Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
Third Quarter 2016

Overview

In the third quarter of 2016, small-cap stocks got their performance revenge on large-caps, with the Russell 2000 rising 9.0%. This was significantly better than the S&P 500 return of 3.9%. Year-to-date, the Russell 2000 has now gained 11.4% (vs. 7.8% for the S&P 500), and from their mid-February nadir small-cap stocks are up over 30%.

What was somewhat unusual about the third quarter was that gains were led by the most cyclical sectors of the market: technology (+16%), materials (+12%), and energy (+10%), all of which did better than the index. Some commentators have noted that it is uncommon to see such a strong rally in economically-sensitive industries this late in a market cycle.

We believe that over the past three years, investors have clearly preferred safe, boring, dividend-paying stocks over more pro-cyclical ones. Going into the third quarter, it was the most defensive sectors that had done the best: consumer staples (+51%), utilities (+39%) and healthcare (+39%).

Composite Performance (net-of-fees)	*Punch Small Cap*	Russell 2000
Q3 2016	***9.0%***	9.0%
2016 YTD	***8.8%***	11.5%
Since Inception*	***10.0%***	7.8%

Please see important disclosures at the end of this Commentary.

We think this is a reflection of a "credit crisis" mentality that still permeates many investors' outlook. Energy (-58%), consumer discretionary (+6%), and producer durables (+8%) have all lagged meaningfully.

The result of this performance disparity, as we have noted before, is a gaping difference in valuations between these two groups of stocks. Cyclical stocks remain as cheap as they have been on a relative basis in over a decade.

Our exposure to the more defensive groups, many of which we consider to be expensive and vulnerable to higher interest rates, is much lower than average today. We are significantly underweight healthcare (-9.3%), real estate (-6.7%), utilities (no exposure), and materials (-2.7%).

We are, however, overweight several of the more cyclical groups that we consider to be depressed, cheap, and out-of-favor. Our largest over-weighted groups are financials (+8.3%), consumer discretionary (+7.5%), and industrials (+5.8%).

We believe that a stock is only as "safe" as the price you pay for it, and when the stocks of non-cyclical businesses get bid up to lofty levels, the risk of investing is magnified.

A final observation about the third quarter was the significant reversal in performance by the smallest public companies relative to the largest. For the past several years, the trend has clearly been *the smaller a company's size, the worse its performance*. Large caps outperformed small-caps, and small-caps outperformed micro-caps. In the third quarter, microcaps finally got their due, rising 11.2% (compared to only 9% for the Russell 2000 as a whole).

The Punch Small Cap Strategy has always favored smaller companies, even within the small-cap universe. The median market cap of the strategy today is $570 million, below the $750 million of the Russell 2000 and significantly below the $1.8 billion of the average small-cap mutual fund. Approximately three-quarters of the portfolio's holdings are under $1 billion market capitalization.

We believe that the structural inefficiencies that make investing in small-caps attractive are most common and most pronounced among these smallest of public companies. It stands to reason that companies with the fewest sell-side analysts writing research reports on their stock, the smallest institutional shareholder bases, and the least press coverage would have the least efficient stock prices.

While this subset of the small-cap asset class has lagged the past couple of years, we think that the record of history shows that, over time, those investors willing to roll up their sleeves and dig into lesser-known companies will be rewarded. Indeed, the smallest decile of public companies has outperformed the largest by two-to-one over the past seventy-five years.

Initiations and Exits

We initiated two new positions and exited one in the third quarter, ending the quarter with 45 total positions.

In July we added software technology company **Carbonite (CARB, $415mn market cap)** to the portfolio after meeting with the company's relatively new CEO, Mohamad Ali (no relation to the deceased boxer). Carbonite was a hot 2011 technology IPO that quickly fizzled; five years after its debut, the stock price sat at roughly half its opening bid. New management, a new strategy, and an attractive acquisition have changed the company's story significantly, and we think the market has yet to grasp the magnitude of these changes.

Carbonite provides cloud backup services on a subscription basis to both consumers and small- and medium-sized businesses. Since the service is so critical, its customers are quite loyal, creating both sticky and highly profitable revenues to the company. While the company does have several close competitors, we think the company's size, track record, and reputation give it an edge in this niche market.

"Broken IPOs" are a good source of ideas for us, and we routinely look for such companies that have gone public to much fanfare but subsequently fail to match lofty expectations. Typically the resulting fallout is a bevy of frustrated investors and intense selling pressure. When a valuation that has gone from "on fire" to "out cold," there is an opportunity for more dispassionate investors to assess the company, its prospects, and its valuation more rationally. Carbonite is a perfect example.

In September we also took an initial stake in Texas-based homebuilder Green Brick Partners **(GRBK, $411mn market cap).** Green Brick operates in two primary markets—the Dallas/Ft. Worth metro area, and Atlanta—and builds a range of house types, from townhomes to luxury homes. The company is unique in its operating model in that they have equity stakes in several smaller builders in their markets rather than owning the building operations outright. This equity participation incentivizes both capital and operating efficiencies and effectively creates partnerships with local builders who have the reputation and local know-how to succeed.

The history of Green Brick is informative and we believe a real competitive advantage in this industry. The company is majority-owned by three entities: Greenlight Capital (David Einhorn), Third Point LLC (Dan Loeb), and CEO Jim Brickman. Mr. Brickman is a Texas native and real estate developer who worked closely with Mr. Einhorn to uncover improprieties at public company Allied Capital, much of which was detailed in Mr. Einhorn's 2007 book Fooling Some of the People All of the Time.

We think that, because it is a controlled company with relatively low float, Green Brick has yet to gain much attention from either sell-side analysts or buy-side investors. The company over 5,000 land lots that were acquired during the credit crisis at distressed prices by Mr. Brickman and Greenlight Capital, and the current valuation of the company does not reflect this embedded value. What's more, the homebuilding sector has not seen a meaningful pickup since the end of the credit crisis eight years ago and should this sector finally show signs of life, stocks like Green Brick

Top Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
INTL FCStone	4.0%	42.4%	144
Lithia Motors	2.8%	34.8%	75
Douglas Dynamics	3.9%	25.1%	62
Nautilus	2.8%	27.4%	60
Carbonite	1.1%	51.0%	42

Bottom Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
Monotype Imaging	2.6%	-9.8%	-76
Syntel	1.5%	-7.4%	-36
Techtarget	1.5%	-0.5%	-25
Gentherm	1.7%	-8.3%	-23
CSW Industrials	2.0%	-0.7%	-21

could shed their discounted valuations.

Also in September we exited long-time holding **Syntel Inc (SYNT, $3.5 bn market cap).** Syntel has been in the portfolio continuously since 2005, and has been a strong contributor to performance. The company provides business process outsourcing (BPO) to major corporations in the U.S., primarily through its labor centers in India. Its largest and longest clients include such behemoths as American Express, State Street, and Fedex.

Way back in 2005, two things initially attracted us to Syntel. The first was the undeniable secular trend by major corporations towards moving low-value labor expenses to low-cost geographies around the world. The second was the stickiness and profitability of these services to the companies providing them. Once a company like American Express decides to shift large chunks of its operations and labor force overseas, outsourced services become embedded into the processes of the company, and it becomes extremely difficult to undo.

The result is high returns on capital for premier providers like Syntel: over the past decade, the company has produced returns on equity between 25% and 40% and has compounded book value per share by over 23% annually.

As you might imagine, this success over the years has attracted attention, and the company now has a dozen sell-side analysts following the stock and a market cap that puts it solidly in the mid-cap sector. We took the opportunity ahead of a large special one-time dividend to exit the stock after having trimmed in several times already over the years.

Outlook and Conclusion

Not long ago, several members from our research team took a day trip down the Mississippi River to visit a small publicly-traded furniture manufacturer in Iowa. As we do with many companies we are seriously researching, we had an afternoon of meetings scheduled with the executives of the company, followed by a tour of the nearby upholstered furniture plant.

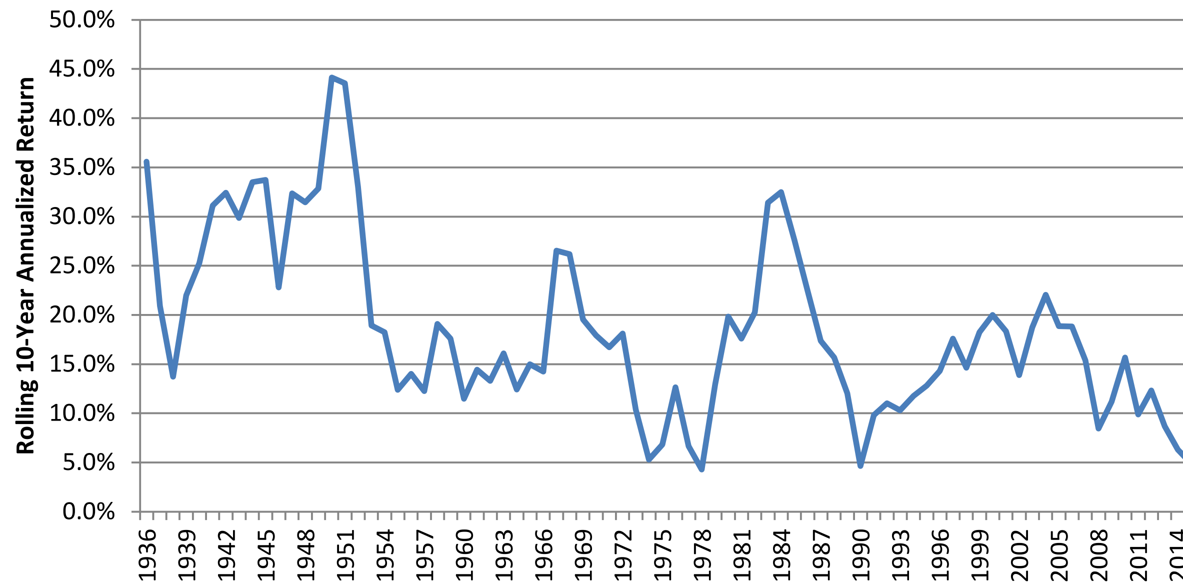
After the usual introductions and pleasantries with the CEO and CFO, we casually asked how often they hosted investors like us. "You're the first ones to visit us in nearly five years!" was their reply. When we hear that from a company, it tends to get us excited, in much the same way that a beachcomber might when his metal detector starts beeping over a clump of sand. While the beeping alone doesn't tell us what lies beneath—it could be a dime or a diamond bracelet—the simple fact that we are one of the few to take notice is significant.

We design our research process specifically to look for the types of companies like the furniture manufacturer in Iowa: unknown, out-of-favor, under-researched, and sometimes hard to get to (the nearest airport was three hours away). Performing due diligence research that others are unwilling or unable to perform is a real competitive advantage. It is also increasingly rare in a money management industry focused on gathering assets and reducing costs.

While the market has not rewarded these types of investments lately (smaller, lesser known companies), we think that this trend in and of itself is creating interesting opportunities for those investors still willing to do the "dirty work" of finding and researching under-the-radar companies.

Over the past ten years, the smallest decile of publicly-traded companies has produced an annualized return of just 5.0% (see chart on the next page). This is one of the lowest figures going back to the 1930s, and has historically been a trough level.

What this means is that small-cap investors have had the wind in their faces for much of the past ten years. Returns have been subdued, and investor enthusiasm is predictably low. As contrarians, we get excited about statistics like these because they are the ideal conditions for planting seeds in hopes of returns in the years and decades ahead.



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Composite performance is shown net-of-fees and brokerage commissions paid by the underlying client accounts. Certain client accounts have directed us to reinvest income and dividends, while others have directed us to not reinvest such earnings. As such, performance data shown includes or excludes the reinvestment of income and dividends as appropriate, depending on whether the account has directed us to reinvest income and dividends. Past performance is no guarantee of future results, and investing in securities may result in a loss of principal.

Punch & Associates claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Please refer to the attached Composite Profile and Schedule of Performance for information regarding Punch & Associates' compliance with GIPS® standards.

**Inception of the Punch Small Cap Equity Strategy was March 31, 2002. **CTR represents the contribution to total attribution.*

The reference to the top five and bottom five performers within the Punch Small Cap Equity Strategy portfolio is shown to demonstrate the effect of these securities on the strategy's return during the period identified. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients during the period of time shown. Past performance does not guarantee future results; therefore, it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list. Please contact Punch & Associates at andy@punchinvest.com or (952)224-4350 to obtain details regarding the calculation's methodology or to obtain a list showing every holding's contribution to the overall strategy's performance during the period of time shown.

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Punch & Associates Investment Management, Inc.
Small Cap Composite
Composite Profile and Schedule of Performance
As of June 30, 2015

	Annual Performance History									
Year	Small Cap Gross of Fee	Small Cap Net of Fee	Benchmark[1]	Composite 3-Year Std Deviation (%)[2]	Benchmark 3-Year Std Deviation (%)[2]	Number of Portfolios	Year-End Composite Assets ($mil)	Year-End Firm Assets ($mil)	Percent of Total Firm Assets	Dispersion[2]
2002 (since 3/31)	-15.21 %	-15.85	-23.53 %	N/A	N/A	12	$ 5.1	$ 103.9	4.9 %	N/A
2003	55.64	54.21	47.25	N/A	N/A	29	12.9	167.3	7.7	6.8%
2004	21.93	20.68	18.32	N/A	N/A	52	21.0	206.2	10.2	4.8%
2005	13.02	11.80	4.55	N/A	N/A	67	23.8	258.7	9.2	3.3%
2006	22.83	21.75	18.37	N/A	N/A	98	38.8	335.0	11.6	3.3%
2007	3.65	2.65	-1.57	N/A	N/A	272	103.9	397.0	26.2	3.7%
2008	-33.54	-34.18	-33.80	N/A	N/A	243	65.5	261.5	25.0	2.1%
2009	32.65	31.41	27.20	N/A	N/A	257	85.2	340.4	25.0	3.3%
2010	18.87	17.77	26.85	N/A	N/A	283	108.4	395.6	27.4	1.0%
2011	0.81	-0.14	-4.18	20.7	25.3	284	113.6	475.6	23.9	0.7%
2012	20.07	19.04	16.34	17.4	20.5	292	152.4	613.6	24.8	0.8%
2013	42.63	41.52	38.82	13.6	16.7	320	266.1	832.7	32.0	0.9%
2014	-0.21	-0.91	4.89	12.8	13.3	328	265.0	905.7	29.3	0.7%
2015 (6/30)	9.77	9.41	4.75	N/A	N/A	319	253.3	879.7	28.8	N/A
Cumulative	358.84	306.52	194.75							

	Annualized Performance History		
Period	Small Cap Gross of Fee	Small Cap Net of Fee	Benchmark[1]
1 Year	9.48 %	8.74 %	6.48 %
3 Year	20.45	19.56	17.81
5 Year	18.03	17.07	17.08
Since inception	12.19	11.16	8.50

Punch & Associates Investment Management, Inc. (Punch) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Punch has been independently verified for the period from April 1, 2002 through June 30, 2015. Verification assesses whether (1) the Firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Small Cap Composite has been examined for the period from April 1, 2002 through June 30, 2015. The verification and performance examination reports are available upon request.

The Composite creation date is December 31, 2005. The creation date is the date in which Punch started reporting returns at the strategy level while they had previously been reported at the account level.

[1]The Russell 2000 Index is the Composite's benchmark.

[2]See Note 5 for discussion of the composite dispersion and 3-year standard deviation calculation. N/A indicates statistics are not required to be presented for the time period pursuant to GIPS.

See Notes to Composite Profile and Schedule of Performance.

Punch & Associates Investment Management, Inc.
Small Cap Composite

Notes to Composite Profile and Schedule of Performance

Note 1. Organization and Nature of Business

Punch & Associates Investment Management, Inc. (Punch) is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The term "Firm," as defined by Global Investment Performance Standards (GIPS), represents Punch & Associates Investment Management, Inc.

The Punch Small Cap Strategy (Small Cap Composite) invests in U.S. listed public companies with market capitalizations between $250 million and $2 billion. Companies from the small cap universe are selected on the basis of economically attractive business models, accelerating fundamentals, cash flow characteristics, valuation relative to cash flow, and general investor recognition.

This description of products and services of the Small Cap Composite (the Composite) is not an offering. Past performance is not an indication or a guarantee of future results. Investments are subject to risk and may lose value. A list of our composite descriptions and our policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Note 2. Performance Presentation Standards

This report includes all of GIPS' mandatory disclosures as well as additional disclosures deemed prudent by Punch's management. Investment philosophies did not change materially during the reporting periods or from period-to-period.

Note 3. Calculation of Rates of Return

The portfolio returns for the period are based in U.S. dollars and have been calculated using a time-weighted, monthly, geometrically linked rate of return formula to compute quarterly percentage returns. Each portfolio's monthly rate of return is the monthly percentage change in the market value, including earned interest and dividends, after allowing for the effects of cash flows.

The monthly composite rate of return calculation is weighted by beginning values. This results in an assets size-weighted rate of return. Security transactions and any related gains or losses are recorded on a trade-date basis.

Note 4. The Composites

Punch has established composites for all fee-generating portfolios for which it has full discretionary investment decision-making authority. Punch's client base within the composites was comprised of institutional and individual investors with a minimum asset balance of $100,000. No alterations have been made to the composites as a result of changes in investment professionals. In addition, Punch is the investment adviser to transitory portfolios that were not eligible for inclusion in any composite because the portfolios are either new for the month first funded, or the portfolios had restructuring which took place during the month.

The Small Cap Composite is one of several composites managed by Punch. Punch’s list is available upon request.

Note 4. The Composites (Continued)

Performance is based on total assets in the portfolio, including cash and substitute securities. Generally, a portfolio will enter a composite on the first day of the first full month following its inception. A portfolio is removed from a composite as of the last day of its last full month. Historical performance results include the results of clients who are no longer clients of Punch. Each composite is comprised of separately managed portfolios.

The Composite is subject to Punch's large cash flow policy which defines a cash withdrawal of more than 10 percent of the portfolio's market value as a large cash flow which requires the Composite to be valued at the date of the withdrawal. This policy has been in effect for the period from April 1, 2002 through June 30, 2015.

Note 5. Composite Dispersion

Composite dispersion measures represent the consistency of a firm's composite performance results with respect to an individual account's portfolio returns within a composite. Account dispersion is measured by the standard deviation from the central tendency (mean return).

The dispersion of the annual returns of the Composite is measured by the asset-weighted standard deviation method. Standard deviation attempts to measure how much exposure to volatility was taken historically by the implementation of an investment strategy. Only portfolios that have been managed for the full year have been included in the annual dispersion calculation of the Composite. Effective for the year ended December 31, 2011, GIPS requires the presentation of the three-year annualized standard deviation. This statistic measures the volatility of returns for the Composite and benchmark over the preceding 36-month period.

Note 6. Investment Management Fees

The net performance results set forth in the Schedule of Performance reflect the deduction of actual investment management fees. The standard fee structure is based on 1 percent of assets per annum on all discretionary assets unless otherwise specified. Prior to December 31, 2005, the fee structure was variable based on strategy and account size, not to exceed 1.5 percent per annum.

Account minimums and fees are negotiable on a case-by-case basis due to potential growth, size and services rendered.

Note 7. Comparison with Market Index

Punch compares its Small Cap Composite returns to a certain market index management believes has similar investment characteristics. The returns of this index do not include any transaction costs, management fees or other fees. This index is the Russell 2000 Index.