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Punch

A BOUTIQUE INVESTMENT ADVISORY

Wealth Strategies Group

A Culture of "Stock Rats"

When I was a kid, there was an outdoor hockey rink no more than 100 yards from my bedroom. I could see everything that went on at the rink just by looking out the window. There were half a dozen neighborhood kids who were always at the rink. We called them "rink rats," and I was one of them. Each of us had varying levels of talent (indeed, none of us ever made a living playing the game). What we all had in common was that we loved playing the game and, during the winter, thought of little else. Some of the really talented kids would show up at the rink every now and then, and we'd have some amazing pick-up games. Most of the great players knew they were great, but they didn't show up all that often. When they did show up, they would coast around and strive to make flashy, highlight-reel plays without expending too much energy. As rink rats, we knew we had to work extra hard and do the "little things" like skate to the corner (where the ice wasn't quite as nice) to dig out a puck and pass it to a teammate. We didn't mind. To us it wasn't work. We were kids playing hockey for the love of the game. We showed up early every winter day and shoveled the snow off the ice so that we could skate, pass and shoot. We all got better. When we weren't at the rink, we were thinking about the rink and wondering who was going to show up next time. It is now the dead of winter here in Minnesota, and I look back on those days and consider them as some of my happiest.

When I think about the folks I work with on my analyst team (the people who help Punch & Associates find profitable investments for our clients), I think back to my rink rat days. While we, as rink rats, would leave the rink, our minds never really did. The same can be said about our analyst team. We may leave the office, where our primary objective is assessing businesses and their prospects, but our minds never fully vacate this focus. All members of our research team are continuous observers of the flow of commerce, consumer attitudes, human behavior and the preferences of our families and friends. We observe these factors because they create both risk and opportunity in the capital markets.

Investment management is an extraordinarily competitive business. The devil is in the details, and there are a lot of details that need attention before triggers can (or should) be intelligently pulled. Our team is unafraid of hard work and loves digging into details in the same way the rink rats were willing to do the less glamorous tasks on the ice. Discovering something that other investors have overlooked is like taking advantage of an opposing player's mistake and scoring a goal. When your opponents are good, this doesn't happen all that frequently, but if you are not focused and working hard all the time, this success may never happen.

> **"When beggars and shoeshine boys, barbers and beauticians can tell you how to get rich, it is time to remind yourself that there is no more dangerous illusion than the belief that one can get something for nothing."**
>
> — Bernard Baruch

Investors who believe they can create success by chance are the same ones who enter casinos filled with high hopes, a pocketful of cash and no plan. A vast majority of what I have learned about investing over a 34-year career can (perhaps sadly) be summed up in two important sentences:

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1) **Successful investing is difficult.**
2) **As soon as it starts to look easy, it's about to get more difficult.**

I hear many interviews of various market professionals, and they are often asked, "What do you know now that you wish you knew 20 years ago?" For me, those two sentences say it all. They underscore why we always have to be vigilant and why we have to sweat the details; why we don't puff out our chests when we are doing well or gnash our teeth when we're not; and why we're always trying to refine and institutionalize our process for creating solid results. We know the results aren't always predictable when you do the right things, but we also know they can be disastrous if you don't. We are also well aware of the role luck plays in almost every outcome, and it has to be given its due. No amateur hockey player is deluded enough to believe that he can become a professional without an incredible amount of hard work, practiced skill and some degree of luck. Why is it that there are so many investors who believe they can achieve superior returns without the same effort and luck?

At the beginning of 2017, Punch & Associates added a key player to what we believe is one of the hardest working investment teams anywhere. Paul Dwyer, CFA, comes to us as an experienced researcher with strong credentials, a diverse background, a passion for stock-picking and a shared hunger to do well for our clients. We had met Paul several years ago at investment conferences and he always seemed to be attending the "off-the-beaten-path" company meetings that we were attending. We also met Paul several times at local CFA meetings for value investors. Paul always eloquently shared some of the most unique investment ideas. We believe he will show up to the rink early, be willing to shovel, go into the corners and do the little things that will make him fit into our team quite quickly.

Income Strategy

What a difference a year makes.

In 2016, many fixed income securities performed better than stocks, producing both rising prices and dividend distributions. The total return for several of these asset classes was well into double digits: high yield bonds rose 13.3%, closed-end funds were up 13.4%, and business development companies (BDCs) had a total return of 23.7%.

As is usual in financial markets, the seeds of these investment returns were sown in the difficulties of 2015. In our year-end 2015 newsletter article, we wrote:

"We are seeing prices on some securities enter irrational territory…usually these kinds of valuations occur when investors are panicky, emotional, and have little regard for value—precisely the point when it is better to be a buyer than a seller."

Indeed, 2015 was in many ways the mirror opposite of 2016. As investors crowded out of securities like closed-end funds and BDCs, prices fell, valuations compressed, and yields rose. In our opinion, these investments generally became more attractive even though the rearview mirror suggested otherwise.

Investing, like life, must be lived forward—not backward—and it is the irony of capital markets that the best time to be making investments is often when it is hardest to do so emotionally.

As we survey the landscape ahead of us today, optimism is on the rise, although we would not describe the mood of the market as exuberant. Heading into the presidential election, the percentage of investors with a bullish outlook for the stock market (as surveyed by the American Association of Individual Investors) was at the lowest point of the last decade. That is a lot of negativity to be undone.

Another sign of muted enthusiasm is the complete lack of initial public offerings (IPOs) in the closed-end fund market. Closed-end funds, which are often marketed to retail investors, saw only one new IPO last year, well below the eight new funds that were issued in each of 2014 and 2015. This single municipal bond fund raised only $81 million, compared to all IPOs raising $2.3 billion the year before.

The recent rise in yields, particularly in treasury and municipal markets, is starting to make investing in these stodgier areas of the market more appealing. Municipal bonds were one of the few fixed income asset classes to turn in a negative return in 2016, falling 2.3%. Their yields are now approaching the historical average of the past ten years (see nearby table), a level we see as attractive.

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	Current Yield	Five Year Average	Ten Year Average
10-Year Treasury	2.45%	2.12%	2.81%
U.S. Investment Grade Corporate Bonds	3.84%	3.66%	4.59%
U.S. High Yield Corporate Bonds	6.41%	6.62%	8.51%
AAA-rated 10-Year Municipal Bonds	2.36%	2.08%	2.71%

Large Cap Strategy

> **"Our freedom to operate and maneuver had increased substantially through disciplined procedures. Discipline equals freedom."**
>
> — Jocko Willink (former U.S. Navy SEAL and author)

Every stock owned at Punch & Associates has an investment thesis which was developed in-house. The companies in the Large Cap Strategy are no exception. We develop our thesis as we conduct fundamental research on the moving parts of a company and the underlying sentiment surrounding the name and its sector. After understanding what we think could go wrong, our investment thesis takes the shape of what we think could go right. From there, if we take a position, the investment thesis serves as our guide while we own a piece of the company. Just as Virgil acted as Dante's guide through the inferno, an investment thesis keeps us on track and helps us prevent little mistakes from getting bigger.

Without an investment thesis, our judgement of a company could be clouded by developments such as sensational headlines, changes in management teams, lower than expected earnings results and the like. Issues like these could potentially cause us to react irrationally. Our investment thesis keeps us disciplined.

The thesis for any given stock tells us if we got it wrong, if we're on track or if we're going off track. Ideally, when we are buying a stock for the Large Cap Strategy nobody should believe our thesis and then when we are selling, everybody should. Although a simple tool, the usefulness of a thesis cannot be overstated, because sometimes when we wait for the thesis to pan out, it feels like we're following in Dante's footsteps. It reminds me of the famous Winston Churchill quote, "If you're going through hell, keep going."

By design, turnover is lowest in the Punch Large Cap Strategy. In 2016, turnover was 22.20%, well within the commonly accepted range for low turnover of 20% to 30%. The companies we own are well-capitalized organizations that need time to grow and execute their strategies. Low turnover also means fewer trading fees which accrue to the benefit of our clients. Since the inception of the Large Cap Strategy, turnover has averaged 20.41%.

Large cap stocks, in contrast to small cap stocks, generally have considerable analyst coverage and investor followings which means all information that can be known about a company is essentially available. This abundance of information makes unique insights on large cap stocks particularly rare. As a result, we believe taking advantage of behavioral mistakes is a key component to large cap investing, both in individual stocks and in closed-end funds.

Small Cap Strategy

The week before the presidential election, an investment memo was leaked from the largest hedge fund in the world to a financial journalist. In it, the Chief Investment Officer of the fund predicted that a Trump victory would result in a 10.4% decline in the stock market over the following month. A Clinton victory, on the other hand, would bring a 2.3% gain.

The prediction had credibility for two reasons: first, it came from Bridgewater Associates, a secretive and highly successful fund based in Connecticut with about $150 billion in assets; second, the exactness of the predictions made it seem that some scientific and highly secretive process was at work.

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Of course, most people are now aware of the market's reaction to the election of Donald Trump on November 8th. The S&P 500 rose slightly over 5% in the ensuing month, and the small cap Russell 2000 Index gained over 16%. Gold, which Bridgewater Associates said would surge 8.6%, actually fell 8.3%. And crude oil, which they predicted would drop 2.9%, went on to climb 13.0%.

Presidential elections are a tough thing to predict. Capital markets are even tougher. When you combine the two, you might as well be rolling dice.

Our investment process sidesteps these meaningful, though largely unpredictable issues, simply because they are too tough to figure out. If the largest hedge fund in the world, which likely employs the smartest minds on Wall Street, can get it so spectacularly wrong, what hope do we have?

Rather, our focus is squarely on the individual companies in our portfolios, nearly all of which are either too small or too insignificant for the hedge fund titans of the world to care about. We believe our competitive advantage investing in these companies goes up as the number of eyeballs trained on them goes down.

Moreover, because we try to look beyond the near-term noise of politics, we can focus on longer-term prospects for our portfolio companies. Solid companies with sensible business models and intelligent management teams usually outlast election cycles and presidential administrations anyway, and their performance (good or bad) usually happens irrespective of which political party holds sway.

One of the characteristics we like to see in our portfolio companies is large amounts "insider ownership," or how much of the company's shares are held by its CEO and management team. We think managers who "eat their own cooking" are more committed, better aligned with shareholders and often make more rational decisions with shareholders' money. A CEO whose own hard earned money is at risk in a company more readily feels shareholders' pain, as well as their gain.

We recently did a study of the companies in the Punch Small Cap Strategy and found that high insider ownership was indeed a common characteristic of many of them. The average insider ownership of all companies was 6%--often placing insiders among the largest shareholders of our holdings. Twenty-one percent of companies—over one in five—had over 10% ownership stakes.

We believe that partnering with smart, committed management teams who have their own money at risk in a business gives us significantly better odds of finding investment success over the years to come than competing for the next big headline prediction.

Wealth Planning Perspectives

Raising fiscally responsible adults.

On many levels, money makes parenting harder, not easier. When our children reach a certain age — likely well before we realize — it is necessary that they develop a sense of their own unique purpose. It has been said that work does not really feel like work if it is a passion. (We enjoy this scenario at Punch & Associates where we're fortunate enough to say that if we could wave a magic wand, we would hardly change a thing about our work because we love the work we do and the people for whom we do it.) It is important that our children, as they enter into adulthood, have been given autonomy in their decision making and have the confidence to take risks, fail, learn, rebound and start again. This is, after all, what much of a career is all about.

If children do not have an awareness of consequences that the world will likely levy upon them for any given decision, they will also lack the sense of ownership that is critical to becoming a fiscally responsible adult. Also, if they're given too much, they will lack a critical motivation that could drive them to greater fulfillment.

Somewhat interestingly, there is no word for adult children in the English language. Even as our kids reach the age of majority, we continue to refer to them as our children throughout our entire lifetimes. It is important to note that we're not raising

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"children," we're raising "adults," and hopefully fiscally responsible ones at that (for their sake and for ours).

How much financial assistance is too much?

We have noted many instances over the years when parents with resources have stepped in to help kids and grandkids. Examples of this financial help include: assisting with an apartment or a house, cars, furnishings, education, weddings, and paying off debt or supporting a business endeavor, just to name a handful.

From the day our children are born, we are hardwired to help them. There is absolutely nothing wrong with providing financial assistance to our kids. The challenge occurs when parents feel compelled to "control" the gift after it was made. It is critical, especially in the case of business endeavors, that the "giftees" (our children) have ownership and autonomy in financial decisions, especially in conjunction with a gift that has already been made. They need to know they are the ones who are trying — they will succeed or fail — but it's their own and not anybody else's influence impacting the outcome of their efforts.

While helping future generations, it is important to draw the line and set clear and consistent boundaries. There is immense value in work; it can (and should) be life-giving and not life-draining. A successful support strategy means the parents step up and provide assistance, but they also draw the line and don't overstep. Stated otherwise, it is important that children know they cannot keep "going back to the well." There is a limit on the assistance they'll be provided. If this plan is clearly communicated, children can gain confidence from this experience.

Jack Canfield tells us, "Everything you want is on the other side of fear." Kids need to know this and embrace it. Nothing significant was ever produced from a quest to remain comfortable.

The power of failure as a teacher.

> **"I have not failed. I've just found 10,000 ways that won't work."**
>
> — Thomas Edison

Edward Burger is a Professor of Mathematics at Williams College, and he has noted that "individuals need to embrace the realization that taking risks and failing are often the essential moves necessary to bring clarity, understanding and innovation. By making a mistake, we are led to the pivotal question: 'Why was that wrong?' By answering this question, we are intentionally placing ourselves in a position to develop a new insight and to eventually succeed."

He goes on to mention that students who arrive at his class seem to have been taught to avoid failure at all costs throughout their entire lives. We and our children need to acknowledge the reality that if you spend all your time trying to avoid failure, ultimately, all you may be avoiding is success.

How much information should I share?

For many families, a large, looming question is often: "How much do we tell our children about the depth and details of our wealth, and when do we tell them?" We find that folks don't really have a good "gut feel" on this topic, and initial instincts range from complete transparency to total secrecy.

From an advisory perspective, we've long defaulted to the adage that once you tell them, you can't "untell" them. Although, upon deeper reflection, we find that the following policies have been the most productive and fruitful when implemented at the right time (key words):

- Don't try to hide it. Kids likely know there is some level of resources based on what they've seen and heard. Be honest about the fact that there is some degree of wealth. Having said this, you do <u>not</u> need to spell out specific amounts and timing regarding their inheritance.
- Make sure subsequent generations realize that the money belongs to the generation that currently owns it, and there is no guarantee that it transfers to them. Plans change. Circumstances change.
- In the case of so called "dynastic" wealth (multiple generations), kids need to know that resources should outlast their lives and several generations to come (if that is the goal), and they're charged with being good stewards of that wealth. (They should be "shown" how to be good stewards.) Generosity matters.
- Most importantly, kids should be encouraged to pursue their interests, carve out their own unique niches (in life and in their work), and they should not make any career or financial decisions based on an anticipated inheritance.

We, in Punch's Wealth Strategies Group, are grateful to be engaged with our client families in a trusted advisory capacity regarding these and many other important issues.

Upcoming Events

2017 Arizona Investor Update
Tuesday, February 21, 2017
5:30 – 6:00MST Appetizers and Cocktails
6:00 Presentation

The Clubhouse at Tonto Verde
18401 East El Circulo Drive
Rio Verde, AZ 85263

2017 Minnesota Spring Investor Update
Tuesday, April 25, 2017
5:30 – 6:00MST Appetizers and Cocktails
6:00 Presentation

The Golden Valley Country Club
7001 Golden Valley Road
Golden Valley, MN 55427

Punch Summer Client Event
Tuesday, July 11, 2017
CHS Field

Further Detail to Follow

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

	Fourth Quarter	Last Twelve Months
S&P 500	3.83%	11.98%
Russell 2000	8.83%	21.32%
Barclay's Aggregate Bond iShares	-2.98%	2.66%

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.