



## **Ballast Equity Management, LLC Q4 2019 Commentary**

More information including since-inception performance for each of the strategies may be found at [www.ballastequity.com](http://www.ballastequity.com).

Stocks and other risk assets rallied into the year-end, aided by the Federal Reserve's third cut in interest rates, diminished trade war fears, strong labor markets and resilient consumers. The rally lifted stocks broadly, and particularly lifted those of lower-quality, less profitable and more leveraged businesses, producing headwinds for the quality-biased Ballast strategies. 2019 began with U.S. equities at reasonable valuations and, as a result of tepid earnings growth during the year, ended at more fully valued levels. Accordingly, the team at Ballast Equity Management feels that selectivity and an emphasis on stable, quality companies purchased at reasonable valuations will be increasingly important in the year ahead.

### **Ballast Strategy Performance**

The **Ballast Quality Value Midcap Strategy** produced a return before fees of 7.02% for the quarter, leading the Russell Mid Cap Value Index return of 6.02% while slightly lagging the Russell Mid Cap Index return of 7.05%. Security selection helped performance in the Financials and Real Estate sectors and detracted from performance in the Technology and Industrials sectors.

### **Quality Value Midcap Top Contributors**

**Skyworks Solutions, Inc. (SWKS)** was the leading contributor to performance during the quarter as shares rose in recognition of strong operating performance, the anticipation of improved U.S.-China relations and growth prospects in the build out of 5G networks. Skyworks is a leading supplier of radio frequency components to smartphone makers and other electronics manufacturers and benefits from the move to 5G as well as the need for its radio frequency chips in high-end 4G handsets. The company produces operating margins of 28% and Returns on Invested Capital of 21%.

**Tiffany & Company (TIF)** shares rose in anticipation of the company's acquisition by LVMH. Ballast has held shares of Tiffany since the inception of the Quality Value Midcap strategy due to the company's strong aspirational brand and the pricing power it commands. With the share price reflecting its upcoming acquisition, Ballast sold its position in Tiffany.

### **Quality Value Midcap Top Detractors**

Energy services firm **Core Laboratories (CLB)** detracted from performance after management cut its Q4 2019 guidance, provided Q1 2020 guidance below the consensus and slashed its quarterly dividend to \$0.25 from \$0.55 starting in Q1 2020. These moves were in response to a sharper-than-expected slowdown in U.S. land activity during the fourth quarter, as well as slower-than-expected business from

clients for large international and offshore projects in its Reservoir Description segment. While we agree with management's decision to cut its dividend and preserve its balance sheet, it is unclear where we are in the current energy cycle or when we can expect to see CLB return to normalized levels of profitability. While we believe CLB to be a high-quality company, Ballast decided to exit its position in the company during the quarter in favor of more attractive alternatives.

Self-storage provider **Extra Space Storage (EXR)** modestly detracted from performance. EXR is an excellent operator with 1500 properties in 38 states. Its size and scale give the company a significant cost advantage and market presence relative to its competitors. Shares fell in reaction to discounting that the company is doing to combat competitors' supply in certain markets and the "arms race" that will result. While this discounting and the company's increased marketing costs will impact net operating income in the near-term, we see EXR as well positioned to weather the challenges.

The **Ballast Quality Value Smallcap Strategy** produced a return before fees of 5.24%, lagging both the Russell 2000 Value and Russell 2000 Indexes returns of 8.49% and 9.94%, respectively. Security selection detracted from performance in the Healthcare and Technology sectors, where biotechnology and semiconductor holdings in the indexes soared during the risk-on environment of the quarter.

#### **Quality Value Smallcap Top Contributors**

**Allied Motion Technologies (AMOT)** shares rose during the quarter as earnings growth exceeded analysts' estimates. AMOT is a leading provider of motion control solutions to end markets including automotive, medical, aerospace and defense customers. Growth areas AMOT is targeting include robotics, material handling and factory automation as it takes share and outgrows the broader motion control industry. Ballast believes share of AMOT to be significantly discounted to the company's fair value.

**UFP Technologies (UFPT)** shares increased as sales and income rose significantly over the prior year's results, exceeding expectations. UFPT provides the supply-chain link between producers of raw foams, plastics, composites and natural fiber materials, as the company engineers and manufactures custom packaging, component and product solutions for the medical, automotive, aerospace, defense, industrial, electronics and consumer markets. The company benefits from high switching costs, primarily in its medical products division where it offers custom packaging solutions to medical device manufacturers.

#### **Quality Value Smallcap Top Detractors**

**Ebix, Inc. (EBIX)** shares detracted from performance as the company reported earnings below consensus estimates due to lower margins during the quarter. EBIX supplies on-demand infrastructure exchanges to the insurance, financial, and health care industries globally. Competitive advantages include high switching costs and high renewal rates in its legacy software business. The company has a 20+ year track record of creating shareholder value, heavy insider ownership, aggressive share repurchases, consistently strong capital allocation and a CEO taking his compensation in stock. With a growing business in India, EBIX also offers a pure play opportunity on the country through its U.S. listed shares.

**Core Laboratories (CLB)** Commentary on CLB is provided above.

The **Ballast Select Value Strategy** produced a return before fees of 5.91%, lagging the returns of 7.06% and 8.52% for the Russell 2500 Value and Russell 2500 Indexes, respectively. Stock selection in the

Financials and Real Estate sectors aided returns, while selection in the Technology and Consumer Defensives sectors detracted.

### Select Value Top Contributors

**Badger Meter, Inc. (BMI)** is one of the largest water meter companies in the U.S. and competes effectively against much larger diversified companies in the international arena. BMI's two largest competitors in the U.S. generate less than 15% of annual revenue from their water meter businesses. We expect that BMI's market will continue to grow as countries replace old meters and install meters for the first time. Business performance has been strong, and the company has increased ROIC from 5% in 2001 to its current level of 12%.

The rise in indexing of investment portfolios has created a booming business for providers of the indexes, themselves, including **MSCI, Inc. (MSCI)**. Asset-based fees have been a leading driver of revenue growth over the past several years as the extended bull market has unlocked the leverage potential of its index business. The company benefits from a strong brand and high switching costs, as many ETFs, mutual funds and hedge funds use MSCI indexes. This represents a steep challenge for rivals that is unlikely to be surmounted. Additionally, MSCI offers Environmental, Social and Governance ratings that stand as an impressive source of growth. MSCI currently has strong operating margins of 42% and ROIC of 21%.

### Select Value Top Detractors

**Core Laboratories (CLB)** Commentary on CLB is provided above.

**J&J Snack Foods Corp. (JJSF)** shares were down modestly during the quarter as earnings missed consensus estimates and margins declined. Ballast continues to see the company as a compelling opportunity, delivering 12% ROIC and selling at a reasonable valuation. JJSF is a leader and innovator in the snack food industry, providing affordable branded niche snack foods and beverages to foodservice and retail supermarket outlet. Strong brands stand as a competitive advantage for JJSF and include Superpretzel, Bavarian Bakery, ICEE and Slush Puppie frozen beverages and Minute Maid frozen juice bars. JJSF has a 75% market share in soft pretzels at food service locations and a 90% share in retail supermarkets. Cash is used for dividends and share buybacks, but primarily for tuck in acquisitions. The company announced a 15% increase in its dividend in December 2019.

### Outlook

Looking into 2020, there are many positives to consider including a global economy that seems to be on solid footing, a strong and supportive U.S. consumer and a strong labor market providing opportunities and earnings power for our workers. Points of concern in the economy and markets can be found, as well, including geopolitical tensions, U.S. trade and rising protectionism, weak global manufacturing, high levels of public and corporate debt, full asset valuations and muted expectations for investment returns. Adding to these concerns will be U.S. election year rhetoric and the likely volatility it will create.

Considering both positive and negative factors is inherent to Ballast's investment philosophy and seems very appropriate, given the current state of the economy, the market cycle and asset valuations. As we invest alongside our clients, we are confident doing so in quality business purchased at reasonable valuations. Selectivity is key. Our mission is to deliver a smoother ride in good markets and bad, offering participation in rising markets and smaller drawdowns when markets turn negative. Ballast does this

through deliberate analysis and long-term investment in companies exhibiting strong balance sheets, stable and growing cash flows and returns on invested capital well in excess of their costs of capital. We invite you to join us.

**Disclaimer:**

Returns are for the respective composites of Ballast Equity Management. Gross returns are calculated net of trading fees. Net returns are calculated assuming the maximum advisory fee of 100bps is applied. All dividends are assumed to be reinvested. The returns of the BQV Midcap Strategy are compared to the historical performance of the Russell Midcap Indices as they are a widely used benchmarks for mid capitalization securities. The returns of the BQV Smallcap Strategy are compared to the historical performance of the Russell 2000 Indices as they are a widely used benchmarks for small capitalization securities. The returns of the Ballast Select Value Strategy are compared to the historical performance of the Russell 2500 Indices as they are a widely used benchmarks for SMID capitalization securities. An investment with Ballast Equity Management (BEM) should not be construed as an investment in a program that seeks to replicate, or correlate with, these indices. Market conditions vary between the BEM products and these indices. Furthermore, these indices do not include any transaction costs, management fees and other expenses, as do the BEM Products. Lastly, BEM may invest in strategies and positions that are not included in these indices.

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