Punch

Small Cap Commentary
Fourth Quarter, 2019

Overview

For small cap investors, the year 2019 was a story of a strong beginning and a strong ending, with not much happening in between. Coming off the worst December (2018) for markets in over 75 years, small cap stocks bounced back quickly in the first quarter of 2019. They were mostly flat throughout mid-year until they rallied again late in the year. As of year-end 2019, the Russell 2000 Index was close to all-time highs.

While the Punch Small Cap Strategy performed in line with its benchmark for calendar year 2019, it is notable that all of the outperformance came in the "boring" months (the second and third quarters). When small cap markets were ascending quickly in the first and fourth quarters, we had a difficult time keeping up. This result is not entirely unexpected, as our focus on smaller, higher-quality, value-priced securities leads to better relative performance in boring markets but underperformance in momentum markets.

Portfolio Attribution

In the fourth quarter, the Punch Small Cap Strategy returned 7.7%, below the 9.9% for the benchmark Russell 2000 Index. This underperformance was entirely due to security selection (-2.2%), while sector allocation was mostly neutral to performance (+0.2%).

Annualized Performance as of 12/31/2019 *(net of fees)*						
	Q4 2019	1 Year	3 Years	5 Years	10 Years	Since Inception*
Punch Small Cap	7.7%	25.4%	7.8%	8.4%	11.4%	10.1%
Russell 2000 Index	9.9%	25.5%	8.6%	8.2%	11.8%	8.4%

**Inception date is 3/31/2002. Figures over one year are annualized.*

For the year 2019, the Punch Small Cap Strategy performed in line with the Russell 2000 Index (25.4% vs 25.5%). Security selection was a notable contributor while sector allocation detracted, largely due to underweights in growth-oriented technology and healthcare stocks. Both technology and healthcare performed well in the year, rising 41% and 29%, and outperformed the broader index.

Once again, growth stocks bested value stocks with total returns of 28.4% and 22.4% for the Russell 2000 Growth and Value Indices, respectively. We saw significant strength in speculative areas like biotech (+33%) and communications technology (+18%). Almost half of growth stocks' outperformance came in the fourth quarter alone, which has been referred to as a "melt-up" market (the mirror opposite of 2018's "melt-down").

Interestingly, smaller small caps continued to underperform for the year, and the Russell Microcap Index rose only 22.4% compared to an increase of 25.5% for the larger Russell 2000 Index. Over the past five years, microcap stocks have underperformed small cap stocks by almost 10%. With nearly 20% of our portfolio invested in smaller companies whose market capitalizations are under $500 million (compared to 7% of the Russell 2000 Index), this dynamic has been a notable headwind for us.

Bottom Contributors: Fourth Quarter 2019			
Holding	Average Weight	Total Return	CTR** (bps)
BlueLinx Holdings, Inc.	1.2%	-55.9%	-103
Etsy, Inc.	2.8%	-21.6%	-74
Drive Shack, Inc.	1.7%	-15.1%	-28
Franklin Covey Company	2.4%	-7.9%	-17
U.S. Physical Therapy, Inc.	1.3%	-12.2%	-17

***CTR represents the contribution to total return in basis points. Contribution data is reflective of a representative account in the Punch Small Cap Equity Strategy.*

Bottom Contributors to Return

BlueLinx Holdings Inc. (BXC, $133 million market cap) was our largest detractor in the quarter. BlueLinx is a building products distributor. It is in the process of integrating an acquisition equal in size to itself while also deleveraging the balance sheet through a sale of several non-core real estate holdings. Our thesis is that the company is well positioned to grow with domestic housing starts and see strong operating leverage through the execution of its operational improvement plans. BlueLinx remains underfollowed with only one sell-side analyst covering it. During the quarter it became evident that the integration was not going well and forced the company to pull back on merging operations to refocus on its customers and suppliers after it realized it was losing more market share than expected. Further compounding the stock's decline, the company issued a filing allowing it to raise more equity in the future which raised concerns about its liquidity position. We think the valuation remains attractive as BlueLinx trades at multiples in-line with its peers, but the real estate left to be monetized is worth over 75% of the company's market capitalization. Our opinion is the BlueLinx investment thesis is bent, but not broken, and continue to hold the position.

Etsy, Inc. (ETSY, $5.3 billion) also detracted from the quarter's performance. Etsy is a two-sided marketplace for unique home goods, art, clothing, and other handcrafted items. Investors pressured the stock, as their concerns grew about a slowdown in its growth profile. During the quarter, Etsy reported results for the first full period since it lapped a large price increase it took in July 2018. Despite a difficult year-over-year comparison, the company grew its core revenue over 25%, including organic buyers increasing their spending by 19%. While both metrics do reflect slower growth than in the past, we think the stock is still attractively priced given its uniqueness, customer loyalty, and opportunity to grow internationally. In our opinion, Etsy is a good example of investors focusing too much on the near-term fluctuations and not enough on what the company could be in three-to-five years. The company is well-capitalized and profitable, and we are impressed with management's ability to execute on its strategic initiatives. It is our belief that long-term patient investors will be rewarded.

Another detractor in the quarter was **Drive Shack Inc. (DS, $245 million)**. Drive Shack is a golf-related entertainment company. The company has opened four of its namesake entertainment properties to date, with three opening in the second half of 2019. The concept is a technology-enhanced driving range using interactive games, and it has a bar and restaurant attached. It appeals to a wide demographic, and the target market is not only golfers. The first Drive Shack was put in a poor location and has struggled to attract crowds. The three most recent locations are performing significantly better, but investors appear to be impatient with the lack of results. The other pressure came from the company having its third CEO in 15 months. While not ideal, the Executive Chairman is a top shareholder and involved in the business. In addition to the high-end driving range concept, the company announced a second concept called Urban Box, where it will have a similar bar and restaurant theme but with indoor mini golf. The advantage of Urban Box is a lower cost to build and smaller footprint which will help in finding optimal locations for Drive Shack's unit growth objectives. Drive Shack is the only publicly traded standalone entertainment golf company and has several non-core assets that it is selling to fund the development pipeline. We think the right management team is now in place, and with demonstrated results from the recent openings, we believe the stock will recover. We see an ability for Drive Shack to continue to profitably grow for several years, and we remain a shareholder.

Top Contributors: Fourth Quarter 2019			
Holding	Average Weight	Total Return	CTR** (bps)
INTL FCStone, Inc.	4.9%	18.9%	103
Digi International, Inc.	2.9%	30.1%	86
RadNet, Inc.	2.3%	41.4%	83
Malibu Boats, Inc.	2.7%	33.5%	80
Douglas Dynamics, Inc.	3.4%	24.0%	75

***CTR represents the contribution to total return in basis points. Contribution data is reflective of a representative account in the Punch Small Cap Equity Strategy.*

Top Contributors to Return

The top contributor to performance during the fourth quarter was our investment in **INTL FCStone, Inc. (INTL, $933 million market cap)**. This financial services platform provides niche services such as hedging, commodity trading, and global payments, among several others. An example customer could be a Minnesota farmer who is looking to hedge next summer's crop of corn.

This longtime Punch holding has posted strong results over the past several years while staying under the radar with zero analyst coverage. In December, the company reported its fourth quarter financial results, and we believe it was an inflection point for the business. During the quarter, INTL benefitted from increased market volatility and improved integration of several new offerings, driving them beyond their internal goal of generating 15%+ return on equity. The especially strong results took the market by surprise, and shares appreciated meaningfully.

Looking forward, we remain optimistic about the opportunity for INTL as they continue to invest in new products and technology to create a larger and more powerful platform. Despite the recent run in the share price, INTL exchanges hands at an undemanding price-to-earnings valuation of 9.7x for a business growing both operating revenue and earnings at a healthy double-digit pace.

The second largest contributor to performance was **Digi International, Inc. (DGII, $508 million market cap)**. This Minnesota company sells services and components used in the "internet-of-things" applications and cellular communication. We first took a position in Digi in 2015 when the company had nearly half of its market capitalization in net cash and a new management team. Our investment thesis was rooted in the new team's ability to create a more predictable business by reducing lower margin product count and using the large cash balance to acquire a solutions business that would generate predictable recurring revenue.

While progress has been slow and uneven at times, our original thesis has begun to playout. Digi has made a handful of acquisitions and grown the solutions business to account for over 15% of total sales. In the most recent quarter, the stock responded favorably to the announcement of a large acquisition and solid operating results. We believe several strong tailwinds will drive growth going forward, including the adoption of 5G, international expansion opportunities, integration and cross selling from the new acquisition, and continued M&A.

Last quarter, we introduced a new holding in **RadNet, Inc. (RDNT, $1.02 billion market cap)**, and it was the third largest contributor to performance this quarter. As a reminder, RadNet is an owner and operator of medical imaging centers around the country offering services such as x-rays, ultrasounds, and MRIs. Shares in this medical imaging business are off to the races after reporting another quarter of same center growth, continued integration, deleveraging from recent acquisitions, and their addition to the S&P Small Cap 600 Index.

In December, our research team had the opportunity to meet with management to get an update on the business and hear about their key initiatives for 2020. One critical initiative during the new year will be implementing artificial intelligence into the screening process to more efficiently and accurately evaluate patient images. Artificial intelligence can be used to examine imaging results and highlight concerning images to save radiologists significant time. This cutting-edge initiative is expected to deliver more cost-efficient care over time and was bolstered by a recent acquisition and partnership RadNet made.

RadNet's progress in taking advantage of the industry wide shift towards patients receiving care outside of a hospital or a traditional clinic is impressive. The company offers its services at a fraction of the cost for the same service provided at a hospital, and health insurers are increasingly encouraging this cheaper setting, providing a strong tailwind for years to come.

Portfolio Activity

The Punch Small Cap Strategy ended the quarter with a total of 42 positions, two fewer than the third quarter, after exiting Carbonite, Inc. and Natural Gas Services Group, Inc. Additionally, we added to four existing positions and trimmed three others.

Total turnover in the Punch Small Cap Strategy remains low at 18%, while our active share remains high at 98%. Our top ten holdings accounted for 39% of the portfolio at quarter's end.

In December, we exited longtime holding **Natural Gas Services Group, Inc. (NGS, $161 million market cap)**, a manufacturer of compressors sold and leased for extracting natural gas. We first met its CEO Stephen Taylor in August of 2010 and learned that he planned to shift more of the business into leasing in order to smooth out the lumpy nature of selling compressors to energy companies. We believed NGS was becoming a more predictable business. The company had also just demonstrated its ability and willingness to pay down debt. When we first bought NGS in the second quarter of 2011, the company had nearly $17 million of cash on its balance sheet and was essentially debt free.

Throughout our ownership of NGS sales remained volatile in the cyclical energy sector, but the company always generated solid cash from operations so we bought more shares in the second quarter of 2012 and again in in the fourth quarter of 2014. By the end of 2017, Natural Gas Services had accumulated almost $70 million of cash on its balance sheet. By second quarter 2018, we determined that NGS had no plans for this cash other than to serve as a cushion to the company's cyclical market and to make modest investments in higher horsepower compressor inventory. We began to think NGS was not a sophisticated capital allocator. Our team wrote a letter to the board of directors with ideas of how it could return capital to shareholders and perhaps use some leverage given their steady cash flow generation. The board replied indicating they had no plans to return capital to shareholders and wanted to maintain a conservative approach to their balance sheet.

Natural Gas Services continues to demonstrate its lack of capital allocation acumen while it operates in a sector that is heavily out of favor with investors today. In the fourth quarter of 2019, we concluded that NGS is not the best use of our investors' money, and we decided to sell our shares so we could buy other companies with more promising potential.

Last quarter, we wrote about **Carbonite, Inc. (CARB, $804 million market cap)** as one of our largest detractors of performance. Carbonite is a data protection software company that provides backup, disaster recovery, and migration solutions to secure on premise and cloud infrastructure for businesses and consumers. In the third quarter of 2019, Carbonite announced that its CEO, Mohamad Ali, was voluntarily leaving the company. This was clearly a disappointment to many, as the stock declined from $23 to $18 overnight. The company announced plans to begin a search process for a new CEO, but management was in turmoil given the various acquisitions made in recent years, the largest of which was the most recent. In March of 2019, CARB acquired Webroot for more than $600 million, and Ali departed prior to fully integrating the acquisition. We planned to meet with the new CEO once he or she was selected to determine whether to continue to own the shares, however an acquirer made a bid for Carbonite in November of 2019.

OpenText, a Toronto exchange listed company, bought Carbonite for $23 per share in cash. We believe selling the business to OpenText was the appropriate decision for the Carbonite board of directors, and we received cash for our shares in late December of 2019.

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See disclosures at the end of this commentary

Conclusion

The strong "melt up" market of the fourth quarter has elevated stock prices and valuations, although small and microcap stocks have not risen nearly as far or as fast as large cap stocks. While the S&P 500 is at new highs, the Russell 2000 remains 4% below its all-time high, and the Russell Microcap is 9% below its all-time high. In terms of valuation, the Russell 2000 now trades at a P/E ratio of 16.3x compared to 21.0x for the S&P 500 (when measuring profitable companies only).

Looking ahead, small cap stocks seem to be positioned well for renewed economic strength and are notably cheaper than large cap stocks. We believe we continue to enjoy persistent, structural advantages in this asset class, as both sell-side research and buy-side investors continue to neglect the smallest of public companies. We believe that the smallest, least expensive publicly traded companies represent one of the last pockets of unexploited value for investors today.

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

Year	Annual Performance History			3-Year Standard Deviation		Number of	Year End Composite	Year End Firm	% of Total	
	Gross of Fees	Net of Fees	Benchmark[1]	Composite[2]	Benchmark[2]	Portfolios	Assets (mil)	Assets (mil)	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.