Punch

Small Cap Commentary
Third Quarter 2021

Introduction

Small Cap stocks experienced a choppy third quarter as concerns over supply chains, labor availability, the Delta variant, and rising inflation all weighed on shares. The quarter ended with the Russell 2000 Index falling 4.4%. At its July low point, the index had declined almost 11% from its 2021 high.

Despite second quarter earnings results that were largely positive for many Small Cap companies, conversations on most investor conference calls centered on fading economic momentum and the difficulty in finding just about anything—equipment, materials, labor. Heading into the final stretch of the year, we are hopeful that tentative signs of easing in these strains will continue and that COVID-related headaches will lessen with time. It seems this economic and market recovery has been “stretched” but not “broken.”

Year-to-date, Small Cap stocks are up 12.4% compared to 15.9% for the S&P 500 Index. Small Cap Value stocks have produced a strong 22.9% return this year compared to only 2.8% for Small Cap Growth stocks.

Notably, healthcare is the worst-performing sector in the Russell 2000 this year, declining 7.5%, and this group is down over 26% from its peak early in 2021. Energy stocks, by contrast, have risen 75%. Few would have predicted this turn of events as COVID raged heading into 2021.

Attribution

The Punch Small Cap Strategy returned -3.0% in the third quarter compared to -4.4% for the Russell 2000 benchmark index. Outperformance was driven almost entirely by individual stock selection, although the strategy’s meaningful underweight to healthcare stocks (12.2% average weight vs 20.6% for the index) helped as this index group declined 10% in the quarter.

Year-to-date, the Punch Small Cap Strategy has returned 25.9% compared to the benchmark return of 12.4%. We believe strong performance this year is largely a function of individual stock selection, a value bias, and an underweighting to the Small Cap healthcare sector.

Bottom Contributors to Performance

During the third quarter, **B. Riley Financial, Inc. (RILY, $1.6 billion market cap)** was the largest detractor from performance. This diversified financial services platform has operations across capital markets, retail liquidations, valuations, and appraisals. Throughout the past three quarters, the capital markets group posted strong results as they benefited from a heightened level of activity in the financial markets. Earnings at the business surged during this time, and the shareholder-friendly management team paid out over 14% of the current market cap in dividends.

While B. Riley had been a top performer during the first two quarters of the year, shares pulled back during the third quarter on concerns that activity within capital markets might be slowing. In August, our team sat down with management to get an update on the business and left the meeting feeling confident about the strategy and their ability to offset some of the inherent cyclicality within capital markets with their suite of complementary yet diversified offerings. Insiders at the company took the recent pullback in shares as an opportunity to buy stock, while the business continues to be under

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Bottom Contributors: Third Quarter 2021			
Holding	Average Weight	Total Return	CTR** (bps)
B. Riley Financial Inc.	4.44%	-19.45%	-98
Callaway Golf Company	4.54%	-18.08%	-87
Avid Bioservices Inc.	2.99%	-15.91%	-48
Phibro Animal Health Corp	1.41%	-25.05%	-42
Deluxe Corp	1.41%	-24.30%	-39

***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.*

Annualized Performance as of 9/30/2021 (net of fees)						
	Q3 2021	1 Year	3 Years	5 Years	10 Years	Since Inception*
Small Cap (Net)	-3.00%	65.04%	13.07%	15.07%	15.20%	11.34%
Russell 2000 Index	-4.36%	47.67%	10.54%	13.45%	14.63%	9.27%

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

the radar with no analyst coverage. Shares trade today at a meager valuation of 2.7x enterprise value to EBITDA and the stock remains a top holding in the Punch Small Cap Strategy.

Golf equipment and apparel manufacturer **Callaway Golf Company (ELY, $5.1 billion market cap)** was a top detractor during the third quarter despite reporting what we believe to have been very strong results. Throughout the pandemic, Callaway enjoyed a surge in enthusiasm for golf as newcomers picked up the sport while its strong brands continued to resonate with golfers. Additionally, Callaway made an opportunistic acquisition of Top Golf last fall, and the entertainment business since exceeded management's expectations with sales that are now approaching pre-COVID levels.

Unfortunately, shares traded down after the company reported earnings. We suspect investors became concerned about the company's manufacturing plants in Vietnam temporarily closing due to a surge in the Delta variant. While we believe the temporary plant closures will have some effect on the next quarter, we expect the impact after this coming quarter to be limited and have confidence in management's ability to continue navigating supply chain challenges. Demand for golf equipment remains strong and we believe extremely low retail inventory levels set the business up for a healthy 2022.

The final detractor during the quarter was **Avid Bioservices, Inc. (CDMO, $1.3 billion market cap)**. We first initiated a position in this contract manufacturer of pharmaceuticals last summer and watched management successfully expand their facilities and begin to fill excess capacity. During the quarter, our research team visited the company's two facilities in southern California to meet with management and see the ongoing expansion project.

After generating strong returns during the first two quarters of the year, shares pulled back in the third quarter as the backlog declined slightly. Over the past year, we believe the business development team did an impressive job building the backlog to fill excess capacity created. Management spoke on the earnings call about promising opportunities in the hopper and indicated they expect backlog growth to resume in the coming months. We remain encouraged that ongoing expansion projects can more than double manufacturing capacity and provide a meaningful lift to earnings in the coming years.

Top Contributors to Performance

Global Ship Lease, Inc. (GSL, $860 million market cap), an owner and lessor of mid-size containerships, was a top contributor to performance for the second quarter in a row. An obvious beneficiary of recent supply chain congestion, shipping companies have seen spot market day rates more than triple this year. In the past, elevated prices attracted competitors to build new ships, hoping to capitalize on these higher rates, but today, higher prices are not leading to increased orders as banks are less willing to lend to the industry and uncertainty remains high for future emission regulations. The end result is severe capacity constraints, near-100% utilization, and no "quick fix" in sight.

We believe Global Ship Lease will continue to benefit from this dynamic for the foreseeable future. As the current contracts for ships lapse, they will likely be renewed at higher rates, delivering excess free cash flow that can be used for acquisitions, driving fleet growth further. This virtuous cycle is

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

made possible by the company's Chairman, whom we view as a shareholder-friendly operator with a knack for finding acquisitions at attractive multiples.

Franklin Covey Co. (FC, $577 million market cap) is a name familiar to most people, although the company is no longer associated with its eponymous calendars and planners. Today, the company creates content and training materials for businesses, governments, and schools, focusing on organizational performance improvement.

Franklin Covey's business accelerated in the third quarter, not only compared to 2020 but also against pre-COVID levels in 2019. These strong results and better than expected guidance for next quarter reflect pent-up demand at both the enterprise and education business segments following more than a year of uncertainty. The company will also benefit from significant Federal funding for education (historically 20 25% of revenues), with requirements that focus on social and emotional learning, an area of expertise within the company's existing content.

Novanta Inc. (NOVT, $5.5 billon market cap) was another top contributor to performance in the quarter, with strong second quarter results that exceeded expectations. The company also announced two medium-sized acquisitions in the quarter, both of which will be accretive to earnings.

After putting Novanta through our internal "red team / green team" exercise earlier this year to re-underwrite our investment thesis on the company, we decided to exit the stock on strength given its full valuation. More details are below.

Top Contributors: Third Quarter 2021

Holding	Average Weight	Total Return	CTR** (bps)
Global Ship Lease Inc.	3.76%	22.76%	79
Franklin Covey Co	1.98%	26.09%	43
Ranpak Holdings Corp	3.69%	7.15%	38
Oportun Financial Corp	1.74%	24.96%	37
Stonex Group Inc.	4.41%	8.62%	35

***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.*

Portfolio Activity in the Quarter

During the third quarter, we initiated a new position in **Semler Scientific, Inc. (SMLR, $844 million market cap)**. This healthcare company sells a simple device and software combination that is used to detect the blockage of a patient's arteries, called Peripheral Artery Disease (PAD). Traditionally, PAD was found by a doctor or vascular technician performing a manual 15-minute test on patients with clear signs of complications. By contrast, Semler's software solution takes five minutes and can be done by a nurse or physician's assistant, allowing for all patients to receive screening.

Over the last year, we followed the business closely and found both the software and the go-to-market strategy compelling. Semler spent years building relationships with large insurance companies so they can sell to this influential group instead of targeting thousands of individual clinics. An estimated 20 million people in the United States have PAD, but only about 2 million have been diagnosed, creating a strong monetary incentive for insurance companies to find PAD patients and prevent expensive complications like heart attacks, strokes, and limb amputations.

The company has a net cash balance sheet, a strong margin profile, and a large growth opportunity with limited competition. Additionally, shares were recently up-listed to the Nasdaq which should help this under-the-radar stock become better followed in time. We are excited for Semler to continue driving the adoption of their PAD product and believe there could be a longer-term opportunity to leverage their unique insurance company relationships with additional products.

In September, we exited long-time holding Novanta Inc. (NOVT, $5.5 billion market cap), a laser and motion control technologies company based in Boston. Novanta is a successful example of how we apply our investment philosophy. The company was exiting bankruptcy after the Great Financial Crisis when we first initiated a position due to its cleaned-up balance sheet, strong organic growth, healthy operating margins, low recognition, and a valuation that supported a strong margin of safety. During our holding period, Novanta enhanced its focus on the critical Advanced Industrial and Medical markets, where the company created products vital to innovative technologies such as robotic automation, DNA sequencing, and minimally invasive surgery. A decade later, Novanta still has ambitious growth targets, but the company is no longer under the radar. It now has four sell-side analysts and a lot of future success reflected in the valuation. With the company no longer unrecognized or inexpensive, we exited and redeployed the capital.

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Conclusion

This past summer, as the pandemic seemed to be subsiding, our research team hit the road for the first time since March 2020. We traveled to sunny California to attend a small investment conference and visit a handful of portfolio companies at their offices in the L.A. area. It was refreshing to meet face-to-face with the executives running our companies after a long year of virtual meetings.

Seeing businesses firsthand and meeting with executives in person can yield important—sometimes critical—insights that inform investment decisions. One corporate headquarters was in a dingy building that had not been updated in several decades just off a freeway access road—a sign of the frugality of the company, and the CEO's preference to invest in customer stores rather than executive suites. At another company, boxes and equipment covered the office as they completed the final stages of a large manufacturing expansion—a sign of potential growth to come. Both instances reinforced our investment decision.

Visiting offices and meeting with managers allows investors a firsthand look into company culture, the state of physical assets like plants and equipment, and how much energy and activity is happening around the office. These visits offer potential clues to the long-term success or challenges at a business and are a necessary part of the due diligence required to vet investment opportunities.

Investing in Small Cap companies offers a unique opportunity. Not many investors are willing or able to do the depth of research that we do on smaller, lesser-known businesses around the country. According to Furey Research, the average Russell 2000 Small Cap company has only five analysts covering it, compared to 20 for companies in the S&P 500.

While the recent uptick in COVID cases around the country has again put a damper on travel and in-person meetings, we are hopeful that over the coming year in-person research can resume and we will visit more Small Cap companies "on the road."

Punch & Associates Investment Management Inc.
Punch Small Cap Composite
Performance as of 6/30/2019

Punch

	Annual Performance History			3-Year Standard Deviation		As of December 31st			
Year	Gross of Fees	Net of Model Fees	Benchmark[1]	Composite[2]	Benchmark	Composite Accounts	Composite Assets (mil)	Firm Assets (mil)	Dispersion[2]
2009	32.78%	31.52%	27.17%	20.88%	24.83%	264	$86.0	$340.4	3.28%
2010	18.88%	17.79%	26.85%	23.19%	27.69%	273	$104.2	$395.6	1.03%
2011	0.80%	-0.12%	-4.18%	20.44%	24.99%	281	$104.8	$475.6	0.66%
2012	20.12%	19.07%	16.35%	17.15%	20.20%	290	$152.3	$613.6	0.63%
2013	42.64%	41.53%	38.82%	13.49%	16.45%	323	$267.6	$832.7	0.47%
2014	-0.23%	-1.07%	4.89%	12.61%	13.12%	333	$266.3	$905.7	0.25%
2015	0.52%	-0.38%	-4.41%	15.46%	13.96%	335	$256.2	$938.1	0.65%
2016	20.96%	19.84%	21.31%	17.20%	15.76%	353	$308.7	$1,101.0	0.50%
2017	12.93%	11.92%	14.65%	16.36%	13.91%	380	$357.0	$1,241.6	0.32%
2018	-9.88%	-10.79%	-11.01%	16.40%	15.79%	387	$293.5	$1,157.8	0.53%
2019 (through 6/30/2019)	16.97%	16.43%	16.98%	N/A	N/A	N/A	N/A	N/A	N/A

	Annualized Performance History		
Period	Gross of Fees	Net of Model Fees	Benchmark[1]
1 Year	-5.48%	-6.45%	-3.31%
3 Year	12.82%	11.75%	12.30%
5 Year	7.62%	6.64%	7.06%
Since Inception (3/31/2002)	11.00%	9.96%	8.20%

[1] The Russell 2000 Index is the Composite's benchmark. The returns of this index do not include any transaction costs, management fees or other fees.

[2] 3-Year Standard Deviation and Dispersion calculations for the composite are based on gross of fee returns.

Notes:

1. 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, 2019. 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, 2019. The verification and performance examination reports are available upon request.
2. Punch & Associates Investment Management, Inc. (Punch) is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940.
3. The Punch Small Cap Composite was created December 31, 2005 and includes discretionary, fee paying accounts over $100,000 invested in the firm's Small Cap strategy (Strategy). The Strategy invests in small cap companies that are typically between $250 million and $2 billion in market capitalization. The Strategy is benchmarked to the Russell 2000. The Strategy has been open since firm inception (March 31, 2002). Accounts are removed from the composite for cash flows exceeding 10% of the account's monthly beginning market value.
4. The portfolio returns for the period are based in U.S. dollars and reflect the reinvestment of dividends and other earnings. After June 30, 2018 net of fee performance was calculated by deducting one quarter of one percent from each quarter's gross performance and geometrically linking the resulting returns. Prior to June 30, 2018 net of fees performance figures are reflective of quarterly gross of fee returns minus actual investment fees paid by the underlying accounts in the composite for the period. The dispersion of the annual returns of the Composite is measured by the asset-weighted standard deviation method. Only portfolios that have been managed for the full year have been included in the annual dispersion calculation of the Composite. The three-year annualized ex-post standard deviation measures the volatility of returns for the Composite and benchmark over the preceding 36-month period. Punch's policies for valuing portfolios, calculating performance, and preparing compliant presentations and a list of composite descriptions are available upon request.
5. Punch has updated the historical performance results provided in this presentation to more precisely illustrate composite performance based on revised accounts' composite membership exit dates. For more information about the revisions and performance update, please contact us.
6. Past performance is not an indication or a guarantee of future results. Investments are subject to risk and may lose value.