Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
Fourth Quarter 2015

Overview

In a year of manic markets and renewed market volatility, we were pleased to come through a tough period for small-cap stocks with mostly breakeven performance. While the Russell 2000 declined 4.5% in 2015, the Punch Small Cap Strategy declined 0.2%. The strategy outperformed in three of the four quarters this year.

We believe that outperformance in tough markets is a reflection of our risk-averse approach to investing in a traditionally volatile asset class. Historically, our strategy has generated the bulk of its alpha in flat-to-declining market environments.

The big story in 2015, of course, was the all-out collapse in energy and material stocks, which declined 39% and 24%, respectively. The small-cap market hasn't seen a decline of this magnitude since the telecom bust in 2000-2001, and energy stocks are down over 80% since their mid-2014 peak as of this writing.

Performance (net-of-fees)

	Punch Small Cap	Russell 2000
Q4 2015	***3.77%***	3.59%
CY 2015	***-0.23%***	-4.42%

We were spared the downdraft in materials given that we had precisely zero exposure to this commodity-driven sector, and this is typical for our strategy. We tend to prefer businesses that have some degree of control over the selling prices for their products and whose competitive advantages do not come from simply being a low-cost producer in a commodity-driven market.

While we effectively had an equal-weighting to energy in the year, that portion of our portfolio (two stocks) outperformed the broader sector (-23% vs -39%). These two stocks are both services business—one is an equipment lessor and the other is a telecom provider to oil rigs—and have a higher degree of predictability, recurring revenue, and cash flow conversion than your average E&P stock. While we are definitely sniffing around the energy and materials areas more these days in search of underfollowed, misunderstood, or just plain undervalued companies, this sector is not our bailiwick, and we are unlikely to make a big bet one way or the other on the subject of oil and commodities.

The expensive and much-loved healthcare sector continues to be a headwind for our portfolio, as it was the single best-performing sector in the index in 2015 (+4.8%). We remain materially underweight this group (-7.2% relative weighting) and are willing to wait on the sidelines until valuations and sentiment become more amenable to our contrarian natures or until a unique opportunity presents itself.

While roughly one-third of our total alpha in the year came from simply avoiding or underweighting the materials and energy sectors, the other two-thirds came from our significant overweight in consumer discretionary shares. This diverse group of eleven holdings constituted 23.7% of the portfolio (compared to 13.7% for the Russell 2000), and outperformed the index sector by nearly 16% (+4.3% vs -11.5%). Our concentration here is the result of bottoms-up stock selection rather than any top-down macroeconomic bet on "the American Consumer" and in general we continue to like the fundamentals and valuations we see here.

Positive Contributors in 2015

Top Five Contributors

Holding	Average Weight (%)	Total Return (%)	CTR (bps)
INTL FCStone, Inc.	3.4%	62.7%	176
LendingTree, Inc.	2.0%	84.7%	160
Hackett Group, Inc.	2.0%	85.3%	119
Journal Comm Inc.	0.5%	44.4%	111
Gentherm, Inc.	2.8%	28.1%	100

Our largest single contributor to performance in the year was financial services firm **INTL**

FCStone (INTL, $630mn market cap). This company has no analyst coverage, low institutional ownership, and we believe is a prime example of the informational inefficiencies in the small-cap market.

We first came across INTL in 2012 when screening for companies reporting higher year-over-year earnings *with no analyst estimates for those earnings.* Upon further investigation, we learned that the company's CEO, Sean O'Connor, had built the business from scratch and had grown its book value per share over a decade from $3 to $17—an 18% CAGR. We quickly set to work learning more about the company and meeting with its management team.

INTL's primary business is acting as a financial intermediary for small businesses clients—primarily farmers—who need to transact in capital markets to operate their businesses.

INTL also had a "hidden asset" in the form of a cross-currency payments business that management had just begun to report as a standalone segment and talk about publicly in detail. Our valuation work suggested at the time—and continues to suggest today—that this segment could be worth more than the market value of the entire company. But because of a lack of sell-side research and institutional sponsorship, this hidden gem had been largely underappreciated by investors.

2015 was an excellent year for INTL because many of the factors that have hurt other businesses—namely, market volatility and higher interest rates—are a boon to INTL. Higher trading volumes, wider market spreads, and higher interest paid on float, all contributed to an impressive 21% ROE for INTL in 2015. As a result of significant growth and operating leverage, shares began the year at a discount to book value but ended the year at a 50% premium.

Our second largest contributor to performance in the year was also a financial-sector company, **LendingTree, Inc. (TREE, $1.1 billion market cap),** a provider of marketing services to banks and specialty lenders. When we initially started researching TREE several years ago, the company's market value was less than the value of its cash holdings. They were also transforming their business by divesting a direct-lending platform and focusing exclusively on marketing to consumers in search of loans through their namesake website. The CEO, Doug Lebda, was a former IAC/Interactive executive and remains the second largest shareholder of the company after John Malone's Liberty Media Corp. We thought that the changes at the company and the quality of its management were being sorely underappreciated, and that the high consumer recognition of its website was an undervalued asset.

The year 2015 also turned out to be a near-perfect environment for TREE, as revenues are on-track to grow 50% and EBITDA should nearly double. As competition for new loans has grown this year among banks and specialty lenders, TREE has enjoyed both increased numbers of consumer leads sold and the price that lenders are willing to pay for leads. Many times in the past CEO Doug Lebda has compared the dynamics of the online lending industry to that of the travel industry ten years ago. We agree with that assessment and think the results in 2015 are a testament to that vision. Needless to say, investors have woken up to these impressive results at the company, and valuation has expanded significantly. We have trimmed the position several times.

Negative Contributors in 2015

Bottom Five Contributors			
Holding	Average Weight (%)	Total Return (%)	CTR (bps)
Techtarget, Inc.	1.6%	-29.4%	-54
Ascent Capital Grp	1.1%	-45.8%	-79
Rignet, Inc.	1.2%	-49.6%	-82
ARC Document Solutions, Inc.	1.4%	-50.2%	-114
Corenergy Infra Tr.	0.2%	-39.3%	-121

Our biggest mistake in the year was not an energy company per se, although it was a

company whose ties to lower oil prices were much stronger than we anticipated. **Corenergy Infrastructure Trust (CORR, $180mn market cap),** is the only REIT in the country dedicated to investing in energy infrastructure real estate. Formed in 2013 and externally managed by Tortoise Capital Advisors, CORR invests in pipelines, terminals, and storage facilities as an alternative to traditional MLP financing.

Because the REIT structure is a new one in the energy sector, CORR has been slow to ramp up its portfolio and today has roughly $700 million in assets. Importantly, this portfolio is concentrated between two triple-net lease tenants: Ultra Petroleum (UPL) and Energy XXI (EXXI), which account for 30% and 37% of assets, respectively. Although CORR's claims on these assets would be protected even in the case of the bankruptcy of its lessees, the precipitous drop in oil prices has called into question the viability of these two tenant companies and the economic feasibility of the gas and oil fields that support the surrounding gathering and transportation infrastructure owned by CORR. The market has clearly taken a dim view of the viability of the CORR business model given the current energy environment.

As recently as November of last year, CORR management raised its dividend per share by 11%. Since then, they have reiterated, both privately and publicly, that they view the dividend as sustainable. However, the stock has been cut in half since we took our initial position last April, and the market now assigns the company a 19% dividend yield—signaling a high likelihood of a cut. We are watching developments at UPL and EXXI closely and treating our interest in their assets as secured creditors in the case of a bankruptcy at one or both.

Our second largest detractor from performance in 2015 was **ARC Document Solutions (ARC, $210mn market cap),** which is a provider of print and digital solutions to the architectural, engineering, and construction (AEC) industry. ARC is far and away the market leader in the reprographics (blueprints) industry and is a household name among professionals in AEC. However, like other print-related companies, the digitization of information is eroding the competitive advantages of old business models and supplanting them with new technologies. ARC has responded to these "existential threats" by introducing its own digital products and services, as well as expanding into new areas like outsourced printer management. ARC's natural advantage is its strong customer relationships and industry reputation, and the company is attempting to leverage those strengths into new, more modern products and services. Today, over one-third of the company's sales come from these new growth areas while the legacy blueprint business is slowly declining but still generating meaningful free cash flow.

For the past two quarters, ARC's new, growth segments have grown more slowly than management's previous expectations. While management is attributing the weakness to delayed implementations of large projects by new clients, many investors fear that the transition from blueprints to digital technologies is not going well and have marked down shares accordingly.

We take solace in the fact that, despite this slower growth, the company's free cash flow continues unabated, and the stock sports over a 20% free cash flow yield today. What is more, business model transitions like this one usually take time and can be uneven. The company's CEO is also the second largest shareholder of the company and is enthusiastically involved in building the next generation of ARC.

Initiations and Exits

We initiated three new positions and exited two in the fourth quarter, bringing the total portfolio to 47 stocks as of December 31.

In November, we initiated a position in **Deluxe Corp (DLX, $2.7 billion market cap),** a Minnesota-based print and digital marketing company that is the largest printer of personal and business checks in the country. Deluxe has a long heritage in the check business, and effectively operates as a duopoly in that market

with competitor Harlan Clarke. Despite the secular decline in printed checks (-5-6% annually), profitability and cash flows have actually improved over the recent past, providing sufficient capital for management's initiative to diversify into other services businesses aimed at small- and medium-business customers, including website hosting, marketing material printing, and loyalty programs. Deluxe's competitive advantage in these new market segments is a long history and reputation of working with small business customers, and this cadre of check customers is an excellent lead generation tool for cross-selling new products.

We met with management recently at their headquarters and were impressed by the energy, enthusiasm, and drive at the company. Management is adamant that 90% of their businesses are growing organically, and that most investors still view them as a "check company" and fail to appreciate the diverse set of products and services that DLX now provides. With a conservative capital structure, a healthy dividend, and a valuation at only 10x free cash flow, we like the prospects for the business and think there is also the potential for a re-rating of the stock as investors appreciate the business beyond just checks.

In December, we added two new financial services names: **Capital Southwest Corp (CSWC, $220mn market cap),** and **Newcastle Investment Corp (NCT, $270mn market cap).** Capital Southwest Corp is a business development company (BDC) that, because of a spin-off of two-thirds of its assets last year, declined over 20% in the fourth quarter as legacy shareholders sold positions in order to buy the newly spun-off shares. After this decline, the stock trades at a 20% discount to its net asset value (NAV), which at this point is largely cash. Because the company has no standalone financial history and has not yet declared its first dividend, the stock does not screen well and we think remains well below the radar of the average BDC investor. Importantly, CSWC is internally managed, rather than managed by an external advisor, and we find it interesting that no internally managed public BDC trades for less than NAV. As the company deploys its capital and begins paying a dividend, we think investors will wake up to the reality of what is going on at CSWC and value it more appropriately.

NCT is a similar situation, whereby the assets of this REIT have shrunk from nearly $5 billion only a few years ago to under $2 billion today by way of several spin-offs. NCT is now something of a "stub stock" with an oddball collection of assets that we estimate to be worth over $7 per share. Ultimately, we believe the company will focus on its portfolio of golf course real estate and be seen and valued as such. In the meantime, the stock sports a 14% dividend yield and holds mostly liquid and transparent assets.

Our two exits in the portfolio can both be filed under the category of "good ideas…*at the time*." Indeed, we liquidated positions in **MVC Capital Inc. (MVC, $175mn market cap)** and **Syneron Medical Ltd (ELOS, $250mn market cap)** with our collective tails between our legs.

While we can easily recount the details of what went wrong in each of these cases, perhaps the

Sector Allocation (average for 2015)

Sector	Punch Small Cap	Russell 2000	*Difference*
Consumer Discretionary	23.7%	13.7%	***10.0%***
Industrials	15.7%	12.7%	***3.0%***
Financials	26.6%	24.2%	***2.4%***
Telecommunication	3.0%	0.8%	***2.2%***
Consumer Staples	4.8%	3.2%	***1.6%***
Energy	3.3%	3.3%	***0.0%***
Information Technology	14.3%	17.3%	***-3.0%***
Utilities	0.0%	3.5%	***-3.5%***
Materials	0.0%	4.0%	***-4.0%***
Health Care	8.2%	15.4%	***-7.2%***

more instructive and useful discussion—and what we as an investment team try to focus on—are the lessons learned from each mistake.

In the case of ELOS, our mistake was misjudging the management team at the company, both in terms of transparency and alignment with shareholders. When we first met management about five years ago, we were impressed with the CEO at the time—a gentleman named Lou Scafuri who was candid, intelligent, and clearly working for shareholders. However, when Mr. Scafuri was ousted in early 2014 by the founder and chairman of the company, Shimon Eckhouse, we assumed the best but ultimately encountered the worst. Management became increasingly opaque, difficult to contact, and not forthcoming with details of operational missteps and employee turnover. As the company's strategy became more convoluted, capital allocation became more haphazard and returns suffered. While ELOS was not a significant losing stock for us since the time of our first purchase, it did incur a great deal of opportunity cost as the Russell 2000 rose significantly over the holding period.

MVC Capital was a perfect storm of negative developments over the last year, including an accounting restatement, poor operating results, and a decline in the company's peer group. This BDC was originally purchased at a substantial discount to its NAV in mid-2014 when the stock was getting kicked out of the Russell 2000 index. We assumed that, if this discount did not close in relatively short order, management and active shareholders were likely to take corrective, shareholder-friendly action. Our mistake was overestimating the quality of the assets owned by MVC, and the discount to NAV that would provide a sufficient margin of safety for us. Simply put, we didn't understand the portfolio as well as we thought we did, and spent too little time with management trying to understand it.

Outlook and Conclusion

Given the rough start to the year that we have already experienced, the question on many investors' minds is, "what's next?" Parallels to 2008-09 are being brought up with increasing frequency.

While we spend very little time analyzing or forecasting the economy or broader markets, our observation from talking to companies and watching investor behavior is that the risks to the market at this point are largely overestimated. We think investor fears have outpaced economic reality, and that a lot of bad news has already been priced into this market. From its peak in June of 2014 to its nadir in January of 2016, the Russell 2000 has declined over 26%. According to Furey Research, this magnitude and length of decline is more or less inline with the average small-cap bear market over the past 25 years.

We are actually positive on the prospect for healthy returns over the coming years, and are excited about the companies we are partnering with to generate shareholder value going forward. Especially during times like these, investors' emotions can get the better of them, ultimately creating distortions between market prices and reality. We hope to take advantage of these moments of irrationality.

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