

Punch

Small Cap Equity Strategy Fourth Quarter 2021 Commentary

INTRODUCTION

Small Cap stocks ended the fourth quarter of 2021 almost exactly where they began, rising only 2.1% during the period. That is not to say that the last ninety days were dull, however. Midway through the quarter, the Russell 2000 Index experienced a correction of over 12% on fears of Covid resurgence and Fed tightening. Despite these headwinds, the Russell 2000 did rebound to a 2.23% return in December, and as we look forward to 2022, we believe that many small cap companies are well-prepared for the coming year with record earnings performance, improved balance sheets, and strong demand backlogs.

Following a record performance in 2020 with a 19.9% total return, small cap stocks returned 14.8% in 2021. This performance was the largest difference from large cap stocks since 2003 as the S&P 500 Index rose 28.7% for the year. From the pandemic bottom on March 18, 2020, small caps stocks are up 131%, while large cap stocks are up 104%.

A few other observations from the year:

- *Low quality stocks continued their multi-year outperformance in the first half of 2021 with meme stocks, SPACs, and unprofitable technology companies all doing well. In the second half of the year, though, this trend began to reverse in a meaningful way and high-quality companies outperformed. Given the magnitude and duration of low-quality performance over the past few years, we believe that many high-quality stocks look poised to continue their relative strength.*
- *The difference between growth and value stock performance was stark for small caps in 2021, with the Russell 2000 Value Index returning almost double the Russell 2000—28.2% versus 14.8%. The Russell 2000 Growth Index produced a meager 2.8% return for the year. The outperformance of value over growth was the second-largest in 43 years; the first was in 2000 following the dot-com bust.*

- *Despite lagging performance relative to large cap stocks in the year, small cap earnings growth is expected to be significantly better than large cap in 2022 and forward valuations relative to large caps are currently at their lowest level since 2002.*
- *Sector performance was widely divergent for the year. Energy (+37%), Consumer Discretionary (+28%) and Financials (+27%) rose significantly in 2021. Healthcare was a significant outlier for the year, declining -18% for the year.*

The Punch Small Cap Strategy had a total return of 10.7% for the fourth quarter and 39.3% for the full year compared to 2.1% and 14.8% for the benchmark Russell 2000, respectively. For the year, security selection accounted for 20.4% of a 26% outperformance for a representative separate account.

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BOTTOM CONTRIBUTORS IN Q4 2021			
HOLDING	AVERAGE WEIGHT	TOTAL RETURN	CTR** (BPS)
Sleep Number	1.72%	-18.06%	-37
Oportun Financial Corp	1.41%	-19.10%	-36
Semler Scientific	0.86%	-27.20%	-35
StoneX Group	3.83%	-7.06%	-29
Hooker Furnishings	0.94%	-13.00%	-16

**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 IN Q4 2021			
HOLDING	AVERAGE WEIGHT	TOTAL RETURN	CTR** (BPS)
B. Riley	5.52%	58.38%	226
Bluelinx	3.72%	95.91%	197
Franchise Group	4.26%	49.05%	150
Green Brick Partners	3.67%	47.81%	129
Ranpak	3.79%	40.12%	115

**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 AND TOP CONTRIBUTORS

Sleep Number (SNBR, \$1.7 billion market cap) was the largest detractor from performance in the quarter despite strong earnings results and a positive outlook for 2022. We believe that many investors expect consumer spending to shift away from large-ticket home furnishings as the pandemic fades. However,

ANNUALIZED PERFORMANCE (Net of Fees)						
	LAST MONTH	1 YEAR	3 YEARS	5 YEARS	10 YEARS	SINCE INCEPTION*
Small Cap (Net)	4.65%	39.32%	26.56%	15.17%	14.99%	11.76%*
Russell 2000 Index	2.23%	14.81%	20.01%	12.01%	13.23%	9.27%

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

mattress sales are often tied to housing activity, and we believe that severe housing shortages across the country are not likely to ease soon. Sleep Number's innovative mattress technology, adept marketing, and impressive operational performance through the pandemic give us confidence that the company is poised for growth in the coming years. With shares trading at a single-digit price-to-earnings multiple, we added to our investment in the fourth quarter.

Oportun Financial (OPRT, \$620 million market cap) also detracted in the quarter following its decision to not pursue a bank charter and the announcement of a \$200 million acquisition of online credit subscription service Digit. Oportun, a provider of alternative credit services, continues to benefit from exceptional consumer credit profiles nationally and a growing need for non-bank lending by its target market.

Semler Scientific (SMLR, \$540 million market cap), a medical device company with an innovative technology for assessing peripheral artery disease (PAD), reported an uncharacteristically weak quarterly result as pandemic conditions affected the timing of at-home testing. We believe this quarter was anomalous and look forward to more detail on the company's new product launches in 2022.

No new companies were added to the portfolio in the fourth quarter and the single exit was **Deluxe**

Corp. (DLX, \$1.4 billion market cap). Following weak operating results, a large acquisition, and unclear strategic direction under a new CEO, we decided to exit the position.

The largest holding in the Punch Small Cap Strategy at the end of 2021 was also its top contributor to performance in the fourth quarter. **B. Riley Financial (RILY, \$2.3 billion market cap)**, a Los Angeles-based investment bank and diversified financial services firm, reported record earnings following a strong year for underwriting, institutional brokerage, and principal investments. In October, the company raised its regular quarterly dividend to \$1 per share and declared its fourth special dividend of the year. The trailing twelve-month dividend yield today is almost 15% as the company follows its stated policy of returning a significant portion of earnings to shareholders every year.

Bluelinx Holdings (BXC, \$770 million market cap) was the second largest contributor to performance in the quarter and as a distributor of specialty building materials continues to benefit from robust housing activity and elevated commodity prices. We had the chance to sit down with the company's new CEO in September and came away optimistic about the company's renewed strategic focus.

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Franchise Group (FRG, \$2.1 billion market cap) was also a large contributor to performance in the quarter after announcing two large acquisitions—Sylvan Learning and Badcock Furniture, both of which fit the company’s model of retail businesses with strong free cash flow and significant re-franchising opportunities. As a result of strong core earnings, the company raised its dividend 65% in December and currently yields almost 5%.

The Punch Small Cap Strategy ended the year with 43 individual company holdings and had 32% turnover in the year.

	ONE QUARTER ATTRIBUTION	ONE YEAR ATTRIBUTION
Top Contributors to Relative Results	<ul style="list-style-type: none"> • Stock selection in Consumer Discretionary and Healthcare • Stock selection in Communication Services and Materials • Overweight to Industrials 	<ul style="list-style-type: none"> • Stock selection in Healthcare, Financials, Materials, and Industrials • Meaningful underweight to Health Care • Overweight to Consumer Discretionary
Top Detractors from Relative results	<ul style="list-style-type: none"> • Overweight to Communication Services and Information Technology were modestly negative 	<ul style="list-style-type: none"> • Stock selection in Consumer Discretionary • Stock selection and underweight to Energy

Attribution shown is that of a representative small cap separate account.

Data as of December 31, 2021.

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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.

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