Punch

Newsletter
First Quarter 2019

More Opportunities than Money

Howard Marks, the highly regarded Co-Chairman of Oaktree Capital, has long been known as a risk-conscious investor. He assesses markets and attempts to figure out our location in a given market cycle in order to determine how he should position his clients' portfolios. The oft-quoted, cerebral billionaire has uttered comments that make him seem almost too stodgy to manage money in this age of unicorns, although on several occasions, he has also stated that certain declining markets are "too bad to be true."

After an inexplicable downturn in equities during the fourth quarter of last year, we penned an article entitled "Uncautiously Optimistic." In it, we wrote that we felt stock prices at that time reflected the belief that we were entering more than a simple, garden-variety recession. It is human nature to harken back to the most recent recession (which was more than ten years ago), however this extrapolation did not square with what we were hearing from the leadership of our portfolio companies. We wrote, "We are not macroeconomists at Punch, but we talk to CFOs and CEOs of small- and medium-sized companies every day. There seems to be a disconnect between what we read on the front page of the Wall Street Journal and what we are hearing from the leaders of the companies we own." In short, we believed that the sinking equity prices of our companies were reflecting something that was "too bad to be true." While we didn't necessarily predict it, we were heartened by the quick recovery in stocks we witnessed in the first quarter.

Wither Groupthink

Groupthink is the opposite of independence. In investing, as in life, people tend to get into trouble when they try to be somebody that they are not. While we are not perfect, we do our best to think independently and introduce unique, contrarian investment ideas for our strategies.

Mike Wilson, Chief U.S. Equity Strategist at Morgan Stanley recently commented, "I can't remember a time in my career when institutional investors have been so preoccupied with what everyone else is doing….When investors are more focused on what everyone else is doing, rather than what the fundamentals are doing, it's probably the end of a trend."

For our part, we are not negative on any particular sector of the market. We believe that solid risk/reward opportunities can arrive at our doorstep in any shape or size. We need to be flexible and prepared to assess each unique opportunity.

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>
> *- Mike Wilson, Morgan Stanley*

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Mr. Marks is also fond of saying, "Investment success doesn't come from 'buying good things,' rather from 'buying things well.'" Buying things well means you are buying specific companies when others are not and at values that account for uncertainty.

The future for any enterprise or economic system is never perfectly choreographed or scripted. Some companies today trade as though their bright futures are a "given." These are familiar names. Other companies that are perhaps too dull, too small, or too cyclical struggle to command the attention of many investors. They don't get "points" for a permanently rosy outlook. Groupthink has no interest in these companies, and therefore it can't beat them up when the environment around them doesn't play out according to script.

A Long-Term Orientation and a Cyclical Leaning

We've long felt that our clients' time horizons need to match that of the investments we are making.

In December, Federal Reserve Chairman Jerome Powell indicated that the Fed would be on auto-pilot in shrinking its balance sheet. In early January, he seemed to reverse this sentiment when he said, "We're listening carefully with sensitivity to the message that the markets are sending and we'll be taking those downside risks into account as we make policy going forward."

Chairman Powell's comments seemed to be all the market needed to spark a 13% rally in the S&P 500 Index in the first quarter. While this was positive for stocks in general, the recovery has not been as "even" between cyclical and non-cyclical stocks. Despite the Fed being on guard, the biggest question most investors are still asking is, "When is the next recession going to begin?" Our answer? We have no idea. Our interest is in whether or not investors are over-discounting this fear. We believe the chart below illustrates that the best long-term values may be found in industries with some cyclicality right now.

Many investors are behaving as though the "end is nigh" for this economic expansion, and they don't want to get stuck when the next recession hits. The Electric Utilities ETF (XLU) has more than doubled the return of the S&P 500 Index in the last 12 months, because investors like certainty. We think differently.

We believe a carefully curated portfolio of well-managed, cyclical companies with strong balance sheets and adept management teams offers solid value based on what we are paying today. Because the average investor is fearful of the next recession (or infatuated with profitless unicorns), we have more than our share of opportunities.

Indeed, we have more opportunity than we have money.

Cyclical vs. Defensive Stock Valuations

Relative Forward P/E Ratio of Cyclical vs. Defensive Stocks, Z-Score

Source: Punch & Associates and Bloomberg

Punch Income Strategy

A Bear Market in Bonds

Rising interest rates create a headwind for income investors

The first quarter of 2019 turned out to be a strong start to the year, with many income-oriented asset classes more than making up for their fourth quarter losses. Closed-end funds as a group did well, rising 12% after a disappointing 9% decline last year, and the average discounts on many funds have closed meaningfully, with some even trading at premiums to their net asset value (NAV). The historical seasonality of returns for these funds has so far held true—performance during the first half of the year was better than the second half of the year.

What was interesting about the first quarter for bonds was that positive returns were relatively uniform across asset classes. Treasury bonds rose (and interest rates fell) while high yield corporate bonds also gained. Usually, if treasury yields are falling, it is because there are concerns about the potential for economic weakness, which is negative for corporate bonds. The economy seems to be doing well, however, and inflation remains well-contained.

The decline in yields in the quarter gave investors a reprieve from the bear market in bonds that has been ongoing since mid-2016. Over the past two-and-a-half years, interest rates have been steadily rising and many income oriented-asset classes have declined in price. On a price-only basis (not including interest income), long-term treasury bonds were down 13% and investment-grade corporate bonds declined 8% from June 30, 2016 through December 31, 2018. The only return that investors got from these securities over that period was from the interest income they received.

We continue to believe that it is more likely that we will see higher interest rates over the next several years rather than lower rates, and we continue to take a more defensive approach to investing for income. One way to overcome the headwind of higher interest rates is to favor investments with higher-than-average yields to make up for muted price returns. Of course, reaching for yield must be done with caution so we do not end up with higher-than-average credit risk if the economy sputters.

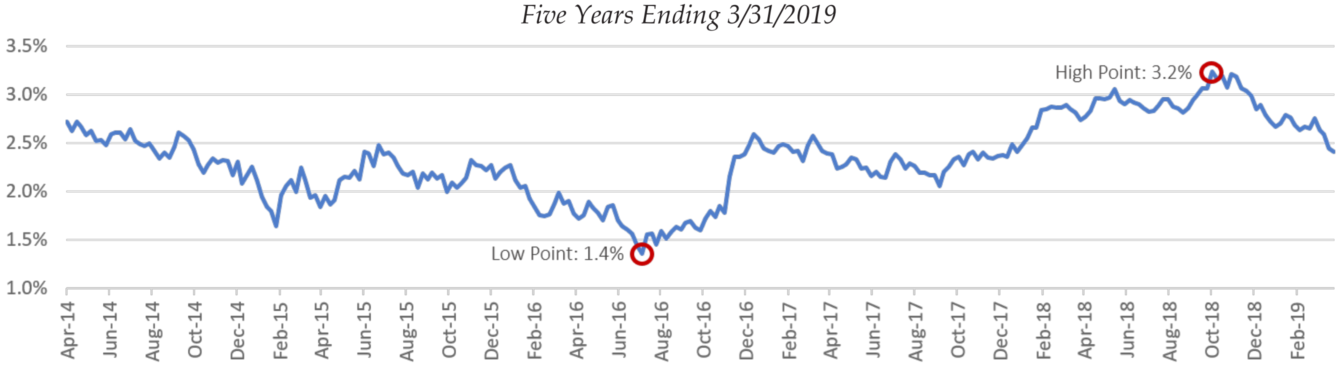
We also continue to be on the lookout for dividend-paying investments that could benefit from higher interest rates. In the first quarter, we added a real estate investment trust (REIT) that invests in timber to the portfolio. Timber as an asset class tends to do well when inflation picks up because trees naturally grow in value over time. The value of timber is also driven in large part by housing construction, which has been depressed for the past several years, but that we think will continue to grow for the foreseeable future. The timber REIT we own today is the largest in the country, boasts high-quality acreage, and has a valuable wood products division. Its dividend yield today is over 5%, higher than its long-term average.

We reduced our positions in several closed-end funds in the quarter; as a result, we are holding higher than normal levels of cash and short-term securities. If markets should weaken or interest rates continue their move higher, we will look to redeploy some of that dry powder into higher-yielding opportunities.

The Punch Income Strategy is a total return strategy that emphasizes current income over capital appreciation. The strategy invests in a variety of securities and asset classes that generally share the common characteristic of producing cash flow income that has the potential to rise over time.

U.S. Ten-Year Treasury Yield

Five Years Ending 3/31/2019



Source: Punch & Associates and Bloomberg

Punch Large Cap Strategy

Stocks, Unplugged

Underappreciated investment opportunities in the media sector

"You may not realize it when it happens, but a kick in the teeth may be the best thing in the world for you."

Walt Disney

After a strong first quarter rally from the S&P 500, the index made up most of the ground it had lost in the final quarter of the prior year. Down 13.8% in the fourth quarter of 2018, the S&P 500 Index hit bottom on Christmas Eve. The first quarter of 2019 was a different story (nearly the exact opposite), as the index delivered a positive return of 13.5%. While the rally was led by the technology sector, all sectors delivered positive returns in the broad advance. The volatility we witnessed between Q4 2018 and Q1 2019 is not unprecedented, but it was still significant, especially given the fact that we hadn't seen much volatility in recent quarters leading up to that point. Generally, when we encounter volatility of that magnitude, we've seen opportunities present themselves, even among some of the largest and most widely-owned stocks.

One part of our research process at Punch is to look for industry trends that are causing permanent change in a certain area. We then look for individual companies that are positioned to capitalize on that change over a long period of time. One theme we've been monitoring is the impact of "cord cutting" within the media industry.

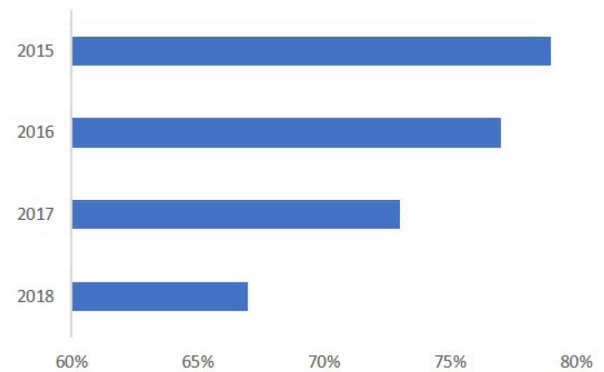
Have you considered cutting the cord from traditional television? Over the last decade, Americans have been canceling their paid cable television subscriptions at an accelerating pace. Cord cutting can be a bit like getting kicked in the teeth, though. While it initially may seem quite unpleasant, it might open your eyes to something new or something you haven't noticed in a while. While lower recurring costs is typically the main reason to cut the cord, the additional benefits appear to be robust.

At Punch, we don't own Netflix any longer because the stock is too expensive, trading at 95 times EV/EBITDA ("enterprise value" to "earnings before interest, taxes, depreciation, and amortization"). We're usually looking for reasonableness of valuation for a new investment in the "high single digits," or "low double digits," within this valuation metric. We point out Netflix, however, because it was recently referred to as a "cultural necessity" by one analyst. If he's right, we're in the early innings of cord cutting.

In the first quarter of 2019, we took a new position in a large cap company we consider to be a capital compounder. The narrative on the stock for the last several years has been the deterioration in the company's most profitable segment (its media networks) which caused the stock to flat-line. Resting on its sports channel laurels caught up to it in 2015, when the cord cutting pace began to accelerate. To cure the ills of canceled cable subscriptions, the company has developed its own internet streaming service filled with original content.

While everyone was distracted by the media content declines, the company also reinvested in its theme parks and studio film content, the core of the business dating back to its origins. Now, the company has a strengthened core business in addition to new offerings coming online later this year. The company also acquired one of its larger competitors which will expand its content offering and worldwide distribution. If all goes according to plan, this iconic entertainment company should be able to give Netflix and Amazon's Prime Video a run for their money in this growing on-demand environment.

U.S. Consumers Paying for TV Subscriptions



Source: www.techjury.net

The Punch Large Cap Strategy invests in large publicly traded companies. The strategy takes a long-term, concentrated approach to owning companies with durable competitive advantages, cash flow generation, and growth potential.

Punch Small Cap Strategy

If God Picked Stocks

Even the "perfect" portfolio requires patience and a long-term focus

On March 9, 2019, we officially crossed the 10-year anniversary of the stock market bottom. Since 2009, the S&P 500 Index is up almost four-fold. Of course, some stocks are up significantly more than that, as the distressed market environment at the time was pricing many companies as though they were going out of business. When it became apparent that the financial world was not in fact ending, their valuations soared.

Given the once-in-a-lifetime returns that some of these stocks produced, a fun question to ask might be, "What would returns have looked like from a portfolio of only the best-performing stocks over the past 10 years?" If you had perfect omniscience on that fateful day in March of 2009, which stocks would you buy?

A research firm called Alpha Architect recently conducted a study on the returns of the best-performing stocks not only over the past decade but also going back to the 1920s. As you might expect, the performance of a hypothetical "God" portfolio was amazingly good. Over the past 10 years, a portfolio of the 100 best stocks in the Russell 1000 Index would have returned nearly 20 times that of the benchmark. Since 1929, a "God" portfolio would have produced nearly three times the annual return of the S&P 500 Index.

What the researchers found, however, is that while the long-term performance of this perfect portfolio was obviously stellar, the short-term performance often was not. In fact, each portfolio suffered significant drawdowns (losses) and underperformed the index for meaningful periods of time. In 2011, the "God" portfolio lagged the S&P 500 Index by as much as 10%. Since 1927, the worst peak-to-trough loss in the portfolio was -76%, and it lagged the index by 50% on multiple occasions. The study's authors concluded that, if God were a money manager, he would likely get fired multiple times over by his clients for short-term underperformance!

In the stock market, investments go in and out of favor with some regularity. What grabs the attention of the investing public today is unlikely to remain in the spotlight for long. For much of the past decade, growth stocks have enamored investors. Since March of 2009, small cap growth stocks are up nearly 450%, while value stocks are up only 370%.

As the following chart shows, growth and value stocks often go through extended periods of time where one does significantly better than the other. In the two-year runup to the dotcom bubble in 2000, growth stocks dramatically outperformed (+93% vs. +11%), but in the subsequent two years, value stocks were up (+45%) while growth stocks declined (-47%). Since the inception of the Russell 2000 Index in 1978, value stocks have more than doubled the return of growth stocks.

Small Cap Stocks: Value vs. Growth

Russell 2000 Growth Index / Russell 2000 Value Index
From 1978 to 2019

Source: Punch & Associates and Bloomberg

In the Punch Small Cap Strategy, we take a value-oriented approach to buying companies that we think can grow over time when we believe they are out-of-favor, misunderstood, or simply unrecognized.

Long-term success in investing often requires the patience and fortitude to endure periods of lackluster performance as stocks or investing styles or asset classes go in and out of favor in the market. No strategy can outperform in all environments—even a portfolio constructed with perfect foresight. By focusing on the true long-term and anchoring ourselves to a disciplined, sensible, and patient investment approach, we believe we can avoid the siren song of short-termism and attempt to achieve long-term investment success.

The Punch Small Cap Strategy is a growth oriented equity strategy that invests in smaller publicly-traded companies, primarily located in the U.S. The strategy looks for higher-quality companies that are trading at discounted prices because they are under-the-radar, out-of-favor, or simply misunderstood.

Wealth Strategies Group

Giving and Growing

Charitable giving as part of the financial planning process

Last fall, we journeyed to Seattle to learn about generosity. The conference we attended had the primary goal of inspiring giving in significant and creative ways. Many of the speakers talked about giving through charitable donations, but some talked about giving in other ways. A woman talked about her experience donating her liver to a new employee at her husband's company, someone she barely knew. It was common throughout our time at the event to hear a sentiment like, "Not giving costs way more than being generous." This experience caused us to reflect on the ways in which giving can impact our own outlook on life and create positive character change through the act of releasing resources. We came away from the conference valuing this insight and seeking ways to implement charitable giving as part of our regular financial planning conversations with our clients.

Have you considered the multifaceted impact of giving?

At the Seattle conference, we discovered that the effects of giving go way beyond our expectations. We were surprised to enter into a conversation about the very purpose of wealth. One speaker talked about generosity as a rebellious act, moving us away from the normative story we buy into as we accumulate more possessions and larger account balances. We considered the benefits of moving from a mindset of scarcity—the fear of running out of money—to one of abundance. Living in the knowledge that many of us have plenty to sustain us and our families can change our feelings toward money. For most of you reading this article, good stewardship of resources has put you in a position to share and to be a part of positive change in the lives of others. That's incredibly exciting! When we engage in conversations with clients about giving, we regularly uncover opportunities for increased family communication, cooperation, and the alignment of a financial plan with a family's values. We exist to remove barriers, problem solve, and answer questions at every step along the way for many areas of financial planning—including and especially charitable giving.

Are you familiar with the various creative ways to structure a charitable gift?

In addition to personal benefits and community impact, did you know there are several ways to design a charitable gift to minimize taxes while addressing the financial goals of you or your family members? Consider the following as a broad look at available charitable giving options and how Punch can help you discern the purpose of your wealth, maximize your giving potential, advance the mission of charitable organizations, and achieve tax and estate planning objectives.

APPRECIATED STOCK

Stock that has appreciated may be directly transferred from your brokerage account to charity. Representatives from the charitable organization can assist with the stock transfer. You receive a double tax benefit for donating appreciated securities:

1. You receive a charitable income tax deduction for the fair market value of the security at the time of the gift (if you have owned it at least one year), and
2. You also avoid capital gains tax associated with the security if you would have sold it instead.

Be aware that if you sell appreciated securities first and then gift the cash to charity, you will owe capital gains tax on the appreciation. We can help you evaluate this giving option and coordinate your gift of stock to charity.

DONOR ADVISED FUND (DAF)

Beginning in 2018, Congress changed the tax rules so that many Americans must make larger charitable gifts than previous years in order to receive an income tax reduction. Many donors are now choosing to “bunch” their charitable donations by giving two years’ worth of gifts every other year into a donor advised fund account housed at a charitable foundation. They may then choose to request distributions from that account to their chosen charitable organizations in the years when they don’t make any gift into the donor advised fund. Using a donor advised fund is a great way to manage charitable gifts and facilitate regular giving while bunching donations for tax purposes. We work with several foundations that offer donor advised funds and can assist you in establishing your own fund.

IRA GIFT

Tax-deferred retirement accounts are subject both to ordinary income tax and estate tax—to the extent there remains a balance in the account upon death. If you name a charity as the beneficiary of a portion or the entirety of your retirement account, you may be able to avoid both income and estate tax.. (If you are age 70 ½ or older, you can gift up to $100,000 from your IRA each year directly to a charity and exclude the gift amount from your required minimum distribution income.) In addition to your estate receiving a charitable tax deduction for the amount designated, the charity also avoids any income tax on assets received from a tax-deferred retirement account because of its exempt status with the IRS. You can name charity as a beneficiary of your retirement account by requesting a beneficiary designation form from your account custodian or by contacting us to help you navigate the process.

TESTAMENTARY GIFT

You can leave a gift to charity at death under your estate plan. The amount passing to charity is deductible for estate tax purposes. An attorney can add the language to your will or revocable trust to designate charity to receive a certain percentage of your estate, certain assets, or a specified dollar amount. Your Punch team is available to discuss your charitable intent with you and your attorney and to coordinate any needed updates to your estate plan with your legal advisors.

CHARITABLE REMAINDER TRUST (CRT)

If you would like to make a charitable gift now while retaining an income stream, you may want to consider a charitable remainder trust. This means that you, your spouse, and/or other individuals can receive payments from the trust for a term of years or for your/their lifetimes. At the end of the trust term, the trustee pays the remaining assets to your designated charity. An attorney and a tax accountant would be involved in the design, preparation, and implementation of a CRT as part of your plan, and your Punch team can coordinate and participate in these conversations. We can also assist as the trustee manages the CRT over time.

CHARITABLE LEAD TRUST (CLT)

If you would like to support a charity via a stream of payments, while also gifting assets to your children, nieces, or nephews with little to no gift tax consequences, you may want to consider a charitable lead trust. You would name a charity as the beneficiary of a stream of payments from the trust, which lasts for a term of years. At the end of the trust term, the trustee pays the remaining assets to your designated family members. A CLT is an excellent estate planning option if you have a taxable estate and significant charitable intent, and CLTs work best in low interest rate environments. Similar to a CRT, we would work with you, your attorney, and you accountant as they design and implement the needed legal and tax documentation for the CLT. We can also stay in close contact with the trustee over the term of the trust.

We are humbled and honored to partner with you as you give and grow.

We are here to engage with you and your family no matter your stage in exploring charitable giving. We want to be a resource for education about your giving options and for communication with your advisors and family members who might be involved with the gift. We are joyful to partner with our clients in this area and want to do more of it!

We are heading to Atlanta for another conference on generosity soon. For any of you who might want to know more about what we are learning, including the ideas and tools we bring back, please ask. We invite you join us in this conversation.

This material is for informational purposes only and is not and should not be construed as accounting, legal, or tax advice. Punch & Associates does not provide legal, accounting, or tax advice, and accordingly encourages clients and potential clients to consult professional advisers with respect to these matters.

You are Invited

The annual Punch Summer
Client Appreciation Event will be held at

CHS Field on Tuesday, July 23rd.

Please mark your calendars to come watch the

All Star Game!

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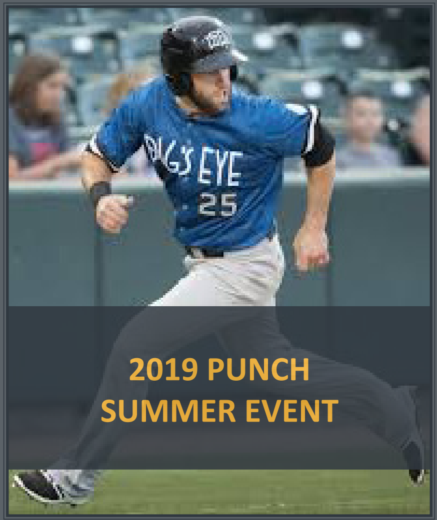

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