Real World, Real Businesses, Real Values

The Ballast composite portfolio returned -6.1% net of fees for the first quarter of 2022, which compares to the Russell 2500 Value's -1.5% return.

Performance*		Yearly Returns								Annualized Returns*		
		2015†	2016	2017	2018	2019	2020	2021	2022 YTD	3 Yrs	5 Yrs	Inception
Ballast Portfolio[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	16.1%	12.5%	41.8%	-5.9%	16.0%	13.6%	14.5%
	Net	-8.0%	22.5%	12.4%	-3.2%	15.0%	11.4%	40.4%	-6.1%	14.9%	12.5%	13.4%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	27.7%	-1.5%	12.9%	9.2%	11.5%
Russell 2500[3]		-6.9%	17.6%	16.8%	-10.0%	27.7%	20.0%	18.1%	-5.8%	13.8%	11.5%	12.7%

* Annualized 3-Year, 5-Year and from Inception returns reported through 3/31/2022
† 2015 Performance from 8/11/2015 through 12/31/2015

While we performed well on a relative basis throughout most of the quarter, we missed the commodity-driven rally in March. Our exposure to transportation and housing also cost us some relative performance in the short term, but we believe that is tolerably okay given the longer-term real return potential. We keep our focus on fundamentals, valuation and the ability of select businesses to deliver reliable, long-term value creation. Although we are only about halfway through earnings season, so far ~75% of our companies have beaten both our and market earnings expectations. That fundamental measuring stick, not stock volatility of the factor of the month, is our benchmark because it is business returns that ultimately drive stock returns.

Stating the obvious, investors are dealing with multiple global crosscurrents. You can throw a stick in any direction and hit someone with an opinion on inflation, interest rates, probability of recession, etc. Rather than speculate, we focused this letter on what we know, and where we are finding opportunity in this environment.

What we know

Interest rates have risen steeply, the potential start of a secular uptrend, while inflation is running at levels not experienced in 40 years, and the Fed is set to drain liquidity out of the system. This is uncharted territory – those investing professionally today have little personal experience with the paradigm change. The biggest issue we see is that this inflation is a supply problem, not an issue with demand. That single perspective is what concerns us the most because it means incrementally higher interest rates are unlikely to quell inflation. If you really want to dramatically alter a supply-driven inflation problem, you must do one of two things. First, be patient enough to allow the global supply chain to catch up with demand, or second, strangle demand (i.e., put us in a recession). We do not believe anyone who claims to "know" which of these will happen.

We also know that one of the main sources of this latest form of inflation (Energy and Commodities) stems from two things – Russia invading Ukraine and a massive underinvestment in production for the better part of the last decade. Setting aside the Russia/Ukraine tragedy for a moment (we have no idea how that

will end), a number of industries are realizing enormous pricing power. Some of that is directly tied to the war and policy missteps, other cases are a result of underinvestment, and then there are those instances affected by both.

Where we are finding attractive opportunities to invest today

We believe that real businesses with real cash flow and pricing power are likely to do well in absolute terms regardless of how fast the Fed raises rates. Below are several industries witnessing elevated demand and tremendous pricing power: Energy, Commodities, Housing, Truck Transportation, and Shipping.

Energy – Russia invading the Ukraine was simply the last straw (or perhaps a log) that broke the camel's back. We have written extensively on this subject for years now, but the net is that the transition from fossil fuel-based energy to renewables is inherently inflationary. Geopolitics and poor policy just made it worse. Oil, Natural Gas and Coal producers have faced massive headwinds from banks, investors, asset allocators, and consumers. Many of these businesses went bankrupt. For those that did not, management was heavily influenced to invest less in new production, pay down debt and return more capital to shareholders. As a result, the vast majority of these companies now have good/great balance sheets, attractive yields (free cash flow and/or dividend) and low valuation multiples. The downside is that we have seen, and will likely continue to see, a slow incremental supply response, in large part because management still has a proverbial foot on their throat. Thus, we believe we are in for a sustained period of higher traditional energy costs.

Commodities – a broad category with a variety of different drivers, but generally in tighter supply with rising prices. Some are temporarily constrained; for instance, about 15% of the world's grain ships through the Black Sea from Russia and Ukraine. Russia happens to produce a significant portion of global fertilizer (phosphate and potash) and nitrogen (ammonia) from natural gas, which has longer-term implications for grain prices. Others share characteristics with Energy; for instance, mining. Mining investment shrank for much of the 2010s and was due to expand when COVID-19 started. Meanwhile, the transition to lower carbon electrification, including EVs and battery storage, accelerated boosting demand for Lithium, nickel, rare earth minerals, copper, and platinum group metals.

Shipping – yet another industry that saw an overbuild in supply in the pre-GFC business cycle. Again, many of these companies either went bankrupt, were forced to restructure their balance sheets, or dramatically curtailed capital spending on new ships – or all of the above. In addition, emissions standards evolved making many aging ships unsuitable for continued operation. Yet globalization in supply chains continued to increase demand. Less desire to debt finance new purchases and fully booked shipyards mean only limited new capacity is coming for the next several years.

Housing – After building like drunken sailors up to the GFC, home construction has consistently lagged household formation. It took the better part of a decade to work off pre-GFC overbuild, due to far tighter lending standards and more cautious attitudes, especially among potential first-time homebuyers. While inventory would have been tight in any case, the surge in demand caught homebuilders off guard. Today, builders are scrambling to meet demand amidst a 50-year low home ownership rate, great consumer balance sheets, ongoing household formation, solid equity positions in existing homes and a shortage

amounting to 2 million or more new homes. Rising interest rates will obviously temper demand, but the 200bp increase in mortgage rates has not dampened demand enough for supply to catch up.

Transportation – This is an industry with inflation stemming more from a shift in demand overwhelming supply, rather than pure underinvestment. Web-based consumption led to more stuff being shipped directly to us from warehouses/distribution centers, rather than via stores. While not a new phenomenon, that trend continued to accelerate amidst equipment and chronic driver shortages. That change in how stuff ultimately makes it from the manufacturer to the consumer continues to drive rapid investment, change and innovation today.

Conclusion

We do not pretend to have all the answers or a crystal ball on the unprecedented number of macroeconomic crosscurrents we face today. The good news is, we do not have to own anything in an industry or sector if we cannot find attractive investment opportunities there. We believe the 30+ year trend of having tailwinds from lower long-term rates and an accommodative Fed will bring about more uncertainty and increased volatility. Historically, periods of uncertainty and market dislocation have brought about unique investment opportunities we have been able to take advantage of due to our fundamental approach to investing. That is what we are focused on now – using our *process* to find those unique opportunities to the benefit of our investors.

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.

This presentation contains "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Because such forward-looking statements involve risks and uncertainties, actual results of Ballast Asset Management may differ materially from any expectations, projections, market outlooks, estimates or predictions (collectively, "Predictions") made or implicated in such forward-looking statements, and all Predictions contained herein are subject to certain assumptions. Other events which were unforeseen or otherwise not taken into account may occur; these events may significantly affect the returns or performance of any investment strategy. Any Predictions should not be construed to be indicative of the actual events which will occur.