Punch

Small Cap Commentary
Second Quarter, 2019

Overview

The second quarter of 2019 was mostly unremarkable for small cap equities, with markets ending slightly higher than they began and no significant moves in between. The Russell 2000 Index rose 2.1% for the quarter, below the 4.3% gain for the S&P 500 Index. On the heels of a sharp snapback in the first quarter, the Russell 2000 is now up 17.0% for the first half of the year. Small cap growth stocks have continued their strong run this year outpacing small cap value stocks with a total return of over 20.3% compared to 17.0%, and they have now bested value stocks by over 3.2% annually over the past five years.

Portfolio Attribution

The Punch Small Cap Strategy gained 3.3% in the second quarter, ahead of the benchmark Russell 2000 return of 2.1%. For the first half of 2019, the strategy return is mostly in-line with the benchmark return at 17.0%. While stock selection continues to be the primary driver of relative performance (+216 basis points in the second quarter), sector allocation continues to be a drag (-64 basis points).

We have been asked several times recently why our portfolio looks dramatically different than the index and whether we would consider altering our strategy to be more in line with the index sector allocations. As of June 30th, we are 12.5% overweight consumer discretionary sector and 9.9% underweight the healthcare sector. We have no exposure to utilities and REITs, and we are meaningfully overweight the financial and energy sectors as well.

The short answer is that we believe one of our strengths as small cap investors is finding individual companies that are lesser-known among investors and underappreciated, wherever they may be on the GICS (global industry classification standard) spectrum. Often, these classifications can be misapplied or irrelevant for small cap companies anyway, as some companies may be in transition, may have a mixture of businesses, or may simply be misclassified. And with a relatively concentrated portfolio of 44 stocks, the addition or subtraction of one or two holdings in our strategy may shift these weightings quickly.

Annualized Performance as of 6/30/2019 *(net of fees)*

	Q2 2019	1 Year	3 Years	5 Years	10 Years	Since Inception*
Punch Small Cap	3.3%	-6.1%	11.9%	6.7%	12.6%	10.0%
Russell 2000 Index	2.1%	-3.3%	12.3%	7.1%	13.5%	8.2%

**Inception date is 3-31-2002. Please see disclosures at the end of this commentary.*

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The longer answer to this question is that our strategy looks the way it does because of the way we view risk management in the investment process. While we consider ourselves "small cap core" managers (because we are willing to hold onto companies long after they become growth stocks), we are value-oriented when looking for new investments or committing additional capital. We demand a margin of safety when initiating new positions, and we apply it not only in terms of a stock's valuation but also in "behavioral" terms, or, how well known and understood a company may be. The less attention and understanding that exists around a company, the more likely its shares may be inefficiently priced.

We look for situations with a high margin of safety wherever they might present themselves. Today, we are having difficulty finding margins of safety in several areas, notably healthcare. According to Bloomberg, 70% of Russell 2000 Healthcare companies are unprofitable on an earnings per share (EPS) basis, and the median price-to-sales multiple in this group is 7x.

While we do maintain absolute limits to the amount of exposure we have to any one sector, we think that the best "risk management" is not an arbitrary limit relative to a benchmark, but common sense and discipline that consider both upside and downside potential over time. Maintaining discipline in a market environment like today's—when unicorns abound—can be difficult.

Bottom Contributors to Return

The largest detractor from performance in the first quarter was **EW Scripps Company (SSP, $1.2 billion market cap)**, a diverse media enterprise that owns one of the nation's largest independent TV station portfolios. The company, along with the rest of the broadcast industry, is embarking upon a consolidation strategy to leverage back-office operations and improve pricing power. For Scripps, recent acquisitions have driven debt levels to the high end of the company's targeted range, which we believe weighed on the stock after the most recent quarterly earnings report. In addition, political advertising spending is a major driver of revenue that only appears on a two- and four-year cycle. The year 2019 is an "off-cycle" year and may be disappointing for short-term investors. Looking ahead, we believe that the execution of their consolidation strategy will drive margin improvement across the portfolio, and 2020 should be another expensive election year for advertising.

Ferro Corporation (FOE, $1.3 billion market cap) was another detractor in the quarter. Ferro provides coatings for manufacturing and color solutions for consumer products. The company has differentiated itself from a typical commodity company through value added development work and tailored services for its customers. However, Ferro is not immune to the macro environment, and as the global economy slowed during the first half of 2019, its business was also impacted. We believe the underperformance of the company's stock is largely related to these global headwinds, and we continue to like management's aggressive strategy for driving growth and profitability and their track record of operating across market cycles.

Bottom Contributors: Second Quarter 2019

Holding	Average Weight	Total Return	CTR** (bps)
EW Scripps	2.3%	-27.0%	-71
Ferro Corp	2.8%	-16.5%	-55
Farmer Brothers	1.8%	-18.2%	-44
BlueLinx Holdings	1.3%	-25.6%	-40
Hooker Furniture	1.2%	-27.9%	-37

***CTR represents the contribution to total attribution in basis points. Attribution data is reflective of a representative portfolio in the small cap strategy.*

Coffee foodservice company **Farmer Brothers (FARM, $279 million market cap)** was a third detractor to performance in the quarter. It became apparent that Farmer Brothers is an example of what can go wrong when a company embarks upon too many strategic initiatives at once. In the last two years, the company has moved its operations from California to Texas, built a new roastery and headquarters, and they acquired a large competitor, Boyd Coffee Company. During the quarter, FARM announced an unexpected decline in revenue, largely tied to missteps integrating Boyd and resulting customer dissatisfaction. Compounding market concern was the announcement that Farmer Brothers' CEO would be departing with no permanent replacement named. While disappointed in the execution, we think Farmer Brothers will be able to overcome these self-created obstacles, and the long-term opportunity remains intact.

Top Contributors: Second Quarter 2019			
Holding	Average Weight	Total Return	CTR** (bps)
B. Riley Financial	3.6%	26.7%	86
Lithia Motors	2.9%	28.4%	70
TechTarget	2.6%	30.6%	69
Franklin Covey	2.0%	34.4%	61
Columbus McKinnon	2.3%	22.4%	48

***CTR represents the contribution to total attribution in basis points. Attribution data is reflective of a representative portfolio in the small cap strategy.*

Top Contributors to Return

It's not every quarter a top-five position is the top contributor to performance, but that was the case in the second quarter for our strategy. **B. Riley Financial, Inc. (RILY, $540 million market cap)** is not your typical investment bank. While the company does offer traditional investment banking services, equity research, trading, and wealth management, it is uniquely diversified because of its auction and liquidation business, forensic accounting, and principal investments segment. We believe B. Riley is becoming less cyclical because of this broad set of business lines. The company also pays a small dividend and has made a habit of paying special dividends as well. B. Riley does not "screen" well (particularly because of its somewhat complex balance sheet) which we believe means that the stock is cheaper than it looks at first glance. In our opinion, Chairman and CEO Bryant Riley has proven to be a smart capital allocator and has significant ownership in the company.

Several members of our team attended the B. Riley FBR Institutional Investor conference in May. It is arguably the best small cap conference in the country given the number of participating companies and the quality of those companies. At the conference, we had over 30 one-on-one meetings with management teams. We noticed the B. Riley presentation by Bryant Riley was one of the best attended of the entire conference. The company does not have analyst coverage and, therefore, has no earnings estimates. However, strong first quarter results were followed by additional strength in the second quarter, driven by robust capital markets, auction and liquidation, and principal investing. All of these factors helped the stock's total return in the second quarter.

Lithia Motors, Inc. (LAD, $2.7 billion market cap) operates a large network of automotive dealerships across the U.S. Lithia's products and services include: new and used car sales, repairs, vehicle financing, and insurance. The company started out as a niche regional player in small rural markets and has grown through acquisitions. When we first got into our position with LAD, the company owned 86 dealerships in 11 states. Today, Lithia operates 182 dealerships across 18 states. Their 2014 acquisition of DCH Auto Group, Inc. brought the company into the urban market for the first time. We believe LAD has successfully leveraged its operational prowess to improve the margins of those acquired sites. Since 2014, Lithia has made more than 15 dealership acquisitions, and their M&A strategy has remained consistent throughout the years. LAD acquires targets with margins lower than their corporate operating margins, and they use their operational expertise and employee training to get the newly acquired dealerships integrated into their successful model. LAD has been in the Punch Small Cap Strategy since 2012, so we have a long history with the CEO, Bryan Deboer, and we're familiar with his operational talent.

Lithia's first quarter 2019 results reflected positive comparable store sales, and EPS beat estimates (actual EPS of $2.44 vs. estimates of $2.16). Also discussed on the Q1 2019 earnings call was the plan to re-engage in M&A after taking a few quarters off to tune up a few things operationally. Lithia management believes the M&A pipeline remains robust, given that approximately 75% of dealerships in the U.S. are single-family owned with aging principals.

During the quarter, longtime holding **TechTarget (TTGT, $591 million market cap)** was also a top contributor to return for the Punch Small Cap Strategy. TechTarget operates over 140 unique information technology (IT) websites that help generate leads that are then sold to technology vendors. These websites contain detailed information for IT professionals as they are researching purchasing decisions. When IT professionals visit these sites during their research process, the search generates valuable site visit data that can predict exactly which IT departments are looking to purchase specific equipment or software for their project. This data is sold by TechTarget to vendors, and they sell increasingly through a subscription model.

In late May, a member of our research team met with the co-founder and Chairman of TechTarget after the company posted what we believe was a strong quarter and improved our view of the company's prospective financial condition for the remainder of the year. During the quarter, the company added a record number of customers, driving both strong growth throughout each segment of the company and appreciation in the market value of TechTarget shares. As you might remember, shares of TechTarget stumbled and were a detractor from performance last year in the third quarter, and we seized that opportunity to add to our position.

After our recent management meeting, we continue to be encouraged by the number of opportunities ahead for the company. Namely, we believe there is a significant opportunity in the coming years to sell project leads to thousands of smaller businesses that historically have not been targets for the company. Additionally, we believe that broad IT spending is in the early stages of a several year upgrade cycle, providing the business with a tailwind. Finally, we believe the company has a strong moat as evidenced by its ability to increase prices on its flagship solution, called Priority Engine, by 20% in 2018 and another 10% in 2019. We remain optimistic about the growth and margin expansion opportunities ahead for TechTarget.

Portfolio Activity

At quarter-end, the Punch Small Cap Strategy had a total of 44 positions. While we added to two existing positions and trimmed four; we did not initiate a new holding during the quarter. The most notable portfolio activity was our complete exit from shares of Nautilus. The total turnover in the strategy over the past twelve months has been only 12.8%. Our top ten holdings accounted for 36.5% of exposure, and our active share remained high at 98.3%.

In last quarter's newsletter, we expressed in detail our frustration regarding fitness equipment manufacturer Nautilus. Since our last update, Nautilus reported especially poor results, as the mounting competition from Peloton proved too much to overcome. Our original thesis in the third quarter of 2013 was rooted in the company's ability to develop, manufacture, and market a portfolio of recognized brands within the growing category of in-home fitness equipment.

Our thesis began to playout initially, however in recent years, the company's new products and digital platform struggled to gain traction with consumers as competition from privately owned Peloton became increasingly fierce. We have continued to lose confidence in the increasingly unclear path forward for the company. We believe these challenging conditions are unlikely to relent, causing us to throw in the towel and move on.

Conclusion

A few years ago, on a business trip to Boston, several members of the Punch & Associates investment team stopped by the offices of a smaller publicly-traded company for a meeting with its CEO and CFO. Since we were considering an investment in the company and had not met the management team in person, we were looking forward to hearing about the business and strategy firsthand.

After the usual handshakes and pleasantries, we asked the CEO how often they met with professional investors like ourselves. He replied, "You're the first to come see us in five years!" We were surprised, to say the least. After all, their office is less than an hour outside of downtown Boston, one of the oldest and largest financial centers in the country, and this is a company with a long history of growth and profitability.

In the years since that meeting, we have noticed this same phenomenon with increasing frequency. It seems that smaller public companies, many with attractive businesses and compelling share prices, are getting less and less attention from the money management industry. Pressured by trends towards indexing, quantitative investment strategies, and shrinking research budgets, we believe many of the investment managers who used to spend time researching companies and making investment recommendations have walked away from this approach or are significantly downscaling their efforts.

The reality is that when fewer investors are willing and able to do the hard work of touring factories, meeting with management teams and understanding the intricacies of a business, then capital markets become less efficient and increasingly disconnected from reality. We believe that this disconnect creates opportunity for more intrepid investors to roll up their sleeves and develop unique investment insights.

For example, understanding the unique history of a company helps us understand its current strategy, culture, and direction. Mission-driven companies embody qualitative factors at work. A few select examples of recent qualitative research from our team include:

In April, members of our investment team visited the Atlanta headquarters of a company that was recently added to our portfolios. Leaders of this company, a building products distributor, told us that they believe many investors misunderstand their business and its investment merits, mostly because they are small and have no analyst coverage.

In May, we traveled to Los Angeles to attend one of the largest investment conferences for small-cap companies in the country (previously described). Over 250 public companies gave presentations and held individual meetings with investors. Over the course of three days, we met individually with the CEOs and CFOs of over 30 companies.

In June, several analysts from our firm participated in a gathering of internet-of-things (IoT) professionals from around the world hosted by a technology company in our portfolios. After interacting with engineers from the company, listening to expert panels, and engaging with this company's key customers, we gleaned important insights into the investment opportunity.

At Punch & Associates, we emphasize the importance of the qualitative aspects of an investment, which are the intangibles that an income statement or balance sheet cannot always capture. We believe this approach over time may offer better return and risk control than owning companies about which we know little to nothing. Fortunately for us and our clients, the research opportunities abound.

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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.

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. Punch & Associates calculated this attribution data using a representative institutional client account which: 1) imposed no material restrictions related to investments made; and 2) was fully invested in the Punch Small Cap Equity Strategy during the entire time period shown. 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 our calculation methodology or to obtain a list showing every holding's contribution to the overall strategy's performance during the period of time shown.

We compile company specific information referenced in this commentary 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, or 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.*

**Some index performance information has been gathered from Furey Research Partners with permission.*

Punch & Associates Investment Management Inc.
Punch Small Cap Composite
Composite Profile and Schedule of Performance as of 6/30/2018

Punch

Year	Annual Performance History Gross of Fees	Net of Fees	Benchmark[1]	3-Year Standard Deviation Composite[2]	Benchmark[2]	Number of Portfolios	Year End Composite Assets (mil)	Year End Firm Assets (mil)	% 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	55.66%	54.22%	47.25%	N/A	N/A	29	$12.9	$167.3	7.7%	6.8%
2004	21.92%	20.67%	18.33%	N/A	N/A	52	$21.0	$206.2	10.2%	4.8%
2005	13.01%	11.81%	4.55%	N/A	N/A	67	$23.8	$258.7	9.2%	3.3%
2006	22.84%	21.74%	18.37%	N/A	N/A	98	$38.8	$335.0	11.6%	3.3%
2007	3.64%	2.66%	-1.57%	N/A	N/A	272	$103.9	$397.0	26.2%	3.7%
2008	-33.53%	-34.18%	-33.79%	N/A	N/A	243	$65.5	$261.5	25.0%	2.1%
2009	32.65%	31.40%	27.17%	N/A	N/A	257	$85.2	$340.4	25.0%	3.3%
2010	18.88%	17.78%	26.85%	N/A	N/A	283	$108.4	$395.6	27.4%	1.0%
2011	0.80%	-0.13%	-4.18%	20.7%	25.3%	284	$113.6	$475.6	23.9%	0.7%
2012	20.04%	19.01%	16.35%	17.4%	20.5%	292	$152.4	$613.6	24.8%	0.8%
2013	42.63%	41.54%	38.82%	13.6%	16.7%	320	$266.1	$832.7	32.0%	0.9%
2014	-0.21%	-0.90%	4.89%	12.8%	13.3%	328	$265.0	$905.7	29.3%	0.7%
2015	0.51%	-0.39%[3]	-4.41%[3]	15.7%	14.2%	330	$254.7	$938.1	27.2%	0.8%
2016	20.96%	19.94%	21.31%[3]	17.6%	16.0%	350	$307.4	$1,101.0	27.9%	1.2%
2017	12.96%	11.94%	14.65%	16.5%	13.9%	377	$340.3	$1,241.6	27.4%	0.4%
2018 (through 6/30)	11.58%	11.12%	7.66%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Cumulative	540.55%	452.25%	302.88%							

Period	Annualized Performance History Gross of Fees	Net of Fees	Benchmark[1]
1 Year	22.93%	21.88%	17.57%
3 Year	11.76%	10.79%	10.96%
5 Year	13.70%	12.76%	12.46%
Since Inception	12.11%	11.09%	8.95%

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, 2018. Verification assesses whether (1) the Firm has complied with all the composite construction requirements of the 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 examined for the periods from April 1, 2002 through June 30, 2018. The verification and performance examination reports are available upon request. N/A indicates statistics are not required to be presented for the time period pursuant to GIPS.

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 7 for discussion of the composite dispersion and 3-year standard deviation calculation.

3 - According to Punch's Error Correction Policy, this Schedule of Performance has been updated from prior versions which incorrectly displayed the 2015 Composite TWR (net), 2015 Russell 2000 Index, and 2016 Russell 2000 Index figures as -0.26%, -5.11%, and 20.35% respectively.

Notes to Composite Profile and Schedule of Performance

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. Accounting Policies

All assets and liabilities in the Composite are reported on a fair value basis using U.S. Generally Accepted Accounting Principles. Investment transactions are recorded on a trade date basis. Dividends are reported on pay date basis. Punch's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Note 4. Valuation Methodologies

The Composite values all of its investments at fair value in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification 820 ("Fair Value Measurements") and the GIPS Valuation Principles. The Composite invests in Level 1 securities (i.e. marketable securities for which prices are readily available).

Note 5. 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 6. 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, 2018.

Note 7. 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 8. 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 9. 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.