



The Ballast composite portfolio returned (5.5%) net of fees for the second quarter of 2024, which compares to the Russell 2000 Value's (3.7%) return.

Performance		Yearly Returns								Annualized Returns*		
		2017	2018	2019	2020	2021	2022	2023	2024 YTD	3 Yrs	5 Yrs	Inception
Ballast Portfolio ¹	Gross	13.5%	-2.2%	16.1%	12.5%	41.8%	-13.3%	18.6%	-2.2%	1.8%	10.6%	11.4%
	Net	12.4%	-3.2%	15.0%	11.4%	40.4%	-14.2%	17.4%	-2.7%	0.7%	9.5%	10.3%
Russell 2000 Value ²		7.8%	-12.8%	22.4%	4.6%	28.2%	-14.5%	14.6%	-0.9%	-0.6%	7.0%	8.4%
Alpha (net of fees)		4.6%	9.6%	-7.4%	6.8%	12.2%	0.3%	2.8%	-1.8%	1.3%	2.5%	1.9%

*Annualized 3-Year, 5-Year and (since Inception performance start date 10/01/15) returns reported through 6/30/24

“The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought.”

— Rudiger Dornbush on the Mexican Peso crisis and other economic catastrophes

At this point, most folks we talk to understand that Small Cap Value is at a 25-year low relative to Large Cap Growth, both in terms of relative performance and valuations. We also get very little pushback that the Small Cap Value passive indices are junk due to all the zombie businesses within them. The single biggest question we get is, what will be the catalyst for the shift? By nature, this is a timing question, and timing in this business is exceedingly difficult. It is particularly difficult when stock performance is being driven by behavioral aspects rather than fundamental attributes. That said, we wanted to offer a framework, based on history, that might offer a window into what that catalyst might be, and when it might happen. For that, we took a dive back into 1999. Be warned, this is a much longer letter than our typical quarterly write-ups, but we wanted to offer several perspectives and lots of data to show the magnitude of outcomes.

Stating the obvious, the late 1990s looked similar to today in a lot of ways. We were in the midst of a huge technology paradigm shift that was expected to change the world (the Internet). Capex spending levels were elevated, and the pick-and-shovel providers of the internet were experiencing massive revenue growth as tens of billions of dollars were being poured into the infrastructure that facilitated the internet (remember that the internet started using dial-up connections of traditional copper phone wires). The Fed was raising rates to battle *irrational exuberance*.

The internet was expected to change everything, and it did – over the next couple of decades. One important distinction between then and now, which we will write about later in the letter, is that even in the mid-1990s, the Internet had killer apps (transformative applications like Search, Email, etc.), whereas we would argue generative AI does not yet have any obvious killer apps right now.

Regardless, the companies that directly participated in the late 1990s TMT spending frenzy saw massive share price returns. Investors were leveraging behavioral finance rather than traditional fundamental analysis, largely because of the uncertainty of future results (e.g., how long growth could/would remain at those levels, and how large revenue could ultimately be). Then, starting in 1999 and through 2001, revenue growth began to slow quite rapidly, and the equity values of those businesses were crushed. To be clear, that did not happen because the promise of the internet was wrong, only that it would take

decades to realize that promise. Furthermore, the ultimate winners became less certain as new players came in to compete (remember Netscape, AOL and Yahoo!).

So, let's compare that to today. The 7 largest companies are almost exclusively driving the performance of the S&P 500 today. In fact, the spread between the equal weighted S&P and the market weighted or standard S&P is the widest it has been since March of 2000. The common thread between those 7 companies is AI – specifically generative AI. We understand that roughly \$1 trillion has been spent on building out AI infrastructure to date, with at least another \$500 billion expected in the next year or so. The problem is, none of those companies have been able to show any meaningful return on that investment aside from NVIDIA, the “picks and shovels” play in AI.

After we began putting this letter together, several sell-side firms released research reports on this exact subject. These are long reports, so we will not go into all the details, but here is a direct quote from Goldman's head of global equity research: “We've found that AI can update historical data in our company models more quickly than doing so manually, but at six times the cost.” This phenomenon is the opposite of how past technology paradigm shifts have worked, namely technology solved problems both faster *and* cheaper. To be fair, we are still in the very early days of AI, and we believe that over time, the costs will come down dramatically and this will likely get solved. However, this is exactly the point – the spending has been front-loaded, but it will likely take years/decades before the functionality (the killer apps) is ready for prime time.

At some point, and we believe we are very close to that point, we believe the businesses spending money on AI infrastructure (GPUs, data centers, etc.) will be compelled to show a value proposition – a shift in mindset from mania investing on the basis of AI's perceived strategic importance to a return to focusing on fundamentals and ROIC. Stated plainly, they will eventually ask themselves the question, “How much money can we make/save from this investment?” At that point, the pick-and-shovel companies will likely see a significant slow-down in revenue growth (declines?) and a massive reduction in their equity values. Folks who have followed the technology space for decades like Fred Hickey, who started writing *The High-Tech Strategist* back in 1987, recently warned of 80% type drawdowns for companies like NVIDIA, comparing it to Intel in the late 1990s. We agree on that magnitude of risk.

In summary, we believe a catalyst that could drive allocators to shift from Large Cap Growth into Small Cap Value could stem from slowing/declining revenue growth from the AI players – particularly the Magnificent 7. Furthermore, based on the paltry current returns on AI investment and lack of killer apps, we expect to see that sooner rather than later (i.e., quarters not years).

In the next few pages, before hitting the normal portfolio activity items, we dive into the above points with more details and some of the evidence behind our thinking – particularly how today compares to the tech bubble and bubbles more generally. We also make the case for active management in small cap by comparing our own characteristics and history to IWN (a Russell 2000 Small Cap Value ETF) and IJS (an S&P 600 Small Value ETF).

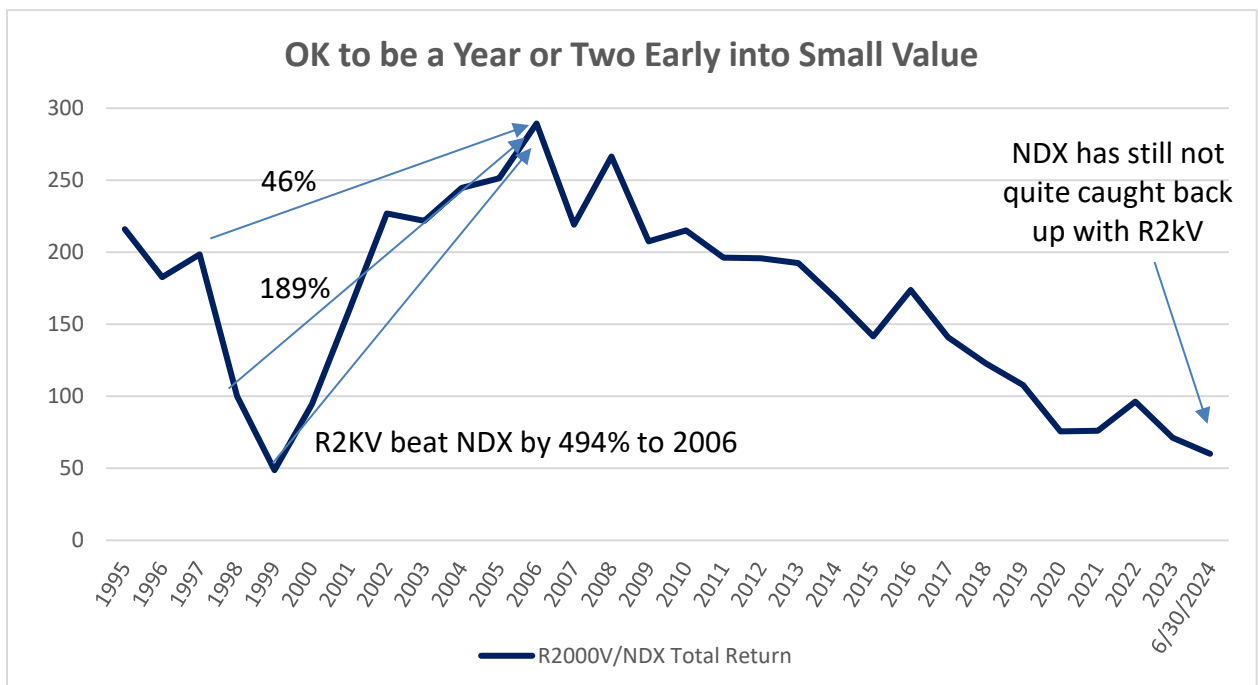
Are we too early? Possibly, but far better to be early than late.

We have written extensively about the valuation and performance disconnect between LCG and SCV, which remain multiple standard deviations from normal. At this point, you can do a simple search on X (formerly Twitter) and find dozens of charts that depict that. Much like what happened in the '90s, it has gone on far longer than we expected. In fact, in the first half of 2024 small caps underperformed the S&P 500 by the most in recorded history – the rubber band is extremely stretched at this point.

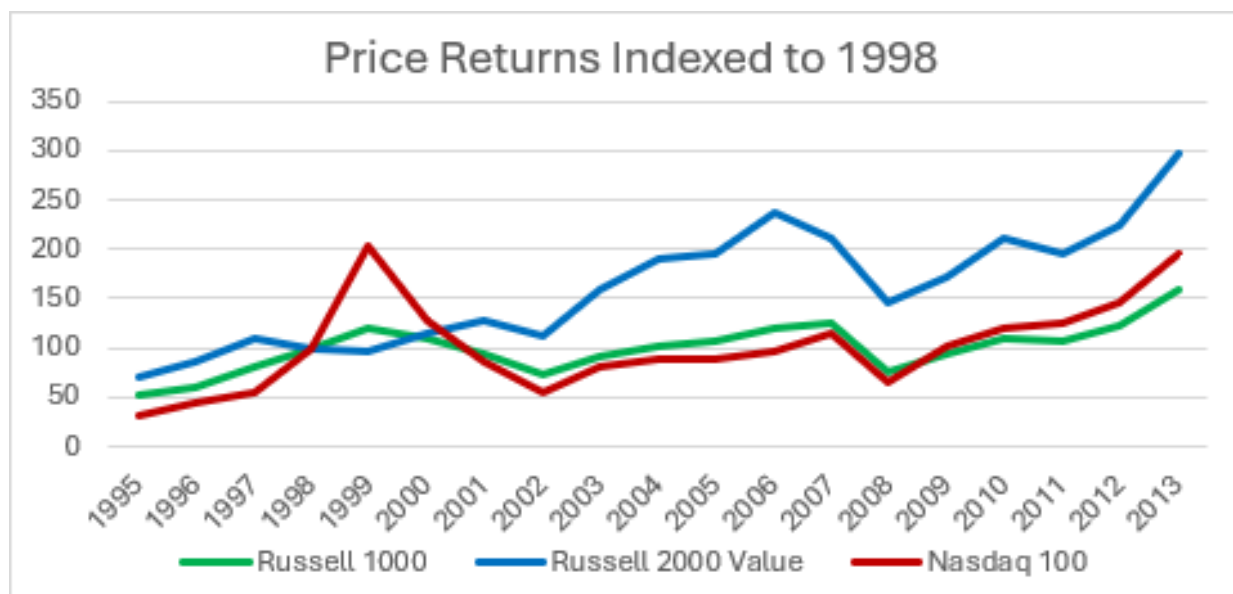


Many of our clients and readers agree with us, but are worried about being early. So, we went back and looked at the late 1990s and compared the performance differential based on when would have made the theoretical shift in allocations. The results may surprise you.

The chart below shows the relative return of long Russell 2000V, short Nasdaq 100, indexed to 100 as of the end of 1998. Starting from 1998, the trade would have lost 51% in 1999, gained 94% in 2000 and 69% in 2001 for an annualized excess return of about 17% per year compared to staying long Nasdaq. Said another way, the Russell 2000 Value gained 28% cumulative from the end of 1998 to the end of 2001 while the Nasdaq 100 fell 14%.



This next chart assumes swapping into SCV from the Nasdaq in 1998 (i.e., it rebases the indexes to 100 at end of 1998 like the prior chart). It shows that the Nasdaq 100 (as a proxy for mega cap tech) performed more or less in line 1995-97, then crushed both large caps and small caps to 1999. Starting as early as 1997, but by 2002, small cap value had pulled slightly ahead of NDX.



The point is, during the Dot.Com bubble it was much better to be early into small cap value than late unless you had serious market timing skill. Even if it is only 1998 by analogy, it is not too soon to prepare for a rotation. It was much better to be early than late for all but the most skilled market timers. From end of 1998 to 2006, the Russell 2000 Value returned 138%, outperforming the Nasdaq 100 by 142%. Even as early as the end of 1996, the RUJ still worked out better than NDX over the next decade.

These charts also help illustrate at least three cognitive biases that contribute to bubbles:

Availability bias: When intuitively estimating a probability, the brain substitutes the frequency with which it recalls various facts, not the frequency of the actual issue. Moreover, the more recent and the more extreme, the more vivid the memory is and the easier it is to recall. Large Tech has been crushing SCV for at least a decade. Intuitively, that is without actively seeking balanced historical statistics, one is far more likely to overestimate the likelihood of LCG outperforming SCV over the next 3, 5 or 10 years.

Confirmation bias: Bullish mega cap tech investors, whether retail or professional, are selectively ignoring the data. It clearly shows that Nasdaq is very expensive relative to the market and its own history, and that RUJ outperformed the Nasdaq for more than a decade last time the valuation and price gaps were this huge.

Social proof: If everyone you know claims to be making bank on mega cap tech, that this time it is different because the companies have such great business models, it is hard to take the opposite view and risk ostracism. It is easier just to go with the crowd.

These biases are even worse for professional managers exclusively managing other people's money at large institutions. In the short term, they need to be in mega cap tech to keep up with the highest-returning large cap portfolios or they will lose clients. That's just the way it is – most people chase returns without considering the possibility of reversal. It might not be the best for clients, but most pros know

they are less likely to get fired for losing a lot of money at the same time as everyone else than they are for underperforming peers year after year. The longer a bull market runs, or a bubble inflates, the greater the risk of losing your job for underperformance. That means that the pressure to conform is often strongest in the times when independent thought is much more valuable.

By the way, each member of BAM's investment team has a significant proportion of personal wealth invested in Ballast and our portfolio. This is not to show we eat our own cooking, but because we are intrinsically motivated to add value by consistently outperforming in a material way after fees and taxes. One way we try to minimize heuristic errors is BAM Bias Bingo – a simple scorecard of potential cognitive biases we use to call each other out on any of them, the bias of believing you are more unbiased than others.

Past as prelude (or prologue)?

AI will, like the internet, change many, many things in time. But right now, just like the internet boom in 1998-2000, there are more resources willing to invest than there are reasonable business opportunities and the current plug-and-play applications, such as predicting credit card fraud, are penny-ante compared to the resources being directed at AI. The introduction to the 2022 book *Power and Prediction* lays out the case for AI entering an “in between time” more thoroughly than we can.

In the first rush of euphoria, it is easy to self-justify extraordinarily speculative investments with reasonable sounding arguments like “we have to keep up with our competitors” or pitch decks along the following lines: “we’ll make billions if we can just get 20% of Chinese consumers to buy our \$100 product that costs just \$20 to make.” While mathematically true, it ignores the risk of actually being able to sell to 20% of the population and the risk that in most industries, competition will eventually drive excess profits to zero. In the meantime, businesses spending on AI infrastructure (GPUs, data centers, etc.) will slow until it shows more certain value propositions. Just as with the internet revolution, investors and businesses will stop throwing spaghetti at the wall and pause to figure out the process and systems changes needed to produce an Amazon or Google.

The markets always stop believing in the gold rush at some point. Again, we believe that point is very close, and that the pick-and-shovel companies (like NVDA) will likely see a significant slow-down in revenue growth if not outright declines, which would almost certainly trigger a massive reduction in their equity valuations.

Sorry, Alan, you can spot a bubble in advance

After having worked and lived through two huge bubbles, even in 2010 Alan Greenspan still asserted that it is impossible to identify bubbles in advance. That was important advice, as it taught us to ignore radically ideological free-market economists, government officials and mostly every “expert” that puts more weight on their beliefs than evidence. Markets are not always right, that is why you hire us. Predicting the start and end of a bubble with much precision is likely impossible, but that does not rule out spotting them in progress. You do not have to take our word for it, investing legend Jeremy Grantham has produced reams of evidence that bubbles are identifiable. So, are we in the late stages of a bubble? Almost certainly given the following list of typical bubble flags that fit historical, recent and the current bubble. Consider the following and decide for yourself.

A breakdown in traditional economic relationships. For instance, a major divergence in the price and valuation of the bubble assets relative to historical relationships and fundamentals. For instance, valuing

internet stocks based on growth in eyeballs even as revenue growth slowed. During the housing bubble, it was home prices rising in places where the economy was soft and/or people were losing their jobs. A recurrent example is an extreme concentration of a large cap index into a single sector (financials in the 2000s) or group of stocks like internet stocks in the late 1990s and mega cap stocks today.

A truthy article of faith trumps evidence. For instance, software and the internet were going to eat the world in 1997-1999, home prices were to never fall in the mid-2000s, European government bonds were all equally risky because of the European Union and the ECB right up until 2012, and AI changes everything. AI very likely will change many things over time just like the steam engine, cotton gin, automobile, computers, cell phones and the internet did. But also like those inventions, not much can change right away because it takes time to reorganize the system. For instance, EVs are currently limited by the lack of reliable charging infrastructure and/or sufficient power dense batteries (range anxiety). It took more than 30 years from Edison's light bulb to the electrically powered assembly line, which completely upended steam-powered manufacturing. (See Power and Prediction again.)

Price stops mattering. Peak-to-trough, the NASDAQ dropped 78% after the internet bubble. Given a failure rate in the range of 50%-90%, does it even matter that Amazon is now worth about two-thirds of the estimated \$5 trillion destroyed? And do not overlook the fact that other genuinely great companies, like Oracle and Cisco, who survived, have yet to regain their prior peaks even in nominal terms, never mind in real terms. Fairly valued stocks do not drop nearly 80% and take decades to recover, but they can temporarily get caught in a downdraft. To mitigate that risk, we focus on acquiring overlooked sustainably good-to-great businesses with easily managed leverage at valuations attractive enough to limit downside market risk to less than 30%, with even lower fundamental valuation risk, in our estimation.

Fraud grows rampant. Sam Bankman-Fried is probably just the tip of the iceberg in the current bubble. In the internet bubble it was sell-side analysts intentionally pitching awful investments to get fat bonuses from investment banking deals plus accounting and securities fraud of epic proportions, and not just with bubble-related companies like Worldcom – think Enron and Tyco which were well underway even though they did not come out until later. This is often very hard to detect, but it is even harder if you do not read the SEC filings with a critical eye for funky accounting details. In every bubble, the majority of investment pitches turn out to be complete nonsense if not outright fraud. For example, one evidenced-based estimate suggests that by 2004, roughly 50% of bubble startups had failed and that the remaining ones were worth trillions less. Other estimates put the eventual failure rate at about 90%. It is not just fraud on investors and savers. In the housing bubble, mortgage brokers sold hundreds of thousands of loans they knew would never be paid back, callously wrecking the financial future. NINJA (No Income, No Job and No Assets) loans made filling out a fraudulent credit application unnecessary. It is not always visible in real time, but it is almost always there.

Conventional wisdom becomes incontrovertible. Disagreement becomes heresy, ostracism, and being thought a fool. Evidence? Watch or reread *The Big Short* and reflect on how Michael Burry and Mark Baum were treated. It's fun to laugh at what dopes the big investment banks were, but it is not actually very funny at all that such smart, hardworking, well-resourced and highly incentivized people were unable to see the reality of the evidence under the sway of social proof and the influence of authority figures. For example, although Greenspan cited "irrational exuberance" in 1996, he publicly denied the possibility of identifying a stock market bubble in advance of a crash, insisting that market prices were always right. As the housing crisis became a global financial crisis, Hank Paulson (ex-Goldman, Secretary of the Treasury) declared the banking system fundamentally sound and solvent even as money market liquidity seized, counter-party credit risk skyrocketed, and major financial institutions teetered on or over the brink of insolvency. It can be very difficult to have courage of conviction when your industry peers, public

personalities and assorted “experts” insist you are wrong. On the other hand, it turned out to be very expensive for many, many people that did not think for themselves.

Putting more numbers to the Potential Reversions

Small cap value is extremely underweight as a percentage of total US market cap. The Russell 2000 Value would need to gain 58% to get back to its average weight since 2000, all else equal.

What’s the catalyst? Our best guess is a slowdown in AI investment, akin to what happened to internet investment in 2000. Unfortunately, 2024 feels a lot like 1999 and early 2000. If/when the AI bubble bursts, market cap weightings are likely to mean revert to historical averages, in which case the Russell 3000 would need to drop 31%, along with a greater than 50% decline in the Nasdaq 100. We are not predicting a market crash in large cap growth over any particular timeframe, just pointing out that when this much snow accumulates on an alpine slope, the risk of major avalanches rises.

A Russell 2000 Value (RUJ) reweighting could be funded with a 30% cut in NVDA’s market cap alone. We understand that its GPUs are the only game in town and that the market is tight, but it is after all only a single-source manufacturer, which is not a situation any major corporate customer will permit for long. Consensus expectations are extremely robust even though AI investment is slowing while at the same time competition from many well-heeled customers is just starting to ramp up. NVDA trades at 59x trailing EV/EBITDA and would still trade at 27x on 2026 consensus if the price were 30% lower. For reference, BAM currently trades at 8.5x EV/EBITDA, Nasdaq trades at 21.2x and the Russell 1000 trades at 15.7x.

We stick to our discipline of putting downside first and owning only good to great businesses with rock-solid balance sheets and cheap to fair valuations. We would expect fundamental business returns (ROE) to drive a 15%-20% CAGR in the value of our companies, even if multiples do not expand to reflect the quality. BAM’s fundamental and valuation characteristics are far better than the Russell 2000 Value and the fundamentals are comparable to the Russell 1000 at less than half the EV/EBITDA multiple.

SCV should rip once the AI, crypto, mega cap tech mania ends, which is likely much sooner than later.

When the Internet bubble burst in 2000, Value of all flavors finally caught a bid after years and years of apathy. From the end of 1999 through 2007, Russell 2000 Value had a price return of 148% versus a -53% loss in the Nasdaq 100. For context, the Russell 3000 returned 4% cumulative over the same period. With tech valuations, especially AI plays, about as stretched as they were at the end of last century and the increasing prevalence of narratives pointing to a dearth of near-term returns on AI investments, we think 2024 is more like sometime in 1999 than 1998 or 1997.

What if we are early? From right now, today, the risk of being too early is far smaller than the risk of being too late. From the end of 1998 through 2006, SCV’s cumulative price return was 138% versus -4% for the Nasdaq. From the end of 1997 through 2006, RUJ’s cumulative price return was 118% versus 77% for the Nasdaq 100. Even switching into the RUJ at the end of 1996 was hardly a disaster, given its cumulative price return to 2006 was 181% versus 114% for the Nasdaq. From 2000 to 2006, SCV had positive returns in each year except for 2002, a recession year, when it drew down -13%, compared to a -23% drawdown in the Russell 3000 and the -38% drawdown in the Nasdaq – and that was after the Nasdaq was already down 58% from the end of 1999.

If historical average market cap proportions were to reassert, using data from 2000 to 2023 with the Russell 3000 as a proxy for the total market, and assuming no change in total market value, then:

- Russell 2000 Value would need to gain 58% to return to its historical 5.3% weight.
- Nasdaq 100 would need to drop -52% to return to its historical average of 21%.
- To balance those changes, the Russell 3000 would need to fall -30%.

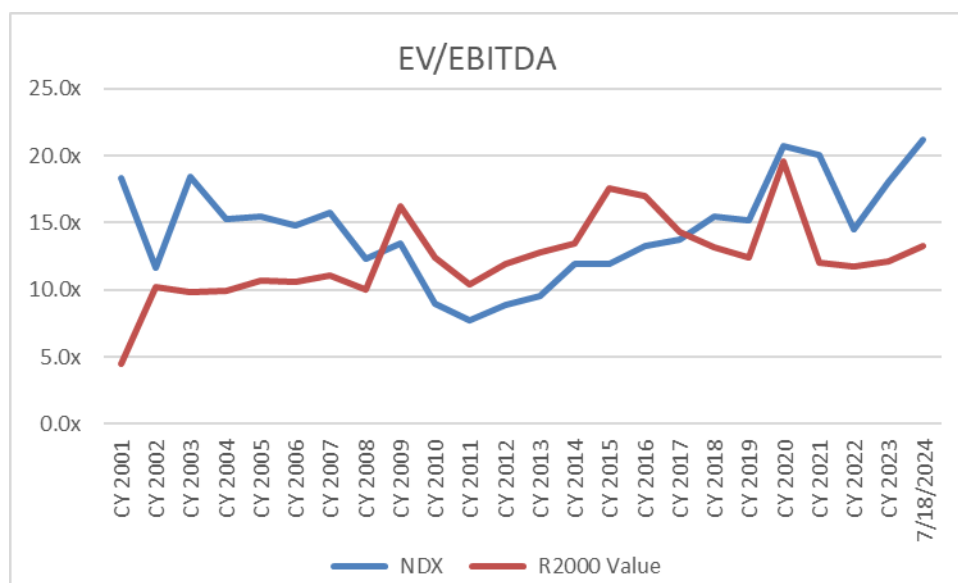
Allocation Reversion Risk as a Percentage of R3000 (2000-2023)

	Average Weight as % of Russel 3000	2Q24 Weight	Current Percentile	Percentage Change to Average	Dollar Change in trillions
Nasdaq 100	21.4%	44.8%	100.0%	-52%	-\$12.9
R2000 Value	5.3%	3.4%	0.0%	58%	\$1.1
S&P 600 Value	1.9%	1.6%	17.3%	22%	\$0.2
Russel 1000	91.6%	94.6%	100.0%	-3%	-\$1.6
Russell 3000	100.0%	100.0%	50.0%	-31%	-\$11.8

Source: Bloomberg and BAM calculations

Not a prediction, but last time weights were this distorted, in 1999-2000, things got ugly for the darlings and the broad market but not for Small Value.

If valuations mean revert to the 1995-2023 average z-scores of trailing Earnings Yield, Price-to-Book, EV/Sales, and FCF/EV, the Nasdaq 100 would need to fall -37% and the Russell 1000 would need to fall -24% while the Russell 2000 Value would gain 12%. Looking at EV/EBITDA, it is possible the spread could revert to 2000 levels (our Nasdaq data stops here), but more likely the Nasdaq will correct the gap via lower prices once the AI bubble stops. Also note that almost all the RUJ multiple expansion occurred in the first year in the following chart. This is part of why we believe early is better than late.



Source: Bloomberg, Ballast Asset Management calculations

Active Management can and has added value in Small Cap Value

Most investors we meet share our view that active management can generate consistent excess returns in small value because SCV is under-researched and because the indexes have lousy fundamentals. Since inception, we have outperformed the Russell 2000 Value (RUJ) after fees in each and every one of the 70 rolling three-year periods, which is our internal investment horizon. On average, BAM outperformed RUJ by 13.4% and by 2.99% in our worst three-year period. IWN, the ETF that tracks the RUJ, has trailed the RUJ in each of those three-year periods, by -0.5% on average and by -1.0% in the worst three years. IJS, an S&P 600 Small Value Index ETF which has slightly better fundamentals than the RUJ, outperformed by 3.6% on average and underperformed -2.8% in its worst three years.

How do we do this? We start our analysis by estimating the downside risk first and spend far more time understanding the knowable facts than trying to predict the inherently uncertain future. COVID? PIIGS crisis? We also focus on the underlying business economics, competitive positioning, and profitability. As the table below illustrates, we mainly invest in quite profitable companies at valuations offering a very asymmetric upside/downside.

	EV/EBITDA		EBITDA		Price/Earnings*		EPS	Net Debt		Return on Equity		Dividend
	Trailing	BEST NTM	Growth NTM	Trailing	BEST NTM	NTM		to EBITDA	P/B	LTM	NTM	Yield
Nasdaq 100	21.2x	17.2x	23%	35.2x	29.7x	18%		0.9x	8.1x	22.6%	24.9%	0.8%
Russell 2000 Value Index	13.3x	11.0x	21%	14.7x	14.5x	1%		5.0x	1.5x	9.3%	9.0%	2.2%
S&P Small Cap 600 Value Index	12.9x	9.9x	30%	16.4x	15.6x	5%		5.9x	1.4x	8.6%	8.6%	2.3%
BAM/MGMT	8.5x	6.2x	37%	15.7x	12.5x	26%		0.8x	2.5x	19.2%	27.2%	1.9%
Russell 1000 Index	15.7x	14.4x	9%	26.5x	23.1x	15%		1.7x	4.5x	17.8%	19.3%	1.3%
Russell 3000 Index	15.7x	14.3x	10%	26.0x	22.8x	14%		1.6x	4.8x	17.0%	18.5%	1.3%

Source: Bloomberg and BAM calculations
Future characteristics are BEST next twelve months
* positive, before XO

In the table above, note that BAM's Net Debt to EBITDA of 0.8x is actually lower than that of the large cap indices and an order of magnitude lower than for IWN or IJS. In our experience, and common sense, lower debt leverage reduces the impact of fundamental risks, such as major earnings disappointments or sudden change in bankruptcy risk, which also helps moderate downside price risk. BAM's portfolio is also slightly cheaper than either SCV index, and much cheaper than all the large cap indexes, providing further downside risk protection.

By comparison to the primary small cap value indexes, BAM's portfolio is twice as profitable on ROE, and BEST consensus reflects nearly twice as much EBITDA and EPS growth as the broad market. Not even the Nasdaq is expected to grow EPS faster. ROE is a crucial metric because it compares profits to the cost of obtaining them and governs how fast the business can grow without outside capital. All else equal, and this is a dangerous oversimplification, but theoretically, if a stock's multiple does not change, and the business can reinvest all profits, the stock's return over time would equate to its ROE.

Since inception October 2015, our strategy has returned 11.4% gross and 10.3% net of fees. We admit that is a fair amount of fee drag compared to the 0.24% charged by IWM (a Russell 2000 Value ETF) and 0.18% charged by IJS (an S&P600 Small Value ETF). Are we worth 1%? We think it is fair given the excess return we have generated. Our clients are 36% better off than investing in IWM and 24% better than IJS since our inception.

In addition to consistent medium-term excess returns after fees, our clients have had much less market-related indigestion along the way because we manage fundamental downside risk, something that indexes simply cannot. Our worst absolute return in all 70 of the three-year periods since our inception was -18% versus -26% for IWN and -24% for IJS. BAM returned less than 0% in only 2 of the 70 periods

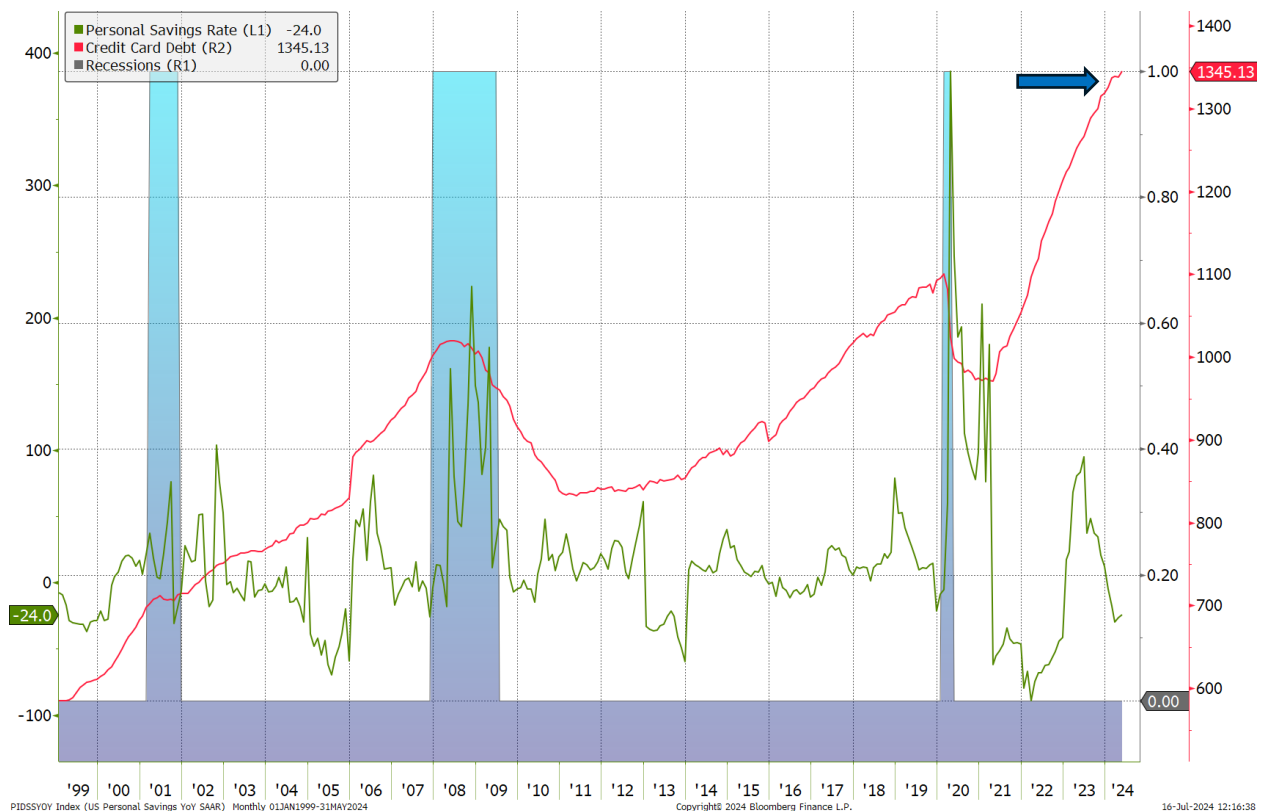
versus negative returns 12/70 times for IWN and 11/70 times for IJS. Our rolling three-year risk statistics have essentially the same relationship to the index funds.

As an aside, the returns to RUJ in rotation out of LCG could be capped by the low quality of the Index over time. The less diversified S&P 600 is higher quality on average and likely a better passive choice, but the fundamentals still are not great. In the shortest term, if there is a violent shift out of LCG, RUJ might have more torque off the floor than BAM or IJS. A rush of fund flows could boost index members indiscriminately, goosing zombies currently priced for eventual bankruptcy into a short-term bounce. Unjustified by the fundamentals, that is unlikely to be sustained if not accompanied by much lower interest rates and very loose underwriting standards. (It might be possible to make that off-the-bottom trade, but this is not our primary approach. We would rather play for more reliable returns available over longer horizons than engage in trying to capture every wiggle of the market perfectly.)

Economic Backdrop

As we have written all year, we remain cautious on the overall economic environment – particularly as it relates to the consumer. While the Industrial economy largely went through a recession/inventory digestion in 2023, the consumer was buoyed by massive government stimulus payments coming out of COVID. As you can see in the following chart that excess savings have been exhausted. For better or worse, we as Americans do not like for our standard of living to cycle down when we face personal headwinds. In the near term, revolving debt (e.g., credit card debt) serves as a shock absorber when our incomes fall, enabling us to push back the needed spending cuts until forced to do so. That overarching psychology is perhaps even more pervasive today due to the massive headwind of inflation on nondiscretionary items (e.g., food, shelter, energy, etc.).

What we notice most about the chart below is the rapid acceleration in credit card debt we experienced prior to each of the last three recessions. Candidly, credit card debt increases over time, so the trend-line is clearly upward sloping. That may be an issue in and of itself, but less relevant to our near-term concern. What we notice is the significant acceleration in credit card debt prior to recessions, which appears to be what we are seeing today.

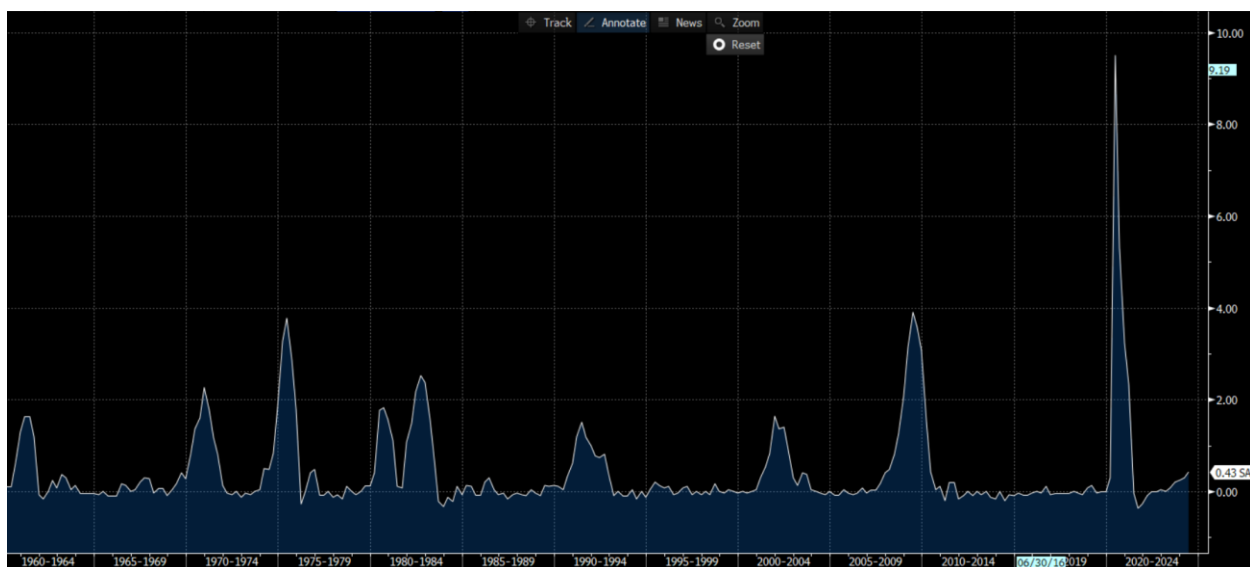


Other datapoints of concern include:

- Rising credit card delinquencies
- Falling permanent jobs
- Consistent downward revisions in the jobs data
- Increasing delinquencies in multifamily housing

As a result of these building concerns, most of the new buys over the last 12-18 months are of businesses with less cyclical, more idiosyncratic risk. If our fears of a downturn come to fruition, particularly as it relates to the consumer, we believe our investors should be more protected from any relating downturn relative to the passive indices. However, in fairness, that sword cuts both ways. In a general beta rally that we experienced last week, this positioning could prove challenging in keeping up with the more cyclical passive indices. This is particularly true as it relates to our massive underweight to banks, which tend to spike hard during major beta rallies. Over time, we expect the company-specific factors we focus on to outperform both on a relative and risk adjusted basis, but our quality focus tends to trail in behavioral “risk-on” rallies.

The Sahm rule probably is as good as any other recession indicator and it stands on the brink. Historically, whenever the ratio of trailing three-month unemployment exceeded the trailing twelve-month low by more than 0.50, the economy was either in or just about to enter a recession. At 0.43, we are not in a recession yet, but perhaps one is not far off.



The rates market appears a little lopsided, clearly reflected in forward rate bets putting Fed rate cuts this year at 100%. Rates may well be more likely to come down than rise, but nothing is ever 100% and there are competing reasons to think that they might in fact go up. For instance, if the economy is slowing enough to justify the market odds, how do we reconcile that position with extremely tight credit spreads? There is basically no premium in spreads for the possibility of a recession and consequent defaults. Moreover, tight spreads on lower-rated credits may also indicate that equity risk appetites are very strong, which is also hard to reconcile with an economic slowdown given current equity valuation levels. Luckily, we are bottom-up investors and do not have to make the rates call. If we did, it would probably make sense to bet against the chances of a rate cut given that it would not pay very much if the market is right but it could lose a lot if the market is wrong. Conversely, one month of lower-than-expected inflation data does not confirm a change in the trend and there is still plenty of government stimulus liquidity sloshing around.

Top Contributors and Detractors

Top Contributors	Average Weight	Total Return
Consol Energy	3.0	21.8
Sprouts Farmers Market	1.9	29.7
Northern Technologies	1.9	23.6
Lennox International	2.1	9.7
Bel Fuse Inc	2.2	8.3

Bottom Detractors	Average Weight	Total Return
Trip Advisor	2.1	-35.9
Green Plains	1.9	-31.4
Atkore	2.0	-29.0
Eagle Materials	2.9	-19.9
Cass Info Systems	2.7	-16.2

New Positions

The Brink's Company (BCO)

In June, we initiated a new position in The Brink's Company. Historically, the Company provided security services that specialized in the logistics/transportation of cash and other valuables. The industry has gone through several changes, including significant consolidation, and the two largest players (Brink's and Loomis) both began focusing and providing more value-added services to customers to improve efficiency and costs. For example, Brink's has cash "vaults" on-site at their customers that count and store the cash as it is inserted into the vault. The vaults are then typically integrated into the customer's own financial systems, which reduces the amount of time to access the cash from their bank account (i.e., they receive credit for the cash prior to it actually being picked up from the on-site vaults).

Historically, before digital cash vaults, customers would enter into a contract with a secured transportation company to pick up cash on some level of frequency. This delayed customers' access to cash and required Brink's to make multiple trips per week to collect cash, without knowing how much was in the vault and whether a trip was worth it. Today, once the cash is in the vault, it is effectively the same as depositing cash in the bank for the company. Brink's will ACH funds to the customer's desired bank account the next day.

Brinks is also aware of how much cash is in each vault at any given time and ultimately will be able to better optimize their routes and improve asset and employee efficiency – they determine when it makes the most sense to go pick up the cash. The other large competitor can offer similar services, but they do not advance the money themselves, it is typically through a relationship with a bank. The bank that advances the money has requirements on when cash should be picked up and reduces operating flexibility. This subtle but important difference provides Brink's with a significant competitive advantage in optimizing routes. In addition, many of the smaller customers get charged relatively high factoring rates from banks offering these service, and larger customers may find it more difficult to consolidate their banking relationship.

Ultimately, Brink's offers flexibility and better terms to smaller customers. Advancing money against the cash vault directly provides value to the customer, while at the same time providing better operating flexibility for their own operations. This should provide for long-term runway of increased margins, returns and cash flows. We believe the market is most concerned about the future of cash as a mode for transactions, and this concern has created the opportunity for us to participate at a reasonable price (7x EBITDA and 10% FCF Yield) in a dominant business that is on the cusp of a structurally improving their business's profitability and returns over the next 3 to 5 years.

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.

¹Account 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.

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²The 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).

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