Q & A with Jeff Kautz and Randy Hughes
Ballast Equity Management, LLC

Jeff Kautz and Randy Hughes co-founded Ballast Equity Management in 2016. More important to their clients may be the fact that they have invested together for over twenty years. Previously, the two worked together at Perkins Investment Management, a subsidiary of Janus Henderson Group, where Jeff held roles including Portfolio Manager, CEO and Chief Investment Officer and Randy held the roles of Director of Research and Analytics and Equity Analyst. Assets under management during Kautz' and Hughes' tenures at Perkins grew from $30 million to over $20 billion at the peak.

Q: Jeff, you and Randy have invested together for more than 20 years, including your time at Perkins. What qualities do you insist on building into the culture of your new firm, Ballast Equity Management?

A: **(Kautz)** Randy and I have worked in small, entrepreneurial firms and in large, publicly traded companies. We believe the culture we are creating at Ballast, a small, employee-owned firm, is the best approach to align ourselves with the interests of our clients. We invest significant sums of our own liquid investments alongside those of our clients and we focus our efforts each day on building portfolios of quality businesses to meet the investment needs of those clients. We love what we do and we're here for the long term, without pressure to deliver short-term business or investment results.

Q: Talk about your investment philosophy and process.

A: **(Hughes)** Ballast Equity Management holds an investment philosophy grounded in four core beliefs. First, we believe that many small-cap companies are underfollowed by the marketplace resulting in overlooked investment opportunities while mid-cap companies, albeit more established than small caps, offer better prospects for growth than large-caps especially when purchased at reasonable valuations. Second, we believe that investors often overpay for stocks of low-quality, high-beta companies, overlooking opportunities in more stable, higher-quality businesses. Third, we know that compounding is powerful; investors will build lasting wealth through a strategy that protects during down markets and participates in rising markets. Finally, we understand that patience is essential to investing success, but hard in practice.

A: **(Kautz)** Ballast employs a research and screening process that includes four distinct steps:

1. Ballast begins by charting the ratio of Enterprise Value to Invested Capital relative to the Return on Invested Capital (ROIC) for a universe of 3000 small and mid-cap stocks. This is done with the theory that an investor should be willing to pay more for a business that earns high returns on invested capital. Ballast considers those businesses whose stocks appear to be undervalued and excludes those businesses that appear overvalued in this analysis.

2. Next, we employ quantitative analysis that, we believe, is one way that Ballast differentiates itself from competitors. The team rates stocks in its universe according to its proprietary Quality Rankings Model, using factors including leverage, interest coverage, stable and growing cash flows and stable and growing Returns on Invested Capital.

3. After ranking businesses using the Quality Rankings Model, Ballast does considerable qualitative analysis, focusing on those stocks that rank in the top two quintiles of its universe. Ballast believes strongly that high returns on capital are maintained and defended through proven, durable competitive advantages, such as economies of scale, strong intangible assets, high switching costs, network effects and cost advantages. Ballast professionals use a combination of proprietary research, third-party research, regulatory filings and other publicly available company information to assess the durability of competitive advantages for each business.

4. Strong quantitative scores from the Quality Rankings Model and durable competitive advantages may result in a portfolio of well-performing, high quality businesses, but Ballast strongly believes that valuation plays a vital role in successful investing. Team members have used many valuation tools in their history of working together, but believe that a calculation of economic profit considers the capital allocation decisions made by business management and allows Ballast to answer its primary question: *"Does the company create wealth for investors over time?"*

Q: Has your process changed since your tenure at Perkins? If so, how?

A: **(Hughes)** At Perkins we always owned companies that had strong balance sheets, but cheap valuation was the primary and foremost consideration. We were buying cheap companies that had problems with the hope those problems would get fixed over time. At Ballast, It's not enough to sift through cheap stocks in search of a good business; we want to begin with good, high-quality businesses, supported by durable competitive advantages, and then have the patience to invest in them when the market gives us the opportunity to buy at a discount to the future economic profits that the company will produce. Warren Buffet always says that It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.

Q: Your process focuses on quality companies and downside protection. Tell us about how you feel these priorities work together?

A: **(Hughes)** Investing in quality businesses and our emphasis on downside protection work together, without a doubt. There are many examples we could give, including looking into the performance of businesses ranked by our own proprietary Quality Rankings. A quick answer, though, is to look at the performance of the Russell 3000 Defensive index (to represent high quality companies) versus the performance of the Russell 3000 Dynamic index (to represent low quality companies). Between February 2007 and the end of March 2019, the high-quality companies represented here dropped 3.3% in down markets, outperforming low quality companies that fell, on average, 5.1%. Importantly, high quality companies, as represented by the Russell 3000 Defensive index, have also outperformed lower quality (Russell 3000 Dynamic index) companies over a full market cycle, with less risk. Indexes and quality measures aside, we also believe we can mitigate risk through careful attention to valuation; only buying quality businesses when we believe they are trading at discounts to the economic profits of those companies.

Q: As a small team, how do you make portfolio decisions?

A: **(Kautz)** First a comment on the "small team" dynamic at Ballast: Randy and I have worked together for more than twenty years. We are a small team, yet the experience we each have in researching and investing in small and mid-cap companies and the experience we have investing together is significant. Investing is a craft where you can learn and get better over time and we believe we have. We make decisions together, with full agreement, or we pursue other opportunities where we can reach consensus.

Q: Where should an investor position your strategies in their portfolios?

A: **(Hughes)** We insist on owning quality businesses and seek to buy their stocks at a discount. We are value investors. That said, we are not deep discount value managers and, due to our conviction in the businesses, some of the stocks we own may trend toward the growth style over the time we own them. It's fair to consider us as a relative value manager and we can serve as the "Ballast" in a client's portfolio that also holds a more aggressive growth manager. We also can serve as a complement to a deep discount manager on the value side of the menu.

Q: What else should investors know about you and Ballast?

A: **(Kautz)** We enjoy working together and love what we do. The independent, employee-owned structure of our firm permits us to be patient and take the long view, both with respect to our investment portfolios and with our business decisions. We know that our clients have many options when they seek out investment firms and we're grateful to work for them.

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