Quarterly Newsletter | Volume 15, Issue 2
July 2015

Punch

A BOUTIQUE INVESTMENT ADVISORY

Wealth Strategies Group

Anticipating Your Next Mistake

"In their calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their prediction: they act as though uncertainty has vanished and the outcome is beyond doubt. Reality is abruptly transformed into that hypothetical future where the outcome is known. These are rare occasions, but they are unforgettable: major tops and bottoms are defined by this switch from doubt to certainty."

— Peter Bernstein, Investor and Author

Airline pilots are well-known for their use of a pre-flight checklist. The FAA and other aviation governing bodies recognize that these pilots are human beings and, as humans, they carry with them into the cockpit more baggage than just their overnight carry-ons. We are all better served when our captains are 100% focused on safely transporting passengers. Relying on a person's memory or intuition when flying an increasingly complex 75-ton spacecraft is a stronger leap of faith than the FAA, airline companies, or their customers are willing to take. Checklists help ensure that mistakes are minimized. As a passenger, I tend to favor fewer mistakes.

Similarly, we believe the best investors employ disciplines that help minimize mistakes. While some have formal checklists that they use when analyzing an investment, most employ a rules-based discipline that steers them away from low probability bets and toward investments in which time is on their side. Perhaps even more than believing in themselves, these investors believe that the market will reward a disciplined investment approach over time while punishing an emotional, distracted, or disorganized process. The best investors recognize that the investment world is not set up to funnel below-average investors toward the world's best investments at any given point in time. It's the opposite. A verse from Max Ehrmann's Desiderata says it best:

"Exercise caution in your business affairs, for the world is full of trickery."

The confluence of natural human emotions and the need for media outlets to amplify good and bad news create an environment that is less than ideal for prudent, long term investment decision making…unless you have a discipline.

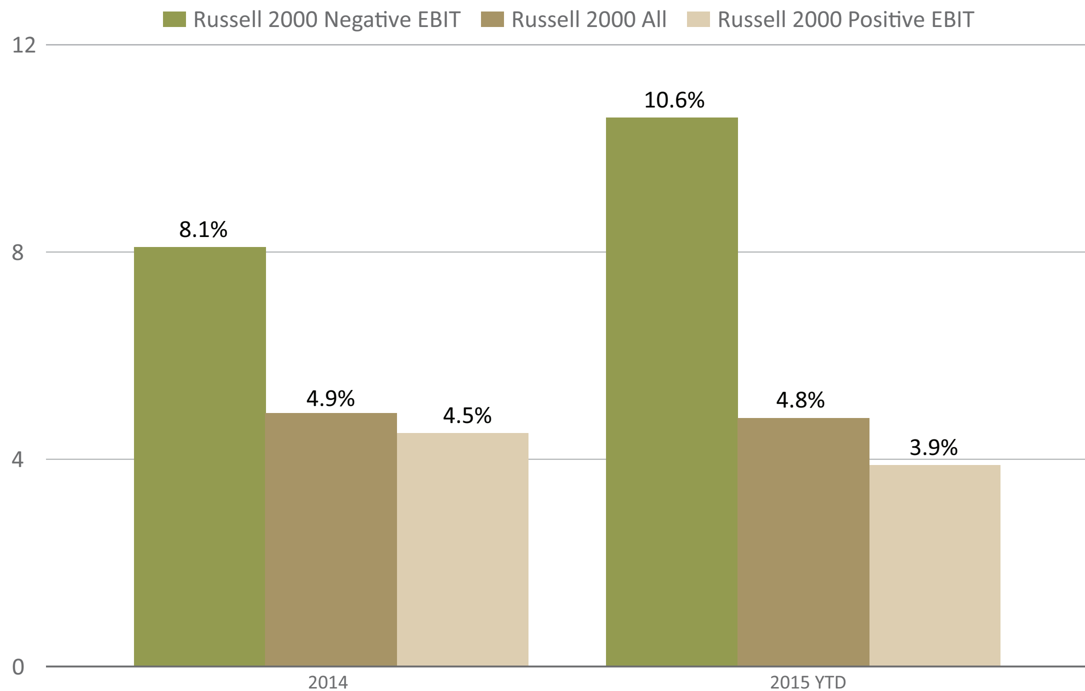
I have been investing other people's money for over 30 years. Many folks trust our group with their life savings. The ultimate irony is that I don't trust myself 100% of the time. Our group needs rules or a discipline to avoid mistakes and increase our probability of success with your money. A discipline can't be discarded when things are going well and you feel you've earned the right to "roll the dice" with your next pick; nor can it be abandoned when it does not produce superior near-term results. A discipline is most valuable when it makes you perform the tasks required when everything in your body and mind is telling you to do the opposite.

"[All] of the information you have about a company represents the past, and [all] of a stock's valuation depends on the future."

— Bill Miller, Portfolio Manager of the Legg Mason US Value Fund

One of the hallmarks of our discipline here at Punch is that (except under unusual circumstances) we invest in companies that are profitable. One would think that this selectivity would always result in better performance than investing in money-losing enterprises, but that is not always the case. We have just experienced a considerable time period where the money-losers beat the money-winners in the Russell 2000 small cap universe. Furey Research points out that last year and this year it was considerably more lucrative investing in money-losing enterprises. While unusual, this is not unprecedented (remember the dot-com era?). Our discipline of insisting on profitability meant that we had the wind in our face over the last 18 months in the Punch Small Cap Strategy.

Continued on page 2



Russell 2000 Return by EBIT (as of 6/30/15)

While we will make some mistakes over the next few years, one of them will not be chasing unprofitable internet and biotech companies. The other mistake we will actively avoid in this strategy is employing an indexed-based approach. To the extent that Russell Small Cap Indices have representation in more of these unprofitable companies, they will be on the wrong side of the "reversion to the mean" mountain versus our approach. Again, according to Furey Research, the newly reconstituted Russell 2000 expects 7.5% income growth in 2015 vs. 9.6% for the old constituents. This is due to 28 profitable former members with $2 billion in aggregate 2014 net income being replaced by 128 smaller companies with over $200 million in '14 losses. Yet individual and institutional investors alike continue to plow money into these passive strategies.

When I'm forced to think about this, it occurs to me that this would be like turning our discipline upside- down.

Small Cap Strategy

Many investors, in their search for new investment ideas, often use "screens" or "filters" to narrow a universe of thousands of stocks down to only a handful that may be worth serious research. Popular financial websites like Yahoo Finance and Morningstar include such screening tools to help users quickly eliminate securities that don't fit their desired parameters. For value investors, it's common to screen for stocks using such criteria as low price-to-earnings ratios, low price-to-book-value, or high dividend yield.

While even we use these traditional screens in our hunt for undervalued small cap stocks, there are several problems with their use. First, the most popular screens (low price-to-earnings, high dividend, etc.) are commonplace, which leads to many investors picking over the same cheap stocks—not a great source for finding unique, contrarian investment ideas.

Second, the surface-level financial metrics that these screens use don't always reflect the reality of what's going on inside a business. Sometimes these numbers are just plain wrong, as data gets recorded incorrectly in databases. Sometimes simple numbers don't reflect the complexity of a business. For example, consider one-time expenses, "hidden" assets inside a large company, and acquisitions or divestitures; sometimes, these items

Continued on page 3

are not reflected in historical financial statements. To twist the cliché, sometimes numbers *can* lie.

Finally, simply because a stock is "cheap" does not necessarily mean that it is "undervalued." Commodity materials businesses routinely trade at low multiples of earnings and book value, but even at these low valuations they may be fairly valued. Conversely, a stock that appears "expensive" may not necessarily be "overvalued." Fantastic businesses with high growth and return-on-capital characteristics may trade at above-average valuations and still be undervalued relative to the quality of these businesses.

In our process for seeking out unique, contrarian stock ideas, we use a method we call "behavioral screening." We don't simply want to know which stocks are cheap; we want to know *why* certain stocks are valued the way they are. A stock's valuation comes from the market's perception of its business and future prospects. But we know from experience that investors don't always get things right, and that irrational behavior can create irrational stock prices. If we can identify situations where investor behavior is the likely culprit behind a stock's mispricing, then we gain an edge over other investors and our odds for investment success go up.

In the second quarter we added a new technology stock to small-cap portfolios: a Minnesota-based company which has been public since the late 1980s. Despite being public for twenty-five years, its stock price has largely gone nowhere. From a behavioral standpoint, investors had come to expect subpar results from this company for a long time, and the stock's valuation reflects this. However, late last year the company's CEO and CFO were replaced by a new management team with a track record of turning around other companies and creating significant shareholder value. While a traditional screen may have identified that this was a cheap stock (which it is), it could not have told us that a disconnect was forming between the positive developments at the company and the market's continued apathy towards the shares as a result of years' worth of disappointment and frustration.

With behavioral screening, we want to identify stocks where investor expectations are low or non-existent and then look for reasons that these expectations might be exceeded. When looking for opportunities we agree with a quote by Warren Buffett:

"I don't look to jump over 7-foot bars: I look around for 1-foot bars that I can step over."

— Warren Buffett

Large Cap Strategy

"The four most dangerous words in investing are: 'this time it's different."

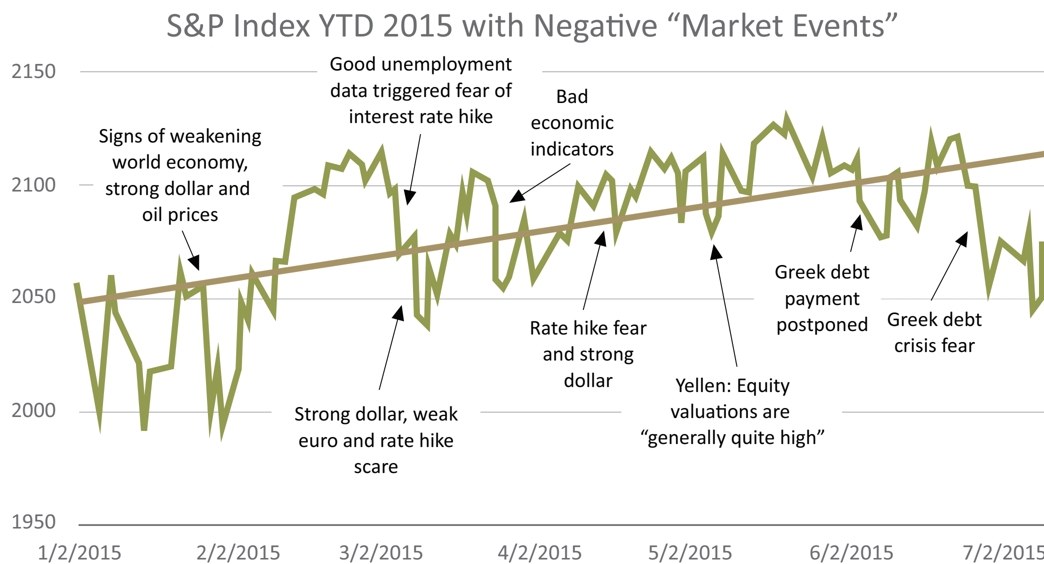
— Sir John Templeton

There was no shortage of world events and economic news to driving investor behavior in the second quarter (see chart below), but there seems to be a particular market obsession with the inevitable Federal Reserve interest rate increase. Investors want to know when the Federal Reserve will raise rates, but it's simply guess work. After all, the Fed has not increased rates since 2006. The probability of accurately timing the rate increase event and benefiting from it would be similar to predicting when the price of oil will go up - no one truly knows. It's not different this time.

The truth is, the longest bull market of all time from 1987 to 2000 is still twice as long as the current bull market, which makes any kind of rate hike prediction a true needle-in-the-haystack task.

The large cap space is the most efficient equity market based on information availability. At Punch, we believe that it is difficult, if not impossible, to gain an information advantage in large cap stocks. We can, however, be disciplined enough to capture behavioral missteps by other large cap investors. Buying opportunities are frequently created when the market overacts to the latest news cycle, which currently includes potential Federal Reserve actions and Greek debt crisis fears. When news cycles become intense, individual and professional investors alike tend to shorten their time frames. They put away their calendars and take out their stopwatches. Successful long term participation in the success of great American businesses requires the opposite reaction.

Continued on page 4



The nearby chart illustrates events taking place in a continuum. We can't predict the outcome of any one of these events and they all cause concerns and price movements. We can predict that the concerns next year and the following year will be different. To the extent that this year's concerns cause parts of the equity market to "over-react" we want to take advantage of this. Volatility in the second quarter created an opportunity for us to buy a new closed-end fund position and increase our position in another. At the end of June, CEFs were trading at the widest discounts (think cheap) to NAV we have seen in six years.

Income Strategy

Taper Tantrum Redux

In the summer of 2013, interest rates rose and bond prices fell in relatively sudden fashion as markets began to anticipate the end of quantitative easing (QE) by the Federal Reserve and its then-Chairman, Ben Bernanke. In a matter of four months, long-maturity treasury bonds fell nearly 20% and investment-grade corporate bonds fell 10%* as 10-year treasury rates rose from 1.7% to nearly 3%. The media dubbed the episode the "taper tantrum".

Fast forward to the summer of 2015, and we have seen much the same sound and fury over the anticipated first Fed rate hike that is widely expected to come by the end of 2015. Long-maturity treasuries are down 16% since their January high and investment-grade corporates are down 7%. Interest rate-sensitive sectors like REITs and Utilities are also in negative territory since the beginning of the year. What lessons, if any, are to be learned by comparing this year's episode to the previous market "tantrum"?

If history is a guide, it would appear that markets have already gone a long way to adjusting for the beginning of a new fed rate cycle. Whatever path this cycle of rate hikes ultimately takes, it is entirely possible that markets may react favorably once the anticipation turns into fact. Going back to previous rate hikes (notably 2004), it isn't uncommon for fixed income markets to decline in anticipation of higher rates but then rally once they actually come to fruition.

In the closed-end fund universe, investors have likewise reacted to the prospect of higher rates by marking down prices, even more than fund asset values. According to Merrill Lynch, the discount on the average closed-end fund today (about 9.2%) is as wide as it has been since the credit crisis of 2008 and is at a level that typically attracts large institutional investors who are likely to put a floor on discounts. Certainly this level of fear and pessimism can't be sustained for long. We are taking advantage of this fear and uncertainty by adding to closed-end funds with wide discounts and strong dividend yields.

While volatility is likely to pick up in bond markets in the years ahead, we will attempt to navigate this environment of uncertainty by focusing on undervalued securities with sustainable cash flow payouts. The average closed-end fund today generates a 6.8% yield on its assets, and after taking into account the discount on these funds, the yield jumps to almost 7.5% (source: Merrill Lynch). As yields for many income-producing securities have risen over the past few months, the income generated by our strategy is the strongest that it has been in some time.

Wealth Planning Perspectives

"The four most dangerous words in investing are: 'this time it's different."

— Richard M. DeVos

Summer is a wonderful time when families are together. Whether it's at the family lake place, floating in a boat on the shimmering water, taking in the sights, sounds and scents of a ball game or enjoying the rich landscapes and freshly cut grass of a golf course, these months are that sweet retreat that we (in the north country, at least) *long for* throughout the long, cold winter.

As families get together, an item that is perhaps not at the top of the list of things to talk about—but one that is advisable nonetheless—is having conversations about family wealth. These times together in a relaxed, comfortable environment can be ideal for bringing family members who don't typically deal with the day-to-day management of the family's wealth *closer in* to the process. Whether it's one spouse or another, or the next generation(s), it's a good idea to use this time to address some of the following topics. For example:

- Educate family members and provide the ability and forum to ask questions
- (Re)familiarize everyone with all associated advisors to the family (attorneys, CPAs, insurance advisors, etc.)… Know "who to call for what"
- Define, or *refine*, your family's mission, vision and goals (be it financial, charitable or otherwise)
- Explore ideas how to involve family members of all generations in financial discussions and seek input from parties who don't frequently have a voice in these matters throughout the year
- Begin to *assign responsibilities* (in an age-appropriate manner) to *involve* more family members in the stewardship of the family's wealth
- Consider charitable giving objectives, review current donees and research new ones which may represent new areas of interest, philanthropically, for family members

Among these topics, one of the most interesting and relevant is the effective and efficient intergenerational transfer of wealth. This is a topic that we are passionate about at Punch. We are in the early innings of the largest intergenerational transfer of wealth in history, and in many cases, advisors and families have done a tremendous job structuring estate plans (establishing trusts, assigning beneficiaries, etc.). However, all too often, it's the heirs themselves who are unprepared for the wealth and the associated responsibilities and complexity that can come with it. *Indeed, most of our clients are more concerned about the impact their wealth will have on their children, rather than maximizing the total amount of wealth that will be transferred.*

What have you done to involve your children in the estate planning process?

Family dynamics can be the single most important factor in determining the long term success of a plan to transfer wealth. Therefore, it is critical to make wealth management a "shared mission" among as many family members as possible. Often, conflict, confusion, lack of clarity, a lack of understanding, and the absence of a safe, comfortable forum to ask questions (there is no such thing as a dumb question) can lead to mistakes or, worse, fully derail the family's good work preparing the assets for wealth transfer in the first place. This is a situation that should (and can) be avoided.

Importantly, kids should seek advice, roles and responsibilities in managing wealth, and they should seek mentorship, either within the family or outside. Senior family members should assign these roles and relinquish more responsibility, as they "take the training wheels off" and let the new generation "step up" to a more active role in managing family wealth.

Punch's network of advisors and experts in several areas are some of the best in their respective fields. We bring these advisors together to craft the optimal solution(s) for your family. We take an active role in "preparing heirs," as we help to address family dynamics, work to establish and engender trust among family members, foster communication and bring about clarity – all in an effort to fortify relationships and increase the odds of an effective and efficient intergenerational transfer of wealth. Our approach is to work with you to help define and promote a family's *shared mission* and to make sure that, once assets are transferred to the next generation, the family's wealth and harmony remain intact.

We remain available to commence, or continue, these and other critical discussions as they become of interest.

Welcome to Katie Carlson and Nancy Kelly

In June we welcomed Katie Carlson to the Punch and Associates family. Katie came on board to work with Andy and Angie in the Wealth Strategies Group. Like several other members of the Punch family, Katie also graduated from the University of St. Thomas here in St. Paul. She graduated with a major in finance and a minor in mathematics and will be pursuing the CFP designation over the next several months. Katie is from Brookfield, WI and enjoys cooking gourmet meals and exploring new foods and experiences.

Katie Carlson

Nancy Kelly joined the Punch family in July. Nancy is our new administrator and the friendly face which welcomes you when you visit the office. In addition to front desk responsibilities, Nancy will be assuming responsibility for coordinating client events, client communications, and other administrative functions. Prior to joining Punch, Nancy spent fourteen years in a variety of office settings after a career as an elementary school teacher. Nancy has three adult sons; one lives here in Minneapolis, and two live in Houston, TX. Prior to settling in Minnesota, Nancy lived in Ohio, Florida, Indiana, and Beijing, China. In addition to traveling, she enjoys live theater, volunteering for charitable events, music of all types and her many friends – both old and new.

Nancy Kelly

Welcome Katie and Nancy!

Our Strategies

In communicating with you on a quarterly basis via this newsletter, we try to give you a sense for how we position our clients' portfolios in light of what has happened and what we think is likely to happen. We do this in three distinct strategies, each with different risk and return characteristics. A brief review of these strategies follows.

The Punch Income Strategy is geared toward income generation and is generally more conservative than our equity strategies. This strategy incorporates individual municipal, corporate, and government bonds, as well as other "yield vehicles" like preferred stocks, closed-end income funds, and utility and REIT shares.

The Punch Large Cap Equity Strategy uses a "hub-and-spoke" approach to gain exposure to the broad U.S. stock market. Core holdings include index funds and closed-end funds that are broadly diversified, while "spoke" positions are individual large cap stocks with above-average, long-term growth potential.

The Punch Small Cap Equity Strategy is the most aggressive of our three strategies; this is the place where we look for more substantial returns. In general, this strategy attempts to discover growth companies whose shares sell at value prices.

2015 INDEX RETURNS

	Second Quarter	Last 12 Months
S&P 500	0.28%	7.43%
Russell 2000	0.42%	6.48%
Barclays Aggregate Bond iShares	-1.68%	1.86%

This message is intended to be educational in nature, and does not represent tax or legal advice. Punch & Associates is neither an accounting firm nor a law firm, and we encourage the reader to consult a tax or legal expert for specific tax or legal advice. The information provided is derived from sources deemed to be reliable, but we are unable to guarantee its reliability. For more information about Punch & Associates' services provided, please contact us at info@punchinvest.com, 952-224-4350 or 800-241-5552.