Driverless Investing

> "What wise men do in the beginning fools do in the end."
>
> - Warren Buffett

A few months ago, the evening news made a big deal out of somebody getting killed in a car powered by Tesla's driverless technology. Yes, a person was killed in an autonomous vehicle. While every death is tragic and many are preventable, according to government statistics this is something that happens 3,287 times per day (Asirt.org.) Why does the media shower such attention on the one driverless death?

I might guess it's because "fear sells" and, if we are at the beginning stages of autonomous driving, how afraid should we be of unmanned cars? Nobody knows...yet. I can think of more than a few people with whom I'd prefer to not ride. Given the option, I'd definitely favor the driverless vehicle to arrive somewhere safely. Considering the level of human distraction while driving these days, driverless cars could in fact save lives.

Turning back to the world of investing, we observe that the investment firm, Vanguard, is inhaling over a $1 billion per day in new assets. Most of this money is flowing into low-cost, passive index funds and much of it at the expense of actively managed mutual funds. It is hard to say what inning we are in with regard to this trend. The last time I remember the S&P 500 index fund being this popular relative to everything else was during the .com bust of 2000.

While the make-up of the S&P is more balanced right now, the mindset of investors appears to be similar. "I don't know exactly what this is, but get me into it because it's doing better than whatever it is that I own." By the way, in case we all needed to be reminded, an investment in the S&P 500 at the beginning of 2000 didn't become profitable until 2007. At that time, two less popular indices were the S&P Value Index and the S&P 600 Small Cap Index. Both of these indices contained a far "less sexy" mix of securities and ended up being profitable several years earlier than the S&P 500. Over one-third of the S&P 500 Index contained technology companies that were frighteningly expensive at the time. Cisco was one of the largest companies in the index and seventeen years later it is still not back to 2000 levels. The ensuing 10-year return (From 1/1/2000) for the S&P 500 was a minus 13.7%. Assets typically follow returns; they don't precede them. As we know, every so often the S&P 500 becomes directionally challenged and one wonders if $1 billion a day would be pouring into an investment that yields these results.

At Punch, we are not disbelievers in index funds and this is not a "passive investing vs. active investing" debate. Both approaches work and can complement each other. We use select index-type vehicles tactically in some of our strategies. We tend to favor them more when everything is cheap within the index, and less after a large advance in an index. Most importantly, we believe you cannot abdicate your understanding of what you actually own and its role in your financial life. It's good in these instances to have a driver in place so you can avoid owning a broad cross-section of overvalued companies. An index fund is the benchmark because somebody decided it was representative of a class of securities, not because it makes sense all the time and is a good value. Empirical Research notes that index funds have a distinct advantage over other funds in that they get to call themselves the benchmark. So they can't underperform. It's a good gig if you can get it.

Punch Income Strategy

Jeff Gundlach is widely regarded as the "bond king" with over $100 billion in assets under management. His California-based investment firm, Doubleline Capital, focuses on fixed income investments. Like the old E.F. Huttons commercials, when Mr. Gundlach talks, people listen.

In a January 2017 edition of Barron's magazine, Mr. Gundlach did talk, giving his thoughts in an interview on interest rates, bond markets, and investment ideas. One investment idea that he pitched was a $600 million closed-end fund that invests in a diverse portfolio of bonds. "One way to position yourself for further rate increases," said the bond king, "is to look for things that don't have much interest rate risk. [...] this fund holds allocations to assets that dampen interest-rate-related volatility." He then gave his imprimatur: "If someone wants to own one bond investment after this rally is over, this is a good one to have."

With that simple recommendation, the market price of the fund jumped 3% in a single day—a years' worth of return for some bond investments—and nearly 6% over the next two weeks. Investors flocked to the shares in droves, driving up trading volume and bidding up the price quickly as they heeded his advice to buy in.

What is unique about closed-end funds is that the market price of the fund is distinct from the asset value of the fund. In other words, as the share price of Mr. Gundlach's recommended fund rose 6% in those two weeks, the value of the assets in the fund rose only 1%. As a result, the discount between the market price and the net asset value (NAV) shrunk from 11% before the recommendation to only 5% afterward. Shareholders benefitted from this newfound demand for shares.

Closed-end fund discounts shrink or expand for a number of reasons. On occasion, recognition from a noteworthy investor will cause shares to pop. More often, though, the size of discounts (or premiums) on funds tend to reflect the relative popularity of a fund's strategy or asset class focus. For example, following large declines in the energy and MLP (master limited partnership) industry in 2015-16, many funds in this sector went from premiums to large discounts as investors fled.

The widest discounts can often be found during periods of maximum pessimism towards a fund's assets. We think this can be an excellent time to buy cheap, out-of-favor securities.

Aside from market forces, discounts also shrink as a result of shareholder pressure on the fund management, or shareholder activism. Excessively cheap funds often attract activist investors who push for mergers, liquidations, or stock buybacks that force a discount to narrow. While we do not normally participate in such activism, we have benefited from other investors' willingness to apply pressure to these funds.

The reason that we focus so intently on closed-end funds as an asset class is that buying funds at substantial discounts to their net asset value (NAV) can provide the opportunity for better performance as discounts shrink or even evaporate completely. Mr. Gundlach's recommendation is a good example of the unexpectedly good things that can happen when investing in this area from time to time.

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Punch Large Cap Strategy

"I paraphrase Lord Rothschild: 'The time to buy is when there is blood in the streets.'"

- David Dreman

When is the last time you visited the mall? Are you shopping online more? It's no secret that traditional brick and mortar retail is under siege from online retailers and has been for about a decade. That said, things have intensified over the last couple of years as giant online retailers like Amazon continue to give customers more reasons to shop online. Online is winning because you can buy just about anything with a computer or mobile phone today and chances are it will ship to your front door in less than two days for free. You want the product today? Well, that is quickly becoming a reality with some products too. In December last year, Nordstrom management said full-line brick and mortar traffic levels were the worst they've been since 1972. It's clear, brick and mortar retail is suffering.

Although online sales accounted for just 8.1% of total retail sales in 2016, they grew 15.1% over the prior year while total retail sales grew only 2.9%. The chart below seems to show that the shift to online retail is not slowing down anytime soon. One retail industry consultant believes online sales will make up 50% of total retail sales over the next ten years.

There have already been as many large retail bankruptcies in 2017 as there were in all of 2016. At least nine brands have filed for bankruptcy this year, including names like Gordmans, RadioShack, Gander Mountain, Eastern Outfitters and The Limited. CNBC noted that the current rate of retail bankruptcies is on pace to surpass the 2009 high-water mark of eighteen by this September. What's unique to this round of bankruptcies is that many of this year's filings are coming from brands owned by private equity firms that used debt and equity to buy the businesses. That debt can quickly become a financial burden when consumer traffic slows down and it can expedite the path to bankruptcy. All in, almost 3,000 stores are expected to close in 2017.

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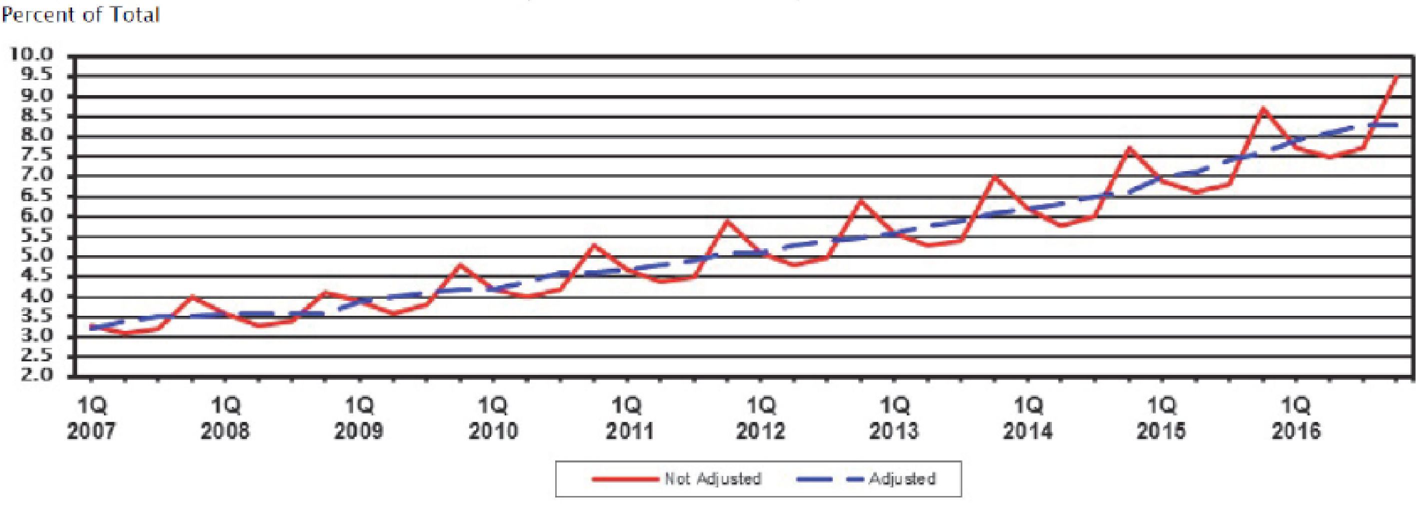
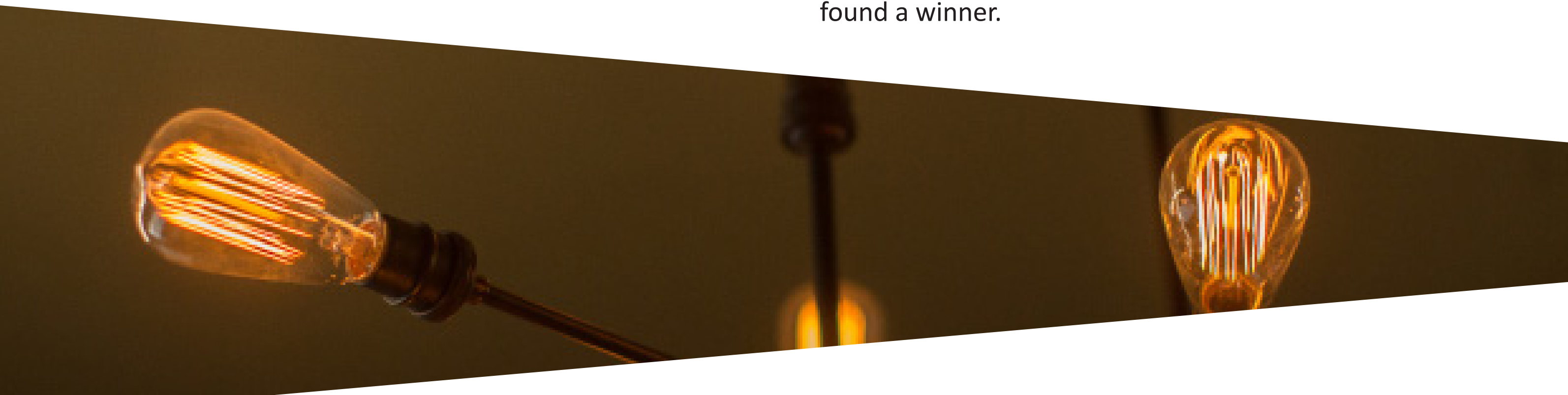


Value investing is contrarian investing at its core. We look for ways to invest in the mispricing that is the byproduct of a major trend like the growth in online retail. With these kinds of market dynamics there are clear winners and losers. Given the current retail landscape, we made a contrarian investment into a large retailer in the first quarter. This retailer has managed to grow both revenue and earnings by 60% and 70% respectively over the last six years, but the stock does not appear to reflect this growth.

We believe it's cheap. After several peers declared bankruptcy, this company is now the clear market leader within its retail sub-segment. The company should benefit from a less competitive environment where the need for promotions is reduced. We believe the management team is highly competent and there is no debt on its balance sheet. Like the other retailers that continue to survive the brick and mortar turbulence, we believe this company will continue to drive store traffic by surprising and delighting its customers. In our view, we bought the best house in what looks like a "blown up" neighborhood. Hopefully, we found a winner.



Punch Small Cap Strategy

The Wall Street stock analyst today is a dying breed. Twenty years ago, the S&P 500 Index had 20 analysts for every $1 billion in market value. Today there is only 1 (adjusted for inflation). Fewer and fewer professionals are doing the work historically associated with investing: researching the fundamentals (sales, earnings, cashflow) of a company and determining whether a stock is cheap or expensive.

In their place, a new type of professional investor is in high demand: the quantitative analyst. According to a recent survey of job listings on a major job site, listings for "quant" analysts now outnumber listings for "fundamental" analysts by a factor of over 2-to-1.

The quantitative analyst often has a mathematics or engineering background, rather than a financial one, and spends their days creating algorithms and models based on data sets to exploit markets and produce winning strategies. We believe this is in sharp contrast to the fundamental analyst's duties of reading annual reports, crunching income statements and balance sheets, interviewing CEOs and CFOs, etc. Many of us would likely have a hard time understanding the mechanics of most quant strategies and their complex mathematical formulas, which is why they are commonly referred to as "black boxes."

The rise in popularity of quant strategies and the analysts who create them has created an interesting paradox: with so few analysts focused on long-term fundamentals, the opportunity to produce original insights into companies actually goes up. "Ironically," says Merrill Lynch Strategist Savita Subrmanian, "what should be an increasingly efficient market has shown signs of becoming less efficient over the long term. [...] One of today's greatest market inefficiencies may stem from the scarcity of capital devoted toward long-term, fundamental investing."

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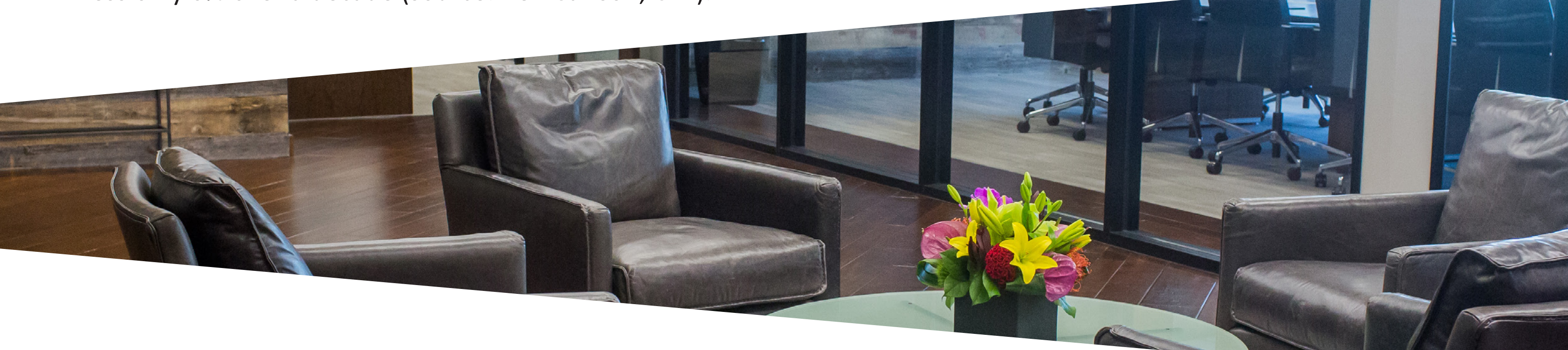
In this environment of short-term, quantitative, rapid-fire investing, we believe a patient, fundamental approach like ours has two distinct advantages.

First, time is on the side of the patient investor. While the vicissitudes of the stock market may affect prices randomly and unpredictably in any given day or year, the longer a person owns shares the more likely it will be that the growth and success of the company will drive returns, not the market. The probability of loss in the stock market drops from nearly 50% on any given day to less only 6% over a decade (source: Ben Carlson, CFA).

Second, research is most valuable when it is not widely shared (and therefore already reflected in stock prices). The "crowded trade" in today's market seems to be in quantitative strategies, not fundamental ones, and we believe that we benefit from less competition for ideas and insights.

We believe that, over the long-term, a patient, fundamental approach to investing is best, and we are excited by the opportunities that may come from fewer investors sharing this belief.



The Benefits of Consolidation

> "Simplicity is the ultimate sophistication"
> - Leonardo DaVinci

There are many benefits to keeping your financial situation as simple as possible. At Punch, we have long been advocates of simplicity and believe that greater simplicity promotes better decision making. For example, we advocate maintaining "clean" balance sheets, paying off debt and consolidating accounts where possible. The following is a discussion about consolidating assets and thereby simplifying your situation. The fewer the moving parts, the easier life is.

Avoiding "Di-WORSE-ification"

"Open architecture" can be one of the greatest allures of the advice industry. Countless advisory firms tout a conflict-free approach where they do not offer any proprietary products and therefore have no ax to grind. While this approach often makes sense, an unfortunate outcome in many cases where it is utilized can be an unnecessary duplication of fees. Advisors charge a fee for asset allocation and manager selection, and on top of that, the client also pays investment management fees for the underlying manager(s) - whether through mutual funds or otherwise.

From an asset allocation standpoint, it is critical that one hand knows what the other hand is doing. With a multi-advisor / multi-firm approach, duplication of effort, or "overlap," is another unfortunate and unintended consequence. If you have more than one advisor or fund manager, you may end up with a substantial imbalance in your overall portfolio when more than one favors overweighting a certain sector. If you have investments in several locations, it can be challenging to monitor your broad asset allocation.

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With a consolidated approach, it becomes much easier to implement your strategy and keep your intended asset mix on track. Importantly, rebalancing can be a much simpler task with one, integrated view.

More effective planning, progress measurement

Consolidating will likely also improve your planning and execution in the following areas:

- Minimum Required Distributions (MRDs)
- Tax / Distribution arbitrage
- Tax loss harvesting
- Appropriate marriage of account type & strategy
- Charitable giving
- Performance measurement

Holders of traditional, pre-tax retirement accounts need to take mandatory distributions beginning at age 70.5. The calculation is made easier when you can review any and all accounts whose balances would be part of this equation on one screen or statement.

Planning opportunities are also enhanced when you have multiple pools of investments, each with its own tax treatment, so you can optimize your income tax picture when accessing your assets. This so called “tax arbitrage”, with respect to IRA distributions, is appealing because you can control whether or not, when, and the extent to which, your withdrawals are taxed.

For taxable accounts, it’s sometimes a good idea to review your realized gains year to date and, where possible, liquidate positions that are at a loss in an effort to offset any gains. The ability to track individual tax lots and manage your accounts in a more tax efficient manner is promoted when assets are in one place. Also, your more tax-efficient investments should often be held in a taxable account, while less tax-efficient assets can be kept in tax-advantaged accounts. If your accounts are housed at one custodian, it is much easier to manage and monitor your account and strategy selection.

Charitable giving is made easier in a consolidated view, especially when gifting appreciated securities. As you may know, in order to deduct the full market value of securities being gifted which are at a gain, they need to be held for at least a year, making them long-term, unrealized gains. With multiple custodians, this planning can become cumbersome.

Lastly, performance measurement is a necessity, and it becomes easier when accounts are easily summarized. There is a difference between diversification of brokers/advisors/custodians and diversification of asset classes, sectors, industries and holdings.

One call to make. A relational benefit. A behavioral counselor.

Steve Jobs has been noted for stating, “Simple can be harder than complex: You have to work hard to get your thinking clean to make it simple. But it’s worth it in the end because once you get there, you can move mountains.” Time is precious. An advisory relationship, done correctly, requires a significant investment of time both on the part of the client and the advisor. A best case scenario is to have one advisor who works alongside you to present a consolidated view which leads to clarity and understanding. Those clients who work with one primary family advisor know the benefits and simplicity of having a singular point of contact who knows the intricacies and details of your family’s financial plan.
Ultimately, you have data, and then you have behavior. Any “robo advisor” can compile and present data for you, but investing can be a highly emotional process. As human beings, we are subject to temptation and biases, weaknesses and blind spots. A single advisory relationship – a human one, going through life with you and remaining familiar with your family’s circumstances - can bring immeasurable value to the wealth creation, preservation and transfer process.

We are grateful to be entrusted by you with the “human” side of investing.

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 Equity Cap 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.

	First Quarter	Last Twelve Months
S&P 500 Index	6.07%	17.20%
Russell 2000 Index	2.46%	26.21%
Barclay's Aggregate Bond Index	0.81%	0.44%

Upcoming Events

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.