BALLAST
ASSET MANAGEMENT

The Case for Strategic and Tactical Overweight in Active SMid Cap Value

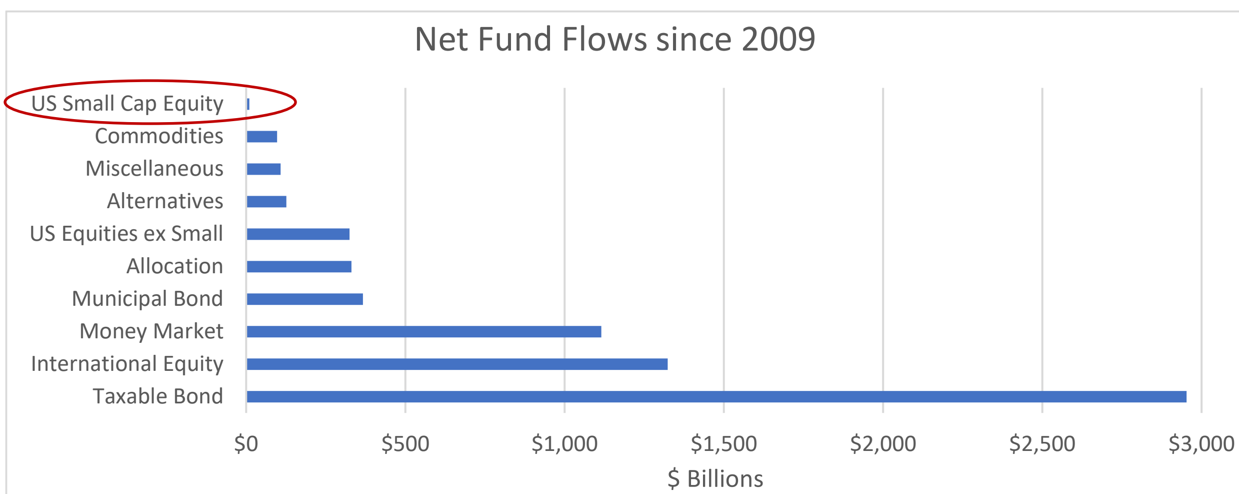
Weighting SMid value above a market cap weighted neutral position can maintain equity exposure in the face of inflation, reduce pure small cap volatility, and help generate higher CAGRs as mega cap stocks deflate and allocations play catch-up toward mid and small cap. Active management can help reduce the historical volatility of small cap value and mitigate the zombie problem, adding returns to a much maligned but ready to shine segment of equities.

Performance*		Yearly Returns								Annualized*		
		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%	-8.6%	17.2%	12.9%	13.6%
	Net	-8.0%	22.5%	12.4%	-3.2%	15.0%	11.4%	40.4%	-9.0%	16.0%	11.8%	12.5%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	27.7%	-6.5%	12.7%	8.5%	10.3%
Russell 2500[3]		-6.9%	17.6%	16.8%	-10.0%	27.7%	20.0%	18.1%	-13.6%	12.0%	9.7%	10.9%

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

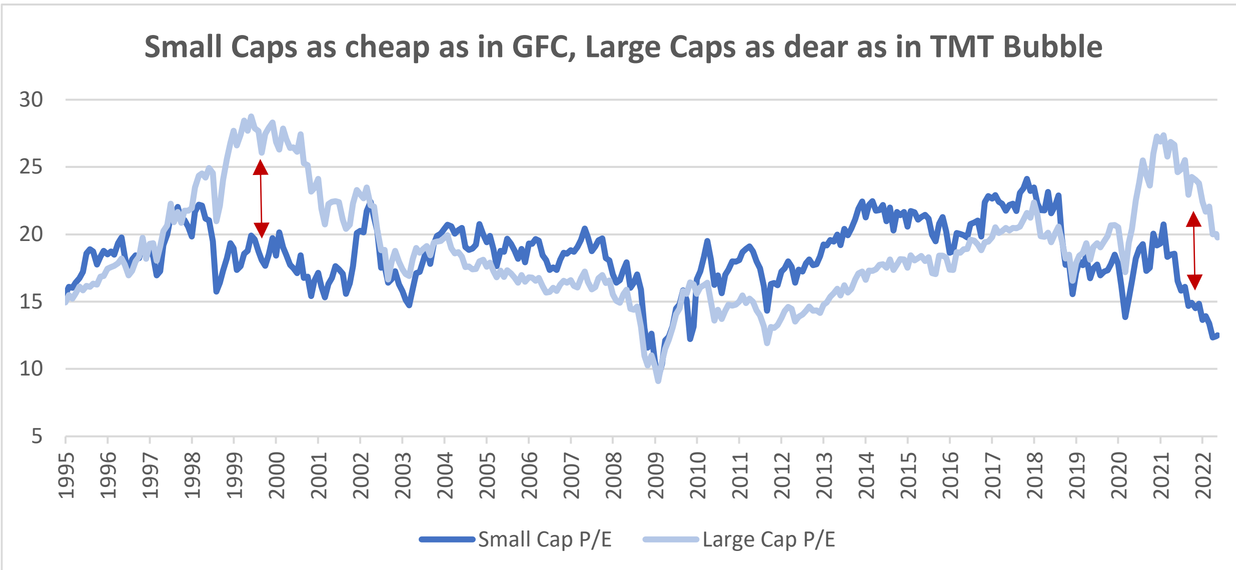
The Setup for SMid Value

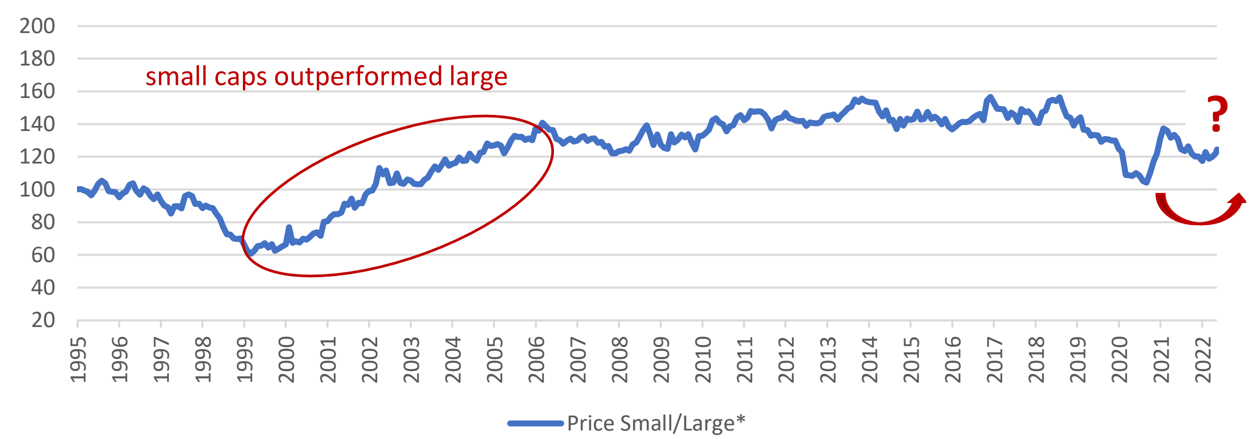
Since the crisis in 2009, US equity funds have taken in about $366 billion net, of which only $1 billion went into small cap. So investors as a group are overweight in the largest stocks, the biggest of which got ahead of themselves and are now seeing multiple compression due to inflation and interest rates. The outlook for fixed income is similarly clouded by those two factors.



Source: Furey Research Partners and Morningstar. Based on Morningstar's 10 US category groups and US small cap equity separated from other US equity. Includes all US open-ended, ETF, MM & FoF, active and passive. Excludes unclassified. Data as of 4/30/22.

We believe that small value was especially disregarded over the last five years for a variety of reasons, but especially due to the bubble in mega caps. We think SMid value is primed to close the valuation gap with large caps as happened with value in general after the TMT bubble burst.





Source: Bloomberg, Ballast Asset Management
** Large Cap is S&P 500. Small cap is S&P 600, which is a decent proxy for the Russell 2500 Value and has more history available.*

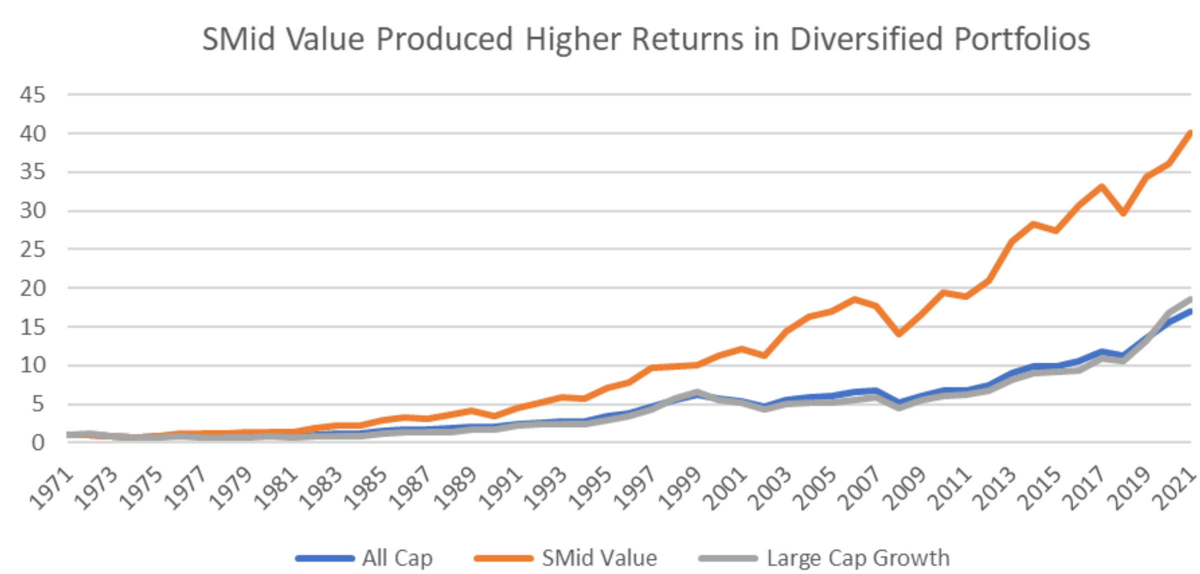
The Long-Term Case for SMid Value: Higher CAGR and Better Risk-Reward

The following table shows the real, after inflation, rate of return on all US Stocks. The categories include the nine US equity categories that make up the Morningstar Style boxes, along with US Micro Caps and SMID Value which is a blend of Mid and Small value reflective of BAM's typical portfolio weights from 1971-2021. The details might surprise many investors given how little has flowed into small cap since the crisis, but Small Value has had the highest rate of return (or CAGR, which is compound annual growth rate) of any of the style boxes. Also of interest, note that Mid Cap Value has the highest Sharpe Ratio – a measure of reward for each unit of risk. Blending the two gives a significant reduction in the volatility of small stocks without giving up much of the upside and produces the highest Sharpe Ratio of all.

REAL RETURNS 1971-2021	All Stocks	Large Cap	Mid Cap	Small Cap	Micro Cap	Large Cap Growth	Mid Cap Growth	Small Cap Growth	Large Cap Value	Mid Cap Value	Small Cap Value	SMID Value
Cumulatvie	1924%	1897%	3619%	3067%	4569%	2051%	1968%	1455%	2432%	5002%	7744%	6422%
CAGR	6.1%	6.1%	7.4%	7.1%	7.9%	6.2%	6.1%	5.5%	6.6%	8.1%	9.1%	8.7%
St Dev	0.17	0.17	0.18	0.20	0.20	0.20	0.21	0.16	0.18	0.19	0.23	0.19
Sharpe	0.36	0.36	0.42	0.36	0.40	0.31	0.29	0.35	0.36	0.43	0.39	0.46

Source: Ballast Asset Management, Portfolio Visualizer

To put these statistical differences in a practical context, consider the chart below, which depicts a typical portfolio allocation of 70% in equity and 15% in each of treasury bills and bonds, rebalanced annually at year end, constructed using (1) All Caps, (2) Large Cap Growth, and (3) a blend of mid and small value approximating MGMT's typical SMid Value mix. The SMID Value portfolio's CAGR was 7.0% versus 5.2% for All Cap and 5.4% for Large. SMid Value also had a higher Sharpe Ratio 0.59, versus 0.43 for All Cap and 0.39 for Large Cap.



Source: Ballast Asset Management, Portfolio Visualizer

Perhaps more importantly to investors, on a rolling five-year basis, the SMid Value portfolio never lost real purchasing power, the All cap version had positive real returns in 91% of rolling five-year periods, but the Large cap version had losses in 20% of rolling five-year periods with a worst case loss of 6%. This is a warning for “diversified investors” that rely on Large cap indexes for their equity allocation. It is particularly timely when bubbles like the Nifty Fifty in the late sixties, the 2001 tech bubble burst and current defanging of Mega cap tech start.

The Mismeasure of Value and Active Management

Common sense suggests that buying good businesses for less than they are worth is the surest way to generate attractive equity returns. If that seems questionable to you, it is most likely because “value” index methodology, which was developed in the 1960s, no longer sorts for value. It’s more appropriate to call value indexes low-multiple factor indexes. This matters because low-multiple stocks are often just zombie companies, with too much debt, too little investment in intangibles and weak competitive positions.

This is a problem in all passive investment strategies, but is a particular problem in smaller capitalization, low-multiple value indexes. According to a recent Bloomberg report, 620 of the Russell 3000 companies failed to generate enough operating profits over the last 12 months to cover their interest expense. Saddled with $900 billion in debt, they were shock absorbers for inflation, and now face lower margins, higher borrowing costs and more difficult credit conditions. While zombies only make up about 20% of total market and large cap passive indices, we believe they account for a third or more of the Russell 2500 Value SMid cap index.

In addition to crosscurrents from inflation, global economic imbalances, higher energy prices, the war in Ukraine, rising interest rates (falling bond prices) and contracting equity multiples, investors looking to diversify overweight positions in Large cap now face an increasing risk of zombies. As an equity investor, the question of whether they survive (many will not) is less important than the question of equity value impairment. We believe this list will grow over the next year as the Fed raises interest rates. While quantitative approaches can help screen out the most impaired, there is risk of zombies sneaking in and genuine values being sorted out. Consequently, we think our discretionary strategy, with nearly two decades of successfully generating consistent excess net returns, is more relevant than ever.

About Ballast SMid Value Strategy

We believe that real businesses with real cash flow and pricing power run by good management teams that are committed to expanding their competitive advantages and rewarding shareholders are likely to do well in absolute terms regardless of how fast the Fed raises rates. It is not simply a matter of screening for stocks that meet certain criteria. It requires fundamental analysis, business acumen, understanding economic reality and planning for a variety of scenarios to capture both valuation discrepancies and to harness internal business compounding. Ideally, we find businesses that are robust to a wide range of conditions, that can compound at above market rates over a three- to five-year horizon where management's incentives are aligned with shareholders.

Historically, periods of uncertainty and market dislocation have brought about unique investment opportunities that we have been able to take advantage using a fundamental business approach to investing – our *Process* aims to provide upside in excess of fees (220bp per annum since inception) while moderating downside volatility for its own sake and to facilitate sticking with our discipline over the cycles, which is a crucial element of generating exceptional CAGRs.

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.