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Punch

A BOUTIQUE INVESTMENT ADVISORY

Wealth Strategies Group

Value Investing in a Disruptive World

"Some people don't like change, but you need to embrace change if the alternative is disaster."

— Elon Musk

"There is nothing so stable as change."

— Bob Dylan

As value investors, we are constantly on the lookout for companies that are relatively inexpensive. Everybody likes to find a good deal, right? Historically, it may have been enough to examine the last ten years of a well-managed company's trading history and purchase shares when they sold at the lower end of their valuation range (i.e. a low price-to-earnings ratio). Today, however, we live in a more disruptive world than we have ever seen. Entire industries are being turned upside down by new technologies or alternative offerings. So, when a stock looks historically cheap, it is more crucial than ever to ask "Why?" Why is the market giving me such a great deal here? Many companies have looked cheap right before they completely disintegrated. Witness companies like Wang Labs, Kodak, Blockbuster and Border's Books. This is just a small sample of companies that didn't respond quickly enough to changing tastes and new technology.

We own several companies in our equity strategies whose business is threatened by the way the world works. This makes "business as usual" a choice that can lead to self-destruction. Because we like to own companies when they are cheap (which gives our investors a "margin of safety"), we can be susceptible to owning companies whose businesses have the potential to be displaced in some way. (After all, why would they be so cheap?)

In our equity strategies we own traditional media companies (TV and radio stations, newspapers, etc.) whose business models are to create content, gain subscribers or viewers, and sell advertising. Now, both consumers of content and advertisers have more choices. Facebook, Twitter, satellite radio, over-the-top TV options and other streaming video services have clearly disrupted the traditional media company model by delivering customized content to consumers and giving advertisers the potential for immediate feedback on how effective their dollars are being spent.

We need to be continuously attuned to business models that may be under attack—especially those where it's not so obvious; where it is obvious, the threats can be priced into the stock. For example, a glaring disruptive force in retail these days is Amazon. Run by a genius, Jeff Bezos, Amazon is gaining market share on a daily basis from virtually every retailer, and its stock reflects this traction selling for over 100 times its 2016 estimated earnings. (That's 10 times more expensive than Macy's, one of the major retailers whose fortunes Amazon threatens.)

For a value investor, the best opportunities may present themselves when these "obviously" disrupted victims figure things out, their businesses stop shrinking and start growing again. The companies that we mentioned previously were all disrupted and, eventually, filed for bankruptcy. Aside from being slow and perhaps stubborn, they had one thing in common: they all

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had loads of debt. By the time these companies realized they needed to change their business models, it was too late. Their debt loads limited their options, and their best employees likely fled for greener pastures. Game over. That is why one of the first orders of business when we research new companies is to examine the strength of a company's balance sheet. A solid balance sheet can allow companies to alter their business model and assemble a competitive response. Debt-impaired companies enjoy no such luxury.

There are some well-known disruptors in the public and private markets today in areas such as lodging, home security and automation, media and transportation. These innovative enterprises threaten the business models of broadcasters, car manufacturers and dealerships, hotel chains and traditional home security companies and others where it is not so obvious. It is easy for an investor to get swept up in the enthusiasm when they own an inventive company that everyone is talking about. It is even easier to succumb to negativity if you own one of the companies whose business model is getting interrupted.

If you believe that you own a company that can't be disrupted, look harder. We believe there are very few companies which would not be impacted by changing competitive technology. If you own a disruptor, you can bet that the "disrupted" will not stand idly by and watch their enterprises disintegrate without a competitive response. In this market, we believe the quickest way to lose a lot is to own a disruptor that gets disrupted. MySpace and Groupon were disruptive companies years ago with a "first- mover advantage," but their investors never enjoyed the spoils because they were quickly displaced by new and better entrants.

We will always be valuation sensitive with our security selection in all of our strategies. This means we will always examine companies that are getting disrupted in some way. The emotion surrounding a shifting technology (both negative and positive) can sometimes be greater than reality warrants. This, we believe, is frequently where opportunities exist and where good research and judgment can pay off.

Income Strategy

Throughout history, investing in "fixed income" securities has involved purchasing a bond and receiving regular coupon interest along with the return of one's principal at maturity. No longer.

With a significant chunk of global debt bearing a negative interest rate, investors in such securities no longer have to worry about returns at all. If held to maturity, a bond with a yield less than zero guarantees a loss. This is the topsy-turvy world of income investing in which we live today.

The Financial Times recently reported that over $13 trillion of sovereign debt around the world has a negative sign in front of its quoted yield. In July, the country of Switzerland sold a bond with a 50-year maturity at -0.01% interest. And in a rather humorous (if not confusing) scenario, some European homeowners with variable interest rate mortgages now find themselves in the enviable position of their bank paying them to live in their homes.

With stories like these, it isn't hard to feel like the days of irrational exuberance are back. If the 10-year U.S. Treasury bond were a stock, its price-to-earnings (P/E) ratio would be 57x. Its average from 1966 to 2007 was 15x. We are a long way from normal in the world of fixed income.

Navigating these tricky times for income investing presents unique challenges. In the Punch Income Strategy, we are being selective and opportunistic, avoiding the obvious pitfalls of buying into expensive securities that offer no income at all while patiently waiting for pockets of value to open up.

We encountered two such pockets of value in the third quarter which we think offered attractive levels of income at prices which provided a margin of safety. The first was in June at the time of the surprising Brexit vote. We took advantage of weakness in European-related stocks to invest in a real estate investment trust (REIT) with high-quality office properties in major EU cities. The second came with the implosion of the energy market, specifically the master limited partnership (MLP) sector. Dismal returns over the past few years have created investor frustration and more than a few enticing values. We took a position in an MLP-focused closed-end fund with an above-average dividend yield which also traded at a discount to its net asset value in the third quarter.

While much of the income investment world today appears expensive and over-hyped, the reality is that investors cannot afford to simply sit on the sidelines in cash, awaiting higher yields. The coming normalization of interest rates has appeared "inevitable"

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for most of the past seven years, yet rates have only gone lower. Trying to predict when and by how much rates will go up is impossible, so we spend no time attempting to do that. Rather, we are focused on identifying individual securities with the most attractive levels of income that appear cheaper than most. Our hope is that these securities will retain their reasonable value regardless of the direction interest rates are headed next.

Large Cap Strategy

"Keep your eyes on the horizon and your nose to the wind."

— Clint Eastwood

The Punch Large Cap Strategy boils down to time arbitrage. In theory, time arbitrage simply means by employing a long-term view, time is on our side, and it's about being more patient than the next guy. Most investors measure success in days, weeks, months and quarters. By contrast, we measure success in years, which means time is, in fact, on our side. Maintaining this perspective allows your Large Cap Strategy to weather periods of volatility in the market, even though exercising patience can be difficult (just ask anyone who has small children or grandchildren).

We avoid "hot" sectors in favor of boring (and usually cheaper) areas of the market. We get particularly interested in a company when most others are not. We want good deals and are suspicious of the market's most popular stocks. The concept of time arbitrage can test your fortitude when stocks are declining. A mistake we try to avoid during a bear market is selling a company that has great fundamentals and in whose future we have strong conviction. By holding a stock for three to five years, we give it a chance to reflect what is really going on inside the company's walls and work past whatever negative sentiment might be keeping the shares inexpensive. Our expectation is that the stock will eventually reflect the company's intrinsic value in the long run. Our application of time arbitrage also results in lower turnover and, therefore, fewer taxable gains. As we otherwise wait for our ideas to play out, the strategy carries a current dividend yield of around 3%. This income stream (which we believe will rise with inflation) is favorable compared to the 10-year U.S. Treasury Bond which currently yields less than 2% (and carries a fixed coupon).

At the large cap end of the equity market, shares trade frequently, and information flows with a high degree of efficiency (unlike smaller companies). At Punch, our goal is to make fewer, better decisions. If we are able to exercise more patience than other investors, we can improve our odds of capitalizing on others' predictable mistakes. Employing this philosophy makes time our competitive advantage, and this strategy allows us to patiently buy and sell opportunistically, particularly within the "hub" of the strategy which is made up of closed-end funds (CEFs). It's within these CEFs that investors' mistakes are most obvious.

We made a few changes in the third quarter. Among them, we trimmed our position in a mega-cap, 130-year-old health care products manufacturer. This company was favored by many investors for its safety, making it a bit expensive in our view. The Brexit vote created some investor fear and caused the some European ETFs to trade down on a near term basis. We took the opportunity to initiate a position in a Euro ETF that invests in high quality companies domiciled on the continent. As noted, high quality non-cyclical companies have garnered the most love so far this year from investors, and this has created value at the other end of the spectrum (i.e. cyclical companies). As a result, we started a new position in a high quality, dividend paying cyclical which appears cheap. This company is a market leader in boating and fitness equipment, both of which are growing industries with positive secular and cyclical trends. Boat buying activity (75% of their business) remains 45% below pre-recession averages. We think we are getting this one in the early innings.

Small Cap Strategy

Not long ago, several members of our research team took a scenic road trip down the Mississippi River to visit a small-cap company in Iowa. The company is a good-sized furniture manufacturer with a gleaming new headquarters right on the banks of the river. As we do with many companies we are seriously researching, we had a full afternoon of meetings scheduled with the senior executives of the company, followed by a plant tour of the nearby upholstered seating division.

After the usual introductions and pleasantries with the CEO and CFO, we casually asked how often they hosted meetings with investors like us. "You're the first to come visit us in five years!" was their reply. When we hear that from a company, it tends to excite us, and it's not that unusual.

We get excited about unknown companies in the same way that a beachcomber might get excited when his metal detector starts beeping over a clump of sand. 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.

Taking notice of companies that are unknown, under-researched and hard to find isn't all that unusual for us because those are exactly the types of opportunities we seek. Information is a valuable commodity in investing, and the scarcer it is, the more valuable it becomes. Performing due diligence that others are unwilling or unable to perform is a real competitive advantage. The same opportunity does not exist in Apple, General Motors or IBM.

As you might imagine, this focus generally leads us to smaller-than-average public companies. As of September 30th, the median market cap for the forty-five companies in the Punch Small Cap Strategy was $570 million. This is meaningfully below the $750 million for the Russell 2000 Index and significantly below the $1.8 billion for the average small-cap mutual fund in the U.S.

Since 2011, the trend in the stock market has been the *smaller the company, the worse the stock performance*. This is true on a one, three and even a five-year basis. Large-cap stocks have outperformed small-caps, and small-caps have outperformed micro-caps. We saw reprieve from that trend during the third quarter of 2016 when micro-caps gained ground in a big way.

Over longer time periods, we firmly believe that such hard work will be rewarded, and the data bears that out. According to records going back to 1926, the smallest decile of public companies outperforms the largest decile by more than two-to-one.[1] Over shorter time frames, it's a roll of the dice.

In other words, lately, the market has not rewarded those investors who have the willingness to roll up their sleeves and do the dirty work of finding, researching and owning these smaller companies. Currently in the stock market, these out-of-the-way companies find themselves out-of-favor, and we are particularly excited about their prospects in the years ahead.

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[1] Ken French Library

Wealth Planning Perspectives

> **"Money won't make you happy, but everybody wants to find out for themselves."**
>
> — Zig Ziglar

Although our overall stress is down since the Great Recession began, many Americans continue to be anxious about money according to the latest American Psychological Association Stress in America survey. "Regardless of the economic climate, money and finances have remained the top stressor since our survey began in 2007," says APA CEO Norman B. Anderson, PhD. "Furthermore, this year's survey shows that stress related to financial issues could have a significant impact on Americans' health and well-being."

The survey was conducted by Harris Poll on behalf of APA among 3,068 adults in August, 2014. It found that 72% of Americans reported being worried about money at least

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some of the time during the past month, and 22% said that they experienced "extreme stress" because of money issues during the past month. For the majority of Americans (64%), money is a "somewhat" or "very significant" cause of anxiety, especially for parents of children below the age of 18 and younger adults.

We are the wealthiest nation in the world and somehow we still have some of the highest levels of financial stress. It really doesn't matter how much money you have either. Obviously, folks with a negative net worth are stressed. Although, we have also had meetings with clients who have over $15 million saved and invested, and even they are worried about whether or not they have "enough." (Incidentally, this is also not a distinctly "American" problem, either.)

Here are some of the factors that are known to cause stress in our financial lives:

- Watching or reading too much news
- Debt: credit cards, mortgages, car loans, etc.
- Loss of a job
- Budgeting: Do I know what I'm spending and saving? Are we being irresponsible with our spending?
- Am I going to be "ok?" Do I have "enough?"
- Am I doing what I should be doing? Am I making the right decisions?
- Wall Street salesmanship
- Reporting: Lack of clarity, knowledge of the bigger picture and how all the various moving parts fit together
- Market volatility
- Dates, deadlines and timing
- Taxes
- Education
- Medical bills or health care coverage
- Insurance: Am I paying too much? Am I over or under insured?
- Unexpected expenses

There are, invariably, things that come up which cause stress and uncertainty. Situations that are out of our control simply cannot be completely avoided. But, you can significantly reduce both the likelihood of these triggers occurring and also the propensity for them to influence your well-being.

What are some ways to alleviate some of these known causes of stress and anxiety?

1) Have a trusted, long-term, personal relationship with a competent, conflict-free, fiduciary advisor who knows you and your family's needs intimately and who takes the time to care deeply about your circumstances. Someone who "does life" with you.

2) Work within the context of what matters most to you. Treat money as a means to some end, not an end in itself, and prioritize what you're trying to accomplish. Then, don't lose sight of that purpose.

3) Communicate with family members and throughout generations. Involve all interested parties. Prepare heirs for the responsibility and complexity that come with resources. Educate family members.

4) Don't buy financial products (which are "sold" to you), rather, invest in strategies which are guided by a long-standing philosophy and implemented with a repeatable, durable and sustainable investment process.

5) Understand the power of less, and the reality that boundaries are life giving. The enemy of art is the absence of limitation. This applies to accumulating "stuff," especially.

6) Give money away. Generosity is not discussed, explored or considered nearly enough. By giving money away, you're reducing the claim that money has on your life and reducing its relative power over you. You're acknowledging that you already have more than enough, and you get to experience the joy of seeing someone who needs these resources more than you do benefit from them.

Stress has some terrible effects on our bodies. It results in irritability, fatigue, and nervousness and unfortunately, money consistently ranks as one of the greatest causes of it. But that doesn't need to be true of us. At Punch, we're grateful for this opportunity to "do life" with you, our trusted partners. We never take for granted the gift it is to have these and other meaningful conversations with you.

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

	Third Quarter	Last 12 Months
S&P 500	3.9%	15.5%
Russell 2000	9.0%	15.5%
Barclay's Aggregate Bond iShares	0.5%	5.2%

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