BALLAST
ASSET MANAGEMENT

For the first quarter of 2025, BAM's strategy returned -7.7% gross and -8% net of fees versus -7.7% for the Russell 2000 Value. Given the portfolio's quality bias and relatively low tariff risk, we expected better. However, it is neither surprising nor concerning that strong, improving fundamentals were insufficient to offset market turmoil in such a short measurement period. For the prior 12 months, BAM returned 2.5% gross and 1.5% net versus -3.1% for the Russell 2000 Value.

Performance		Yearly Returns								Annualized Returns*		
		2018	2019	2020	2021	2022	2023	2024	LTM	3 Yrs	5 Yrs	Inception
Ballast Portfolio[1]	Gross	-2.2%	16.1%	12.5%	41.8%	-13.3%	18.6%	14.7%	2.5%	4.9%	21.1%	11.4%
	Net	-3.2%	15.0%	11.4%	40.4%	-14.2%	17.4%	13.5%	1.5%	3.9%	19.9%	10.3%
Russell 2000 Value[2]		-12.8%	22.4%	4.6%	28.2%	-14.5%	14.6%	8.1%	-3.1%	0.0%	15.3%	7.8%
Alpha (net of fees)		9.6%	-7.4%	6.8%	12.2%	0.3%	2.8%	5.4%	4.6%	3.9%	4.6%	2.5%

*Annualized 3-Year, 5-Year and from Inception returns reported through 3/31/25

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
— Benjamin Graham, *The Intelligent Investor*

We started writing this letter shortly after the end of the quarter. Then Liberation Day hit and backward-looking Q1 commentary suddenly seemed less relevant. We have no special insight into hot topics like the basis trade unwind, scarce "top of the book" volume, inflation/deflation, dollar hegemony, recession risk, capex boom and inventory shortages, other than to make the pedestrian observation that the range of outcomes is much wider than any other point in most investors' professional lifetimes. We wrote a piece on tariffs (Tariffs February 2025) several months ago discussing our positioning. Aside from pointing to that, we'll skip to what we can control – constructing a portfolio that offers compelling long-term returns with lower-than-average risk of permanent impairment and, ideally, less downside volatility.

We named our firm Ballast because our strategy is designed to cut through choppy macroenvironments. Quality is not always immediately recognized by the market, but our companies can continue to compound value regardless of economic and market volatility. That provides resilience amidst market chaos and leaves us the bandwidth to move great companies from our *Wish List* into the portfolio, for instance the five new positions we took in early April. Strong financials, prudent management and strong competitive positions are core to our process because that's what drives return on investment, which is what ultimately drives stock returns.

Either the S&P 500 is fairly valued, and we nearly have 50% upside, or the S&P 500 has over 25% downside, and we have 5% - 10% upside, or somewhere in between. This is just apples-to-apples math – the details are below. Our portfolio's return on assets is much higher, the debt load far lower, with similar growth expectations at valuation multiples that are a fraction of the Russell 2000 Value and the S&P 500.

Why invest in quality small cap value at all?

Small value has lagged large caps for more than a decade – safe to say it is not popular, which makes this a good time. Cycles eventually end and the savvy investors know the highest returns are usually found by investing in unpopular places ahead of the crowd. After a decade of lagging large caps from the end of 2000, small-cap value outperformed the S&P 500 by 177% and the Nasdaq by 223% through 2016. Notably, the Nasdaq has yet to catch up, *even to this day* (thanks to the power of compounding). This cycle has repeated every 8-12 years since the 1920s, which is as far back as the data goes.

Fundamentally, quality small value has less tariff and valuation risk than large caps, Consumer inflation expectations have spiked and consensus forecasts a 40% chance of recession. Stagflation, which was a good backdrop for small value in the past, is a realistic possibility. Moreover, quality small caps fundamentals are more than a match for the S&P 500 at 40% lower valuation.

Quality small value is a compelling alternative for institutional investors increasingly unhappy with private equity. According to Bain and CAIA, PE distributions are down 49% from 2021 to 2023, rather than a full exit, 30% of companies have been leveraged up to meet distributions amidst a $410 billion liquidity crunch. Moreover, until the cash is distributed there is limited liquidity, and interim returns are just the manager's estimate, because obviously there is no market price on PE companies until exit. The appearance of low volatility afforded by opacity was initially desirable to clients but is increasingly seen as inviting abuse. Can you imagine how good the numbers would look if active small-cap managers were allowed to calculate performance numbers using their own estimates of value for owned companies?

We believe active management is essential in small value, but totally out of favor because exceedingly few large-cap managers consistently add value after fees. That is not true in small value, as a fair number of managers are consistently top quartile on a rolling 3-year measurement period. They can do that because small caps are under researched and because the Russell 2000 Value has terrible aggregate fundamentals. We estimate that 30%-35% of the market cap is zombie companies that do not earn enough to pay debt and invest for the future (Fear the Zombies – Part II). When rates fall and credit loosens, they can really rip. However, that does not last, and those stocks are a persistent drag on index returns, not to mention extremely dangerous when borrowing costs rise or growth slows.

Why Ballast?

We are confident in our process and strategy because we have lived through turmoil before and seen how reliably our quality value process delivers. For example:

- During the global financial crisis of 2008, diversified, quality-focused portfolios suffered far less and recovered faster. The mutual fund WHGMX, run by two of our principals at the time, drew down 13.8% less and recovered its pre-crisis value in 19 months versus 42 for Russell 2000 Value.[3]

- Ballast drew down with the market during the initial COVID-19 sell-off, but we capitalized on the dislocations and safely increased both quality and reward-to-risk, which contributed to ending 2021 up 40.4% net of fees, well ahead of the Russel 2000 Value's 28.2%.

- Despite COVID and the other drawdowns, Ballast's cumulative gross return of 179% since inception (2015) is twice the 88% returned by the Russell 2000 Value. We did lag the S&P 500's 233%, but conditions are different now.

Babies with bathwater

Just like during the COVID-19 sell-off, we used the April tariff drawdown to high-grade the portfolio, adding five new positions from our *Wish List* – excellent businesses that we have experience with (and in some cases owned) that did not meet our asymmetric Reward-to-Risk criteria because of high market expectations and expensive valuations. When the whole market is selling off fast and severely, correlations tend to go to one, and sometimes great businesses drop to compelling valuation levels.

Portfolio positions compete for our capital, and the source of funds was a combination of trimming or outright sales of positions with less attractive Reward-to-Risk ratios. Each of the added businesses has a safe balance sheet, high returns on capital, a solid competitive position and strong management.

Competitive Position and Return on Capital Drives Stock Prices

"Over the long run, it is a company's return on capital, not changes in quarterly earnings, which primarily determines the direction of its share price. The return on capital of any company is largely subject to the state of competition within its industry."

— Edward Chancellor, *Capital Account*

Warren Buffett has also made this point many times, perhaps because it is so important but so often forgotten or dismissed as irrelevant. However, it is just a matter of math and market logic: A stock cannot sustainably compound at a rate higher than the business's own return on capital, because any benefit from buying at a low valuation becomes negligible over long holding periods.

Fair warnings – we get pretty deep in the weeds of Finance here, so we might recommend grabbing a cup of coffee prior to reading. Or you may prefer to just skip this section and take our word for it that we own businesses with high Returns on Capital, which is vitally important to long-term outperformance.

At BAM, quality small value is much more than low multiples and high growth rates. Management and competitive position are as, or even more, important than demand growth. This is reflected in the portfolio's weighted average ROE of 17.5% on trailing earnings and 19.3% on consensus estimates for the next 12 months (as of 4/30/25). As long as a company's competitive position is intact, and the valuation reasonable, we know the underlying value is compounding. That makes it much easier to calmly execute our process and act with justified deliberate aggression when the market is whipping around.

Empirically, return on invested capital (ROIC or ROE) is far more important to valuation multiples than growth. It explains nearly 64% of variation in S&P 500 stock prices, whereas five-year EPS growth explains less than 0.1%.[†] In fact, if the return on capital is less than the cost of capital, growth just destroys value faster. Competitive advantage, management and industry economics determine normalized ROIC. Typically, the more commoditized the product or industry, the faster competition drives high returns down to the industry average.

Nonetheless, the characteristics of our portfolio companies are as important as the *Wish List* companies when it comes to acting decisively in moments of market trauma. We are highly confident that our companies will survive a recession and expect them to continue to compound fundamental value over time, regardless of what current price action might imply. It might seem like an irrelevant soft issue, but this kind of built-in guardrail is an important part of maintaining the emotional equilibrium required for consistent decision-making under potentially stressful circumstances.

Although small-cap value has historically outperformed large caps, it is inherently more volatile because smaller companies have less ballast. Additionally, conventional small value benchmark methodologies sort for zombies – companies that do not earn a high enough return to service their debt while investing for the future, especially in the sort of intangible assets that sustain competitive advantage.

Our strategy simply has a lot less fundamental risk than the Russell 2000 Value, in part because its characteristics are a lot more like the S&P 500's. Key operating and valuation metrics are shown in the table below. Our trailing growth is about the same, but the most important driver of economic value creation is how long a superior return on investment can be maintained, not how fast sales or assets grow. Admittedly, consensus expects the S&P 500 to earn a higher Return on Equity than our portfolio over the next 12 months, but that is largely a function of significantly higher financial leverage, which is a potential risk.

Over the prior 12 months, **BAM's Return on Assets was 80% higher than the S&P 500** – an advantage that is partly related to industry mix, but is even more so a reflection of the strong operators and capital allocators managing the companies we own.

	Ballast	R2000V	S&P 500
Sales Growth	4.4%	1.5%	4.4%
Return on Assets	7.3%	0.1%	4.1%
Return on Equity (ntm)	19.3%	6.2%	22.6%
Net Debt / EBITDA	0.8x	4.7x	1.4x
Total Debt / Equity	0.6x	1.1x	1.1x

	Ballast	R2000V	S&P 500
Free Cash Flow / EV	5.8%	0.2%	2.9%
Price / Cash Flow	7.6x	9.6x	19.0x
P/B	2.7x	1.2x	4.8x
P/E (ntm)	13.8x	19.5x	21.2x
EV/EBITDA (ntm)	6.2x	10.7x	14.3x

Source: Bloomberg, as of 4/30/2025

Getting more value than the price you pay

After the underlying returns of a business, the second most important driver of superior long-term compounding is purchase price. Our portfolio is significantly cheaper than either index in terms of trading multiples.

Fundamentally, BAM's portfolio is much cheaper than either index. The valuation estimates to the right are derived from a simple EVA-style dividend discount model.‡ The mathematical exercise below is meant to roughly point out the large discrepancies amongst asset classes, rather than to calculate an exact answer. We start with observable inputs for the S&P 500, current price, consensus EPS and current book value, then solve for combinations of long-term growth and opportunity cost of equity that equate the S&P 500's price to its fundamentals. In all realistic combinations of growth and cost of equity, BAM is significantly undervalued relative to both indexes. Three representative scenarios:

	Ballast	R2000V	S&P 500
Consensus NTM ROE	19.3%	6.2%	22.6%
Upside using 7.5% COE	**48%**	**-45%**	**0%**
Target PE @7%	22.6x	10.0x	23.5x
Target P/B @7%	3.9x	0.7x	4.8x
Upside using 9% COE	**8%**	**-163%**	**-27%**
Target PE @9%	14.9x	-12.4x	15.4x
Target P/B @9%	2.9x	-0.8x	3.5x

Scenario one: **the S&P 500 is fairly valued and BAM's upside is nearly 50%.** We started with a 3.5% estimate of terminal growth, reflecting some combination of inflation of around 2% and productivity growth of about 1.5%, which implies a 7.5% cost of equity. In this scenario, the Russell 2000 Value has 45% downside because its return on investment is so much lower.

Scenario two**: the S&P 500 has about 25% downside and BAM is at fair value**. This keeps the 3.5% long-term growth rate and uses a 9% cost of equity, which is more consistent with typical empirical estimates in the range of 9%-10%. In this scenario, ***the Russel 2000 Value is basically worthless*** *because its 6.2% ROE is less than the 9% cost of equity*. Again, this is an academic exercise – we realize one cannot lose more than 100% of your capital in stocks.

In a third inflationary scenario, *45% upside for our portfolio,* we started from a 9% opportunity cost of equity and backed into a 5.4% perpetuity growth rate to set the S&P 500 to fair value. That growth is plausible if real GDP growth picks up to 2.5%-3% and inflation runs 2.2%-3.1%. This is consistent with the history of small caps tending to outperform when inflation is higher.

Tariffs, Competitive Position and Pricing Power Valuation Implications

Companies facing higher tariff costs will have varying degrees of success passing the cost on to consumers, depending on competitive position and comparative supply chain geographies. We use this model to show how tariffs can interact with company pricing strategies, competitive position, and the potential impact on valuation.

- In **highly competitive industries**, especially with significant operating leverage or barriers to exit, tariffs may pass through incompletely or not at all, which will reduce margins, dollar profits, return on investment and valuation multiples.
- In **rationally competitive industries**, dollar-for-dollar price increases to cover tariff costs are a reasonable expectation. Although margins will decrease, dollar profits would be unchanged causing minimal impact to ROI or valuation.
- The most **competitively advantaged companies** may be able to maintain their percentage markup over the new costs, which would keep margins constant, increasing dollar profits, ROI and valuation multiples.

If higher tariffs remain in place long-term, we believe this distinction will eventually be reflected in valuation multiples. The table below demonstrates how tariffs increasing a company's cost of goods sold by 10% could impact the share price under three different pass-through scenarios. The current scenario starts with the S&P 500's approximate cost structure and multiples, then uses the model from above to calculate what the multiples ought to be, all else equal.

		10% Tariff Pass Through		
	Current	Zero	Dollar for Dollar	Constant Margin
Revenue	$1,800	$1,800	$1,920	$1,980
Cost of goods	$1,200	$1,320	$1,320	$1,320
Gross Margin	**33.3%**	**26.7%**	**31.3%**	**33.3%**
Other Costs	$360	$360	$360	$360
Net Profit	$240	$120	$240	$300
Net Margin	13.3%	6.7%	12.5%	15.2%
Shareholder Equity	$1,170	$1,170	$1,170	$1,170
ROE	**20.5%**	**10.3%**	**20.5%**	**25.6%**
EVA Justified P/E	20.7x	16.5x	20.7x	21.6x
EVA Justified P/B	4.3x	1.7x	4.3x	5.5x
Implied Share Price	$4,980	$1,980	$4,980	$6,480
Expected Price Change		**-60%**	**0%**	**30%**

At the extreme, a company with zero pricing power would see ROE cut in half, risking a significant, potentially permanent, capital impairment. Companies that pass tariffs through dollar-for-dollar should experience minimal impact. We expect most tariff exposed companies to fall somewhere between these points. Competitive position and pricing power are essential considerations in our process, so we expect companies in our portfolio to be somewhere between the dollar-for-dollar and constant-margin scenarios.

Portfolio Additions

Royal Gold (RGLD) owns gold royalties and streams, which are basically loans that get repaid with a fixed percentage of mined production volume. The initial return on new projects is uninspiring but improves dramatically over time because gold has appreciated about 9% per annum relative to the U.S. dollar since 1971. From 1995 to the time of our purchase, RGLD (11.1% CAGR) outperformed both gold (6.8% CAGR) and the S&P 500 (10.8%). Royal Gold is superior to owning a mine because it much more diversification and essentially zero operating leverage. It is superior to gold itself because it pays a dividend (e.g., it has Intrinsic Value) and can reinvest for further production growth.

Performance Attribution

In the first quarter, the portfolio performed in line with the Russell 2000 Value, returning 7.7% gross (about 2bps ahead of the index). Sector allocation was about 250bps drag, completely offset by security selection.

First quarter’s top and bottom contributors are as follows:

Company	Ticker	Avg Weight	Total Return	CTR (bps)
Cavco Industries	CVCO	3.9%	16.4%	52
Intl. General	IGIC	3.5%	10.7%	33
EPR Properties	EPR	1.8%	20.9%	31
Genpact	G	1.8%	17.7%	25
Epsilon Energy	EPSN	1.3%	14.7%	18

Company	Ticker	Avg Weight	Total Return	CTR (bps)
Solaris Energy	SEI	4.0%	-24.0%	-102
Intl. Money Exch.	IMXI	1.8%	-39.4%	-82
Core Natural Res	CNR	2.1%	-27.6%	-66
Climb Global	CLMB	5.2%	-12.5%	-66
Kosmos Energy	KOS	1.4%	-33.3%	-56

We allocate to sectors based on our bottom-up security selection. Financials, REITs and Utilities are relatively undifferentiated businesses with limited prospects for above market ROIC and as a result our 18.4% allocation was 60% lower than the Russell 2000 Value's 46.0% weight, which was a 100bps drag with 55bps contribution from security selection partially offsetting the loss from underweighting the sectors.

Our largest overweight is Energy (16.9% weight versus R2KV's 7%), which was also the largest drag on performance with sector allocation costing 65bps and selection costing 80bps. Solaris, Core Natural Resources and Kosmos cost 220bps in the quarter, which followed 350bps contribution in 2024.

Information Technology is our second-largest overweight (16.1% versus R2KV's 6.5%), which added 30bps from security selection but cost 80bps from sector weighting. The largest detractor was Climb Global which cost 66bps in the quarter after 410bps contribution in 2024.

Despite a 25bps allocation drag, Consumer Discretionary (12.3% weight versus R2KV's 9.1%) and Industrials (17.2% weight versus R2KV's 12.6%) were the top sectors adding 120bps and 75bps respectively from security selection. Cavco, which makes affordable housing, was the largest contributor in consumer discretionary. Consulting firm Genpact, a quasi AI play, was the top contributor in Industrials.

Regards,

Ballast Asset Management

Appendix

† https://www.financierworldwide.com/stock-price-and-roic-what-drives-performance "Stock price and ROIC," August 2017.

‡ The Edwards Bell Ohlsen (EBO) residual income model values a business as the sum of current book value plus future earnings less the cost of equity (COE) capitalized at a perpetuity growth rate (g). The formula is basically the dividend discount model restated in terms of book value and EPS:

$$P = BVPS + (EPS - COE * BVPS) / (COE - g)$$

A discounted cash flow valuation configured to properly respect the interaction of investment, incremental returns, and economic value growth, the answer is mathematically identical to the EBO model. In addition to parsimony, EBO is less sensitive to terminal growth and incremental return on capital assumptions. The cost of debt is captured on the income statement and the details of capex, depreciation and working capital investment are captured in clean surplus accounting for book value.

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]Account returns are presented both gross and net of management fees. All account returns are net of transaction costs and gross of non-reclaimable withholdings taxes, if any, and reflect the reinvestment of dividends and other earnings. Monthly composite returns are calculated by weighting each account's monthly return by its relative market value. All returns are expressed in US dollars. **Past performance does not guarantee future results.**

The gross performance results presented do not reflect the deduction of investment advisory fees. Actual returns will be reduced by such advisory fees and other expenses as described in the individual contract and, where applicable, Form ADV Part 2A.

Net performance results do not reflect the deduction of investment advisory fees actually charged to the accounts in the composite but do reflect the deduction of a model investment advisory fee of 1.00%, which is the maximum advisory fee rate in effect for the respective time period. Actual advisory fees may vary among clients invested in the strategy. Returns for each client will be reduced by such fees and expenses as described in the individual contract and, where applicable, in Form ADV Part 2A.

Ballast Asset Management, LP claims compliance with the Global Investment Performance Standards (GIPS®) and has been independently verified for the period October 1, 2015 through December 31, 2020. Verification assesses whether (1) the firm has complied with all of the composite construction requirements of the GIPS Standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS Standards. The verification report is available upon request. Verification does not ensure the accuracy of any specific composite presentation. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy of quality of the content contained herein. A GIPS composite report can be obtained by calling 469-502-3652.

[2] The Russell 2000 Value Index measures the performance of the smallcap value segment of the US equity universe includes those Russell 2000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 years) growth and lower sales per share historical growth (5 years).

[3]Ragen Stienke and Jay Singhania represented a significant percentage of voting members of the committee managing the Westwood Quality SMidCap Fund (WHGMX) during the time period referenced. At that time, the portfolio was managed by a team of portfolio managers sharing equally in the responsibilities for selecting holdings for the Fund and managing execution of trade ideas, and the team was led by Mr. Stienke. Ballast intends to pursue a similar investment management process for selecting and managing risk as Mr. Stienke and Mr. Singhania practiced for WHGMX at that time, but there is no assurance that the process will produce similar results.

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.