Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
Fourth Quarter 2016

Overview

In many respects, 2016 was the year that no one predicted. In the first six weeks of the year, the Russell 2000 plummeted 14% and officially entered bear market territory from their previous high in June of 2015. From there, it rocketed 42%, aided by a post-election pop that ended the year in almost the mirror opposite way that the year began.

The year started in fear, was punctuated by Brexit and a tumultuous Presidential Election, and ended in some old-fashioned greed and performance-chasing. The tenor of this market has shifted 180 degrees over the past twelve months.

As observers of the behavior of other investors, the ebullience of the past few months has begun to make us a little uncomfortable. Deal flow is surging, valuations are moving up, and there is plenty of optimism surrounding the new administration.

However, we are cognizant of the fact that these are the first real signs of "animal spirits" that we have witnessed since this recovery began some six years ago. Before the election, the Russell 2000 Index was basically flat for three years running and we believe that valuations for many companies are fair but not excessive. What is more, the potential impact of a pro-business political environment is real and could be meaningful.

Composite Performance (net-of-fees)	*Punch Small Cap*	Russell 2000
Fourth Quarter 2016	***10.2%***	8.8%
Calendar Year 2016	***19.9%***	21.3%
Five Years *(annualized)*	***14.8%***	14.5%
Since Inception of 3-31-02 *(annualized)*	***10.6%***	8.4%

Please see important disclosures at the end of this Commentary.

In 2016, the Punch Small Cap Strategy lagged its benchmark Russell 2000 Index, with a total return of 19.9%, net of fees, compared to 21.3%. Our risk-averse investment philosophy generally means that we tend to lag in strong up-markets which are being bid up quickly and when there is less regard for value. The significant outperformance of the Materials (+47.9%) and Energy (+28.3%) sectors—both of which we have historically avoided—also contributed to our underperformance.

If we did anything right in 2016, it was our severe underweighting of the healthcare sector, which was the lone small-cap sector to decline (-7.3%) for the year. As we have written about several times in the past, healthcare has become an expensive and much-loved group over the past few years, and we have had some difficulty finding quality companies at reasonable valuations in this area.

Our three healthcare holdings in the year were all healthcare services companies and represented an average weight of 5.0% of the portfolio compared to 13.9% for the benchmark. This significant variance from the benchmark, which we view as a risk mitigation measure, was a strong tailwind to performance: the weighted average performance of our three healthcare stocks was +47% for the year.

It is a hallmark of our risk-averse investment philosophy that areas of the market that are the most popular, the most expensive, and the most over-weighted are often the riskiest. For us, there are no "must own" investments, and we are unafraid of looking different than the benchmark—sometimes meaningfully so—and of risking short-term underperformance with the goal of avoiding long-term pain.

We remain significantly underweight healthcare today for several reasons. First, valuations still appear stretched for the group as a whole. On average, the Russell 2000 healthcare index trades at nearly 1.8x price-to-sales, above the pre-Obamacare average of only 1.2x. With an uncertain regulatory environment ahead, these valuations may compress. Second, this group of stocks is what we consider relatively "low quality"—as of December 31, 62% of the companies in this group were unprofitable on a GAAP earnings per share basis.

Another observation we have made recently is that a startling number of companies in the Russell Microcap Index have no earnings at all. In fact, 44% of companies lose money on a GAAP earnings per share basis—a record proportion not seen since the recession years of 2008-2009. If

there is froth in this market, we believe it is concentrated among these unprofitable, speculative companies (many of which are healthcare-related), whose shares have levitated on the back of easy money and driven much of the performance of the small-cap market these past several years.

Over the long-run, of course, profitable companies do win out, on average. This is a core belief of ours and it is reflected in our strategy: 87% of our holdings are profitable on a GAAP EPS basis over the last four quarters. We recently did a study in Bloomberg and were unsurprised to find out the magnitude of outperformance of profitable companies over the long-term (see nearby chart by Bloomberg and Punch & Associates).

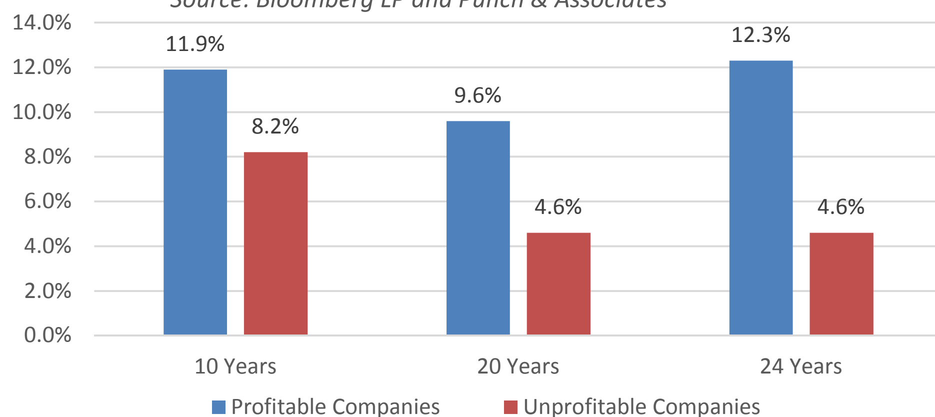
Positive Contributors in 2016

Our top contributor to performance in 2016 was **Douglas Dynamics (PLOW, $757mn market cap),** which is the largest manufacturer of attached snowplows in the country, with over a 50% market share. Despite a mild winter in 2015-16, Douglas is benefitting from strong light-duty truck sales and pent-up demand by its core customers. Pre-season sales going into the winter season were exceptionally strong, and management's outlook was likewise positive heading into this all-important time of year.

The management team at Douglas, which we believe has done a phenomenal job driving high and consistent profitability in a business that is both seasonal and cyclical, executed their largest acquisition to-date ($200 million) in July of a New York-based manufacturer of customized truck parts. As the deal closed in mid-July, we have yet to see full combined financial results, but we think this management team

has a lot of credibility in selecting and executing such deals.

Our second-best contributor to performance in the year was a REIT, **Corenergy Infrastructure Trust (CORR, $414mn market cap)**, whose share price was hurt in 2015 by falling oil prices but likewise helped in 2016 by rising prices. Corenergy, which owns energy-related infrastructure assets on a triple-net lease basis, came through the energy crisis of the past couple of years virtually unscathed—an impressive feat. While many energy business models were badly dinged in the downturn (some did not survive),



	Holding	Average Weight (%)	Total Return (%)	Contribution to Return (bps)
Top Five Contributors	Douglas Dynamics	3.60%	65.40%	217
	Corenergy Infra	1.50%	163.30%	157
	Landauer Inc	2.60%	50.20%	121
	CECO Enviro	1.30%	87.20%	114
	Alamo Group	2.30%	47.00%	105
Bottom Five Contributors	Gentherm Inc	1.90%	-28.60%	-84
	Destination XL	1.80%	-23.00%	-52
	DHI Group	0.70%	-23.90%	-49
	Monotype Imaging	2.70%	-14.30%	-46
	Lithia Motors	2.90%	-8.20%	-40

Corenergy actually raised its dividend twice in 2015 and held it steady in 2016 with no credit impairments to speak of. Having come through the worst of the crisis with its business model intact, the company is now in a position to execute further leases to asset owners in need of capital, with the goal of growing both dividends and book value per share over time.

The third-largest contributor to performance in the year was **Landauer (LDR, $463mn market cap),** a provider of radiation monitoring services to hospitals, utilities and the military. As you might imagine, this service is critical, highly technical and has massive barriers to entry. As a result, Landauer enjoys leading market share and high profitability in this niche. The company entered 2016 having just gotten through some operational issues under a previous management team, and the stock was quite depressed. In 2016, under a new CEO and CFO, the company has done a nice job of re-focusing on their core "crown jewel" business and preparing to launch a new wireless technology platform that could improve its financial profile meaningfully.

Negative Contributors in 2016

Our largest detractor from performance in the year was automotive supplier **Gentherm (THRM, $1.2 billion market cap)**, largely amid concerns of a peak in U.S. auto sales as well as competitive pressures in its heated- and cooled-seating products. A major customer of the company, Lear Corp (22% of sales), announced in September a new joint venture with a private company called Tempronics that competes directly with Gentherm. While it would likely take several years for Lear to displace Gentherm to any meaningful degree, the threat is real, and we are trying to discern its impact.

In the meantime, Gentherm management has been diversifying away from its largest end-market (passenger cars) and has, so far, done a nice job of expanding into other consumer, medical and industrial areas that hold promise for the company's unique thermal technologies.

Our second largest detractor from performance was **Destination XL Group (DXLG, $216mn market cap),** a specialty retailer focused on the men's big-and-tall segment. Destination XL is in the midst of a significant transformation of its business model, going from old and outdated stores under the "Casual Male" moniker to new, big-box concepts under a new brand, "Destination XL." What we like about the company is that they are by far the leader in the small but growing big-and-tall niche, which has unique characteristics that make it difficult for other retailers to compete. In fact, both Men's Wearhouse and JC Penney have tried and failed to expand into this area. It is one of the few areas in retail with some clear competitive advantages, especially against online merchants like Amazon. Also, we have been impressed by the company's CEO, Dave Levin, who has shepherded the company for the past 15 years and knows this space intimately.

In 2016, DXL struggled with same-store sales growth primarily because the company is transitioning to a completely new brand, for which it takes time to develop awareness and a customer base. The retail environment has also been difficult generally as of late, although we believe that DXL held up better than most. Looking into 2017, we think the company is coming to an inflection point where sales growth from new stores will start to overshadow lost sales from closed stores, and the company's free cash flow should grow meaningfully.

In 2016, we exited holding **DHI Group (DHX, $423mnn market cap at the time)**, but not before it could do some damage to the portfolio. The holding declined nearly 24% before we exited in June, and it was our third worst detractor from performance for the year.

DHI is an online recruiting service and operates such websites as Dice.com for IT-related job listings and eFinancialCareers.com for finance-related jobs. We initiated a position in DHI in 2012 because we were attracted to the company's asset-light business model that consistently generated significant free cash flow and its exposure to improving employment trends. The company's websites were well-established (Dice.com was founded in the early 1990s) and focused on specific industries and verticals which

we believed made them valuable to employers, recruiters and job-seekers.

The stock had been pressured going into 2012 on fears that a start-up in the online recruiting world called LinkedIn would disrupt the business model of traditional job sites. The company's valuation was pressured to around a 10% free cash flow yield, and management was buying back significant amounts of its stock with cash flow—the share count declined nearly 25% while we were shareholders. After our own research and conversations with people in the industry, we came to the conclusion that the "LinkedIn Effect" was overblown.

Over the ensuing three years, we slowly came to the conclusion—as did the management team—that LinkedIn was indeed having a meaningful impact on how employers and recruiters source job candidates, and that companies like DHI needed significant investment to keep up with their fast-growing competition. After several disappointing quarters and difficult conversations with company management, we came to the conclusion that the investment required to keep up with LinkedIn was too significant and that cash flow was at risk. We exited in mid-2016.

Initiations and Exits in the Fourth Quarter

We initiated three new positions and exited one in the fourth quarter, ending the year with 47 total positions.

In November, we added e-commerce provider **Etsy (ETSY, $1.4bn market cap)** to the portfolio, a 2015 IPO that entered the year down nearly 80% from its peak. ETSY fit neatly into the category of "Broken IPOs" where investor expectations have gone from exuberant to apathetic in short order. We like such situations because there is a tendency for the selling pressure on these stocks to be overdone as investor frustration takes hold.

Etsy is the largest e-commerce platform for handmade goods in the country and boasts over 1.6 million active sellers and 24 million active buyers. Unlike many e-commerce companies, Etsy is a marketplace (akin to Ebay) and not a seller themselves, so the company carries no inventory and operates in a relatively asset-light model. Over half of revenues come from providing back office services to the individuals who sell products over the platform.

A large part of the stock's decline over the past year has come from fears that Amazon may encroach on the "handmade" goods segment and disrupt the Etsy platform. We think that, like Ebay, Etsy has a strong competitive advantage in its established network of buyers and sellers, as well as in its brand value. The company generates healthy free cash flow which is expected to grow exponentially as the company continues to scale.

In December, we added both **CommerceHub (CHUBK, $644mn market cap)** and **Par Pacific Holdings (PARR, $662mn market cap)** to the portfolio. Both stocks had not participated in the strong post-election market rally, and we believe that both were experiencing some degree of selling pressure going into year-end (CommerceHub because it is a spin-off, and Par Pacific because of tax-loss selling as the stock declined over 38% in 2016).

CommerceHub was separated from its parent company, the John Malone-controlled Liberty Ventures (LVNTA) in July of 2016. The company provides drop-ship software services to retailers and consumer goods companies, allowing them to more effectively and efficiently sell their goods online.

We like the CommerceHub business model because it benefits from a network effect. Having created the largest network of connections between retailers and consumer goods companies in the country, the value of the business grows exponentially with each additional node added to the network. Moreover, we believe that this network would be extremely difficult to replicate by a potential competitor. The business is subscription-based, growing rapidly and sports healthy margins. We think we are getting the opportunity to accumulate shares of this attractive business at reasonable valuations because of the "spin-off effect" and a lack of analysis on it—the company has no analyst coverage.

Par Pacific Holdings is an energy portfolio company whose principal assets are two oil

refineries, a network of gas stations on the island of Oahu and assorted interests in domestic drilling wells. Additionally, the company has over $1 billion in net operating losses (NOLs), which management is attempting to utilize by acquiring profitable assets in the energy sector.

The company grew out of a bankrupt shell in 2012 and was taken over by an investor group led by real estate mogul Sam Zell. Because of the company's concentrated ownership, unique mix of assets and history of raising equity through rights offerings to preserve the value of its NOLs, the company remains largely unknown, and shares trade at a significant discount to what we believe to be NAV.

Our lone exit in the quarter was **Inventure Foods (SNAK, $185mn market cap at the time),** a manufacturer of snack foods and frozen berries and vegetables. We initiated a small position in the stock in early 2015, shortly after the company completed an attractive acquisition and follow-on equity raise.

We had followed the company for several years beforehand and liked their strategy of shifting their product mix away from less healthy "indulgent" snacks (like potato chips) toward healthy snacks (like frozen berries and vegetables). The company had successfully integrated and grown several acquisitions and looked capable of doing more.

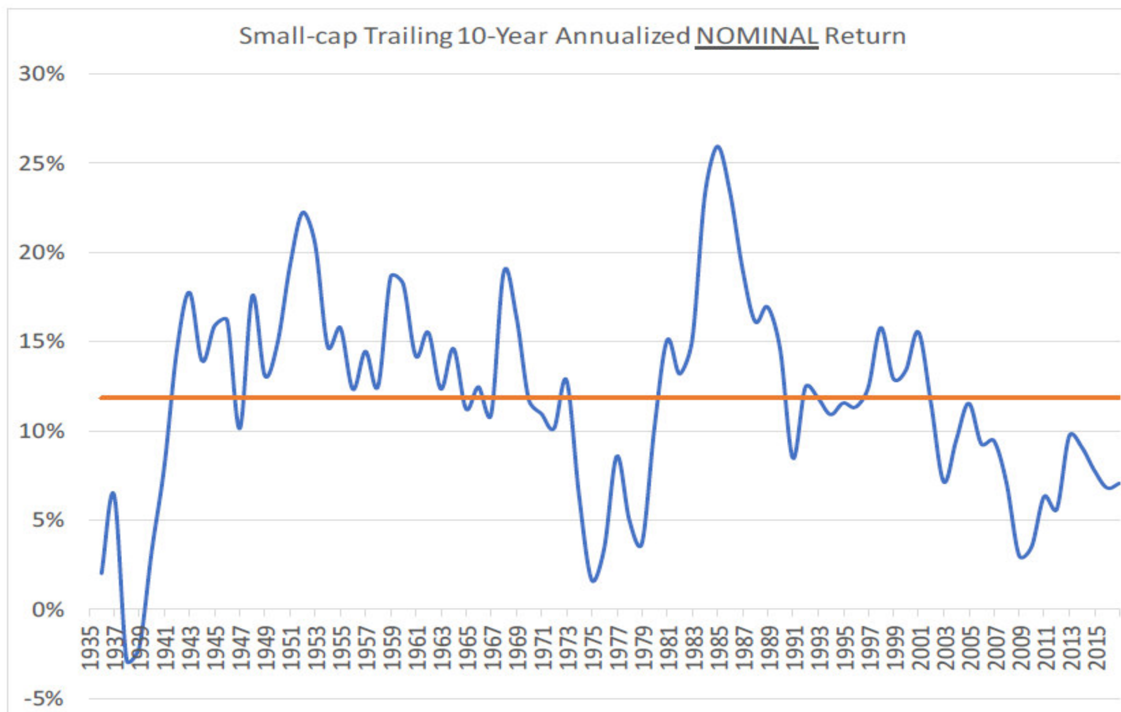
Unfortunately, about a year after closing the large frozen vegetable acquisition, there was an outbreak of listeria at the company's Georgia plant which resulted in a large-scale recall. After several lengthy conversations with management, we came to the conclusion that, although they were handling the situation as best as possible, the potential long-term damage to the brand was real, and their financial flexibility was limited given a hefty debt load and contracting cash flow.

When the company announced that it was exploring strategic alternatives in mid-2016, the stock moved to a range that we considered within its likely fair value to a potential acquirer, and we exited the stock at a loss.

Outlook and Conclusion

Despite the strong returns for small- and micro-cap stocks in 2016, we think it is relevant that, over the past decade, this asset class has performed below its long-term average. The rolling 10-year returns for small-cap stocks remain at a multi-decade low (see nearby chart).

Our takeaway is that this asset class remains out-of-favor, undervalued and relatively attractive. From a contrarian point-of-view, we are excited for the prospects of this group of stocks over the years to come.



Source: FRP and Morningstar; Small-cap returns are for CRSP 6-8 Decile before 1979 and for the Russell 2000 since 1979

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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.

The holdings included within the Top 5 and Bottom 5 charts represent the five best and worst performing holdings over the period of time referenced (Measurement Period) taking into account the weighting of every holding within the Punch Small Cap Equity Strategy portfolio. The holdings identified do not represent all of the securities purchased, sold or recommended for Punch & Associates' clients during the Measurement Period, and the past performance shown is not a guarantee of future results. Users may obtain the calculation methodology used as well as a listing of every holding's contribution to the Punch Small Cap Equity Strategy portfolio overall performance during the Measurement Period by contacting Punch & Associates at andy@punchinvest.com or 952-224-4350.

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.*

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Punch & Associates Investment Management, Inc.
Small Cap Composite

Notes to Composite Profile and Schedule of Performance

Punch & Associates Investment Management, Inc.
Small Cap Composite
Composite Profile and Schedule of Performance
As of June 30, 2016

	Annual Performance History			Composite	Benchmark		Year-End			
Year	**Small Cap Gross of Fee**	**Small Cap Net of Fee**	**Benchmark [1]**	**3-Year Std Deviation (%) [2]**	**3-Year Std Deviation (%) [2]**	**Number of Portfolios**	**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	0.51	-0.26	-5.11	15.7	14.2	330	254.7	938.1	27.2	0.8%
2016 (6/30)	0.31	-0.13	1.41	N/A	N/A	337	251.2	957.4	26.2	N/A
Cumulative	321.44	270.07	170.77							

	Annualized Performance History		
Period	**Small Cap Gross of Fee**	**Small Cap Net of Fee**	**Benchmark [1]**
1 Year	-8.15%	-8.96 %	-8.14%
3 Year	7.73	6.90	6.54
5 Year	10.65	9.77	8.02
Since Inception	10.62	9.61	7.24

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 periods from April 1, 2002 through June 30, 2016. Verification assesses whether (1) the Firm has complied with all the composite construction requirements 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 exam for the periods from April 1, 2002 through June 30, 2016. 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.

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 asset's 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.
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 periods from April 1, 2002 through June 30, 2016.

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.