Punch

Newsletter
Second Quarter, 2017

Our Trip to Omaha

To reinforce what is possible when you attempt to be consistently "not stupid," our investment team visited the Berkshire Hathaway Annual Meeting in early May. We have enjoyed this trip, off and on, over the last ten years, as we get to listen to now 86- and 93-year-olds wax eloquently on a variety of topics, both financial and philosophical. Buffett even gave relationship advice to a young female questioner. While visiting the exhibits, sampling the products (we'd recommend See's Peanut Brittle), and witnessing enthusiastic shareholders of all ages, one is reminded of why they call this gathering "The Woodstock of Capitalism." It was great to be with nearly half of the individuals from our company to break bread, swap stories, and even enjoy some of the under-rated night life that Omaha has to offer. We named Paul Dwyer, the newest member of the investment team, having attended Omaha-based Creighton University, our unofficial guide for the weekend. He did not disappoint. The Havana Garage (Cigar/Jazz Bar) was a highlight as well as Sunday morning brunch at Wheatfields in the Old Market District of downtown Omaha.

Berkshire Hathaway, Incorporated ("BRK") is a company whose market cap is about $420 billion, making it the fifth largest company in the U.S. One of the big differences between BRK and other massive companies is that Berkshire is a conglomerate comprised of 63 separate subsidiaries as well as a huge investment portfolio architected and lorded-over by the best investor of all time. One of the issues brought up in Omaha was the massive amount of cash (over $95 billion) they have sitting on the sidelines ready to be put to work. The company could buy 100% of all the shares outstanding in each of the 47 companies in the Punch Small Cap Strategy, and this maneuver would still only use about half their cash. Mr. Buffett and Mr. Munger no longer have the luxury of discovering small companies and parlaying them into multi-year compounding machines, but they still talk about how they used to do it.

We, as an analyst team, were reminded of how important these smaller companies were to Berkshire's early foundation when they weren't so burdened by sheer size. Both Mr. Buffett and Mr. Munger take pride in expounding on their story of investing in See's Candies. Berkshire Hathaway bought See's in 1972 for $25 million – still a microcap even by today's inflation-adjusted valuation. Mr. Buffett revealed that profits are now up to $82 million annually. This means that Berkshire earns over three times the cost of their original investment each year. In fact, they have collected around $2 billion of pre-tax earnings from See's since making the investment. While Mr. Buffett reinvested some of this cash flow back into the candy company, they used most of it to buy other successful businesses.

Successful Investors Behave Better

What does this have to do with investing now? Like in 1972, not too many people today are excited about buying steady, "old economy" businesses with annual unit growth of about 2%. There are far more exciting opportunities in industries such as e-commerce, software as a service (SaaS), biopharma, and other "white-hot" areas. In the early 70s, there was the allure of the Nifty Fifty; these were 50 companies that were deemed "one decision" stocks (companies that were to be bought and not sold, regardless of valuation). According to USA Today, the Nifty Fifty embodied that new sense of economic manifest destiny. While the price to earnings ratio (or P/E) of the S&P back then stood at 19x (similar to where it is today), the Nifty Fifty's P/E was more than twice that at 42x.

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(Our Trip to Omaha - Continued)

It was thought that the economic forces that acted on other companies did not affect this vaunted group. Investors were earning massive stock market returns from such companies as Eastman Kodak, Kresge's (yes, the precursor to K-Mart was a prestige holding), Polaroid, and Avon Products. This was the backdrop against which Mr. Buffett paid a meager eight times earnings for See's Candies (a microcap company).

If Mr. Buffett was worried about beating the index over the next couple quarters, he might have missed this "game-changer." Instead, he bought a business he identified as having a good defensive moat (Who would dare give discount chocolates to their loved ones on Valentine's Day?) in a predictable industry and an opportunity to generate "boatloads" of cash for many years into the future. The man thought better than others, and he behaved better.

Post-Berkshire Visit

The Berkshire Hathaway meeting draws a crowd of investors from around the world, and many then stay in the Midwest for a day or two after the meeting to leverage their trip. Bob Robotti, a former CPA, fellow value investor, and "no BS" New Yorker, took the opportunity to visit us in Edina on Monday after the annual meeting to compare notes and swap ideas. Bob is reputedly unafraid to look bad for a while (like Buffett in 1972) in order to create outsized returns over time. As value investors, we aspire to gain an informational edge over other investors. Bob would argue that the behavioral side of our craft is equally important. Bob remarked, "The ability to maintain conviction, without stubbornness or blindness, when the market increasingly disagrees with you is a sustainable competitive advantage."

We couldn't agree more.

Welcome Jessica!

We'd like to take the opportunity to introduce Jessica Johnson as a Managing Partner and head of our Wealth Strategies Group.

Jessica is involved in all aspects of the design and delivery of our wealth planning services for private clients. She brings a unique perspective to family conversations, having practiced trust, estate, and charitable planning law at a large, Minneapolis-based firm for nearly a decade. Jessica is an advisor skilled in both family financial education and navigating complex planning opportunities. Above all, Jessica enjoys helping clients identify thier goals while feeling organized and confident about their plan.

Jessica received both her Juris Doctorate and Bachelor of Arts in Economics with honors from the University of Minnesota. She has been a frequent speaker at educational events for financial advisors, attorneys, and accountants. She also served as an attorney advisor for the United States Tax Court. In her role at the court, she researched complex tax matters and wrote judicial opinions for estate, partnership, corporate, and individual tax cases. Prior to law school, Jessica began her career with a wealth management group in Minnesota.

Punch Income Strategy

Closed-end funds have been a staple of the Punch Income Strategy since its inception over fifteen years ago. We like the asset class because of its strong dividend yields, persistent discounts to net asset value (NAV), and lack of professional attention. We believe we are one of the few professional money managers to devote a significant amount of time and attention on this niche asset class.

To that end, 90% of closed-end funds in the U.S. have no analyst coverage, and the average fund has less than one-third of its shares held by large institutions, rather than individual investors. The opportunity to perform unique research and develop insights into this group of investments is real, and it is one we seek to exploit.

Over the past year, closed-end funds as a whole (of which there are 429 with a cumulative $230 billion in assets in the U.S.) have done relatively well, advancing 15.5% (according to the S-Network Composite CEF Index). The average discount on U.S. closed-end funds has shrunk from 6.2% at the start of the year to only 3.5% today. Many of these funds have gone from out-of-favor to in-favor over the past several years.

So far this year, we have been net sellers of closed-end funds and have exited several funds completely, as their discounts shrank or even became premiums. We have been re-investing in funds whose discounts remain relatively wide or holding slightly more cash until opportunities re-emerge, as we believe it is prudent to be more selective in the closed-end fund space for the time being.

Despite this strong recent performance, we are by no means packing up our things and moving on. Closed-end funds are not a homogenous group, and we believe that pockets of opportunity remain. A few of our favorite reasons to continue to own select funds include:

A Snapshot of the Closed-end Fund Market Today

	Average U.S. Closed-end Fund Today
Discount to NAV	3.5%
Dividend Yield	6.4%
Institutional Ownership	27%
Number of Funds	429

Source: Bloomberg LP and Punch & Associates

Dividend yields remain attractive in a low-rate environment. The average closed-end fund sports a dividend yield of 6.4%, which compares favorably to long-term treasury yields of 2.3% and investment-grade corporate bond yields of 3.2%. Higher dividend yields in closed-end funds come from the use of modest leverage by some funds as well as the opportunity to purchase shares at market prices below the fund's net asset value.

Term trust funds are most likely to have discounts that close over time. Unlike traditional funds, term trusts have set liquidation dates when they will return capital to shareholders. Some of these funds trade at premiums to NAV today, as investors are willing to "pay up" for this feature. We believe that term trusts that persist at discounts today will likely see those discounts evaporate as liquidation approaches.

Select asset classes appear attractive. Closed-end funds that invest in senior loans, Build America Bonds (BABs), and energy-related Master Limited Partnerships (MLPs) appear attractive to us today, and as long as these funds trade at meaningful discounts, we continue to favor them. Some of these asset classes should also perform well if interest rates begin to rise.

Punch Large Cap Strategy

> *"I'm not the strongest. I'm not the fastest. But I'm really good at suffering."*
>
> \- Amelia Boone

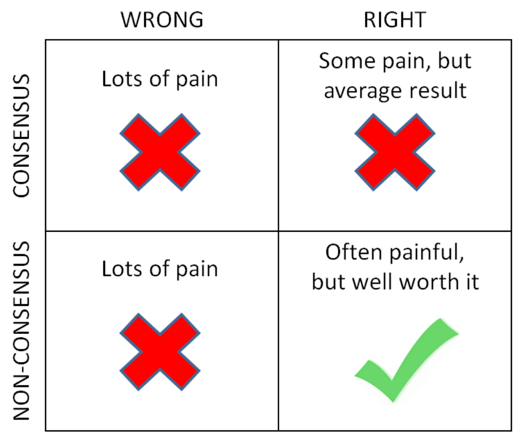
It's officially "sufferfest" season here in the Twin Cities. It's the time of year when 9-to-5 folks embrace their primal survival instincts by enduring the challenges of obstacle course races ("OCRs") like the *Tough Mudder* and the *Spartan Race*. OCRs consist of a long-distance run - usually five miles - with substantial obstacles along the way with names like *Trench Warfare, Hangin' Tough,* and, of course, lots of mud. The popularity of these kinds of events has grown exponentially in the last several years. Why would someone care to endure such an event? The reason is simple: people want to know what they are capable of physically and mentally. Finishing brings a true sense of accomplishment.

Few know the feeling of accomplishment better than Amelia Boone, dubbed "The Queen of Pain." Amelia is a four-time world champion obstacle course racer (three World's Toughest Mudders and one Spartan Race World Championship). To give some perspective, the World's Toughest Mudder is a non-stop 24-hour race that declares a winner based on the person who makes it through the five mile course the most times. Amelia is the sport's first celebrity, and she is exceedingly good at suffering.

Virtually all the great value investors agree that a high threshold for pain is needed in order to have success in investing. A great deal of the hardship associated with long-term investing comes from being contrarian, and at Punch, we ***strive*** to be contrarian. We look for investments in areas where others do not, and then we wait.

The balance between risk and reward all but guarantees some kind of pain while we wait for an investment thesis to pan out in our favor or, in some cases, not. Our long-term orientation in the large cap strategy means, unquestionably, there will be periods of suffering.

Andy Rachleff, co-founder of the robo-advisory firm Wealthfront, addresses the importance of being contrarian in the nearby matrix (we added the pain piece). He said investing can be explained with a 2x2 matrix. On one axis, you are either right or wrong. On the other axis, you are either operating within a consensus view, or you're out of consensus. Obviously, if you're wrong, you don't make money. The only way as an investor and entrepreneur to make outsized returns is by being both right and out of consensus.



Howard Marks, a well-known active value investor, has shared a similar idea in his shareholder letters. Instead of targeting the "non-consensus, right" quadrant, Marks focuses on a sort of "unconventional behavior, right" quadrant to earn above-average results. No matter how you look at it, we're going against the grain, which means there will be challenges. And although we are not obstacle course racers, we believe that we have developed a high pain tolerance for investing over our collective careers. Through these newsletters and educational conversations, our clients have perhaps developed some "investment callous" as well. We have said it before: successful investing is difficult, and as soon as it starts to look easy, it's about to get more difficult.

Punch Small Cap Strategy

> ***"The essence of investment management is the management of risks, not the management of returns."***
>
> - Benjamin Graham, the 'Father of Value Investing'

If you were to line up a portfolio in the Punch Small Cap Strategy next to a portfolio of stocks in the small cap Russell 2000 Index, the two would look strikingly different. In Wall Street parlance, the Punch portfolio would have a high "active share" (98%), which is to say that we have only 2% of our holdings in common with the benchmark index.

	Punch Small Cap	Russell 2000 Index
Median Price-to-earnings	21.1x	21.5x
Median Price-to-free cashflow	16.4x	17.5x
Median Market Cap	$696m	$800m
Median Analyst Coverage	4	7
Return on Equity	10.1%	6.8%

The Punch portfolio has fewer stocks (47, versus 2,009 in the benchmark), and those stocks, on average, are smaller, cheaper, and of a higher quality. As shown in the nearby table, our companies tend to have higher returns on equity (a measure of profitability), but they also trade at lower multiples of earnings and cashflow than the index. Also, since we favor under-the-radar companies, they also tend to have fewer analysts covering them.

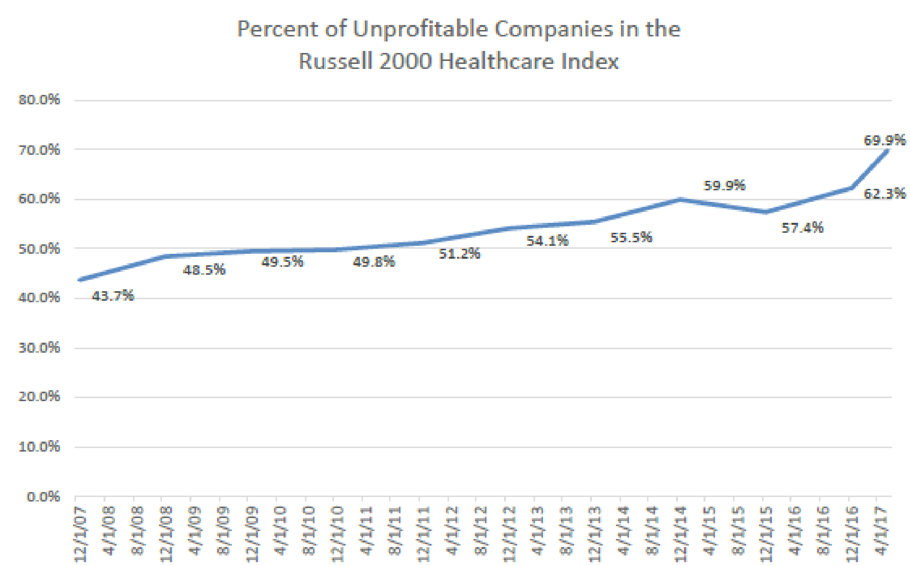
Notably, we avoid small cap companies whose operations are unprofitable and whose businesses may be early-stage, unproven, or speculative. We believe that this is the essence of "the management of risks" that Benjamin Graham alludes to in the quote above. Almost all of the 47 companies in the Punch Small Cap Strategy are operationally profitable and generally have a proven track record of generating cashflow for shareholders.

In the first six months of 2017, healthcare and technology stocks were the star performers of the Russell 2000, rising 22.5% and 11.0%, respectively. These returns are well ahead of the benchmark return of 4.3%. As of June 30, we were 11% underweight healthcare (4.1% vs 15.1%) and 3.5% underweight technology (13.6% vs 17.1%).

Our underweight to these two areas has been deliberate over the past several years, mostly because we see them as riskier parts of the market. Today, 70% of healthcare stocks in the index are unprofitable – the highest proportion in the past decade.

It is a core belief of ours that businesses that do not generate profits are likely to have lower long-term returns to shareholders, so we avoid them. Many are also expensive, as the median P/E ratio for the Russell 2000 Healthcare Index is over 35x, well above the 22x valuation of the benchmark as a whole.

Despite living in a market that does not reward such things today, we remain squarely focused on those small cap companies that are higher quality and cheap because they are relatively unknown with the expectation that, over the long-term, such a focus will prevail.



Getting to a Thoughtful and Complete Estate Plan

One of the best gifts you can give to your family is a thoughtful, organized, up-to-date estate plan. (And yes, this means you actually need to review and sign those documents your lawyer mailed you months ago!) Estate planning is a critical component of your family's financial life, and at Punch, we can help you work effectively with your lawyer to ensure your estate plan is not only in place but that you understand it and it accurately reflects your wishes. The last thing your surviving spouse or children need after your death is confusion about your intent, an unexpected tax result, or a prolonged and unnecessarily complicated estate administration. But estate planning may not be at the top of your list. So how do you get to a place of happiness and harmony with your estate plan?

Consider the big questions in advance

Good lawyers will provide expert guidance about what documents to have in place and the type of tax planning to incorporate into your estate plan. Even the best lawyers can't make every decision for you, however. Some decisions relate to matters that are unique to your family and your financial situation. Before meeting with your attorney, consider the following:

1. *Who is the right person to handle financial matters if you are unable to do so?*
2. *Whom would you trust to make health care decisions for you if you lose capacity?*
3. *If you have small children, who should make financial, health care, and other lifestyle decisions for them if you and your spouse are unable to do so? Do you want the same person to be in charge of financial matters as well as all other lifestyle and care decisions or would you like two different people to provide a check and balance for decision-making?*
4. *Would it be a concern if your spouse remarried and redirected assets to a new spouse or children from a second marriage?*
5. *How important is it that you treat your children fairly? What does "fair" mean for you and your family?*
6. *Are you concerned about your children's ability to manage money or navigate relationships?*
7. *How much financial protection do you want to provide for your surviving spouse and children?*
8. *What role should charity play in your estate plan?*

Keep moving toward the goal

Do you remember that moment when your high school teacher told you that no one was going to keep tabs on your homework but you? Procrastination is a significant problem for clients and busy attorneys alike when it comes to estate planning, but you don't have to tackle this alone. We recognize the challenge of staying engaged in the process and want to help motivate and encourage you in each next step until the plan is finalized. An unsigned estate plan is worthless, but a tailored and well-executed plan is extremely valuable for your loved ones. We also recognize that circumstances change, and we value regular, intentional reviews of your plan. We would welcome the opportunity to engage in your estate planning with you and help you to keep the process on track and on time.

Communication is key

Once your plan is in place, consider how and when you would like to communicate your plan with the people you've chosen as decision makers and beneficiaries. These are likely the most important people in your life. Having an intentional communication strategy will eliminate uncertainty and may open a dialogue about the things you and the people closest to you care about the most.

We encourage communication in a "family meeting" format, and we can help you to create the agenda in advance. You may prefer to lead the discussion yourself, or you could choose to have your Punch team guide the meeting. You may decide to take an "open book" approach, sharing your financial information and the terms of your wills, trusts, powers of attorney, and health care directives. If that isn't the right path for your family, you could start by having a meeting to let your family know that you have everything in order, introduce them to your team of advisors, and educate them on assigned roles should something happen to you. We can work with you to customize the timing, location, and format of this meeting based on the personalities and dynamics unique to your family and situation. We are confident you will feel good knowing you have planned carefully, finalized documents, and avoided surprises when it matters the most.

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 Equity Cap 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.

	Second Quarter	Last Twelve Months
S&P 500 Index	3.09%	17.91%
Russell 2000 Index	2.47%	24.61%
Barclay's Aggregate Bond Index	1.44%	-0.32%

Events

Thank you to everyone who joined us at the Saints Game for the 2017 Punch Summer Event! If you didn't get to make it this year, we hope you're able to join us next summer. We enjoy every opportunity to connect with you and particularly those outside on a beautiful Minnesota summer evening!

In October, we will be hosting a Fall Investor Update in Minnesota. The date and location have yet to be determined, but please keep an eye out for the email invitation.

The material shown is for informational purposes only. Past performance is not indicative of future performance, and all investments are subject to the risk of loss. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, and actual results may differ materially from those anticipated in forward-looking statements. As a practical matter, no entity is able to accurately and consistently predict future market activities. While efforts are made to ensure information contained herein is accurate, Punch & Associates cannot guarantee the accuracy of all such information presented. Material contained in this publication should not be construed as accounting, legal, or tax advice.