Punch

Newsletter
Third Quarter 2017

The Barrier to Entry to Finding Great Investments

The best investors look for businesses with strong and sustainable competitive advantages. A company may enjoy sustained success without too much competition for many reasons. Makes sense, right? The problem is that everybody is looking to own these types of businesses, and they are not that difficult to find. A couple of simple screens will uncover some of the widest-moat companies in the market. These are also companies that have the richest valuations. The VanEck Vectors Morningstar Wide Moat exchange traded fund (ETF) contains what they identify as the "most attractively-priced" 20 companies with sustainable competitive advantages. Companies like Amazon and Starbucks populate the portfolio. While there is little argument that this ETF contains some great companies, the portfolio sports a valuation that makes it 50 percent more expensive than the S&P 500. "Wide moat plus easy-to-find" is perhaps not the best formula for identifying opportunities across the market cap spectrum.

Beware of Buying Great Companies

As active managers, we compete against the benchmark and other active managers to identify the best ideas. We are not traders. In order to be successful for our clients, we find what we believe are great businesses and hold them long enough for others to arrive at the same conclusion. To minimize risk, we should be reluctant to overpay. Most investors construct portfolios using companies identified through screens without much further consideration.

Where Do We Look?

Usually there is a clear reason why we are able to find a company so cheaply priced. Have we considered all the reasons? How temporary or permanent are the reasons? Of course, investors will never have perfect information; part of an investor's job is to make an assessment with imperfect information. But, in order to skew the odds in our favor, we look in areas where we know there are structural reasons that result in mispriced, higher quality businesses.

Smaller Small Caps

One obvious area we look for these types of companies is in the small cap space and, more specifically, the smallest small caps. Few investors are willing to research companies with a market value of less than $1 billion because of liquidity concerns and lack of information on the company.

Kick-Outs

Every June, the Russell 2000 Index reviews its holdings and will drop or add around 100 to 200 stocks. Companies usually find themselves on the kick-out list after a challenging period in their business. Dropped securities come under selling pressure from passive tracking funds and active managers that are restricted from owning companies that are not in the index. Opportunity arises from substantial selling pressure that is not tied to the underlying fundamentals.

Spin-Offs

A spin-off occurs when a parent company determines that a subsidiary is better off as an independent entity and distributes the subsidiary's shares to its shareholders. The newly created company is usually small enough in size that the original shareholders of the parent may simply sell it. This could be due to constraints of time, capital, and/or allowed number of positions in a portfolio. The new company can have attractive characteristics that investors missed when it was part of a larger organization, and, as a standalone company, it can focus entirely on its core business.

Phoenixes

Companies emerging from the ashes of bankruptcy usually have shareholders that once were debtholders. Given many have a mandate to only hold debt in their portfolios, there is an eagerness to sell out of the equity as soon as possible. Ignored is the fact that some companies go into bankruptcy because of a capital structure issue and not a permanent impairment of the underlying business. Post-bankruptcy, balance sheets are usually much improved.

Broken Deals

If a share price falls below the Initial Public Offering price, post-offering it becomes known as a "broken deal." Often, broken deals are caused by miscommunication during the deal's marketing process or inexperienced public executives' faux pas on the first earnings report after an initial public offering, not a deterioration of the business fundamentals. Rather than assess whether or not the lower share price is actually more attractive, many investors will decide that the initial buy thesis was "wrong" and arbitrarily sell the position rather than risk a bigger loss.

Metamorphosing Enterprises

Businesses in transition may also create an investment opportunity. Many companies that have mature legacy products or services provide the cash for another part of the business that is growing. Because these mature product lines are shrinking, the company likely won't "screen" well during the transition.

Conclusion

Active investing is difficult work, and there is no guarantee of success. If you screen for perfection, it is highly likely you will overpay for an investment. Investors should be very suspicious of "obvious" opportunities. Looking in under-researched or overlooked areas can help identify a reason why the market has assigned a potentially great business a sub-optimal valuation. We gain confidence if we can determine that the business has positive attributes not currently reflected in a financial database. As long-term owners of businesses (not stock traders), identifying where to look is only step one. Our job is to find companies where a mispricing might be only temporary in nature. We then make a judgement call on whether or not the company might someday exhibit the characteristics of companies where we've enjoyed success in the past, namely: healthier balance sheets, simplified business models, better predictability, more transparency, and, ultimately, greater recognition from a broader audience. If a company becomes better recognized by other investors, it can turn into an attractive investment for our clients.

Equifax Security Breach

As you're likely aware, earlier this quarter Equifax announced a major data security breach. In an effort to help protect your identity, we recommend that you contact all three credit reporting agencies and have your credit frozen. We've provided contact information for each of the three credit bureaus below.

A security freeze (also called a credit freeze) locks your credit file with a special PIN that only you know. That PIN must be used in order to access your credit file or to add new credit in your name. Credit bureaus rarely emphasize freezing your credit file because it's not in their best interest or their clients'. Instead, they recommend "credit monitoring", which is often a service for which you pay a fee to receive an alert when your credit file has been accessed. In essence, you are alerted that you may have personally experienced a credit breach AFTER a potential breach has occurred, which isn't protection against identity theft. Unlike credit monitoring for fraud alerts, a security freeze gives you complete control of your credit file and will help provide peace of mind.

Please feel free to call us if you have any questions or concerns regarding this process.

To find out if you were affected by the breach you can visit www.equifaxsecurity2017.com

Equifax	Experian	TransUnion
(866) 349 - 5191	(888) 397 - 3742	(888) 909 - 8872
www.equifax.com	www.experian.com	www.transunion.com

Punch Income Strategy

A Behavioralist Gets His Nobel

Once considered a backwater of economics, the field of behavioral finance finally gets the recognition it deserves.

"Behavioral finance, as it is known in investment circles, argues that human beings are less than flawlessly rational, and this irrationality affects the way markets and securities trade on a daily basis."

On October 9th, the prestigious Nobel Prize committee in Stockholm announced that a certain American midwestern university professor had won the Nobel Prize in Economics. While many may have been surprised by the announcement, we were thrilled. Dr. Richard Thaler of the University of Chicago, one of the "founding fathers" of behavioral finance, was the deserving recipient.

While that name may not mean much to the average American, it means a great deal to us because we firmly ascribe to the research that Dr. Thaler has advocated over his impressive academic career. Behavioral finance, as it is known in investment circles, argues that human beings are less than flawlessly rational, and this irrationality affects the way markets and securities trade on a daily basis. While most of modern economics assumes that investors are perfect cost-benefit analyzers, behavioral finance asserts that investors make mistakes, and those mistakes show up in markets with some regularity.

As the New York Times stated[1], Dr. Thaler's work was critical in establishing that people "consistently behave in ways that defy economic theory."

One of our favorite of Dr. Thaler's groundbreaking books, The Winner's Curse[2], is an explanation of a number of the irregularities, or "inefficiencies," in capital markets that should exist only because investors make mistakes and are not perfectly rational.

In the book, Dr. Thaler dedicates an entire chapter to the "anomaly" of closed-end funds. These mutual funds, which trade on national stock exchanges, regularly trade at discounts or premiums to their net asset value (NAV), an anomaly which Dr. Thaler says should simply not exist. If investors were rational, they could re-create these baskets of securities themselves at then-current market prices, completely avoiding discounted funds. In reality, these mispricings do occur with some frequency, allowing the astute investor the opportunity to purchase funds regularly at discounted prices.

Several of our strategies, including the Punch Income Strategy, are predicated on the idea that the investing public makes mistakes from time to time. Investors are swayed by emotions, taxes, peer pressure, and a multitude of other forces that ultimately result in less-than-perfect security prices. These mispricings are sometimes meaningful, and from them come opportunities for other, more dispassionate, investors who are willing to come to their own conclusions as to the value of an investment.

Our investment process starts with the question, "Where are investors likely making mistakes with their money?" If we can identify areas where outside forces are acting on others and pressuring them into decisions that "defy economic theory," then our opportunity is to research these areas more rationally and dispassionately than the average investor. Our hope is to arrive at a more reasonable and logical conclusion and gain an advantage over the majority of other investors.

We admire Dr. Thaler for his work on behavioral finance, as well as for his humor and wit. When asked what he was going to do with the $1.1 million prize money, Dr. Thaler only responded, "I will try to spend it as irrationally as possible."

The Punch Income Strategy is a total return strategy that emphasizes current income over capital appreciation. The strategy invests in a variety of securities and asset classes that generally share the common characteristic of producing cash flow income that has the potential to rise over time.

1 Appelbaum, Binyamin. "Nobel in Economics Is Awarded to Richard Thaler." The New York Times, 9 Oct. 2017
2 Thaler, Richard H. The Winner's Curse: Paradoxes and Anomalies of Economic Life. Princeton University Press, 1994.

Punch Large Cap Strategy

Measuring Culture

Though difficult to assess, culture at large firms is critical to long-term investment success. New technologies are making it easier for investors to assess a firm's culture.

> *"Culture eats strategy for breakfast."*
> - Peter Drucker

Unlike investing in small cap stocks, where it's relatively easy to organize a call or meet with CEOs, large cap company CEOs are extremely difficult to get on the phone (unless you're a top shareholder, of course). Fortunately, authors and journalists can give us significant insight into the personalities of the people running these large companies. The Wall Street Journal recently published a joint interview with the CEO of a large software products company alongside his predecessor and the company's founder[1].

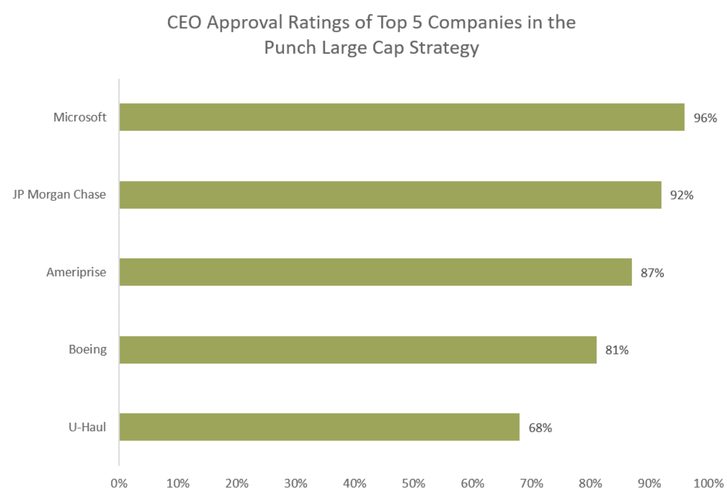
The company has become a stalwart of the Punch Large Cap strategy. We took a position in the stock in August of 2009, when the company's second-ever CEO was at the helm and the stock was cheap. His 14-year tenure at the company ended in February 2014 when the current CEO took the post. What has transpired at the firm since has been subtle, but significant. The current CEO nurtured a real culture shift throughout the company, which is truly incredible given the size of the organization.

Leadership and strategy skills donned by a management team are important, but the culture the team fosters is arguably more important. After reading Mindset: The New Psychology of Success by Carol Dweck, the current CEO started to look at his own company's culture. The CEO came to the conclusion that, "ultimately, the 'learn-it-all' will always do better than the 'know-it-all.' And that shows up in a variety of ways. You'll be a better parent, spouse, team member and manager."

The current CEO was also asked, "How does empathy fit into your management style?" He replied, "Being hard-core and driven is as essential today as it ever was. But there needs to be humility. The reason why I use the word empathy is because the business we are in is to meet the unmet, unarticulated needs of customers." Through this humble approach, the CEO was able to shift the company from an old-line software products business into a cutting edge tech company leading the way on artificial intelligence and commercial cloud computing. He's known for his ability to work well with others, and he can tell people they're wrong in a nice way. He also lets feedback reach him, which is another sign of his unpretentious approach to managing. Employees notice that kind of thing.

Beyond books and newspapers, we often turn to blogs and websites like Glassdoor to glean insight into corporate cultures. Glassdoor allows current employees to anonymously review their company and senior management. The reviews of this software products company on Glassdoor are overwhelmingly positive. Work-life balance appears to be a real thing there. The CEO has a 96% approval rating to boot. Not bad for a company founded in 1975 that could easily be "stuck in its ways."

Admittedly, culture is hard to measure, but it matters, so we have to try. We also look to metrics such as employee turnover and management compensation to evaluate culture. If employees are leaving in droves and excessive management compensation is the only thing keeping leadership engaged, there is likely a culture issue brewing. We look for companies where the employees are happy to show up every day, much like our own culture at Punch. Ultimately, we believe that a strong corporate culture is a positive indicator that a company will be around for the long run.



The Punch Large Cap Strategy invests in large publicly traded companies. The strategy takes a long-term, concentrated approach to owning companies with durable competitive advantages, cash flow generation, and growth potential.

1 Stevenson, Seth. "A Rare Joint Interview with Microsoft CEO Satya Nadella and Bill Gates." Wall Street Journal, 25 Sept. 2017.
2 Dweck, Carol. Mindset: The New Psychology of Success. Ballantine Books, 2016.

Punch Small Cap Strategy

In Search of Apathy

Down over 70% from its 2014 high, the energy sector now looks enticingly cheap and out-of-favor.

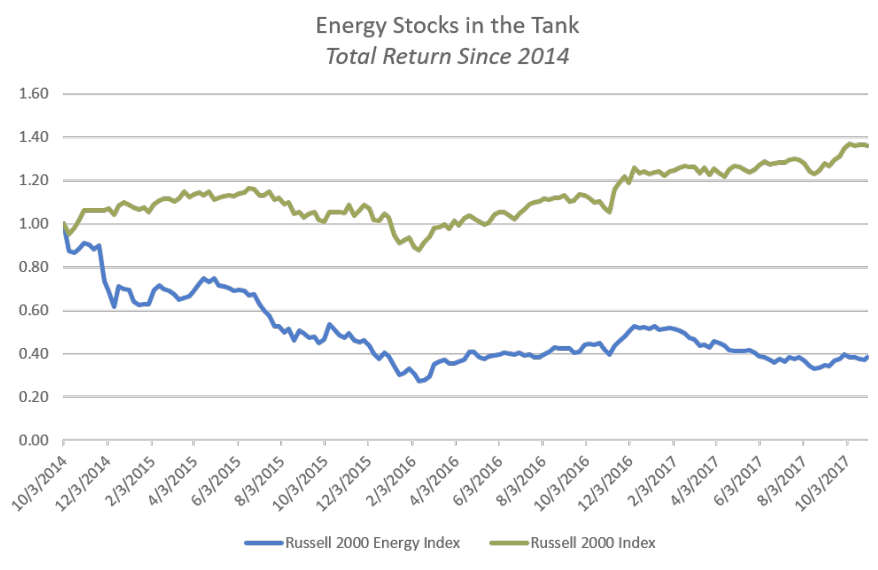
"We are naturally attracted to segments of the market where frustration and disappointment has morphed into apathy and disdain. When investors' emotions take over, price and value can become unhinged, creating opportunity for more rational, dispassionate investors"

For most of the life of the Punch Small Cap Strategy, we largely avoided making investments in the energy sector. In fact, we went through extended periods of time over the past fifteen years (especially when commodity prices were elevated), when we had no exposure to this segment of the economy at all. We rarely invested in the riskier category of exploration and production (E&P) companies.

Since the primary driver of the value of an energy company is the price of the commodity it sells (crude oil or natural gas), and since we have no competitive edge in determining the direction of global commodity prices, we simply avoided these companies. In general, we prefer businesses that control the prices of their products and, ideally, have the ability to raise prices that they charge their customers over time.

For the first time, the Punch Small Cap Strategy is now overweight the energy sector. In other words, we have more exposure to energy-related companies than our benchmark index, the Russell 2000 (5.1% vs 3.7% for the index, as of 9/30). Why is this?

To begin with, energy stocks today are deeply out of favor and have underperformed the broader market for much of the past three years (see chart below). While the Russell 2000 Index is up 35% since 2014, energy stocks are down 63%.



Recently, in a meeting with a large hospital foundation on the east coast, we were discussing our interest in the energy sector. When we mentioned several small-cap energy companies by name, they cringed. Their stinging losses from several energy investments over the past few years were evident on their faces. We are naturally attracted to segments of the market where frustration and disappointment has morphed into apathy and disdain. When investors' emotions take over, price and value can become unhinged, creating opportunity for more rational, dispassionate investors (see Income Article on page 3).

With regard to commodity prices, crude oil remains closer to its bottom ($26 per barrel) than its top ($110) in this cycle, giving us some comfort that we are not too late to the party. While we don't pretend to be able to tell you where prices will be in twelve months' time, we do think there are better-than-even odds that they will be higher than current levels in several years.

Finally, we are finding some interesting energy investment ideas among companies that have come through this severe downturn in energy, have restructured themselves and have re-emerged as public companies with better balance sheets and cost structures. In many cases, these companies are effectively new operations but with less investor awareness. Their stocks often trade at depressed prices as well.

As always, we prefer operating businesses that can control the prices of their products. Our energy investments to-date include a refinery company, a telecommunications provider to oil rigs, and a compressor rental company. We think each of these companies has a superior business model with less direct correlation to oil prices. But in this environment of depressed energy valuations and depressed energy investors, we are on the hunt for value opportunities.

The Punch Small Cap Strategy is an aggressive growth equity strategy that invests in smaller publicly-traded companies, primarily located in the U.S. The strategy looks for higher-quality companies that are trading at discounted prices because they are under-the-radar, out-of-favor, or simply misunderstood.

Wealth Strategies Group

The Value of Integrated Wealth Transfer Planning

We are increasingly finding ourselves in important conversations regarding the various, seemingly disparate, components of our clients' holistic financial lives and have observed that, often, an overlooked area can carry substantial consequences. Throughout our nearly 35 years of experience in advising families, time and time again we've witnessed that estate plans created for families do not necessarily reflect all the components of a family's wealth.

This is understandable because the traditional advisory team isn't always an integrated one. There may be highly competent legal, tax, and investment advisors in the equation, but they don't always talk to one another. Importantly, when large transactions occur from time to time (sale of a business or real estate), or a major life event, someone needs to possess a full understanding of all of the moving parts.

Many people draft a will and think they have an estate plan that governs all of their assets at death. Quite often, however, beneficiaries on various accounts are not thoughtfully updated to reflect both tax and estate planning considerations. Drafting and signing wills and trusts without retitling assets and updating beneficiary designations on assets governed outside your legal documents is a bit like finishing construction on a house without doing any plumbing. Things might appear to be done properly, but there may be major problems under the surface.

Often, after completing a series of meetings with the family's estate planning attorney, documents are drafted and signed, and new wills, trusts, and other entities come into existence. By this point in the process, it is understandable that folks might be fatigued. You have already had lengthy discussions with advisors, time has passed, and your attorney has sent drafts back and forth. You think you've done all the necessary work, but the work to make your plan effective is far from complete.

It can be dangerous to not fully understand your estate plan. The fact is, many assets in your estate are not governed by any will or trust, and if assumptions are made to the contrary, the end result could be an uncoordinated wealth transfer effort, unnecessary taxes, unintended recipients of assets, and family disputes. The best way to approach this is to have a trusted advisor who can explain your financial and estate plan clearly to you and who is positioned to review your overall plan on a regular basis alongside you.

Most people do not to realize that a beneficiary designation on a retirement account – a form that is on file at your broker or custodian – dictates where that asset goes upon death. This simple document, often only one or two pages in length, supersedes any will or trust that you have in place, and the retirement account passes according to terms outside of your will or trust. Included in this list of potential account types that can bring about confusion are Traditional IRAs, Roth IRAs, 401(k)s, 403(b)s, 401(a)s, 457 plans and others.

The same holds true for insurance. Three important variables govern the treatment of life insurance as it pertains to your estate plan: 1) the owner of the policy, 2) the "insured," and 3) the beneficiary. While a death benefit from a life insurance policy is paid to its beneficiary income tax free, what is often overlooked is if the policy is not owned by a trust, son or daughter, or other family member or entity, the full value of the death benefit is included in your taxable estate. In addition, the beneficiaries listed on the policy need to reflect your current intentions as they pertain to your overall estate plan. If an insurance policy is a significant portion of your overall estate, it really doesn't matter what your will says. In that case, a form on file with the underwriter of the policy governs the bulk of your wealth transfer plan.

In addition to retirement accounts and life insurance policies, other important (and sneaky) assets can play an important role in the overall wealth transfer process, and they also need to be coordinated. One example is 529 plans. Each of these plans has a "participant" who controls when, how much, and to whom the education funds are paid out. If a "successor participant" is not thoughtfully named, these funds might ultimately go to unintended recipients. Similarly, donor advised funds (your charitable dollars) have one or more "primary advisors." If one or more "successor advisors" or a designation of charitable beneficiaries are not carefully included in your donor advised fund provider's records, these dollars may not flow to the specific organizations you would have originally intended.

Of course, it is important to consider your entire financial picture and all of its various moving parts holistically as you engage in ongoing reviews and updates of your estate plan. Legal documents drafted by an attorney may govern only certain of your assets. Ever importantly, someone needs to oversee and coordinate this planning among all of the professional advisors who are in the mix. We enjoy this process and are happy to hold your hand throughout.

The Wealth Strategies Group at Punch & Associates provides private clients of the firm with a comprehensive, holistic view of their individual financial situation. The planning and advisory process encompasses asset allocation, estate and gift planning, retirement forecasting, and philanthropic advisory.

Welcome Dan!

We'd like to take the opportunity to introduce Dan Molenaar as an Associate in the Wealth Strategies Group.

Dan began working at Punch as an intern earlier this year and joined the firm full time in August. Dan will be working closely with Andy, Jessica, and Angie to help ensure the highest level of service for all of our clients. He plans on pursuing the CFP designation within the next couple of years.

Dan graduated from the University of Minnesota, Duluth with a B.A. in Finance while also playing hockey for the Bulldogs, helping them reach the Frozen Four in Chicago this past April!

Events

Thank you to everyone for joining us at our Fall Investor Update at the American Swedish Institute! As always we appreciate the opportunity to engage with you, your family, and your friends. We hope you enjoyed this terrific event (organized by Nancy Kelly!) at the historic Turnblad Mansion and the Nelson Cultural Center. If you weren't able to join us for the Fall Investor Update, we hope you'll be able to attend one of our upcoming events listed below.

January 9, 2018
Grey Oaks Country Club
-
2400 Grey Oaks Drive North,
Naples, Florida 34105

February 13, 2018
The Silverleaf Club
-
18701 North Silverleaf Drive,
Scottsdale, Arizona 85255