Punch

Small Cap Commentary
Third Quarter, 2017

Overview

After spending most of this year in a range-bound holding pattern, the Russell 2000 Index suddenly came to life at the end of the third quarter, rallying over 10.0% from its mid-August low, producing a 11.0% total return on a year-to-date basis. In the third quarter alone, the benchmark index rose 5.7%.

The late-quarter rally was broad-based, as all eleven GICS sectors participated, and both growth (+6.2%) and value (+5.1%) stocks rose by similar amounts for the full quarter. While some commentators have attributed the September rally to renewed optimism for federal tax reform, it is interesting that the stocks of ***unprofitable*** small-cap companies continued to outperform the stocks of ***profitable*** companies by a wide margin in the third quarter (+8.1% vs +4.9%, according to Furey Research Partners). Should tax reform eventually happen, we believe the relative economic benefit to profitable enterprises could be meaningful.

Portfolio Attribution

The Punch Small Cap Strategy rose 8.7% in the third quarter, and is now up 10.9% year-to-date. Strong relative performance in the quarter was entirely driven by individual stock selection (+327 bps), while sector allocation continued to be a drag on the portfolio (-11 bps).

The Punch Small Cap Strategy continues to look meaningfully different than the benchmark index today, with variances both on a sector and a position level. During the quarter, we were overweight the consumer discretionary (+1035 bps) and financial (+662 bps) sectors while underweight healthcare (-988 bps) and real estate (-756 bps). In general, we are tilted towards more cyclical companies and many of our portfolio companies would benefit from a rising interest rate environment. Our active share today is 98%.

Bottom Contributors to Performance

LSC Communications (LKSD, $575 million market cap), one of the largest book, catalog, and magazine printers in the country, was the largest detractor from performance in the third quarter, declining 22% with an average portfolio weighting of 1.7%. We initiated a position in the stock in the first quarter of this year, and the stock is down approximately 30% from our initiation price.

Our original thesis for LKSD was that, even though book and catalog printing is a secularly challenged industry, the business produces significant free cash flow and has attractive competitive dynamics, essentially operating in a duopoly with Wisconsin-based Quad Graphics (NYSE: QUAD). Half its revenue cat-

Annualized Performance as of 9-30-2017 *(net of fees)*

	Q3 2017	1 Year	3 Years	5 Years	10 Years	Since Inception*
Punch Small Cap	8.68%	22.25%	12.55%	13.90%	8.36%	10.83%
Russell 2000 Index	5.67%	20.75%	12.18%	13.79%	7.85%	8.66%

**Inception date is 3-31-2002*

7701 France Avenue South, Suite 300
Edina, MN, 55435
(952) 224-4350

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egories are growing, and there remain meaningful consolidation opportunities of mom-and-pop print operations around the country. The company carries modest leverage, at approximately 2x debt-to-ebitda, and may have the opportunity to refinance its debt load within the coming year. Moreover, this no-growth business was being valued at a 20% free cash yield with a 4% dividend yield after declining over 30% following its spin-off from parent company R.R. Donnelly in September of 2016.

In the two quarters since we have owned the stock, the company has disappointed consensus expectations for both sales and operating income, largely driven by unexpected weakness in their book printing and office products divisions. Despite this shortfall, management has maintained their annual guidance for free cash flow, which provides over 3x dividend coverage at the current dividend rate (a 6% yield today). From our follow-on meetings with management, we are tentatively hopeful that the issues in the elementary education book business are temporary, and that the long-term trajectory has not shifted meaningfully, but we will be watching results over the coming quarters closely. We are encouraged by several consolidation acquisitions that LKSD has executed this year, purchasing a large Nevada-based printing operation for only 4x ebitda.

Our second largest detractor from performance in the quarter was **SPOK Holdings (SPOK, $310 million market cap)**, a provider of communications software and services, primarily to the healthcare industry. Aside from being a large provider of pagers, the company has an impressive integrated communications software platform that enjoys leading market share (75%) among major hospital systems around the world. Paging, of course, is a dying business, although among healthcare providers it enjoys surprisingly high utilization because of its extreme reliability and low cost. SPOK management has thoughtfully harvested this "cash cow" business and redeployed capital into growing its integrated software platform as well as returning capital to shareholders. Over the past five years, the company has paid out nearly $65mn in dividends and $35mn in share repurchases on a market capitalization of only $310 million.

Recently, the company has shifted investment even more heavily into its newest software version for hospitals, and this increased investment has weighed on shares. Only 10% of hospitals today have an integrated solution for text, mobile, and alerting communications—a critical function in these environments for which there is no good solution today. Having worked alongside hospital customers for decades, first as their paging provider and then as a software vendor, SPOK has meaningful relationships that allow it to build a solution collaboratively with their customers and then sell it to them. The new version of this platform is set to launch in 2018.

With no sell-side analyst coverage and a relatively concentrated shareholder base (the top ten shareholders control 70% of the stock), we believe that the development of the new platform is underappreciated by the market and that accelerating growth and profitability should begin to show up in the next twelve months.

Bottom Contributors

Holding	Average Weight	Total Return	CTR** (bps)
LSC Communications	1.67%	-21.68%	-0.45
SPOK Holdings	2.71%	-12.61%	-0.39
Trueblue Inc.	0.77%	-24.53%	-0.35
Nautilus Inc.	1.94%	-11.75%	-0.27
Green Brick Partners	1.53%	-13.54%	-0.22

Top Contributors

Holding	Average Weight	Total Return	CTR** (bps)
Ferro Corp.	4.05%	21.92%	0.86
Landauer Inc.	3.08%	29.21%	0.83
Lithia Motors	2.99%	28.01%	0.78
Douglas Dynamics	3.33%	20.53%	0.69
Malibu Boats	2.94%	22.30%	0.63

Top Contributors to Performance

For the second quarter in a row, our top contributor to performance was **Ferro Corporation (FOE, $1.9 billion market cap)**, a maker of coatings and colorings that go into automotive, architectural, and consumer applications. As we discussed in detail last quarter, Ferro is a specialty materials company

7701 France Avenue South, Suite 300

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that has been in turnaround mode since CEO Peter Thomas joined the company three years ago. With the turnaround largely complete, the company is now focused on growth—both organic and inorganic—and we believe that this accelerating financial performance is beginning to be recognized by the broader investment community. We still believe there is more runway ahead of the company, though, and that the stock valuation doesn't completely reflect this potential. At the end of the quarter, Ferro was the second-largest position in the Punch Small Cap Strategy.

Our second top contributor to performance in the quarter was **Landauer, Inc. (LDR, $600 million market cap)**, a provider of radiation monitoring equipment and services. The company was sold to industrial conglomerate Fortive (FTV, $25 billion market cap) on September 6th in an all-cash deal valued at $650 million.

While we were excited about the upcoming rollout of a new technology platform by the company that could have had a meaningfully positive impact on Landauer's business model, the valuation of the deal (4.8x revenues, 18x ebitda) appropriately reflected the uncertainty of such a large-scale rollout over the coming years. We exited the position shortly after the deal announcement as we deemed the likelihood of a competing bid to be low.

Initiations and Exits

We initiated two new positions in the third quarter and exited three, ending with a total of 46 positions in the strategy as of September 30.

Our first new position was the first new healthcare stock we have added to the portfolio in nearly two years. **Varex Imaging Corp. (VREX, $1.3 billion market cap)** is a medical equipment company that designs, manufactures, and sells imaging components. Its products are the tubes, displays, detectors, and software that are used in a variety of x-ray imaging technologies around the world, and Varex is, by far, the market share leader in these categories. The company boasts supplier relationships with the leading manufacturers of imaging equipment going back decades and many of its component products are difficult to displace once they have been qualified to go into imaging equipment, creating long annuity-like product life cycles.

Varex is new to the public company universe as it was spun-out of radiation oncology giant Varian Medical (VAR, $9.8 billion market cap) in January of 2017. As the less exciting, lower-growth segment within Varian, Varex comprised less than 20% of revenues for the combined company and had struggled the past several years with foreign exchange headwinds and margin pressures. We believe that, as a standalone company, management will now have the flexibility to streamline the business and pursue bolt-on acquisitions to return margins back to their previous levels of 20%+ from 15% today. Already the company has closed a $275 million acquisition of the imaging components segment of PerkinElmer (PKI, $8 billion market cap), and we think that there are meaningful top- and bottom- line synergies to be had from this combination that are not fully appreciated by most investors.

As is common with many spin-off stocks, there is a relative dearth of information and analysis on Varex, and only a small handful of sell-side analysts cover the company today. Combined with the messiness of integrating a large acquisition and having no visible track record as a standalone company, the stock does not "screen" well for most investors and receives a discounted valuation in the marketplace compared to its medical equipment peers.

Our second new position in the quarter is specialty mattress company **Select Comfort, Inc. (SCSS, $1.3 billion market cap)**, maker of the well-known "sleep number" bed that is sold through the company's network of 550 owned stores. The Sleep Number bed is a unique product in a crowded mattress industry and boasts exceptionally high customer satisfaction—over one-third of annual sales come from repeat or referral customers. We think the company will be a direct beneficiary of the continued recovery in housing activity over the next several years, and boasts a business model that is unlikely to be disrupted by online competitors owing to its niche, high-end focus.

Select Comfort, being headquartered in our own backyard (Minneapolis), is a company we have fol-

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lowed since its IPO nearly twenty years ago. Historically, the company was not particularly well-managed and went through several cycles of operational "hiccups" that had tarnished its reputation. In 2014, however, several activist investors took large stakes in the company and agitated for change. While the activists were ultimately unsuccessful in wresting control of the company, they did instill a new discipline and rigor among management that has resulted in significant share buybacks, accelerated growth, a strategic focus on return on invested capital (ROIC), and meaningful financial incentives for management that align with shareholder interests.

After spending over $400mn in capital on various internal projects over the past five years, we believe the company now looks set to generate meaningful free cash flow (we estimate a 10% free cash flow yield today) and hit its target of $2.75 in earnings per share in 2019, which will unlock multi-million-dollar incentive payments for top executives. As a show of their confidence, the Board of Directors recently authorized a $500 million stock buyback program—worth almost a third of the market capitalization today—and executed $40 million in the recent quarter alone.

In the third quarter, we exited two positions voluntarily and another position involuntarily. The involuntary exit was **Landauer, Inc (LDR, $600 million market cap)** which, as previously discussed, was acquired by Fortive Corp. in early September.

The first voluntary exit in the quarter was **Monotype Imaging, Inc. (TYPE, $860 million market cap)**, a licensor of typeface (font) technology based in Woburn, Massachusetts. When we took our initial stake in the company back in the third quarter of 2012, we were attracted to the unique assets of the company, its highly profitable business model, and growth potential. As the owner of one of the largest typeface libraries on the planet, Monotype owned and licensed such ubiquitous fonts as Times New Roman, Helvetica, and Sans Serif. Unlike many technology companies who are challenged by short product life cycles and rapidly evolving technologies, Monotype's core technology—fonts and typeface—had exceptionally long life-cycles with perpetual copyrights. As a result, the business boasted over 30% operating margins, double-digit returns on capital, and significant free cash flow.

We got the opportunity to take a stake in Monotype then at a low double-digit multiple of enterprise value to ebitda and nearly a 10% free cash flow yield because of worries that the company's largest customer segment—printer and copier manufacturers—were in secular decline. At over one-third of total revenues, these customers' declines were offsetting growth in other areas. We believed these fears to be overblown and were excited about other high-growth end markets like automotive, mobile, and web.

While we were correct in our thesis for several years, we ultimately ran into some "reputational" issues that were somewhat unforeseen. In 2015, the company's longtime CEO retired, and then-CFO Scott Landers took over at the helm of the company. The new CEO then went on an acquisition spree that saw the company pay high multiples for fast-growing but unprofitable businesses that were largely unrelated to the core, "crown jewel" typeface business. The acquisitions included an emoji company and a social media marketing company, which not only severely compressed margins but also got the company into more competitive markets where the company was no longer the clear leader.

Because of these value-destroying acquisitions, and our lack of confidence in the capital allocation abilities of the new CEO, we exited the position.

Our second exit in the quarter was **Trueblue, Inc (TBI, $890 million market cap)**, a temporary staffing company primarily focused on light industrial and small business markets. Trueblue was over a six-year holding for us, as we took our initial position in the company in the first quarter of 2011.

Back in 2011, labor markets in general were still relatively weak in this country following the Great Recession, and many public staffing companies traded at historically low multiples of normalized earnings and cashflow. Trueblue, with its largest segment being in the residential and commercial construction industry, had been particularly hard-hit during the downturn and we believed its valuation was particularly depressed for this reason.

We liked the company's national branch network, exposure to improving construction markets, and sensible acquisition strategy. However, organic growth has struggled over the past several years—rarely getting above 3%--and margins have compressed, as the company has taken on more national account customers who are both lower-margin and less predictable. The volatility associated with several large national account programs (notably, Amazon and Boeing) have made the combined business less profitable and slower growing. Because of these operational missteps which we believe impaired the core business model, we decided to move on.

Outlook and Conclusion

A hot topic in equity investing recently has been the proliferation of passive index and ETF investing, and its impact on both public companies and active money managers like ourselves. A recent article in the WSJ titled "Wall Street's Newest Puzzle," pointed to research that suggests that the impact of passive fund flows is particularly acute among small-cap companies. We would agree, and we believe that there are three specific ways where passive investing is creating opportunities for value-oriented active investors.

Fund Flows. Passive funds offer investors the ability to quickly gain "exposure" to markets, sectors, or investment categories by buying or selling baskets of securities. Many exchange traded funds are thematic and designed to appeal to current investor interests, such as "Healthcare Momentum Stocks," "Cybersecurity," or "Dividend Aristocrats." It is not uncommon for these themes to move in and out of favor quickly, and for these funds to experience significant inflows and outflows in a short period of time. One prominent cybersecurity-focused ETF with over $1 billion in assets saw its shares outstanding fall by one-third in 2016, only to rebound by 40% in 2017. For small-cap stocks with relatively limited floats, such rapid trading can certainly impact trading activity and valuations, and create opportunities for investors interested less in basket-based themes and more in finding individual companies at compelling prices.

Index Rebalancing. On the last Friday in June every year, the Russell 2000 Index rebalances its constituent members. The criteria for inclusion or exclusion for the index is mostly based on market capitalization, and relatively easy to estimate. In 2017, 138 small-cap companies exited the index and 228 were added. As the market begins to anticipate the change in demand for shares of these companies, it is startling to see the disparity in performance of these stocks leading up to the actual rebalance date. In 2017, while the Russell 2000 was up 4.9% in the six months leading up to the rebalance, those stocks being dropped from the index declined 22% and those being added advanced 23%. Investors who are aware of these non-economic pressures on a stock can take advantage of valuation disparities that may result.

Companies not included in passive indexes. Companies who find themselves entirely outside the purview of passive investing can receive discounted valuations as they lack the natural demand for shares that come from passive funds. While many small-cap companies have 10-20% of their shares held by such funds, companies that do not meet index criteria have negligible passive ownership. Several holdings in the Punch Small Cap Strategy have no or negligible index ownership, and we believe that their discounted valuations are at least in part due to this phenomenon.

We believe that true small-cap investing requires a focus on the smallest public companies in this universe, where inefficiencies are most prevalent and the opportunity to create unique research and insights into companies is greatest. Passive investing, which can be challenging among smaller, less liquid companies, only exacerbates many of these inefficiencies, and makes little sense in this segment of the equity market. We are not having difficulty finding compelling investment ideas in this environment and believe that our competitive advantage over other investors in this space is a sustainable one.

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Composite performance is shown net-of-fees and brokerage commissions paid by the underlying client accounts. Certain client accounts have directed us to reinvest income and dividends, while others have directed us to not reinvest such earnings. As such, performance data shown includes or excludes the reinvestment of income and dividends as appropriate, depending on whether the account has directed us to reinvest income and dividends. Past performance is no guarantee of future results, and investing in securities may result in a loss of principal.

Punch & Associates claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Please refer to the attached Composite Profile and Schedule of Performance for information regarding Punch & Associates' compliance with GIPS® standards.

The reference to the top five and bottom five performers within the Punch Small Cap Equity Strategy portfolio is shown to demonstrate the effect of these securities on the strategy's return during the period identified. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients during the period of time shown. Past performance does not guarantee future results; therefore, it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list. Please contact Punch & Associates at andy@punchinvest.com or (952)224-4350 to obtain details regarding the calculation's methodology or to obtain a list showing every holding's contribution to the overall strategy's performance during the period of time shown.

Company specific information referenced in this commentary is compiled from a variety of sources including SEC filings, quarterly and annual reports, conference calls, conversations with management teams and Bloomberg LP.

Any benchmark indices shown are for illustrative and/or comparative purposes and have only been included to show the general trend in the markets in the periods indicated. Such indices have limitations when used for comparison or other purposes because they may have volatility, credit, or other material characteristics (such as number and types of securities or instruments represented) that are different from those of the Composite and/or any client account, and they do not reflect the Composite investment strategy or any other investment strategies generally employed by Punch & Associates. For example, the Composite for a particular client investment portfolio will generally hold substantially fewer securities than are contained in a particular index.

**Inception of the Punch Small Cap Equity Strategy was March 31, 2002. **CTR represents the contribution to total attribution.*

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Punch & Associates Investment Management, Inc.
Small Cap Composite

Notes to Composite Profile and Schedule of Performance

Punch & Associates Investment Management, Inc.
Small Cap Composite
Composite Profile and Schedule of Performance
As of June 30, 2016

Year	Annual Performance History: Small Cap Gross of Fee	Small Cap Net of Fee	Benchmark [1]	Composite 3-Year Std Deviation (%) [2]	Benchmark 3-Year Std Deviation (%) [2]	Number of Portfolios	Year-End Composite Assets ($mil)	Year-End Firm Assets ($mil)	Percent of Total Firm Assets	Dispersion [2]
2002 (since 3/31)	-15.21%	-15.85	-23.53 %	N/A	N/A	12	$ 5.1	$ 103.9	4.9 %	N/A
2003	55.64	54.21	47.25	N/A	N/A	29	12.9	167.3	7.7	6.8%
2004	21.93	20.68	18.32	N/A	N/A	52	21.0	206.2	10.2	4.8%
2005	13.02	11.80	4.55	N/A	N/A	67	23.8	258.7	9.2	3.3%
2006	22.83	21.75	18.37	N/A	N/A	98	38.8	335.0	11.6	3.3%
2007	3.65	2.65	-1.57	N/A	N/A	272	103.9	397.0	26.2	3.7%
2008	-33.54	-34.18	-33.80	N/A	N/A	243	65.5	261.5	25.0	2.1%
2009	32.65	31.41	27.20	N/A	N/A	257	85.2	340.4	25.0	3.3%
2010	18.87	17.77	26.85	N/A	N/A	283	108.4	395.6	27.4	1.0%
2011	0.81	-0.14	-4.18	20.7	25.3	284	113.6	475.6	23.9	0.7%
2012	20.07	19.04	16.34	17.4	20.5	292	152.4	613.6	24.8	0.8%
2013	42.63	41.52	38.82	13.6	16.7	320	266.1	832.7	32.0	0.9%
2014	-0.21	-0.91	4.89	12.8	13.3	328	265.0	905.7	29.3	0.7%
2015	0.51	-0.26	-5.11	15.7	14.2	330	254.7	938.1	27.2	0.8%
2016 (6/30)	0.31	-0.13	1.41	N/A	N/A	337	251.2	957.4	26.2	N/A
Cumulative	321.44	270.07	170.77							

Period	Annualized Performance History: Small Cap Gross of Fee	Small Cap Net of Fee	Benchmark [1]
1 Year	-8.15%	-8.96 %	-8.14%
3 Year	7.73	6.90	6.54
5 Year	10.65	9.77	8.02
Since Inception	10.62	9.61	7.24

Punch & Associates Investment Management, Inc. (Punch) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Punch has been independently verified for the periods from April 1, 2002 through June 30, 2016. Verification assesses whether (1) the Firm has complied with all the composite construction requirements GIPS standards on a firm-wide basis and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Small Cap Composite has been exam for the periods from April 1, 2002 through June 30, 2016. The verification and performance examination reports are available upon request.

The Composite creation date is December 31, 2005. The creation date is the date in which Punch started reporting returns at the strategy level while they had previously been reported at the account level.

[1]The Russell 2000 Index is the Composite's benchmark.
[2]See Note 5 for discussion of the composite dispersion and 3-year standard deviation calculation. N/A indicates statistics are not required to be presented for the time period pursuant to GIPS.

Note 1. Organization and Nature of Business
Punch & Associates Investment Management, Inc. (Punch) is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The term "Firm," as defined by Global Investment Performance Standards (GIPS), represents Punch & Associates Investment Management, Inc.
The Punch Small Cap Strategy (Small Cap Composite) invests in U.S. listed public companies with market capitalizations between $250 million and $2 billion. Companies from the small cap universe are selected on the basis of economically attractive business models, accelerating fundamentals, cash flow characteristics, valuation relative to cash flow, and general investor recognition.
This description of products and services of the Small Cap Composite (the Composite) is not an offering. Past performance is not an indication or a guarantee of future results. Investments are subject to risk and may lose value. A list of our composite descriptions and our policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Note 2. Performance Presentation Standards
This report includes all of GIPS' mandatory disclosures as well as additional disclosures deemed prudent by Punch's management. Investment philosophies did not change materially during the reporting periods or from period-to-period.

Note 3. Calculation of Rates of Return
The portfolio returns for the period are based in U.S. dollars and have been calculated using a time-weighted, monthly, geometrically linked rate of return formula to compute quarterly percentage returns. Each portfolio's monthly rate of return is the monthly percentage change in the market value, including earned interest and dividends, after allowing for the effects of cash flows.
The monthly composite rate of return calculation is weighted by beginning values. This results in an asset's size-weighted rate of return. Security transactions and any related gains or losses are recorded on a trade-date basis.

Note 4. The Composites
Punch has established composites for all fee-generating portfolios for which it has full discretionary investment decision-making authority. Punch's client base within the composites was comprised of institutional and individual investors with a minimum asset balance of $100,000. No alterations have been made to the composites as a result of changes in investment professionals. In addition, Punch is the investment adviser to transitory portfolios that were not eligible for inclusion in any composite because the portfolios are either new for the month first funded, or the portfolios had restructuring which took place during the month.
The Small Cap Composite is one of several composites managed by Punch. Punch's list is available upon request.
Performance is based on total assets in the portfolio, including cash and substitute securities. Generally, a portfolio will enter a composite on the first day of the first full month following its inception. A portfolio is removed from a composite as of the last day of its last full month. Historical performance results include the results of clients who are no longer clients of Punch. Each composite is comprised of separately managed portfolios.
The Composite is subject to Punch's large cash flow policy which defines a cash withdrawal of more than 10 percent of the portfolio's market value as a large cash flow which requires the Composite to be valued at the date of the withdrawal. This policy has been in effect for the periods from April 1, 2002 through June 30, 2016.

Note 5. Composite Dispersion
Composite dispersion measures represent the consistency of a firm's composite performance results with respect to an individual account's portfolio returns within a composite. Account dispersion is measured by the standard deviation from the central tendency (mean return).
The dispersion of the annual returns of the Composite is measured by the asset-weighted standard deviation method. Standard deviation attempts to measure how much exposure to volatility was taken historically by the implementation of an investment strategy. Only portfolios that have been managed for the full year have been included in the annual dispersion calculation of the Composite. Effective for the year ended December 31, 2011, GIPS requires the presentation of the three-year annualized standard deviation. This statistic measures the volatility of returns for the Composite and benchmark over the preceding 36-month period.

Note 6. Investment Management Fees
The net performance results set forth in the Schedule of Performance reflect the deduction of actual investment management fees. The standard fee structure is based on 1 percent of assets per annum on all discretionary assets unless otherwise specified. Prior to December 31, 2005, the fee structure was variable based on strategy and account size, not to exceed 1.5 percent per annum.
Account minimums and fees are negotiable on a case-by-case basis due to potential growth, size and services rendered.

Note 7. Comparison with Market Index
Punch compares its Small Cap Composite returns to a certain market index management believes has similar investment characteristics. The returns of this index do not include any transaction costs, management fees or other fees. This index is the Russell 2000 Index.