillion from the end of 2019.

- Some type of infrastructure bill is likely on the way. Call it $1 trillion on the low end, with an outside chance of a broader bill in the $3-4 trillion range.

For as long as we can remember, the money supply argument centered on velocity, the rate at which money moves through the economy. Historically, the banking sector played a big role in velocity. Banks'

willingness to lend, along with consumers desire to borrow, increased velocity. By giving money directly to companies and individuals, it took out one of the potential hurdles to increasing velocity (banks' willingness to extend credit). It also took away the financial and psychological hurdles of asking to borrow to finance a purchase. In short, in aggregate, consumers have a lot more money to spend, and we believe they will spend it.

Valuing Intangible Assets

Not everything that can be counted counts and not everything that counts can be counted. —*attributed to Albert Einstein*

You can see the computer age everywhere but in the productivity statistics. —Robert Solow in 1987, the year he won a Nobel Prize for demonstrating the role of innovation in economic growth

Like the great question of reality, value might as well be turtles all the way down. All computations of market value, accounting value, and future value ultimately rest on something inherently intangible. If it were pure math or pure information, edge traders and algorithmic strategies would drive aggregate expected net returns below zero well past the short term.

Our process stands on the turtle at the bottom we named sustainable competitive advantage. It is intangible but leaves evidence. Intangible assets (or liabilities) have value that can be expressed in present value terms that are meaningful when consistently calibrated to fundamentals like pricing power, margins and returns.

In last quarter's letter, we wrote about zombie companies, the walking dead with too much debt and too little profit to make increasingly critical intangible asset investments.

> "Any company that wants to compete long-term needs to be a tech company… more and more economic value derives from information and analytics…"

We also explained why zombie risk was a particular problem for passive small stock investing, that value index methods are an increasingly poor proxy for value in an economic sense, because:

> "Unlike a factory, digitally derived assets are hard to discern… 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."

We cite a recently published whitepaper by McKinsey, "*Getting tangible about intangibles,*"* that provides new evidence backing up the importance of investing in intangibles and especially digitization:

- The top 25% of companies spent 2.6x more on intangible assets than the bottom half, as ranked by Gross Value Added (GVA)**.

- It paid off. The top 25% grew nearly 7x faster than the bottom half, with 20% median growth versus 3%.
- In December 2020, 75% of executives expected technology and innovation spending to accelerate through 2024 versus 55% reporting similar spending from 2014 to 2019.

The paper also includes a case study of potential pitfalls related to accounting for intangible assets. To be useful, accounting rules must prioritize comprehensive, consistent, comparable numbers (that can be justified in court if necessary) ahead of economic verity, which can be very misleading if taken out of context. It is not just a corporate issue, national statistics as labor productivity and costs statistics, jointly derived in conjunction with real GDP and CPI, may have intangible asset distortions that could impact private decision and public policy.

Looking through accounting distortions to the underlying economics and parsing intangibles is not new to us. They are at the heart of our process.

Our "manufacturing" process is guided by behavioral and analytical methods adapted from decision science research for the US intelligence community to ensure a consistent, numerate and probabilistically coherent approach to the essentially qualitative business judgements underlying any valuation estimate. To be clear, this not an atomized 20th century "any color as long as it's black" moving assembly line. It is much closer to a high-volume craft manufacturing process, a systematic framework of poka-yoke modules to quickly produce customized products with reliable quality, leveraging a demand-pull supply chain and direct demand discovery from digital marketing with specific individual granularity—just what the customer wants when they want it. Or a Chinese food restaurant.

Candidly, in the end, it often boils down to a judgment call with a lot of uncertainty, which is why culture matters. Forthright, individual accountability for winning as a team, and judging a decision by how it is made, not how it plays out.

* "*Getting tangible about intangibles,*" McKinsey Global Institute, June 16, 2021. Primary survey conducted in March 2021, 21 sectors across three regions and 16 countries with 861 respondents, of which two-thirds had revenue >= $500m, more than 50% had revenue >=$1b, 20% from advanced manufacturing, 16% from TMT, 14% from retail trade; 13% from financial services; and 6% from energy and utilities. Nearly 80% of respondents were C-suite executives. Highly recommended as a good introduction to innovation and growth, and potential accounting distortion in estimated measures such as GDP, productivity, corporate profits, and others.

** Gross value added (GVA) is a proxy for individual producer, industry, or sector contribution to GDP, basically an entity's revenue minus any costs that are another entity's revenue.

Second Quarter Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
AVID	Avid Technology	+86%	**HUN**	Huntsman	-7%
LDL	Lydall	+79%	**LITE**	Lumentum	-10%
TDC	Teradata	+30%	**FFIV**	F5 Networks	-11%
GDP	Goodrich Petroleum	+58%	**SOI**	Solaris	-20%
EGLE	Eagle Bulk Shipping	+31%	**TRIP**	TripAdvisor	-25%

Top Contributors in the Second Quarter 2021

Avid is a technology company that produces software and hardware serving the media industry. The stock has tripled since our initial purchase in May of 2020. During the COVID-19 lockdown, the suspension of movie and song production, along with concert cancellations, negatively affected sales of many of Avid's products. With production coming back, increased demand for the company's software products (Pro Tools and Media Composer), and a shift to a recurring revenue model has materially boosted Avid's operating results. Evidence of management's success in capitalizing on each of these things became even more apparent when the company reported its first quarter earnings, and the stock reacted positively as a result.

Lydall announced it was being acquired at a significant premium to our targets and recent market prices in 2Q. We first added the nonwoven producer in 2Q20 amidst the COVID-19 sell-off. At the time, LDL stock was typically viewed as an undifferentiated automotive supplier and traded at an extremely favorable valuation with significant market and fundamental downside protection The new ROIC-guided CEO took aggressive action to protect the balance sheet and leverage Lydall's unique engineering and manufacturing capabilities in ultra-fine fiber mesh, which is a crucial component of N95 masks with direct application to retrofit HVAC filters capable of catching viruses. Lydall reduced the fundamental risk of quadrupling capacity with partial grants from the United States and French governments and long-term supply agreements for a portion.

Teradata is a technology company focused on business analytics. While the company has a history going back to the late '70s, a few years ago they decided to change their revenue model to a subscription from a perpetual model. As a result, their near-term revenue and earnings took a material hit. However, now having almost fully transitioned their customer base to this recurring revenue model, revenue and earnings have begun to show material growth again. That, along with the stability associated with a

subscription business has led to the multiple expansion that we expected.

Goodrich Petroleum is a natural gas levered E&P focused on drilling and production in the Haynesville basin. Like its E&P pears, Goodrich suffered throughout much of 2020 due to stressed oil and gas commodity prices, along with a mass exodus of institutional investors from the sector. Part of that exodus was a result of historically poor free cash generation by the companies. Goodrich had one of the cleanest balance sheets of any of its peers, traded at below trough multiples and found religion as an E&P focused on Free Cash flow. That, along with a dramatic rebound in natural gas prices on the back of a post-COVID demand rebound and a remarkably slow response to increase production from the industry, provides a great fundamental setup for the company.

Eagle Bulk Shipping owns, operates and actively manages a fleet of Supramax and Ultramax shipping vessels, the largest bulk class that does not need a deepwater port with loading equipment. EGLE gained 31% in 2Q21, ending the quarter up 149% YTD coincident with a 185% gain in the Baltic Dry Shipping index for Supramax rates. EGLE's 185% YTD peak in late June coincided with the announcement of a secondary equity offering on behalf of a major creditor that is also one its largest shareholders. At the time of the announcement, EGLE had gained 230% in 12 months versus an extraordinary 325% gain in Supramax rates from extreme lows related to COVID-19. Since the end of the quarter, EGLE has declined about 20%, perhaps a mix of negative signaling implied by the secondary offering, a roughly 5% decline in Supramax rates (superheated) and global growth estimates evolving with COVID-19 developments. In any event, bulk shipping supply/demand appears quite favorable for at least the next three years, possibly longer since shipyards are booked up building container liners. Additionally, while the cargos Eagle typically carries are cyclical, they are not deeply cyclical.

Bottom Detractors in the Second Quarter

TripAdvisor operates as an online travel research company and enables booking of travel-related services. The COVID-19 lockdown materially adversely affected their business in 2020, and they continue to face some lingering effects of that. On the hopes of the lockdown loosening, the stock rebounded significantly during the fourth quarter of 2020. As concerns about the Delta version of COVID-19 surfaced, along with travel restrictions remaining in place in Europe and Asia, the stock pulled back from the March highs. We believe that once travel stabilizes, TripAdvisor is in a great position to benefit from the recovering demand. In addition, the subscription service launched earlier this year should augment the recovery in its core businesses.

Solaris is an oilfield services company focused on renting large, portable containers that facilitate the fracking process used in shale oil and gas production. The company was adversely affected by COVID-19 and the subsequent impact to oil and gas prices in early 2020. As those commodity prices increased throughout the rest of 2020 and into 2021, the stock rebounded. However, investors were disappointed that higher commodity prices had not yet resulted in increased drilling/production, and the second quarter stock performance reflected that disappointment. We believe that higher sustained oil and gas prices will eventually lead to increased demand for Solaris' equipment and services. Further, Solaris'

products and technology dramatically increase efficiency and safety in the fracking process, while also reducing costs. We believe Solaris will eventually benefit from increased drilling, while also taking market share from competitors with less-efficient/higher-cost products.

F5 Networks is a technology company that provides software and hardware utilized by companies to manage their network/internet traffic. The stock nearly doubled following strong third and fourth quarter 2020 results. However, software growth reported on the first quarter earnings call that caused the stock to retreat from highs the stock experienced in April is temporary. We believe the marketplace continues to underappreciate the critical natural of the company's core Application Delivery Controller (ADC). That, along with the higher value associated with the faster-growing software business are why we remain bullish on the stock.

Lumentum makes products used in telecom infrastructure (formerly JDS Uniphase) that currently benefits from the buildout of 5G. China got a much faster start than the rest of the world, but spending in the US and Europe is accelerating. A more recent product development stems from 3D sensing technology (the technology that enables facial recognition in the iPhone. While the long-term fundamentals of 3D sensing are extraordinary (world facing, autonomous driving, etc.), the company faces near-term headwinds from two things. First, Samsung delayed implementing 3D sensing in its phones this year, and second, Apple played hardball on pricing in exchange for longer-term certainty in supplier agreements. We believe Samsung will eventually include this technology into their lineup (probably in the 2022 versions). The pricing news related to Apple is disappointing, but we believe this is a near-term hiccup to a much larger fundamental opportunity.

Huntsman is a chemical company that produces everything from fuel additives to the specialty chemicals used in foam insulation used in houses. Huntsman had historically been viewed as a commodity chemical company with too much leverage. However, over the last several years, the company has shed many of its commodity products in exchange for more specialty products in which they get better margins and higher returns. Fundamentally, things are playing out as we expected. The stock had appreciated 126% from its March of 2020 lows through the first quarter of 2021. As with many more economically sensitive stocks, Huntsman took a bit of a breather in the second quarter.

As always, our team is available to discuss performance in greater detail, as well as the changes we have made in response to 2020. 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

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.