Punch

Newsletter
Third Quarter 2019

Screwtape Market II: The Law of Undulation

> *"Exercise caution in your business affairs, for the world is full of trickery."*
>
> *- Max Ehrmann (Desiderata, 1927)*

In C.S. Lewis's 1942 classic, "The Screwtape Letters," the main character, Screwtape, pens 31 letters to his nephew, Wormwood. Screwtape is an elder in the underworld bureaucracy who is advising Wormwood, a tempter on the front lines, on how to procure the soul of a young man ("the Patient") trying to live a righteous life here on earth.

We first introduced readers of this newsletter to "The Screwtape Letters" in 2009 because parallels exist between the forces (temptations, distractions, habits) acting on the Patient and the forces impacting the hearts and minds of individual investors. While these forces may not be described as demonic (some may be), and while the fate of one's soul may not hang in the balance, the fact that these forces exist and that we are all vulnerable at times does indeed matter. The world is not perfectly architected so that you can get rich, beat the S&P 500, or even reach your financial goals. Quite the opposite.

When we wrote "Screwtape Market," our country was going through one of the most difficult economic periods in our history. We call it the Great Recession for a reason. Since the bottom of the market in March 2009, the S&P 500 Index is up more than 350%. The financial world has changed, but the pervasiveness and power of these behavioral influences have grown, and they remain as distracting and potent today as ever. Just as people need to arm themselves to combat temptation at every turn in order to achieve fullness in their lives, investors need to be vigilant, disciplined, and self-aware (three qualities that Screwtape and Wormwood would loathe to see in their patients).

The Law of Undulation

In his eighth letter to his nephew, Screwtape describes the concept of undulation. He explains that the Patient will go through peaks and troughs in his life which affect everything:

> "If you had watched your patient carefully, you would have seen this undulation in every department of his life—his interest in his work, his affection for his friends, his physical appetites, all go up and down. As long as he lives on earth, periods of emotional and bodily richness and liveliness will alternate with periods of numbness and poverty. The dryness and dullness through which your patient is now going are not, as you fondly suppose, your workmanship; they are merely a natural phenomenon which will do us no good unless you make a good use of it."

Do these peaks and troughs affect financial decision making too? You can't fight an enemy if you don't know it exists. Even when acknowledging an enemy's existence, adhering to a well-thought-out plan can be challenging. The alternatives generally appear enticing and, at times, irresistible.

Screwtape argues that there are times when the Patient is more susceptible to certain enticements and distractions. It is in these times that Wormwood could make considerable gains toward the goal of securing the Patient's soul. Expert marketers understand that there are times when the average human might be "taken in" by a marketing message. This is why you

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see fast food commercials on TV late at night when viewers are hungry and will-power is low. Similarly, if you have an investment approach that adheres to a specific philosophy, it can be tempting to abandon this approach after reading a tweet, listening to an ad, or hearing a slick sales pitch during a period when your philosophy isn't in favor.

Noise is something that we all deal with in investing and in our lives. Like Wormwood's whisperings, it's constant. Noise can enter into your life and cloud both your judgement and priorities. People are subject to it one moment, and then they are not. The effect of noise, therefore, undulates. It's not enough, however, to occasionally ignore noise, because mistakes are made in moments. Wormwood's efforts are like the noise we encounter today, constantly whispering in our ears.

The Devil You Know…

In our library, we organize our books by genre. "The Screwtape Letters" sits between books from the genres of finance and faith. We place the book there for a reason; so much about investing is about self-awareness and human nature. Markets are made up of humans making decisions, and we are all flawed.

We have often said that, when investing, many people need to be protected from themselves. Most investors are unaware of the harmfulness of their thinking. In the letters, Screwtape constantly reminds his nephew that people must never realize they can be their own worst enemy. They must remain so distracted that they manage their affairs unaware that their present thoughts and actions are harming their future selves.

The Screwtape Market

Markets go up, and markets go down. We all know this, and there should be nothing surprising about it. Dealing with these fluctuations during the peaks and troughs of our own lives is the tricky part. One needs to be armed with the weaponry to deal with both imaginings and reality. Having allies, good people with your best interests at heart, is critical.

In his eighth letter, Screwtape expresses the key threat to his own existence:

> "We can drag our patients along by continual tempting, because we design them only for the table, and the more their will is interfered with the better. He cannot 'tempt' to virtue as we do to vice.... Do not be deceived, Wormwood. Our cause is never more in danger than when a human, no longer desiring, but still intending, to do our Enemy's will, looks round upon a universe from which every trace of Him seems to have vanished, and asks why he has been forsaken, and still obeys."

The last line is the key because we don't always feel like obeying. We have bull markets and bear markets divided by time. But we recognize that we are always in a Screwtape Market.

What Screwtape Might Say Today…

My Dear Wormwood,

Your patient has fully recovered from the deep pain of a decade past, but not to worry. We can use this evident prosperity to our advantage. Guide your patient's thoughts toward how things can be even better if they examine the way others are achieving even more dramatic results. FOMO is the acronym I believe these mortals use. A plan guided by a single common-sense investment philosophy must be upended. Keep the patient away from well-worn phrases from these Munger-Buffett types. They spout things like, "Be greedy when others are fearful, and fearful when others are greedy." (Warren Buffett) We know that this sounds good, but it is far easier for the patient to be greedy when all his friends are the same. Use this. I have heard that these Facebook and Twitter resources can be quite valuable in this regard.

Point out other investment philosophies that have gained far more popularity recently. Focus on things that are going up with no apparent risk. Call into question your patient's outdated conservative convictions. When the patient's portfolio has experienced a negative month or quarter, guide his attention to the weakness of a non-guaranteed approach. The goal is to make the patient a connoisseur of investment philosophies with no one philosophy having dominion over his actions.

Previously, your patient believed that forecasting was a fruitless endeavor, and that he would be better served by long term ownership in business enterprises. Nonsense. No doubt there are newsletters with pictures of wealthy mortals on yachts in the patient's inbox right now that will effectively demonstrate how easy it is to divine the future and own a larger piece of the kingdom. Strike when the patient is weakest. Perhaps some early victories for the patient using his own forecasting skills may sway the patient more firmly into our camp.

May the father below bless you,

Screwtape

Punch Income Strategy

A Lack of Interest

Investing for income in a negative interest rate world

If you need evidence that interest rate changes are nearly impossible to predict, just look at the past year. Twelve months ago, many investors thought that rates were headed higher, as a strengthening economy and tightening labor market were lifting both growth and inflation. Over most of 2018, the yield on the 10-year Treasury bond had risen steadily by a full percentage point, from 2.25% to 3.25%, and investors widely expected this trend to continue.

Since the start of the year, however, Treasury yields have been cut nearly in half, and they reached a nadir of 1.4% in the third quarter. Dragged down by recession fears, lower global interest rates, and concerns over deflation, U.S. interest rates have found new depths. The consensus now is that rates will be "lower for longer."

We aren't so sure that the broad consensus is any more correct today than it was a year ago. We may see higher rates next year if the economy accelerates, or trade conflicts dissipate. The current majority view does not seem to account for these possibilities.

The difficulty in investing for income today is that a significant percentage of global sovereign bonds have negative yields. In other words, if an investor purchases these bonds and holds them to maturity, they are guaranteed a loss. In the third quarter, the amount of bonds outstanding with negative yields, worldwide, peaked at $17 trillion (source: Bloomberg).

Negative interest rates fly in the face of common sense and are difficult to explain. If an investor isn't buying a bond for a positive interest rate, then that person must be buying it for some other reason. Some buyers of negative-yielding instruments are "forced" buyers, needing to invest in order to match a liability, fulfill a contract, or soak up cash reserves. Others may be purchasing these securities with the expectation that rates will become even *more* negative over time, which would increase the price of the bond. Rather than investing for income, they may be investing for appreciation.

We are playing more defense than offense today when investing for income in this topsy-turvy bond market. We generally avoid areas where low, or negative, interest rates could adversely impact the value of our investment should rates begin to move up again.

We believe a handful of areas are attractive enough to offer above-average yields while offering some margin of safety:

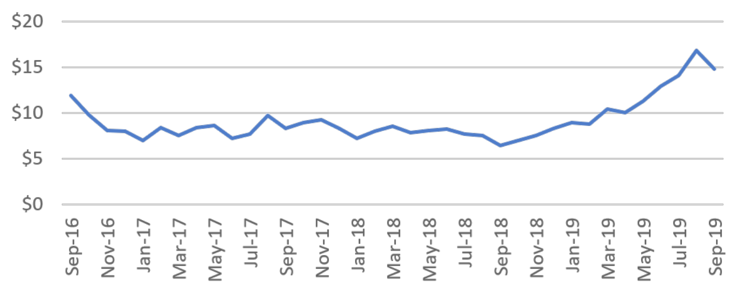
Energy Master Limited Partnerships (MLPs). The energy sector has disappointed this year and generally lagged the broader market, but dividend payouts from master limited partnerships that own pipelines, storage facilities, and terminals have been mostly stable and rising. We continue to like this out-of-favor sector and have increased our exposure through energy-focused closed-end funds trading at discounts to their net asset values.

Select Real Estate Investment Trusts (REITs). While REITs as an asset class tend to be correlated to movements in interest rates, we believe that some areas are less affected than others, including farmland, timber, and single-family housing rentals.

Closed-end Fund Term Trusts. Closed-end funds can provide opportunities to invest in income assets at a discount and with generally higher yields. Term trusts are a subset of closed-end funds that have liquidation dates—generally between five and 10 years—at which the discount will close completely, and investors should realize the appreciation from the closure of the discount.

Investing for yield remains as challenging today as ever, so it requires a thoughtful approach. We believe that a portfolio that is unique and incorporates a variety of asset types should have a better chance of withstanding interest rate uncertainty over the long term.

Worldwide Debt Outstanding with Negative Interest Rates
In Trillions



Source: Punch & Associates and Bloomberg

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

Outsized Performance, Outsized Impact

Shareholder alignment can change everything

People who can both innovate and manage a business well are truly rare. We look for businesses that meet those criteria in the Punch Large Cap Strategy.

At Punch, we often talk about the importance of shareholder alignment. In our research, we consider whether incentives are aligned between a company management team and its shareholders. We like CEOs who own shares of their company, because they are motivated to increase the stock price.

One way to enhance shareholder alignment is to invest in founder-led businesses. Founders usually own a significant amount of stock in their businesses, however, that fact alone does not guarantee a successful investment. People who can both *innovate* and *manage* a business well are truly rare. We look for businesses that meet those criteria for the Punch Large Cap Strategy.

Bill Gates co-founded Microsoft in 1975. Gates served as CEO from 1981 to 2000, and then as Chief Software Architect from 2000 to 2006. He stepped down from his role as Chairman of the Board in 2014 but remains on the board today. Gates helped grow Microsoft from about $200 million of revenue in 1986 (the year the company went public) to more than $22 billion by 2000. During the same time period, net income went from roughly $40 million to more than $9 billion. Today, Microsoft is one of only two companies in the S&P 500 Index with a market cap larger than $1 trillion.

Microsoft is one of the greatest success stories of all time. Its growth has created so much wealth for the founder that he ended up with the resources to tackle health, energy, and education issues on a global scale. This is due, in part, to Mr. Gates owning *hundreds of millions* of shares of Microsoft stock and the value of those shares compounding over time as revenues and profits grew. If an investor bought $1,000 worth of stock at the company's initial public offering on March 13, 1986, the total return would be $2.2 million as of September 30th of this year. Gates didn't become a billionaire 100 times over from his salary; rather, his wealth was largely created by owning Microsoft stock. This is an example of CEO alignment that led to an outsized benefit for both investors and global citizens alike.

Throughout the years, Bill Gates and Warren Buffett have become close friends (one, an innovator, the other, an investor; both like-minded and generous). Buffett saw in Gates a world-class problem solver and decided that the Bill and Melinda Gates Foundation will receive most of his net worth. As of July 2019, Buffett has given away $34.5 billion of Berkshire stock, four-fifths of which went to the Gates Foundation. This extraordinary gifting is only possible because Mr. Buffett is a major holder of Berkshire Hathaway stock.

Quick side note: if you haven't seen the Bill Gates documentary "Inside Bill's Brain" on Netflix, we recommend viewing it. The series does a deep dive into his background, how he thinks, and the incredible work he and his wife, Melinda, are doing today through their foundation.

We believe alignment goes beyond management and shareholders. Clearly, value can be created when CEOs have meaningful ownership positions in the companies they lead. Gates was able to use stock appreciation to pursue passions involving health and poverty issues. Our goal is to invest in companies whose management teams are in step with shareholders so that all stakeholders are well aligned.

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

A Soggy Small Cap Market

Smaller public companies have trailed larger ones over the past few years

In the immediate wake of the 2016 presidential election, a wave of anticipation swept through capital markets in hopes that a new, more business-friendly administration would accelerate economic growth, roll back burdensome regulations, and reduce taxes. Smaller public companies, which are especially sensitive to the domestic economy, responded in kind. In 2016, the Russell 2000 Index of small public companies jumped 20%, nearly twice the return of large cap companies, mostly in response to this expected stimulus.

Since then, the tables have turned. Over the past almost three years, large cap stocks have returned twice that of small cap stocks, rising over 40%. While the S&P 500 Index is up 4% over the past year, the Russell 2000 Index is *down* 9%. What are we to make of this disappointing performance from an asset class that was supposed to benefit so directly from an improved economy?

While it is true that some of the hoped-for economic changes happened and economic growth accelerated over the past couple of years, there is concern that the "sugar high" of stimulus is quickly wearing off and that the effects of global trade conflicts are taking their toll on American consumers and producers. Talk of recession is growing, and many companies that are especially cyclical (sensitive to economic conditions) have seen their share prices decline. We think that these concerns are likely overblown given what we are hearing from many companies directly.

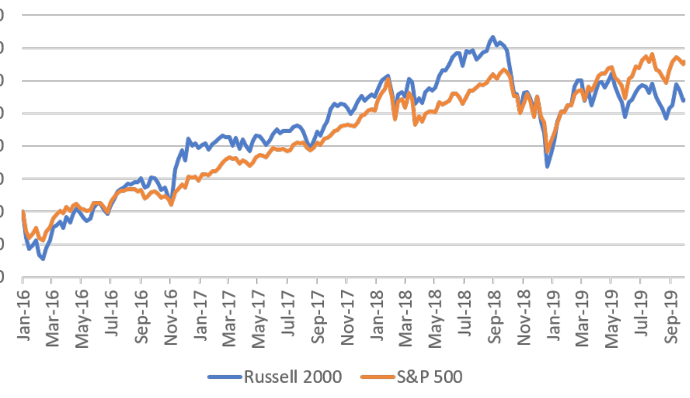
Whether or not a recession occurs in the U.S. soon, we believe that the stock prices of many smaller public companies already reflect that anticipated outcome. The Russell 2000 Value Index, which is largely populated with the shares of banks, manufacturers, and real estate companies, was down over 15% from its high at one point this quarter, and now trades at the same price-to-earnings ratio that it did back in 2012. The index trades at 14x earnings, a 28% discount to the S&P 500 at 19.5x earnings.

In the Punch Small Cap Strategy, we do not attempt to make predictions about markets or economies and do not invest according to where we think they might be headed in the near term. Instead, we look for strong companies with loyal customers that produce regular cashflow and that have reputable management. We try to invest in these companies when their shares are out of favor, unknown, or just plain cheap. Today, many smaller companies with some degree of cyclicality in their businesses fit into this category.

Examples of cyclical companies in the Punch Small Cap Strategy in which we have recently initiated investments include a large industrial hoist company, a building products distributor, and a commercial furniture company. We believe that whether or not a recession materializes, these companies should be able to grow and become more competitive over time. And because they are typically smaller and lesser known than the average small cap company, we also believe in the opportunity for them to become better known.

Over long periods of time, history shows that small cap companies do outperform large cap companies. Since 1999, the average annual return of small companies has been 8% compared to just over 6% for large businesses. This premium comes with higher volatility, though, and small cap companies can have cycles in which performance diverges from large cap companies. We believe that we are in one of those periods today, but, given attractive valuations and the prospect for improved performance, we remain excited about small cap investing.

Small Caps vs Large Caps
Russell 2000 Index vs S&P 500 Index
12/31/2015 to 9/30/2019



Source: Punch & Associates and Bloomberg

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

How Much is Too Much?

Using encouragement and fostering work ethic to diffuse entitlement

Our conversations with clients rarely begin and end with financial planning. We explore a wide range of personal topics, because we manage assets that clients use to further the mission and values of their families. Parents and grandparents often ask us, "How much money can I give to my children and grandchildren without creating entitlement?" It's a great question. There is, of course, no single answer. As you reflect on your unique family and circumstances, we hope you'll appreciate the entitlement advice we recently received from family relationship experts Jim and Lynne Jackson.

Jim and Lynne are the co-founders of the non-profit Connected Families. They are the authors of "Discipline that Connects with Your Child's Heart" (and other parenting books), and they have spent their careers helping families develop warm, communicative relationships. They spoke to us on the topic of raising grateful, generous, service-focused kids. We believe their ideas are highly relevant in the context of family wealth transfer. What follows are practical suggestions that we hope will help your family develop your unique answer to the age-old question, "How much is too much?"

1) Motivate children with encouragement.

We all know intuitively that encouragement is more motivating than criticism. Children will all experience failure to some degree, but if loved ones respond with warmth and positivity, a child is more likely to stay emotionally connected and be motivated to try again. The willingness to try is essential because mastery requires frequent brushes with challenge, if not outright failure. As an example, Howard Punch has consistently told aspiring young analysts that the best way to learn about investing is to lose some of your own money. In this regard, money is no different from any other area of life.

Because we are human, and mistakes are a certainty, clients who are considering a significant transfer of wealth may want to start early and start small. Small gifts given on an annual basis without strings attached allow the child or grandchild the opportunity to learn from a spending or investing misstep.

For those of you who may be hesitant to allow a young family member to experience failure, consider this tip from Jim and Lynne: avoid "snow-plow parenting" (an image all Minnesotans can appreciate), which clears a child's road of <u>all</u> obstacles. The well-traveled road might reduce failure rates in the short term, but the child misses out on the chance to increase self-confidence through learning from mistakes.

A careful repeat gift after a child's mistake may demonstrate confidence in the young person's ability to learn. If handled sensitively, a failure might also be an opportunity for a meaningful teaching moment or an inter-generational lesson from a grandparent.

2) Teach children to value hard work.

Hard work helps children build self-confidence as they reach new levels of accomplishment in an area of life, study, or skill. When a child works hard to help someone else, she feels a sense of purpose that gives a boost of confidence. A positive sense of self-worth has many benefits, including a *reduced sense of entitlement*. Children who have worked hard toward their own accomplishments seem to feel less entitled to a certain lifestyle or their family's money to help achieve that lifestyle. For our clients, the benefits accrue across the generations in the form of less conflict and more freedom to enjoy—and share—family wealth.

3) Let children work for what they want.

Entirely by accident, we might give our children reason to act entitled. It feels good to spend money on a new toy for ourselves, but it can feel even better to spend for someone we love. Jim and Lynne call this the "dopamine dealer" mindset. We love to watch our child's joy at receiving a gift from us. But if this is a frequent or primary way that a child is loved, the gifts ring hollow. There is a risk that the child may never learn the essential lesson that his own hard work can yield unexpected treasures of greater understanding and character. When an adult child is eventually tasked with managing the family's wealth, he will need to draw on that character and knowledge.

4) Gratitude is the opposite of entitlement.

We seek to guide our client families in modeling contentment and gratitude for their children and grandchildren. We frequently address this issue in the context of the parent-child relationship and expectations placed on the younger generation. Parents and grandparents are balancing on a tight rope when it comes to unconditionally loving their children while also having high standards for their children in life and in work. Aiming high is a prerequisite for success, but do we unrealistically demand perfection in all areas? Do we unwittingly communicate that we are entitled to extraordinarily successful children? The tragedy is two-fold: if we push our children to succeed for our benefit, rather than for theirs, we miss the opportunity to love them completely. We also lose our children's trust and, with it, the respect required to transmit our values to the next generation.

Jim and Lynne gave us a few suggestions for parents seeking to be more grateful and thereby model gratitude. Try incorporating one or more of these ideas into your family's life:

1. Make a list of what you are grateful for in your children.
2. Take time to reflect on lessons learned from your own disappointments in life.
3. Talk to your children about a time when you chose not to buy something you wanted.
4. Find a teachable moment for the topic of waiting and working for what your child wants.
5. Demonstrate appreciation for a gift you received.
6. Start a gratitude journal. Make an entry each night to end the day well.
7. Help your child express gratitude when a keenly felt need is met.
8. Ask yourself whether the people around you know that you are grateful for what you have.

We are thankful to Jim and Lynne Jackson and Connected Families for all the work they do to help families grow and connect. At Punch, we are privileged to see families grow closer together in many ways, including in the area of wealth and philanthropy, as we engage in wealth transfer planning. We hope this article sparks fruitful and ongoing conversations around your table at home that enable your family to grow and prosper.

2019 GIFTING REMINDER

Many people consider sending monetary gifts to family and friends and making donations to various charitable organizations as the holiday season approaches. If you are planning to gift or donate from your Punch accounts before year end, please consider the following:

- If you are planning to make a gift during the remainder of 2019, please contact us sooner rather than later.
- If you are over age 70.5 and have not yet withdrawn your RMD from your IRA, consider making a tax-free distribution directly from your IRA to charity. The gift satisfies your RMD but is not taxed as income to you.
- Consider gifting highly appreciated stock as a tax-efficient alternative to cash. This technique bypasses the capital gain that would otherwise be due upon sale, potentially realizing significant tax savings.
- A Donor Advised Fund allows you to make a donation and receive a tax deduction in 2019 but postpone charitable distributions until a later date. A taxpayer with uneven taxable income from year to year can benefit from making larger gifts in high income years.

UPDATING CONTACT INFORMATION

If you have a seasonal address that we may not be aware of, please let us know! We would like to give you the opportunity to join us at our investor updates in Florida and Arizona, and we'd like to make sure that your custodian has your correct information on file for any communications they may mail you.

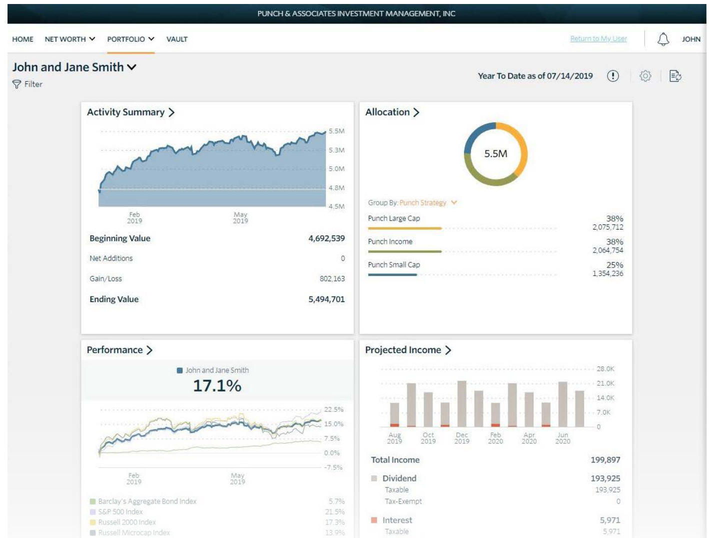
Please call us, and we can help you ensure that your contact information is up to date.

(952) 224-4350

CLIENT PORTAL ANNOUNCEMENT

We are in the process of rolling out our new client portal. Our new portal 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:

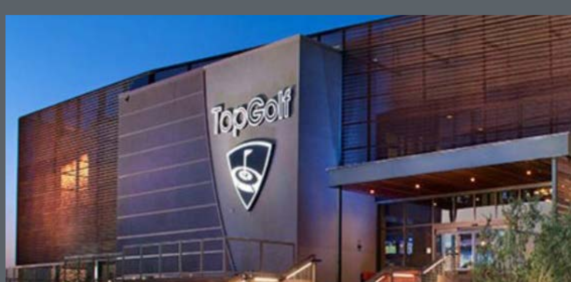
- View performance, asset allocation, holdings, projected income, and transactions by portfolio or individual accounts in an intuitive format;
- Link outside accounts and add private assets and liabilities to allow aggregated net worth reporting;
- View the most recent portfolio and account data and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



Please call us at (952) 224-4350 and ask for Steve if you are interested in accessing our new portal.

PUNCH EVENTS

For more information about upcoming Punch events, please contact Nancy Kelly at (952) 224-4350



2020 ARIZONA INVESTOR UPDATE

February 11, 2020

TopGolf, Scottsdale

9500 Talking Stick Way,
Scottsdale, Arizona 85256

2020 FLORIDA INVESTOR UPDATE

February 25, 2020

Ritz Carlton Beach House

280 Vanderbilt Beach Road
Naples, Florida 34108