Punch

Newsletter
Second Quarter 2019

All You Can Eat Buffet? We Prefer to Order à la Carte.

The merits of evaluating individual businesses one at a time

Most folks ask us what the market is going to do. It's a good question, but it's a tough one to get right. Industry experts might ask, "What current and future economic factors are important to investors?" They would then examine those factors, attempt to weigh them, and forecast how they might change over time. Using this approach, someone could easily predict the direction of the stock market, right? No. Impossible.

What if we turned our attention to a given individual company? In particular, let's examine its total market value relative to its prospects and ask the following questions: Does it look cheap or expensive? What is the current valuation of the company telling us about the future? How fast does its revenue have to grow—and how high must its margins be—to maintain its current stock price? What would all of these metrics need to look like for the stock price to go up 50-100%? Impossible to forecast? No. Hard, but not impossible.

It requires thorough research, but our time is best spent doing this work as opposed to trying to predict the direction of the market. If we start our search asking the right questions, we have a better chance of achieving investment success. And while we freely acknowledge that we can't predict the movements of the stock market, we can observe the types of companies investors are favoring and attempt to manage risk in our clients' portfolios. We believe this degree of risk aversion is outside of consensus today.

We have observed that people are buying profitless, expensive companies just because they're growing their revenue. There is a high appetite for risk, and investors are perhaps taking more risk than they realize. We see this playing out in the market today, as stock prices of unprofitable companies have outperformed those of profitable companies by eight percent so far this year. We have seen several of these profitless, emerging growth companies come public this year (including companies like Uber, Lyft, Pinterest, and Slack). The market is currently rewarding exciting technology companies regardless of whether they're profitable or not simply because they're in a popular industry. The sustainability of a trend like this seems questionable to us. If this trend was a permanent condition, the formula for creating the most wealth would be to own the biggest loss-making companies. This would obviously be an absurd strategy, but it is fueling current investor preferences.

I Hear Sizzle but Where's the Beef?

A company that recently came public is a purveyor of meatless hamburgers. While this company is not the only provider of meatless meat, it is the first to go public, and it certainly whetted the appetite of early investors.

The concept of a meatless hamburger is something a large number of people can digest. The vegetarian population in the U.S. numbers 7.3 million (and growing), and there are over 50,000 hamburger restaurants in our country that vegetarians

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previously had little reason to frequent. As healthcare experts promote diets containing less red meat, meat-eaters may adopt the veggie burger into their diets. People are treating this as the biggest recent development in food innovation.

It didn't take long for folks to do the math. In the first six weeks of trading, shares of the meatless enterprise increased seven-fold from their initial public offering (IPO) price, making this company one of the most prolific IPOs in stock market history. The entire company is now valued at over $10 billion, which is over 85x its revenue for the last year. By comparison, the average company in the S&P 500 Index trades at roughly 2.2x its revenue for the last year. So, it is safe to say the stock price includes some lofty growth expectations.

Facebook came public in 2012 at a valuation that was close to 22x its previous year's revenue (which seemed rich at the time). Since the IPO, they have grown their revenue at a tremendous rate, and now, shares change hands at nearly 7x next year's expected revenue. Despite Facebook's operational success and their dominant position in the marketplace, their shares still haven't achieved in seven years the growth achieved by our meatless company in seven weeks.

Why are Investors Biting?

We have seen a number of factors contribute to popular investor behavior. Recent returns for a certain segment of the market have produced outsized gains and have enticed people to throw caution to the wind. A tangible "fear of missing out" encourages risk taking that we feel is unjustifiable. Greed and runaway imagination can get the best of investors at times, inducing a departure from rational decision-making. Excitement is contagious, and once enough people align to this thinking, they lose perspective and start to conform. There is a perceived safety in numbers, and we would note that a strong consensus typically indicates that the popular view is probably wrong.

On a professional level, career investment managers are held hostage to a high expectation of short-term investment performance. If they underperform their comparable benchmark for too long, they run the risk of getting fired. There is little incentive for professionals in this industry to adhere to a contrarian philosophy, making it nearly impossible for professionals who manage large sums to think independently. It becomes difficult to stay disciplined to an unpopular approach when a small number of investment options are producing the desired returns.

We Have the Meats!

How do we respond when we observe extreme behavior in the stock market? We stick to the substance of what we know. We employ patience and common sense.

Market conditions, it is said, are like the weather. If you don't like them, just wait. They will change. Our current market appears to be anything but monolithic. Therefore, "What is the market going to do?", we believe, is the wrong question. The market appears quite bifurcated to us, with investors generally favoring profitless, growth companies over cheaper, cash-generating cyclicals because of low interest rates and the ongoing fear of a recession. Said differently, we believe there are companies you can own in this market that have a whole lot less risk of permanent loss than others. We are leaning into the wind at this time and favoring what we believe are lower-risk bets.

"Do you swear to calm the jittery financial markets, all the jittery financial markets and nothing but the jittery financial markets, so help you God?"

Punch Income Strategy

Return of Capital

Patiently waiting for investment opportunities in frothy markets

Since their bottom in November of 2018, fixed income markets have been on a nearly straight upward march. The aggregate U.S. bond market is up six percent so far in 2019, and high-yield markets are up nearly 10%. After peaking at 3.2% in the fourth quarter, ten-year treasury yields have fallen to under two percent, providing ample support for this broad rally in income-oriented assets.

As markets have not only stabilized but risen following 2018's year-end meltdown, we are finding ourselves in the unusual position of having companies return capital to us as investors. With capital markets wide open for refinancing and M&A activity, several of our holdings have fully or partially liquidated recently:

- A preferred stock with an eight percent coupon that was issued by a San Francisco-based financial services firm was partially called in May;
- A closed-end term trust with a November 2019 liquidation date announced a proposed early tender offer for 100% of its shares at net asset value (NAV);
- A European office real estate investment trust (REIT) is being acquired at a premium by a multinational insurance company.

When our investments return capital to us through liquidations, tender offers, or acquisitions, we have the unexpected opportunity of re-investing that capital. In all three of the above cases, we would have been content with our investments continuing in these vehicles. While these events mark the conclusion of a previous investment decision, sometimes they can happen at inopportune times. Now appears to be one of those inopportune times.

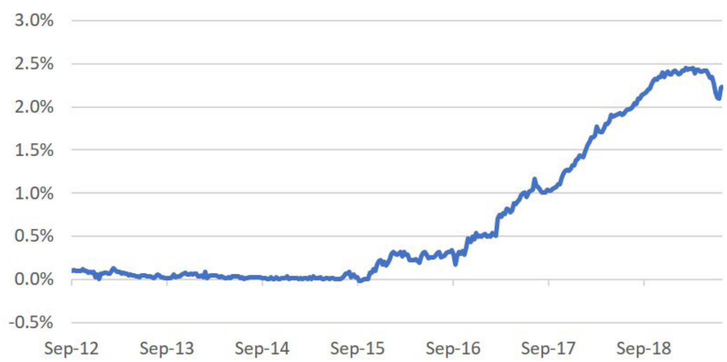
With many income markets appearing somewhat expensive and a little frothy, we are not in a hurry to redeploy capital at elevated prices. According to Bloomberg, a whopping $13 trillion of debt worldwide still has negative yields. As a result, we are holding more cash today, in both cash and short-term treasury securities.

We made four new investments in the second quarter. All four were smaller, "starter" positions which gives us the flexibility to add to them opportunistically over time. We added two preferred stocks and two REITs.

For the preferred stocks, we are very familiar with their issuers, as we own one in the Punch Income Strategy and another in the Punch Large Cap Strategy. Their coupons are eight percent and 6.4% respectively. For the REITs, one owns single-family residential properties and is in the process of potentially selling itself after being pressured from an activist investor. We believe a fair value for the company could be a meaningful premium to its market price. The second REIT invests principally in smaller commercial properties like dentists' offices, vet clinics, and child care centers. The stock trades at a discount to its book value and has a 10% dividend yield, which we believe undervalues the company.

U.S. 3-Month Treasury Bill Yield

September 2012 to July 2019



Source: Punch & Associates and Bloomberg

We like the optionality of cash and short-term investments because: (1) short-term interest rates are better than they have been in awhile and may rise if inflation reappears, and (2) they allow us the flexibility to invest capital quickly when markets get bumpy. Importantly, we are not attempting to time the market. We are simply patiently waiting for attractive opportunities to arise and staying disciplined in the meantime.

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.

Punch Large Cap Strategy

Focus on Fundamentals, not Fluff

"In politics, an absurdity is not a handicap." -- Napoleon Bonaparte

Believe it or not, the 2020 election is underway. We've already seen the first wave of primary debates for the Democratic Party candidates. If you thought the election news cycle in 2016 was over-the-top, just wait, 2020 is going to be worse. We're likely to see absurdity in spades, and this will undoubtedly influence the investment landscape in the short-term.

With the Tweeter-in-Chief in the Oval Office, we have a president that is not shy about commenting on the stock market. Like him or not, he influences the market, at least in the moment. President Trump is not alone in his ability to impact the market either: A growing number of politicians are active on social media, and they offer their opinions as freely as candy in a parade. For better or worse, the American public is hooked up to the intravenous drip of impulsivity, and while it has an impact on the market, the effect is fleeting.

We believe studying the fundamentals of companies – not the latest news of the day – is the best way to evaluate their risk and return potential.

Wall Street is certainly not insulated from this noise. Most trading decisions today are the result of either passive or quantitative investment approaches leading to a lack of specific analysis on individual companies. Computer algorithms dictating equity transactions are sensitive to headlines and tweets, creating a significant void of thoughtful research. Machines cannot account for qualitative factors and behavioral missteps in the same way humans can. We would not buy a house without first walking through it; the same applies to researching companies. Punch seeks to capitalize on the overlooked array of important information. We believe studying the fundamentals of companies—not the latest news of the day—is the best way to evaluate their risk and return potential.

To focus on our approach, we must take political news with a grain of salt. When the noisy headlines on China, Iran, the Federal Reserve, or whatever else that is attracting attention, is in the rearview mirror, company fundamentals remain. At Punch, we all but ignore political news (excluding bills, regulations, or laws that could impact our portfolio companies). A lot of political news lacks substance and should be ignored, in our opinion (see tweet below).

Making trading decisions based on news can be perilous to your financial health. Consider the concept of day trading (speculative trading that involves buying and selling a stock in the same day). Day traders consider themselves successful when they buy a stock at $5 and sell it for $6 on the news of the day. A week or so later, after the next relevant headline appears, the trader hopes to buy the stock for $15 and sell it for $16. Finally, after another quarter or two, the day trader may attempt to buy the stock at $29 and sell it for $30 on additional news. The day trader, if successful, made a $3 profit on a stock that increased in price by $25. Our approach is different. We are long-term oriented, so we buy and hold our positions because we expect the market to reward this patience over time.

A panoply of headlines begged for our attention in the second quarter and created significant volatility, but in the end, large cap stocks posted a gain for the quarter. The S&P 500 Index delivered a total return of 4.25% in the second quarter, led by financials (+7.99%) and technology (+6.07%). Energy (-2.83%) was the biggest laggard in the quarter, followed by healthcare (+1.38%).

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

Rolling Up Our Sleeves

Uncovering investment opportunities by doing the hard work of qualitative research

A few years ago on a business trip to Boston, several members of the Punch & Associates investment team stopped by the offices of a small publicly-traded company for a meeting with its CEO and CFO. Since we were considering an investment in the company and had not met the management team in-person, we were looking forward to hearing about the business and strategy firsthand.

After the usual handshakes and pleasantries, we asked the CEO how often they met with professional investors like ourselves. He replied, "You're the first to come see us in five years!" We were surprised, to say the least. After all, their office was less than an hour outside of downtown Boston, one of the oldest and largest financial centers in the country, and this was a company with a long history of growth and profitability.

In the years since that meeting, we have noticed this occurrence with increasing frequency. It seems that smaller public companies, many with attractive businesses and compelling share prices, are getting less and less attention from the money management industry. Pressured by trends towards indexing, quantitative investment strategies, and shrinking research budgets, we believe many of the investors who used to pound the pavement researching companies have gone away or are significantly downscaling their efforts.

The reality is that when fewer investors are willing and able to do the hard work of touring factories, meeting with management teams, and understanding the intricacies of a business, then capital markets become less effective. In academic terms, they become less "efficient," which is to say that they are increasingly disconnected from reality. Of course, we believe that this disconnect creates opportunity for more intrepid investors to roll up their sleeves and develop unique investment insights.

Understanding the unique history of a company helps us understand its current strategy, culture, and direction. Mission-driven companies are a perfect example of qualitative factors at work. A few examples of recent qualitative research from our team include:

In April, members of our investment team visited the Atlanta headquarters of a company that was recently added to our portfolios. This company, a building products distributor, told us that they believe many investors misunderstand their business and its investment merits, mostly because they are small and have no analyst coverage.

In May, we traveled to Los Angeles to attend one of the largest investment conferences for small-cap companies in the country. Over 250 public companies made presentations and held individual meetings with investors. Over the course of three days, we met individually with the CEOs and CFOs of over 30 companies.

In June, several analysts from our firm participated in a gathering of internet-of-things (IoT) professionals from around the world that was hosted by a technology company in our portfolio. After interacting with engineers from the company, listening to expert panels, and engaging with this company's key customers, we gleaned important insights into the investment opportunity.

At Punch & Associates, we emphasize the importance of the qualitative aspects of an investment, which are the intangibles that cannot always be captured in an income statement or a balance sheet. We believe this approach over time may offer better return and risk control than owning companies about which we know little to nothing. Fortunately for us and our clients, the research opportunities abound.

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.

Capital markets become less efficient when fewer investors are willing to do the hard work of touring factories, meeting with management teams, and understanding the intricacies of a business.

Wealth Strategies Group

Family and Finances: Equipping the Next Generation to Have Confidence with Money

We all have an opportunity to talk to kids about money and prepare them for their financial future. But what is the best way to start? Will they really get it? Some parents dread the idea of talking to their kids about money. However, the reality is, kids will learn about money from someone—ideally it won't be their favorite social media celebrity or a comparison of how their friends' families spend money. We hope you use this article to jumpstart your family money conversations and that it helps make those discussions intentional, engaging, and impactful.

Just do it!

Every journey begins with a single step. Starting a conversation with a simple question around the dinner table is a great way to begin. Ask your kids or grandkids the question: "What does money mean to you?" and give them time think about it and explain their viewpoints. Their response might surprise you. To some, money means security. To others, it might mean opportunity. Freedom, goals, values, and future desires (frivolous or not) are all common associations with money. This is not a time to criticize your kids' views, rather it is a time to listen to what they have to say. We encourage you to ask follow up questions to their responses and encourage them to keep talking.

Once the kids have had an opportunity to talk about what money means to them, share what money means to you. Our kids look to us as examples of how to handle money, and they are impacted by our words and actions. Whether young or old, our opinions and thoughts matter to our kids. Allow space for them to develop their own financial wisdom in their own way.

Lead by Example

Having regular, day-to-day financial conversations in front of your kids will help them understand the decisions that you are making about spending, saving, and giving. For those of you engaging with grandchildren, communicate with their parents to ensure you are on the same team in this effort. Talk openly about how you are spending your money and the financial decisions that you are making for your family. Consider letting your kids "catch" you refraining from making purchases. You do not necessarily need to talk numbers in front of your kids, because the concept of talking through financial decisions in front of them is enough. Believe it or not, your kids are listening and observing as you make money decisions, forming habits which they will carry into adulthood.

Be Honest About Your Mistakes

Your kids need to know that you have made mistakes. Tell them a story about a time (or times) that you have made a bad financial decision, how you fixed it, and what you learned from it. Did you buy a stock that you were certain was going to make you a fortune and things didn't turn out exactly as planned? Did you graduate college with too much debt delaying your savings because your cash flow was being used to pay down that debt? Whatever your story, your kids will benefit from hearing it. Knowing that you have made mistakes allows your kids to learn from the mistakes you have made.

Let Kids Make Their Own Mistakes

As difficult as it is, we have to allow our kids to make their own mistakes in order to personalize the lessons you'd like to teach them about money. They need to test out certain behaviors in order to learn the consequences of their actions. You may be tempted to remove responsibility from the child when you learn about the mistake, but consider allowing the freedom to correct his or her own behavior with your coaching, teaching, and mentoring.

Delaying Gratification, Earning a Paycheck, and Knowing How to Use Income

One of the hardest things to do in our world of next-day Amazon deliveries and ordering groceries online is to teach your kids and grandkids about delayed gratification. Kids need to save money for something they want to buy and understand that it is not always received immediately when they want it. Starting this concept young will help them avoid impulse buys in the future.

Allow your kids to earn their own money. When kids earn money, they learn the value of a dollar because they had to work to get it. Learning how to work is good for us—it gives us financial security and purpose. Have you felt satisfaction when you are working within your skills and abilities? Working gives your children the same sense of accomplishment and allows them to use their gifts and talents in a productive way.

Help your children and grandchildren set goals. Sometimes achieving goals requires sacrifice, which is an important concept to learn at a young age. As soon as your children begin receiving money, discuss the three ways your children can use it: saving, giving, and spending.

Make saving a habit. Whether they receive money from allowance, gifts, or work outside the home, teach them the importance of saving some of it for later (implementing a plan for delayed gratification and avoiding financial emergencies). You can open a custodial savings account for your child to monitor. In order to get kids excited about saving, you could pay your kids an interest rate on the money they save or implement a program to match the dollars they save. This is a fun way to teach your kids about the value of compound interest (with a boost).

Giving charitably at a young age builds a foundation of generosity. Talk with your kids about causes that are important to them and help them research to find the right charity. Encourage giving a certain percentage of money they have earned to a charity they have researched and feel passionate about helping. Offering to match their gift is a great way to encourage generosity—and lead by example!

Kids should also practice spending their own money. After they have saved and given back, encourage them to make their own choices regarding what purchases they think warrants their hard-earned dollars. Many lessons are learned from good and bad spending decisions when kids have the freedom to make their own decisions.

Set Financial Values as a Family

As your kids get older, you have the opportunity to meet together and discuss your family's financial values. Inviting your kids to participate and share their financial values encourages ownership over those values and may instill financial responsibility. As your family discusses values, talk about ways in which your and your children's saving, giving, and spending decisions align with your shared values. Additionally, reflect on how everyone can do better and make financial adjustments to be good stewards of your resources.

The Impact of Debt

As soon as your kids turn 18, they will have an easy time obtaining credit to buy things they can't afford. While building a credit history may be helpful for getting a loan for future large purchases like buying a home, our kids need to understand the dangers of abusing debt. Give your kids real-life examples of how long it would take to pay off a purchase if they used credit to buy it. For example, if someone charges $1,000 on a credit card (maybe the latest and greatest Apple product) paying 18% annual interest, and they make minimum payments of $25 per month, it will take just over five years to pay off the balance. Additionally, they will have paid $539 in interest—paying $1,539 for an item that could have only cost $1,000! We should stress to our children and grandchildren the importance of only using credit cards for items we can afford to pay off in full at the end of every billing period.

Compound Growth

Did you know that if you start investing $1,000 per year at age 15, earn six percent, and continue for 10 years ($10,000 total investment), then stop saving and don't touch the money – you will have more in your account by age 50 than had you saved $1,000 per year at age 26 for 25 consecutive years ($25,000 total investment) until reaching age 50? In the first scenario you will end with $59,964, while in the second scenario you will end with $58,156. The yield on the investment each year when added to the total account value itself grows each subsequent year, so that the difference in these two results is the power of compound growth over time.

Talking with your kids about the power of compound growth should increase their desire to save early. As discussed above, matching their savings is a great way to incentivize their early investing and savings. As your kids monitor an account balance over time, the impact of their savings discipline will be evident. If your child invests the savings in the stock market, he or she may even have the benefit of witnessing the account move up and down. Witnessing an investment loss and subsequent recovery will help kids understand the benefits of staying invested over time.

Punch as a Resource

At Punch, we consider engaging with the next generation of clients as critical to our mission of improving lives and our community through financial education. We are excited to see young people interested in saving for their future. We would enjoy the opportunity to sit down with your kids or grandkids to offer financial education and spark their interest even more. Please encourage them to reach out to start the conversation.

Welcome Ruth!

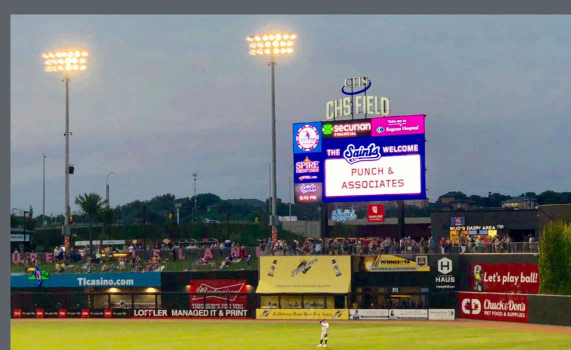
We are pleased to announce that Ruth Langworthy joined Punch & Associates in June as an Associate Advisor. Ruth is working with clients in the areas of financial, charitable, and estate planning. Prior to joining us, Ruth was an estate planning attorney at a law firm in Chicago. She also assisted donors with complex charitable gifts as part of the planned giving team at Wheaton College. Ruth is an honors graduate of both Wheaton College (where she double majored in history and philosophy), and the University of Minnesota Law School. In her free time, she enjoys cooking, reading, and playing with her young children.

Punch Events

Save the date!

October 1, 2019

We will be hosting our Minnesota Fall Investor Update at the Guthrie Theater on the evening of Tuesday, October 1, 2019. More information will be coming soon!



THANK YOU!

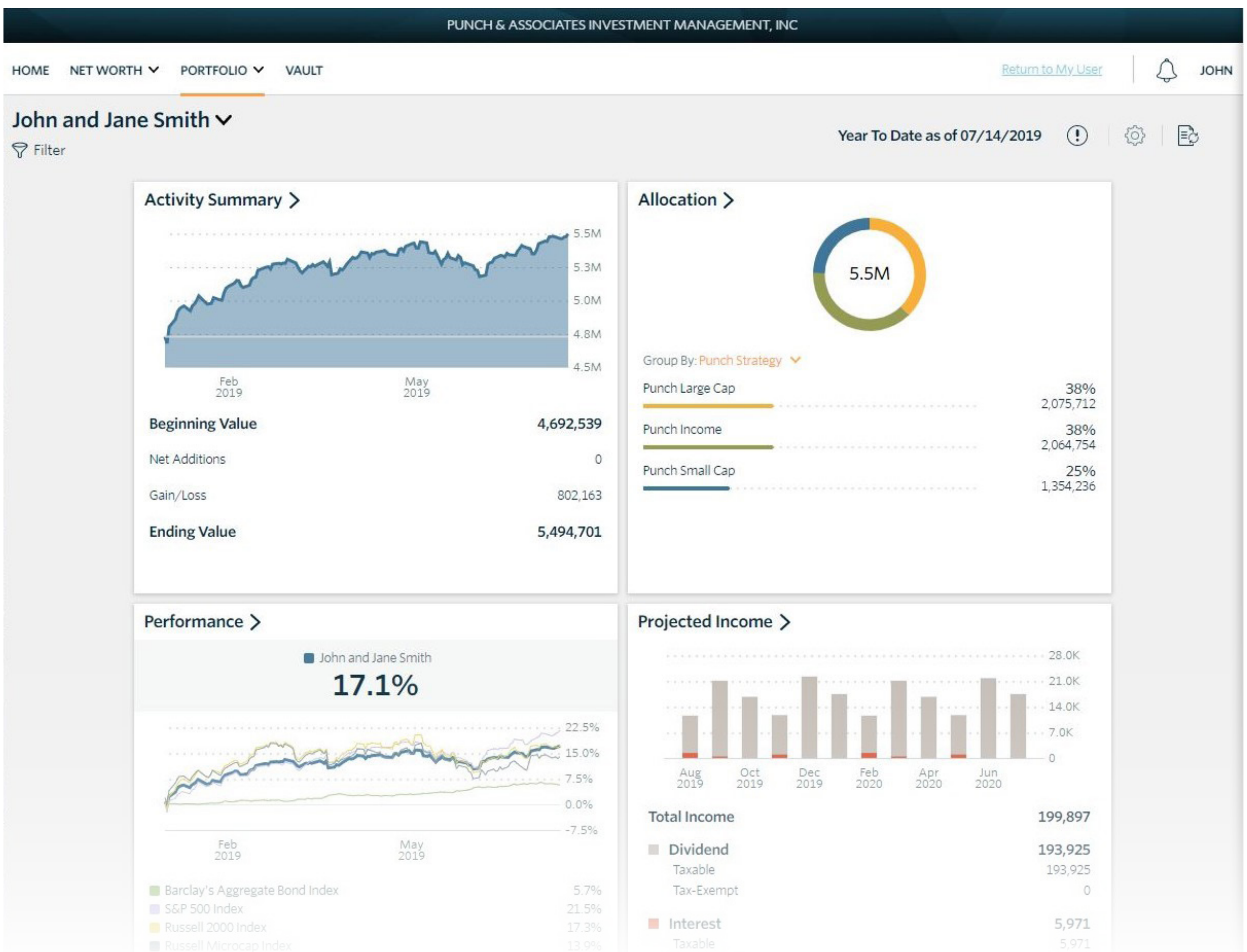
Thank you to everyone who was able to join us for the 2019 All Star game at CHS Field for our Summer Client Appreciation Event! If you weren't able to attend, we hope you will be able to join us next year!

CLIENT PORTAL ANNOUNCEMENT

We are looking forward to implementing a new account aggregation and reporting tool in the coming weeks. We have partnered with Black Diamond Link to customize a solution which is directly integrated with our portfolio accounting and performance software, offering you more clarity and transparency around your financial situation. This new platform will enable you to:

- View performance, asset allocation, holdings, projected income, and transactions by portfolio or individual accounts in an intuitive format
- Link outside accounts and add private assets and liabilities to allow aggregated net worth reporting
- View the most recent portfolio and account data and run reports for custom date ranges
- Securely send and receive documents, statements, and quarterly reports
- Easily connect with members of the Punch team

Please stay tuned for more information!



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