Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
Third Quarter 2015

Overview

The best thing that can be said about the third quarter of 2015 is that it's over. In a quarter where markets struggled across the board, the Punch Small Cap Strategy performed slightly worse than its benchmark, with a total return loss of -12.1% compared to -11.9% for the Russell 2000 Index. On a year-to-date basis, the Punch Small Cap strategy has produced a total return loss of -3.9% compared to -7.7% for the benchmark.

It's never easy to stomach market volatility of the sort we just endured; at its worst, the Russell 2000 declined nearly 17% from peak-to-trough. Since the start of the Punch Small Cap Strategy in 2002, we have only had four quarters with worse declines. The good news is that the average return over the subsequent four quarters in each case was 17% for the strategy.

On a year-to-date basis, over 90% of our relative outperformance (3.9% of our 4.2% alpha) has been attributable to stock selection. We would expect this to continue to be the case over longer time horizons.

Sector allocation actually *helped* our performance in the quarter, adding 0.9% of relative performance. For several years now we have been meaningfully underweight the healthcare sector, as stocks in this group have looked increasingly frothy to us. As contrarians and value investors, we like areas of the market that are cheap, out-of-favor, and have performed poorly. None of these have described healthcare stocks for some time now. Amazingly, roughly half of the Russell 2000's total return has come from healthcare stocks over the past two years (2.6% of the 5.3% total return).

Performance (net-of-fees)

	Punch Small Cap	Russell 2000
Q3 2015	***-12.12%***	-11.92%
YTD	***-3.85%***	-7.73%
Last 12 Months	***3.42%***	1.24%

The healthcare sector performed meaningfully worse than the index as a whole in the quarter (-17.2% vs -11.9%) and our 9.3% average underweight to this group provided a nice tailwind to our performance. We have seen the underperformance of healthcare stocks relative to the broader market accelerate in the last couple of weeks of the quarter and into October, and we're hopeful that some of the air is finally being let out of this inflated group. If this trend continues, it could benefit our portfolio. From September 15 through October 7th, the Russell Biotech Index has lost over 18%, dramatically underperforming the decline in the Russell 2000 of just 1.0%. We have precisely zero exposure to this industry today.

22 (46%) of the 48 stocks held in the strategy in the quarter outperformed the benchmark return in the second quarter. 30 (56%) of the 54 stocks held have outperformed on a year-to-date basis.

Positive Contributors in the Quarter

Top Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
LendingTree, Inc.	2.53	18.34	62
Destination XL Grp	2.02	15.97	30
Digi Intl Inc.	1.22	20.92	29
Ares Comm RE	0.59	10.45	12
J&J Snack Foods	2.19	3.02	5

Our top contributor to performance in the quarter was **LendingTree, Inc. (TREE, $1.1bn market cap)**, an online marketing company that sells consumer leads to banks and specialty lenders. LendingTree has been our single best-performing stock this year, rising 92% through September 30, and we detailed much of our investment thesis here last quarter. We reduced our position in LendingTree significantly in August (from 4.7% to 1.4%) as the past several earnings reports have been materially better than expected. We will likely look to exit the stock in the not-too-distant future as valuation is quite rich at this point.

Our second-best contributor to performance in the quarter was **Destination XL Group, Inc. (DXLG, $300mn market cap),** a specialty retailer of men's big-and-tall clothing based in the Boston area. Destination XL is unique among retailers because it operates in a well-defined niche and has a specialized business model that we believe insulates it from significant competition. Retailing to men of size requires sophisticated inventory management, attention to details like the size of fitting rooms, and relationships with apparel brands that supply plus-sized clothing on an exclusive basis. While this business model may not appear difficult to execute, several retailers including Men's Wearhouse and J.C. Penney have tried and failed to replicate the DXL model.

The reason that DXLG stock has been depressed the past couple of years is that, in 2011, management made the strategic decision to transition its retail footprint from older, stripmall-based "Casual Male" stores to larger, standalone "DXL" brand stores—an entirely new concept with better growth and profitability prospects. This transition is in its middle innings and has been without major hiccups, although many investors remain wary that such a significant transition can be made while keeping the customer base intact. We have been impressed with the company's performance under CEO Dave Levin, now in his fourteenth year at DXL, and with his exciting vision for renewing the company under a new banner. The company's second quarter results, announced in August, were surprisingly good on both the top and bottom line, and we think were an indication of the progress the company is making in its transformation.

Our third largest contributor to performance was **Digi International, Inc. (DGII, $300mn market cap),** which was a stock added to the portfolio only this quarter. Digi is a networking equipment and service provider, and a market leader in supplying the devices that connect industrial and commercial equipment like tractor trailers and restaurant coolers to the internet for tracking and monitoring. Digi shares have largely gone nowhere over the past decade as its longtime CEO executed a scattershot acquisition strategy that led to poor organic growth, deteriorating margins, and an increasingly complex business. When this longtime CEO announced his retirement last year, the market value of the company excluding cash, working capital, and real estate, was a mere $30 million (for a profitable business doing over $200 million in annual sales). Understandably, investors had mostly given up on any hope of value creation.

Our interest in Digi was piqued when the company announced the appointment of an outsider as CEO, Ron Konezny, who is an industry executive that had built and sold several networking companies similar to Digi. We met with him after his first quarter at the company and were impressed with his energy and vision: to simplify the business; to improve profitability quickly; and to use the company's massive cash hoard to execute acquisitions that would make the company more of a recurring-revenue services business. While it's still early, we think Ron has the mindset—and the credentials—to impress investors who have understandably low expectations for this asset-rich company.

Negative Contributors in the Quarter

Bottom Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
E.W. Scripps Co.	3.82	-22.67	-94
Trueblue Inc.	3.11	-24.85	-81
INTL FCStone	2.88	-25.72	-80
Nautilus, Inc.	2.35	-30.26	-79
Malibu Boats, Inc.	1.97	-30.41	-67

Our largest detractor from performance in the second quarter was **E.W. Scripps Co. (SSP, $1.7bn market cap)**, the fifth largest local television broadcaster in the country. Media stocks as a group fell hard in the third quarter on concerns of an acceleration in the trend towards "cord cutting," with more and more TV viewers watching shows and movies on internet services rather than traditional cable and broadcast. While there is a great deal of upheaval today in the media space in general and television in particular, we think that local broadcasters are in one of the best positions in this ecosystem as local news and programming still dominates TV viewership at 40% of total cable viewing hours and is an indispensable part of most consumers' media consumption. The high ratings and viewership of local programming cannot be displaced in cable packages and, because of low retransmission rates, broadcasters like SSP will see growing retrans fees in almost any environment over the next several years. What is more, local broadcasters have been at the forefront of moving their content to online and mobile environments and building out local digital sales forces to successfully monetize this content.

Trading at a mid-single-digit multiple of cash flow, with low financial leverage and a history of prudent capital allocation, Scripps stock is cheap here and should regain credibility with the market as they report earnings and integrate their largest acquisition ever of Journal Media Group, which closed in March.

Our second largest detractor from performance in the quarter was **Trueblue, Inc. (TBI, $1.0bn market cap),** a national temporary staffing business focused mainly on blue collar workers. Employment trends in the U.S. have been mixed and uneven this year, especially in Trueblue's largest market segment of residential construction (25% of sales), and this inconsistency has largely been to blame for the stock's uneven performance. We recently met with the company's CEO and came away enthused about the company's newest acquisition, a business that does "recruitment process outsourcing" (RPO) for commercial clients which only accounts for 4% of revenue but contributed 10% of operating income and is growing 25% organically. Despite mixed results in its core business, Trueblue is still the national leader in its industry and is quickly broadening its offering to include high-value, nicely profitable services like RPO.

Our third largest detractor from performance was financial services company **INTL FCStone (INTL, $470mn market cap).** After reporting third quarter earnings that tripled from the year-ago period, the stock showed little reaction to these phenomenal results and in fact declined with the broader market in the late summer and fall. We attribute this weakness to a lack of analyst coverage on the company (there is none!) and the distribution of shares by several large institutional shareholders. We spent some time with the CEO of the company following the third quarter earnings report and were satisfied to hear that the company is operating in-line with its long-run goal of 15% return on equity even despite continued low interest rates which depresses its interest income on customer float. The business, as a hedging and trading intermediary for commercial and agricultural customers, actually benefits from volatility in financial markets and has seen trading volumes and spreads increase dramatically this year. The company's crown jewel business, a payments processor for cross-border banking transactions, continues to grow immensely and produce over 50% operating margins. We think the value of this business segment alone could account for nearly all of INTL's market capitalization without accounting for the growing and profitable financial services businesses. At 13x trailing EPS and 1.25x book value, we think the stock is exceptionally cheap and are happy with it as a core position.

Initiations and Exits

We initiated three new positions and exited two in the third quarter, bringing the total portfolio to 47 stocks as of September 30. In September we initiated a 1.5% position in Digi International, a company we profiled on page 1 as it was one of our best-performing stocks in the quarter.

In July, we initiated a new position in an industrial products company called **CECO Environmental (CECE, $217mn market cap)** after meeting with several of its executives in our offices in the spring. CECO for much of its corporate life was an old-line industrial products manufacturing concern that made sophisticated air pollution control systems for utility and energy customers. However, in 2010 the company hired an Ingersoll Rand veteran as its new CEO and embarked on a strategy to boost the company's returns on capital by outsourcing low-value manufacturing, bolting on high-value niche industrial products companies, and emphasizing recurring parts and services revenues. The results have been impressive as gross margins have nearly doubled and operating margins have nearly tripled. The company regularly produces healthy free cash flow, and has closed on eight acquisitions in the past two years, all with the goal of pursuing an asset-light, recurring revenue niche products strategy. Concerns over weakness in the Chinese economy (20% of sales) and the integration of a recent acquisition ($150 million for PMFG, Inc.) have pressured the stock recently to under 10x free cash flow, which we think is a highly attractive valuation for a business with secular tailwinds that is run by an intelligent management team. The stock also sports a 3% dividend yield.

Landauer (LDR, $350 market cap) is our newest position in the Punch Small Cap Strategy and is one of the highest quality businesses we have seen in some time, with a competitive moat that we think is virtually unassailable. Landauer is the largest provider of dosimetry monitoring services in the country, helping workers who interact with nuclear equipment every day ensure that they receive safe levels of radiation. In its core hospital segment, Landauer boasts over an 85% market share of dosimetry services. The company is also the exclusive provider of such services to the U.S. military. The business of monitoring radiation exposure via badges worn by employees is as close to a monopoly as we have seen: customers are required by law to purchase the products; Landauer is one of a very small number of providers worldwide who is appropriately licensed and authorized to sell such services, the technology is extremely difficult to replicate; and customer retention is well over 90%. Moreover, these services are sold on a multi-year subscription basis, lending predictability and built-in growth to the business. It's no wonder that the company regularly generates over 30% returns on equity.

As you might expect, a business as high-quality as Landauer is rarely valued cheaply by public markets. For years the stock regularly carried over 25x earnings multiple and a 15x ebitda multiple—hardly a value. Over the last couple of years, though, management lost sight of the attractiveness of the core business and "di-WORSE-ified" into unrelated medical products and services businesses that have diluted the profitability and attractiveness of the whole. These poor decisions culminated in a year-long earnings restatement last year and the termination of most of the executive management team. Now, with current financials and a new management team that is focused on shedding ancillary businesses and re-focusing on its "golden goose" core, we think the time is right to take an investment in this attractive business at valuations that more than reflect the past sins of the company.

In August, we exited mortgage REIT **Ares Capital Corp. (ACRE, $360mn market cap)** which had been a holding since early 2014 and modestly underperformed the Russell 2000 during that period on a total return basis. When we started our research on ACRE in 2013, many mortgage REITS had seen their valuations compressed because of the widely discussed "taper tantrum" over Fed policy. The valuation of ACRE was particularly impacted because just as the entire sector was heading south, management made the decision to raise equity at a highly dilutive price in order to acquire a mortgage origination platform. Many investors in the company, having been burned by this value-destroying move, pitched their shares. The stock's price fell to roughly a 15% discount to book value even adjusting for the dilution, an attractive level for a portfolio of commercial mortgages that had good underwriting and no credit problems and was reasonably financed. The company also paid an 8% dividend yield. In retrospect, our mistake was partnering with a management team that had a history of value destruction, even if the terms of the investment were highly attractive. While the company has more or less executed its business plan over the past two years, their reputation as poor allocators of capital continues and there is little reason to believe that the company will receive a valuation even in-line with its peers. Given this lack of catalyst and better uses for the capital, we exited the position.

More recently, we exited longtime holding **Ascent Capital Group** (ASCMA, $380mn market cap). Ascent Capital was originally added to the portfolio in 2009 when it was spun out of Discovery Communications (DISCA) as a cash-rich holding company intending to pursue acquisitions. With the stock trading below its net-net value and with media mogul John Malone as its largest shareholder, we felt the risks were extremely low to partnering with Malone on an acquisition of his choosing. Not long after the spin-off, Ascent acquired the second largest home security monitoring company in the country, Monitronics Inc., which was an attractive subscription business with recurring revenue, great cash flow, and plenty of consolidation opportunities. In the first couple of years after this acquisition, the stock price tripled in value as the market came to realize the value inherent in the business.

However, more recently, the home security industry as a whole has seen dramatic shifts in the competitive environment. To begin, both Comcast and AT&T, with their immense existing customer bases, have entered the home security business with offerings of their own. Second, the rapid adoption in home automation technology is beginning to take a bite out of the traditional third-party security model, leading to higher customer attrition and increasing competition among the legacy security companies to acquire new customers in order to fuel growth. Unfortunately, we underestimated the real and perceived threats to the Monitronics business model and the last two quarters' results out of the company—with higher customer attrition and lower growth—have finally convinced us that this evolution is unlikely to change soon.

Sector Allocation (average for Q3 ending 9/30/15)

Sector	Punch Small Cap	Russell 2000	*Difference*
Consumer Discretionary	24.45	14.35	***10.09***
Industrials	15.46	12.20	***2.26***
Telecommunication	2.89	0.85	***2.04***
Consumer Staples	4.58	3.36	***1.22***
Energy	3.01	2.92	***0.09***
Stocks	0.00	0.61	***-0.61***
Financials	24.73	25.84	***-1.11***
Information Technology	14.58	17.31	***-2.74***
Materials	0.00	3.54	***-3.54***
Utilities	0.00	3.76	***-3.76***
Health Care	8.17	15.26	***-7.08***

Outlook and Conclusion

The third quarter was unusual for us in that it was our sector bets rather than our stock picks that benefited performance. We say this because we spend the vast majority of our research time looking at individual companies; we spend very little time making top-down sector allocations—no one in our office wakes up in the morning saying, "I need a healthcare stock today!" However, the frothiness and heady valuations in the healthcare sector these days simply cannot be ignored.

We readily admit and fully expect that such meaningful variances will cause us to diverge from the benchmark positively or negatively, and that is a reality we are willing and able to live with for the sake of preserving capital. The recent declines in biotech and pharma shares are stark reminders of the pitfalls of committing capital into "hot" sectors.

Looking forward, we are excited about the prospects for many of our companies. Despite the volatility in the markets, many of our domestically-focused niche businesses are actually doing quite well and reporting to us that they are excited about their own businesses and have uses for capital. We share their enthusiasm.