Quarterly Newsletter | Volume 16, Issue 2
July 2016

Punch

A BOUTIQUE INVESTMENT ADVISORY

Wealth Strategies Group

Paying to Store Money

> **"Imagine a bank that pays negative interest. In this upside-down world, borrowers get paid and savers penalized. Crazy as it sounds, several of Europe's central banks cut key interest rates below zero in 2014, and now Japan has followed. By mid-2016, some 500 million people in a quarter of the world economy were living with rates in the red. Unthinkable before the 2008 financial crisis, the idea is to jolt lending, spur inflation and reinvigorate the economy after other options have been exhausted."**
>
> — Bloomberg.com, June 6, 2016

When I was a kid I was a saver. I had a paper route before junior high school and I caddied until I was old enough to drive. My parents helped me open a passbook savings account at Cherokee State Bank in West St. Paul, Minnesota. I remember being so surprised to learn that there was somebody who would pay me to store my money with them. The longer I left it alone, the more they would pay me. After I received my paycheck, I would hop on my bike and race to the bank with this "passport-looking" little book that showed what I had accumulated in my account. When I arrived, I would give the teller my money and my passbook; they would punch in some numbers and hand the book back to me with my new tally.

Back in the '70s, the interest rate that commercial banks were allowed to pay on savings was around 5.25%. While this was not a "Warren Buffet-like" return, it was what a dumb kid could accrue on a guaranteed basis for just sitting back and doing nothing. Today, the current dividend yield on the riskier iShares Core U.S. Bond Fund (AGG-NYSE) is under 2.5%.

By the time I headed to Carleton College in the late '70s, inflation was heating up which put upward pressure on interest rates. President Jimmy Carter offered college students interest-free loans that were not required to be repaid until after graduation. At that same time, I learned about something called a money market account that could pay me even more than my passbook savings account. I took my excess savings and the free money President Carter was offering, and I opened a Dreyfus money market account. In 1980, taxable money market funds in the U.S. yielded an average of over 12%[1] . I even remember seeing 17% on one of my monthly statements! This marked a generational high for interest rates. However, by the time I graduated in 1983, my Dreyfus account was yielding less than 8%, and the rate was dropping fast.

Fast forward to today: money market rates, savings rates, CDs and other "safe" parking places for money might be above zero, but only microscopically. Last Monday, the *Wall Street Journal* published an article called Black Hole of Negative Rates is Dragging Down Yields Everywhere. "There is now $13 trillion of global negative-yielding debt… In Switzerland, government bonds through the longest maturity due in nearly half a century, are now yielding below zero. Nearly 80% of Japanese and German government bonds have negative yields, according to Citigroup." Most investors only vaguely recall the PIIGS Debt Crisis (Portugal,

Continued on page 2

Italy, Ireland, Greece, Spain) of five years ago. According to Pension Partners, in 2011, Ireland's five-year bond was yielding 17%. Today the yield is negative.

This is where I pause for effect.

So, across the globe people are paying storage fees for over $13 trillion just to be assured that they will have *most* (not all) of it returned at a later date! If you are in Switzerland or Germany, how scared do you have to be of the alternatives to want to put your money into a 20-year Government Bond with a negative interest rate? "How much do I owe you for storing my money this year, Mr. Chairman?" In my mind, the only reason to put your money into a negative rate bond is that you believe interest rates will decline further. How is this any different from people buying overvalued internet stocks in the late '90s under the belief that there would be a "greater fool" who would come along and pay a higher price for their shares? This thinking works until it doesn't.

In the wake of the 2008 Financial Crisis, when Mr. Bernanke engaged in QE1 (Quantitative Easing), he wanted to infuse the economy with the "animal spirits" that would entice folks to take risks again. This policy helped the U.S. bottom out and get on a growth trajectory (albeit a slow one) sooner than the rest of the world. I wonder, however, if he could have imagined this kind of global interest rate landscape. I do know that if I'm a 12-year-old with a paper route and some cash burning a hole in my pocket, I am probably in no hurry to get to the bank to pay my "storage fee."

---

[1] Statistical Abstract of the U.S. 2003

Income Strategy

Until his departure in late 2014, Bill Gross was the manager of the largest bond fund on the planet—the Pimco Total Return Fund. With a track record of outperformance going back decades, the fund had an astonishing $290 billion in assets at its peak. For many investors, it was the "go-to" fund for fixed-income investing.

If you were a shareholder in the fund, you probably did pretty well, right? Not necessarily.

To be sure, if you had purchased fund shares a decade ago, and never bought or sold a dime's worth since, the investment would have been successful. The fund has returned 6.3% annually over the past ten years, nicely beating the annual return of the Barclays Aggregate Bond Index of 5.1%. Over this timeframe, the fund surpassed its performance "bogey" and then some.

However, if you had purchased more shares after a period when the fund did well, or sold shares after a period when the fund did not do well, your performance would almost certainly have been worse than the return that is printed on the pages of prospectuses and glossy brochures.

It's a natural human tendency to get excited about an investment after it has done well—and to want to buy more shares. It's also human nature to get depressed after a period of poor performance and yank money out. The problem is that, in the ebbs and flows of markets, investment styles and strategies tend to go in and out of favor with some regularity. It usually happens that just when a particular style looks best, it is primed for a period of underperformance, and vice versa.

The folks at research firm Morningstar recently came up with a clever way of calculating the return that the average investor received from a mutual fund or ETF, taking into account the flow of investor dollars into and out of that fund over a period of time. They report this "investor return" alongside the "total return" of the fund itself. The difference between the two figures is often called the "behavior gap" because it is the difference in performance that is directly attributable to investors' own behavior of selling and buying at the wrong times.

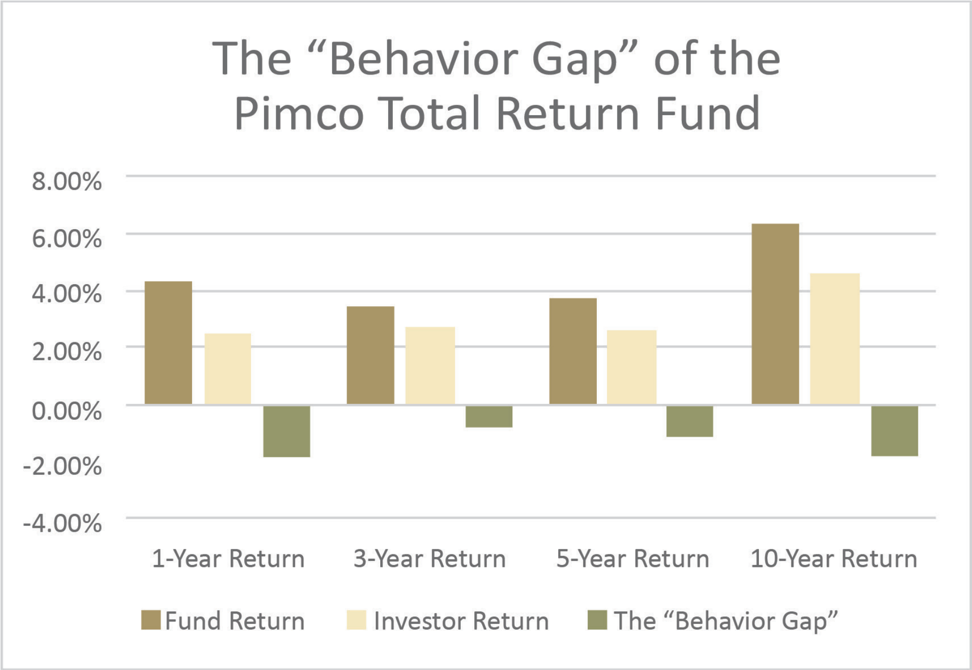
In the case of the Pimco Total Return Fund, it is fascinating to see that not only did investors underperform the fund over every reported time period, but also they underperformed by significant margins. These are real dollars and real returns foregone because of investors' inability to control their emotions and behavior. Over ten years, the average investor in the fund earned a 4.6% return, below even the benchmark return of 5.1%.

Continued on page 3

Morningstar's data (available at Morningstar.com) gives us the ability to quantify the consequences of poor investing behavior. As Warren Buffett once said,

"Success in investing doesn't correlate with I.Q. ...once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

We couldn't agree more.



Source: Morningstar and Punch & Associates

Large Cap Strategy

"If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes."

—Warren Buffett

In the retail industry, there is a rather simple way to think about seasonal inventory or inventory that is in stores for a limited time only – "set and forget." Think turkeys around Thanksgiving or Peeps marshmallows candy before Easter (all *non*-seasonal inventory basically exists in perpetuity). The essence is that the retailer gets the product into its stores and trusts that consumer demand will clear the shelves by the end of the season. Buying trendy seasonal products is arguably the riskiest strategy retailers can pursue because of the possibility of getting stuck with a huge inventory position at the end of the season without any demand from customers.

While it sounds easy enough to use a set and forget strategy, there is a great deal of analysis and planning required to significantly reduce the end-of-season inventory risk. Products need to be selected, buy quantities need to be determined, an inventory allocation strategy needs to be developed, pricing needs to be competitive, seasonal performance needs to be processed and reported etc.; you get the point. There is a lot of planning that takes place well before the season begins, but if planned well, then selling seasonal product becomes much simpler and the end-of-season inventory risk can be reduced. The benefit is the ability to efficiently sell large quantities of product with higher margins than the non-seasonal peer products.

The retail "set and forget" strategy is not unlike the Punch Large Cap Strategy. Before an investment is ever made in a large cap stock, a great deal of research goes into understanding the fundamentals of the company and its risk/return profile. Once we determine the company should be owned, we wait for the right opportunity to buy it - when it's mispriced or just plain cheap. Opportune prices are usually the result of an overreaction to news or a behavioral investing mistake.

While we would never actually "forget" about an investment (we monitor movements daily and watch for strategy changes to make sure our thesis remains intact), we do view large cap investments much like this string of quotes:

"I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."

Continued on page 4

"Time is the friend of the wonderful company, the enemy of the mediocre."

"Buy a stock the way you would buy a house. Understand and like it such that you'd be content to own it in the absence of any market."

—Warren Buffett

Even in seasonal retail, the "forget" piece doesn't really mean you don't do anything. Retailers make tweaks to product pricing or steer inventory to higher volume stores in season, but the whole strategy is never completely changed. Large, quality companies that pay dividends have an endless news cycle, but that's where the "forget" piece comes in. We keep our heads down and only look for changes in the business's fundamentals, not the latest headline.

Small Cap Strategy

During the heady days of the internet bubble, back in 1999-2000, one of the surest signs that things had gotten out of whack was the overpowering dominance of technology stocks as a segment of the market. Collectively, the technology sector came to represent a whopping 33% of the entire value of the stock market. In the decade leading up to the crash, technology had only averaged 12% of the index, so this increase represented nearly a three-fold jump over the course of just a few years.

The largest sector of the stock market never retains that distinction indefinitely. Invariably, sectors grow or shrink as they become more or less favored over time. These changes usually develop gradually, but sometimes they happen quickly. Such sudden, dramatic changes in a sector's weight usually indicate a higher degree of irrational behavior. These situations can portend opportunity for the thoughtful investor.

Today, among small public companies, the utility sector stands notably above its longer-term average weight in the Russell 2000 Index, reflecting many investors' preference for income-producing stocks. By this metric, utilities haven't occupied this much of the index since the crisis years of 2008-2009, a time when investors favored them for their stability, predictability and dividends. Similarly, financial stocks are above their historic average weighting (27% vs 23%) and stand significantly above the lows they experienced in the aftermath of the credit crisis. Much of this inflated value appears to be coming from the real estate sector, which has likewise benefited from low interest rates and a preference by investors for yield. Generally speaking, these are areas we are avoiding given their lofty valuations and investors' fondness for them.

So what areas of the market do we like these days? For one, the energy sector has been pummeled over the past few years and now occupies roughly half its historic weight in the Russell 2000 Index. This sector has many of the attributes that investors loathe today: it is highly cyclical, it produces no dividends, and it has produced terrible returns over the past several years. These characteristics make it intriguing to contrarian, value-oriented, long-term investors like ourselves.

Another area of interest is the industrials sector which hit an historic low in its index weighting in early 2016 and has rebounded slightly since then. While end-markets like construction, agriculture, aerospace and automotive look to have slowed recently, we think there is scant evidence of a recession. Meanwhile, the negative impacts of a strong dollar are beginning to fade as the currency has largely stabilized over the past twelve months.

At Punch, our investment process is squarely focused on building a portfolio one stock at a time. We research and judge each stock based on its own merits, not on any top-down views or forecasts. While we don't make predictions about the economy, we have always believed that much can be discerned by observing investor behavior. In our effort to find stocks that are undervalued, we focus on areas where investor enthusiasm has been completely deflated, and we avoid those areas where expectations are high. When looking for a house, it helps to identify the right neighborhood first.

Wealth Planning Perspectives

The greatest investors in the history of the world are, by definition, long-term investors.

Morningstar has created a new, useful metric, called "the behavior gap," to show side by side comparisons of *fund* returns to *investor* returns (see above Income article). You'd think that if an investor invests money into an index fund, he would enjoy the full returns that the index fund provides, less any fees, right? The results of the behavior gap would suggest otherwise, and they are revealing.

According to recent data we discovered on the Vanguard S&P 500 Index fund, over a *10 year* period ending in June, the *Investor Return* for this fund was 5.04% per year in an index fund that delivered 7.29% per year on a *Total Return* basis. This means that, by buying the fund when it "felt" right (investors were optimistic about future returns, likely because of strong recent returns), and by selling the fund when it no longer "felt" good to own it (likely due to poor recent performance), investors' actual return in the fund was ***less than 70%*** of the returns offered by a simple indexed vehicle. (A difference of 2.25% per year over 30 years is nearly a 100% return, so to say this is a meaningful difference over an investing lifetime is an understatement.) When you look back over a *15 year* period, the results get worse: they show that investors captured ***less than 60%*** of the returns offered by the index. Abysmal.

From a behavioral perspective, investors are systematically and consistently getting less than the total return that a fund offers by virtue of when (and why) they are getting in and out of it. This is not a temporary occurrence; it is endemic, and it is quite predictable. The information that we are now able to quantify is a confirmation of what we have believed for a long time.

Our job, as trusted advisors, is to encourage you to stay committed to your long term investment plan regardless of a given market environment. We attempt to profit from these behavioral anomalies on your behalf, as opposed to being victimized by them. While we are not *unemotional*, we regard ourselves as *inversely emotional*.

Ignore the news

In his highly underrated treatise, "Avoid News," Rolf Dobelli wrote about this little observed phenomenon: that we are so *well informed*, yet we *know so little*. He goes so far as to describe news as "toxic" and how an *over desire* for news leads to "great risk of inappropriate, outright dangerous behavior." This is especially true for investors. We know the physical and dietary risks of consuming too much sugar (obesity, diabetes), but we fail to recognize the mental—even physiological—risks from a steady diet of tiny, meaningless tidbits which do not require thought. These snippets do require our precious time and attention, though, as our minds become more and more monopolized at the significant expense of other, more meaningful things. News is to the mind what sugar is to the body.

At Punch, we have intentionally built an environment that is uniquely designed to prevent distractions. We focus on individual companies and the things going on inside them that matter most. This luxury not only makes for a more enjoyable working environment, it should also accrue to your benefit as an investor, in our humble opinion.

Many investors fail to realize that the stock market, as measured by the S&P 500, is up 210% since it bottomed in 3/2009 through 6/2016. What's more, stocks remain a hated asset class from an investor sentiment point of view. In fact, if you were one of those "unlucky" souls that gained enough enthusiasm about stocks to buy in at the previous top in 10/2007 (immediately prior to the Great Recession), you'd still have a positive return, through 6/30/2016, of 34% -- many multiples of the return you would have had by holding cash throughout this period.

Have faith. For long term investors, we believe the best is yet to come.

Our Strategies

In communicating with you on a quarterly basis via this newsletter, we try to give you a sense for how we position our clients' portfolios in light of what has happened and what we think is likely to happen. We do this in three distinct strategies, each with different risk and return characteristics. A brief review of these strategies follows.

The Punch Income Strategy is geared toward income generation and is generally more conservative than our equity strategies. This strategy incorporates individual municipal, corporate, and government bonds, as well as other "yield vehicles" like preferred stocks, closed-end income funds, and utility and REIT shares.

The Punch Large Cap Equity Strategy uses a "hub-and-spoke" approach to gain exposure to the broad U.S. stock market. Core holdings include index funds and closed-end funds that are broadly diversified, while "spoke" positions are individual large cap stocks with above-average, long-term growth potential.

The Punch Small Cap Equity Strategy is the most aggressive of our three strategies; this is the place where we look for more substantial returns. In general, this strategy attempts to discover growth companies whose shares sell at value prices.

2016 INDEX RETURNS

	Second Quarter	Last 12 Months
S&P 500	2.46%	3.99%
Russell 2000	3.79%	-6.73%
Barclay's Aggregate Bond iShares	2.21%	6.00%

The material shown is for informational purposes only. Past performance is not indicative of future performance, and all investments are subject to the risk of loss. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, and actual results may differ materially from those anticipated in forward-looking statements. As a practical matter, no entity is able to accurately and consistently predict future market activities. While efforts are made to ensure information contained herein is accurate, Punch & Associates cannot guarantee the accuracy of all such information presented. Material contained in this publication should not be construed as accounting, legal, or tax advice. This message is intended to be educational in nature, and does not represent tax or legal advice. Punch & Associates is neither an accounting firm nor a law firm, and we encourage the reader to consult a tax or legal expert for specific tax or legal advice. The information provided is derived from sources deemed to be reliable, but we are unable to guarantee its reliability. For more information about Punch & Associates' services provided, please contact us at info@punchinvest.com, 952-224-4350 or 800-241-5552.