Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
Second Quarter 2016

Overview

The second quarter of 2016 was a positive one for the broader small cap market, with the Russell 2000 Index registering a healthy gain of 3.8%. As energy markets took a step back from the brink, and crude oil prices practically doubled off of their mid-February lows, small caps climbed 20% from their trough. Unsurprisingly, the rebound was largely led by energy and materials stocks—precisely those stocks that were hardest hit in the first six weeks of the year.

While the Punch Small Cap Strategy was spared the downdraft in the first quarter because of our avoidance of energy and materials shares, it was for the same reason that we missed the rebound in the second quarter. We did add one materials stock to the portfolio in the second quarter, although it occurred late in the quarter and was not a "material" contributor to performance. We also increased our position in two energy-related positions, but we exited the quarter with only an in-line weight relative to the index.

We have historically avoided energy and materials stocks—we have even gone through extended periods of time with zero exposure to these groups—mostly because we are not attracted to businesses that have little control over the prices it can charge to its customers.

We think that companies that have unique products or services (not commoditized ones) and can demonstrate pricing power over time are the investments that stand the best chance for creating significant value for their shareholders. We humbly acknowledge that we have no predictive powers over the prices of commodities like crude oil, or gold bullion or hog bellies, and it seems to us that these prices are often the primary determinant of a commodity producer's value.

Notwithstanding this aversion, we are doing significant due diligence on a small handful of energy-related companies today. Some of these are simply too cheap and unloved to ignore. Stay tuned for more to come on these companies if and when they make their way into the portfolio.

The worst-performing index sector in the second quarter was the consumer discretionary sector, which was also the lone sector to decline for the period. Given our significant overweight to this group, this was a meaningful headwind.

Finally, the persistent decline in interest rates, and many investors' hunger for yield, drove significant gains in the utilities sector in the quarter. Utilities gained 9.6% compared to a 3.8% return for the Russell 2000. This sector is another area we have historically avoided and, today, we are especially avoiding it given lofty valuations and the fact that it is very much an "in favor" group. We exited the quarter with zero exposure and don't see this changing anytime soon.

Performance (net-of-fees)

	Punch Small Cap	Russell 2000
Q2 2016	***0.77%***	3.79%
2016 YTD	***-0.13%***	2.22%

Positive Contributors in Q2 2016

Our top contributor to performance in the quarter was, unsurprisingly, an energy-related stock. **Corenergy Infrastructure Trust (CORR, $350mn market cap)** is the only public real estate investment trust (REIT) that invests in energy infrastructure assets like pipelines, storage and terminal facilities that are the tollbooths of the energy industry. Technically, the stock is included in the financial sector because it is a REIT, although its principal business driver is clearly the energy sector, and its shares have traded with energy for the past year.

From June 30, 2015 to mid-February, 2016, CORR shares declined 65%. Since February of 2016, though, the shares gained 150%. During this wild time, the company's two largest tenants—representing a majority of its rental income—filed for bankruptcy.

However, true to our initial thesis, the assets owned by Corenergy were both critical to these tenants' operations and structured to withstand an even worse case bankruptcy scenario, which ultimately came true in this abysmal energy environment. The company's underwriting of these assets was, in short, impeccable.

After raising their dividend twice in 2015, management has held it steady so far in 2016, and they have given guidance that they expect the dividend to be consistent and sustainable for the foreseeable future. The company has experienced a worse-case scenario for its business model and lived to tell the tale with barely any change to their financials. We think this gives them significant credibility in an environment where many energy-related business models have not fared so well. The stock trades at book value and yields 10%, reflecting the high-quality characteristics of the business. While the Russell 2000 Energy Index is down nearly 40% over the past year, CORR's total return is 5%.

Our second largest contributor to performance in the quarter is a relatively new name to the portfolio and one we are particularly excited about. **Landauer (LDR, $400mn market cap)** is a Chicago-based company that is as close to a monopoly business as we have seen in some time. Landauer provides radiation-monitoring badges to people who work near radioactive materials: doctors, nurses, dentists, utility workers, military personnel and others. The company has only one small competitor, claims an 85% market share in its core markets, and the barriers to entry for competitors are significant given complex technology and regulatory requirements. The company's financials reflect these characteristics with high profit margins, excellent returns on capital and copious free cash flow.

Top Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
Corenergy Infra	1.5%	48.3%	63
Landauer Inc	2.5%	25.3%	57
Alamo Group	2.7%	18.6%	47
Douglas Dynamics	3.4%	13.5%	46
Callaway Golf	3.9%	12.1%	45

Bottom Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
Trueblue Inc	2.7%	-27.7%	-94
Malibu Boats	1.9%	-26.3%	-59
Lithia Motors	2.9%	-17.4%	-56
Gentherm	2.1%	-17.7%	-41
Westwood Hldgs	2.9%	-10.8%	-32

New management is refocusing the company on this core, crown jewel business and is in the midst of developing its next-generation technology platform that should be even more profitable and less capital intensive than the current one. After reporting results for the fourth quarter of 2015, the stock declined nearly 30% on concerns that the transition to the new platform was taking longer and was more costly than expected, although management allayed those concerns in their first quarter earnings announcement, and the stock reacted accordingly.

Negative Contributors in Q2 2016

Our largest detractor from performance in the quarter was industrial firm **Trueblue Inc. (TBI, $950mn market cap).** Trueblue is the largest provider of temporary staffing services to the light industrial and small business markets, serving industries such as construction, manufacturing, transportation and hospitality. The company's national branch network and longstanding customer relationships provide significant advantages over smaller, mom-and-pop competitors, and the company has benefitted from the secular trend toward temporary staffing.

In the second quarter, two big issues affected the company, one of which was specific to Trueblue and one of which was not. First, the trend in many parts of the country (most notably California) towards higher minimum wages has compressed the profitability of staffing companies. We think this is a near-term issue that should lessen in time as the entire industry adjusts. Second, Trueblue's single largest customer (Amazon, at 13% of their revenues) shifted where and how much temporary staffing they needed, which negatively affected results for the year. We think both of these issues are not long-term headwinds or indicators that the business is broken, and we continue to like the company's competitive position in the current economy where temporary staffing trends are still strong.

Malibu Boats (MBUU, $250mn market cap) is a Tennessee-based manufacturer of performance sports boats and is a well-known brand among water sports enthusiasts. Malibu is also the inventor of the "surfgate" technology that allows safe and reliable wakesurfing behind boats. For the un-initiated, wakesurfing is an exciting and growing watersport that we think is driving interest and participation in boating more broadly, and it is driving sales for new Malibu boat models in particular.

Companies like Malibu and Mastercraft (a close competitor) are in significantly better operational and financial shape than they were before the downturn, and they are now poised to generate meaningful returns and free cash flow as the industry works its way back to normalcy. Boat sales, industrywide, are 45% below their 20-year average from before the financial crisis of 2008-09, and we think there is plenty of headroom for the industry to grow. Malibu shares have slipped this year on concerns that boat sales are peaking, but recent sales data for the current summer season suggest otherwise. Malibu's valuation, at 1x sales and 10.5x earnings, already reflects a downturn in the industry that we do not think will materialize. On the contrary, we think that at this price, we are investing in a high-quality manufacturer with years of good growth ahead of it.

Initiations and Exits

We initiated one new position and exited one in the fourth quarter, leaving the total number of positions unchanged at 45 stocks.

Late in the quarter we added **Ferro Corporation (FOE, $1.1bn market cap)** to the portfolio, a stock which falls into the materials sector. Ferro is a producer of tile, glass and ceramic coatings primarily used in construction and automotive markets around the globe. Fully 80% of Ferro's sales are outside the U.S., and 50% are in emerging markets.

Ferro was a company on the brink of bankruptcy in 2012 when new management was brought in to re-focus the business and shed low-margin business segments. The turnaround has been impressive with gross margins doubling to over 30% and EBITDA margins approaching 20%. Management has said publicly that they expect free cash flow to double in 2-3 years, approaching $100mn annually. Finally, management recently concluded a review of strategic alternatives, and it was rumored that they turned down several private equity offers at a premium to the current stock price.

We think Ferro is a leader in its niche with scale and unique assets around the globe that, under a management team that has proven itself, should begin to generate meaningful free cash flow. We also like the fact that, because its coatings are used in beverage containers, the company receives a penny each time someone in the world drinks a bottle of Corona!

In June, we completely exited our position in **Carmike Cinemas (CKEC, $750mn market cap)** following their proposed takeover by AMC Theaters. When the takeover was announced in March of this year, we cut our stake in half, maintaining a position in the hope of a raised bid by AMC. By June, the stock traded at a 6% premium to the takeover price as the market anticipated a higher bid that we thought was ultimately unlikely to materialize. We took this opportunity to exit completely and redeploy the proceeds into other holdings.

Outlook and Conclusion

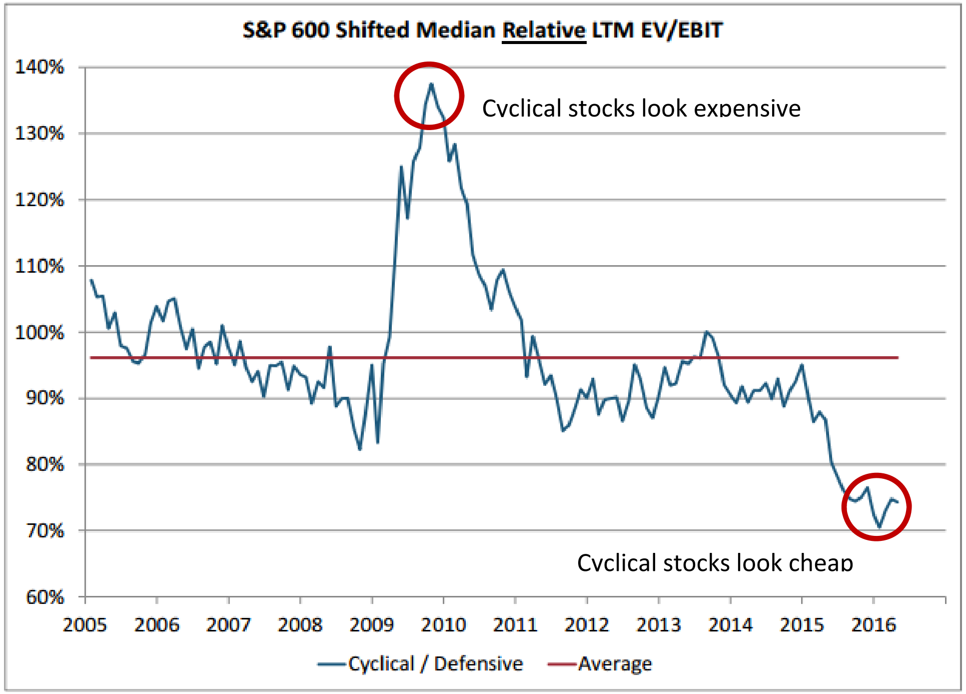
It isn't difficult to detect today that many investors are skeptical of this economic recovery, of the bull market in stocks and of continued gains for the equity markets. We were floored to read in a recent WSJ article that more investor dollars have flowed into gold ETFs in the first half of the year than into all stock ETFs combined! Certainly that is the height of risk aversion.

Surveying our own portfolio, it appears to us that many of our more cyclical companies—auto dealers, boat manufacturers, industrial and tech companies—are quite cheap and out-of-favor, while defensive companies like snack food manufacturers and physical therapy clinics are quite expensive. We think this is reflective of the investment world in which we live, where investors are generally skeptical and prefer the perceived "safety" of low-volatility securities.

Of course, stocks are not "safe" simply because the businesses they represent are not cyclical. We may very well be at a point in this cycle where investors have bid up the valuations on "safe" stocks to a level where forward returns may be disappointing. On the contrary, shares of "risky" cyclical companies have been beaten down to levels where their forward return potential appears quite enticing. Whatever direction the next leg of the economy takes, these valuations already reflect a fairly dim view.

The nearby chart comes to us from Furey Research Partners and does an excellent job of contrasting the valuations in cyclical and defensive small-cap stocks today. The difference is astonishing. We have been trimming and exiting stocks in the defensive category whose valuations appear stretched to us, and "cycli-fying" the portfolio by adding stocks that appear cheap to us and have some degree of economic sensitivity in their businesses.

As with our entire investment process, these moves are not driven by any top-down macroeconomic analysis but rather by our observation that this is where there is glaring value.



Source: Furey Research Partners and FactSet Research. Data as of June 30th, 2016