BALLAST
ASSET MANAGEMENT

Real People, Real World, Real Businesses, Real Values

For the third quarter of 2021, the Ballast Portfolio returned -0.3% before fees and -0.6% net of fees, compared to -2.1% for the Russell 2500 Value. Year to date, the Ballast Portfolio returned 34.8% before fees and 33.8% net of fees, compared to 20.1% 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%	34.8%	72.7%	14.1%	16.6%
	Net	-8.0%	22.6%	12.4%	-3.2%	15.0%	11.4%	33.8%	71.0%	12.9%	15.4%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	20.1%	54.3%	8.8%	10.5%

*Trailing YTD, 1-Year, 3-Year, and 5-Year performance reported through 9/30/21

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

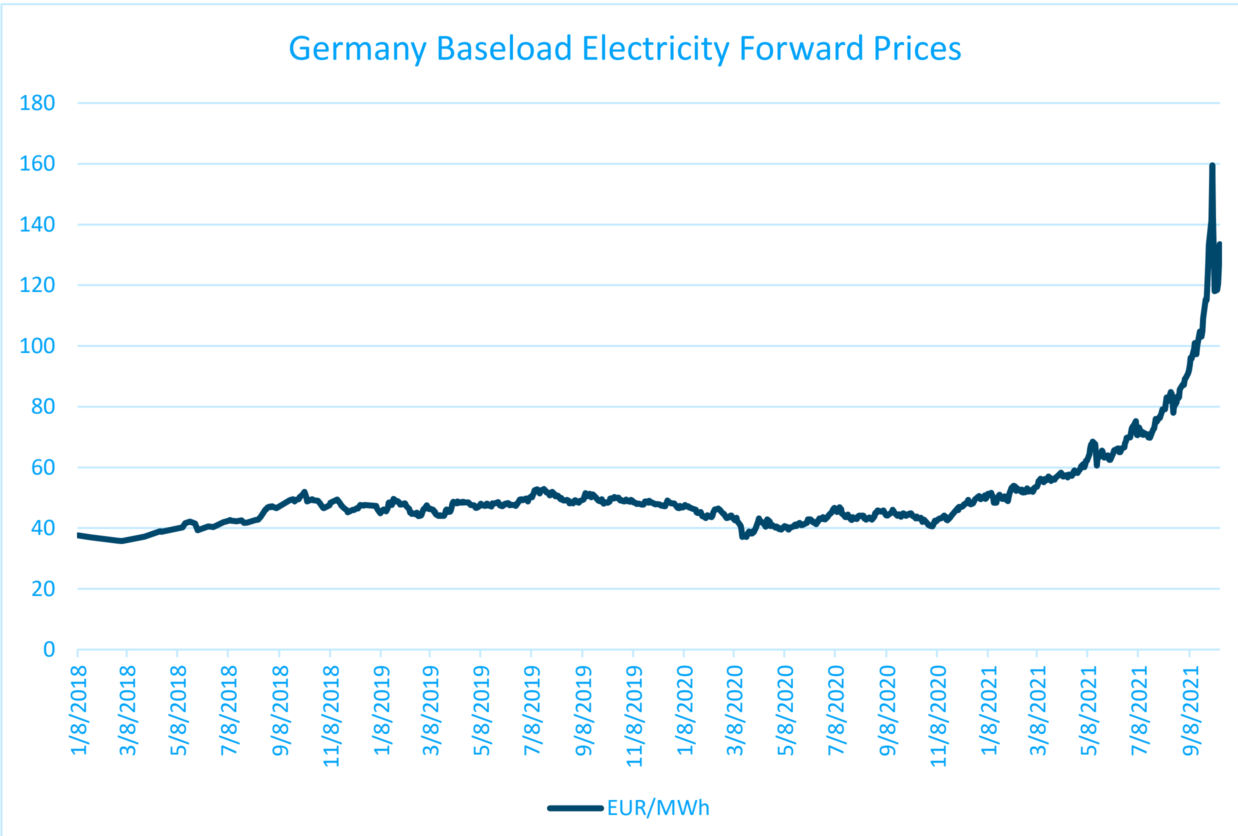
Increased inflation initially stemmed from low levels of inventory and disruptions in the global supply chain. That was followed by higher energy prices resulting from a dramatic decrease in drilling new wells and the natural decline in production from existing wells. So where do we go from here?

While global supply chains will eventually get sorted out, and higher commodity prices should prompt more drilling (the US rig count has nearly doubled in the last year, albeit still ~50% lower than 2019 levels), we believe there is an underlying cause of persistent inflation – sustainability. We believe the global shift to greater sustainability and lower carbon emissions is inflationary.

According to Bloomberg, assets managed under ESG standards will total ~$38 trillion by the end of this year. That is expected to climb to $53 trillion by 2025. By definition, those assets generally avoid companies with significant exposure to carbon – especially fossil fuels. The Sustainable Finance Disclosure Regulation (SFDR) in Europe, which is aimed at ESG funds that are “greenwashing” their investments – using crafty reasoning/marketing to make people believe that a company is doing more to protect the environment than it really is – will likely further erode the aggregate amount of capital available for investment in traditional energy production. That means the cost of capital in traditional energy production will remain high, and will likely continue to go up.

We believe this higher cost of capital, along with a more recent trend of investors requiring E&Ps to actually generate free cash flow (as opposed to just showing production growth and earnings), will stymie production growth of fossil fuels. In fact, that is the point of the sustainability initiative. The reason that will likely be inflationary is because global movement of capital away from fossil fuels into ESG is occurring faster than the build-out of alternative energy sources. As an example, in 2011 Germany got about 25%

of its power from nuclear energy. By next year, Germany plans to have shut down ALL of that nuclear capacity, which will eliminate about 11 gigawatts of electricity production, on top of the 10 gigawatts already scuttled over the last decade. The pace of the transition is largely responsible for the spike in electricity prices in Germany and throughout Europe.



To be clear, we are not arguing this shift to sustainability is the wrong thing to do, only that the mismatch between capacity coming offline from traditional sources of energy versus capacity coming online of new, renewable sources of energy is causing a spike in energy prices that we believe will persist in the medium term.

The transition to electric vehicles further exacerbates the problem because it increases demand for electricity. All the while, we believe the cost of gasoline will remain elevated due to the aforementioned headwinds facing E&Ps. That puts consumers in quite a pickle.

That phenomenon is also why we are concerned inflation will be less transitory than the Fed keeps professing – or at least that this represents a reset in prices rather than a short-term spike. Traditionally, economists view inflation “ex food and energy.” Ignoring the irony in the fact that we actually need those things to live, this calculation was reasonable in the past because those prices tended to be volatile and would revert after some short period of time. While we may see the price of gasoline spike for a year or so, increased production solved the problem in fairly short order. We are concerned that will not be the case this time around. Often producers choose (or are forced) to eat the higher costs in the near term. The longer higher energy prices persist, the more likely we will see those higher costs make it into the products that require that energy – like almost everything.

The other tailwind to inflation from the sustainability shift stems from the cost of this new capacity. Those nuclear power plants, once shut down, are worthless. Actually, they are less than worthless because they have ongoing liabilities associated with them. Conversely, the new sources of energy to offset that nuclear production and growth with increasing demand comes at a significant cost. Even with massive help from governments, there will likely be some sort of demand for a return on the money spent to build that capacity. In fairness, the operating costs of solar/wind production is much lower than coal, gas or nuclear energy and this will eventually sort itself out – but we think we could be decades away from that. We cannot say what the Fed's definition of "transitory" is, but years/decades feels more to us like actual inflation.

Solutions

We will not wade into the solution for the sustainability shift paradox. From an investment perspective, we believe the two most viable solutions is to invest in: 1) Levered Real Assets and 2) Companies with pricing power.

While we are not calling for this type of hyper-inflation, during the Weimar Republic between 1921 and 1923, which witnessed rampant inflation, one of the single best performing assets was leveraged real estate. The reason is simple – the "value" of the debt on the real estate fell dramatically, while the value of the underlying asset increased with the inflation.

The second way to protect against inflation is a bit more difficult. Identifying companies with the pricing power to thwart elevated inflation requires fundamental analysis of competitive position, necessity of the product, substitutions available, etc. For example, a grocery store effectively has no pricing power – while we certainly need their products, their competitive position is terrible and there are ample substitutions available within their product set. In contrast, consolidated industries supplying necessary products with limited substitution risk are more protected – like a software company.

Further, we would avoid fixed income – especially bonds with fixed interest rates. Here you get the double whammy of the value of the principal diminishing because of inflation, and the price of the bond itself falling as a result of rising interest rates that will surely occur in conjunction with the elevated inflation.

Third Quarter Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
GDP	Goodrich Petroleum	+58%	TRIP	TripAdvisor	-16%
TDC	Teradata	+15%	PHM	Pultegroup	-16%
ON	ON Semiconductor	+20%	CRMT	America's Car-Mart	-18%
CBNK	Capital Bancorp	+18%	TPL	Texas Pacific Land Corp	-24%
IRMD	Iradimed	+14%	AVID	Avid Technology	-26%

Top Contributors in the Second Quarter 2021

Goodrich Petroleum is a natural gas levered E&P focused on drilling and production in the Haynesville basin. Like its E&P peers, 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, due in part to low natural gas prices. Goodrich has one of the cleanest balance sheets of any of its peers, and a dramatic recovery in natural gas prices to over $5/MMBtu should enable the company to generate historically high levels of free cash flow. That, along with a remarkably slow response to increase production from the industry, provides a great fundamental setup for the company.

Teradata is a data analytics company originally founded in 1979. The stock continued its climb higher following a 71% return during the second quarter on the back of continued fundamental improvement in the company's public cloud business. Through the end of 2019, the business had suffered headwinds from its transition to a subscription revenue model from its legacy perpetual model. During that transition, the company's revenue and earnings power appeared strained. With that transition firmly behind the company, the company has exhibited a reacceleration in revenue and earnings growth that continues to positively surprise the market.

ON Semiconductor is a technology company that produces semiconductor chips used for data and power management. The company's chips are broadly used in several industries with substantial growth and usage of semiconductors, including Automotive, 5G, Industrial Automation and Energy Infrastructure. We believe the increased number of semiconductors in new vehicle models (particularly electric vehicles), along with the 5G rollout in the US, provides a long runway for ON. That, along with material free cash flow generation (over $1bn/year), should offer a continued tailwind for the stock.

Capital Bancorp is a bank located in Washington, D.C. The company has several traditional bank business lines that include cash management, commercial lending, consumer credit, mortgages and home loans. In addition, the company operates a credit card division (OpenSky) that is fully secured and digitally driven. The combination of OpenSky, a branch-lite strategy and conservative credit culture have all led to significantly higher returns (RoA, RoE) than banking peers. While still a small part of the bank's overall revenue and profitability, we believe the growth profile of this business will continue to drive overall growth in the company, along with expanding profitability and returns. That should, in turn, lead to a higher multiple for the stock.

Iradimed is a medical device company that specializes in producing MRI-compatible products (no metal parts). The company's IV pumps and vital signs monitors are unique to an industry that to this point has relied upon super long cords to keep traditional IV pumps working, or nothing at all for several vital signs monitors. As a result of COVID-19, elective procedures saw a dramatic decline, and hospitals/imaging centers pulled back on spending for capital purchases. As elective procedures continue to climb back to historic levels, Iradimed has seen a resurgence in demand for its products. We believe this high-returns business will continue to benefit from adoption of its products as traditional IV pumps/vital signs monitors are retired and replaced.

Bottom Detractors in the Second Quarter

Avid is a technology company that produces software and hardware serving the media industry. After tripling since our initial purchase in May of 2020, the stock took a breather in Q3. 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 have 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. However, second quarter earnings did not meet lofty market expectations and the stock pulled back from its recent highs.

Texas Pacific Land Corp, formerly known as Texas Pacific Land Trust, owns more than 900,000 acres of surface lands and roughly 450,000 acres of royalty minerals that it garnered in 1888 from debt holders in the defunct Texas and Pacific Railway Company. The 132-year-old trust completed its tax-free reorganization into a Delaware corporation in January. TPL generates revenue and earnings via royalties from oil and gas minerals, and in smaller part by selling pieces of its land inventory and leasing surface rights. Given TPL does not actually drill and produce the wells, their returns are extraordinary. We originally purchased the stock in depths of the oil price collapse in Q4 '19/Q1 '20. The stock more than doubled this year into the summer of 2021, at which time we sold half our position. Given rising inflation expectations, increased investor demand for real assets and commodities (both of which also favored Texas Pacific's properties), we continue to hold a position in TPL.

America's Car-Mart is an ethical, customer-centric "integrated auto finance company" that owns "buy here, pay here" car dealerships. It has a strong and sustainable competitive advantage reflected by its 12% book value CAGR that stretches back to the mid-2000s, not to mention that it repurchased more than half its initial market cap over the last decade paying less than book value. Nonetheless, its fairly unique economic model is widely misunderstood. Analysts that view CRMT as a car dealer were unhappy that the second quarter's gross profit margin rate declined under pressure from extremely tight used vehicle supply even though it actually made more dollars of profit per vehicle "sold." To offset the >20% jump in used vehicle prices, CRMT extended its average loan term about 25%. Analysts that see CRMT as a lender interpreted this as compromising credit discipline to grow faster. CRMT is conservatively accounting and reserving against the possibility of default rates increasing, but with ROE nearing 30% the last few quarters it is more than adequately compensated.

PulteGroup is a homebuilder with operations throughout the US, but with high concentration in the Southeast and Texas. In addition to capitalizing on an overall lack of housing capacity in its target markets, Pulte has a disciplined management team and focuses on generating exceptional returns and free cash generation, a stark contrast to peers and the homebuilding industry historically. Over the last decade, US housing supply has grown extremely tight, dramatically overcorrecting credit-fueled excess supply at the start of the last decade. Moreover, if inflation runs structurally higher, the nominal equity value of its portfolio of inventory land, which is leveraged via debt and options, should increase much faster than the price level and further strengthen its position relative to competitors forced to buy at prevailing prices.

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 continued to linger, along with travel restrictions remaining in place in Europe and Asia, the stock continued its downward drift. 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.

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.