Punch

Newsletter
Second Quarter 2020

Pandemic Investment Guide

Howard Punch
President and CIO

"We are all sick and tired of staying home. But you know what? The virus is not tired of making us sick."
- Dr. Tom Frieden, Former Director of the Center for Disease Control, 2009-17

The end of this pandemic is likely to come on the installment plan, so be wary of anybody who says or acts as though the coast is clear. The worst guess is the one that comes from someone who doesn't know they are guessing. Here is our advice for weathering the continuing storm:

1. *Take care of yourself and your loved ones*

If you don't pay attention to your well-being, nothing else we say will matter. In our last missive, we compared the shock of this pandemic to the shock of 9/11. In 2001, we were similarly stunned, wondering what changes we might need to make. The difference between the two events was that during 9/11, we were continuously encouraged to get out, spend time with friends, go to a restaurant, and get some exercise. The general message back then was to get out of the house and don't let the terrorists win by paralyzing us with fear. This time around, we don't have the same outlets, and it can be stressful. You have heard this from other sources with more knowledge and authority than me, but it doesn't hurt to hear it again:

- Wear a face mask when you are out and encourage others with whom you come in contact to do so as well. Statistics show that Minnesotans are among the worst at this habit.
- Know the whereabouts of your friends and family members, and isolate for a time when risks increase.
- Seek daily exercise and limit alcohol intake. According to Forbes, with most bars closed or restricted, off-sale wine and spirits sales were up 30% for the first seven weeks of the pandemic. With gyms closed or only recently available for restricted use, create a fitness routine alternative. Brisk walks, yoga, or light weights are a sound choice. If you aren't a Peloton subscriber, YouTube has an endless supply of free workout videos for any skill or motivation level.
- Stay constructive and be a positive force for those around you who need a boost. As Babe Ruth said, "It's hard to beat a person who never gives up."

2. *Don't overdose on information*

"News is to the mind what sugar is to the body."

- Rolf Dobelli

Rolf Dobelli wrote an article called "Avoid News" back in 2010 that struck a chord with us, and we reference the article in this newsletter regularly because it remains so relevant. Rolf points out that consuming news leads to the opposite of understanding a situation:

> *Most people believe that having more information helps them make better decisions. News organizations support this belief. Hell, it's in their interest. Will accumulating facts help you understand the world?*

> *Sadly, no. The relationship is actually inverted. The more "news factoids" you digest, the less of the big picture you will understand.*

If your goal in consuming news is to make fewer and better decisions, perhaps curating what you consume is a good use of time. Rolf suggests that we should "cut [ourselves] off from daily news entirely." Instead, he helpfully prescribes that we should "[r]ead books and thoughtful journals instead of gulping down flashing headlines."

3. *Don't overthink things*

Investing is done best when it is kept simple and the focus is on the long-term. We have seen more people get into trouble by saying, "This time it's different, so I have to do different things." Many people twist themselves into knots thinking about how they are going to get through this pandemic, make radical changes, and then end up way outside their circle of competence. The results from a reactionary approach to financial markets are rarely to be envied.

Michael Mouboussin, Author and Head of Consilient Research at Counterpoint Global, discussed recently what many investors might be feeling.

> *What we know is that stress tends to shorten peoples time horizons. That makes enormous sense evolutionarily. Because if you're the zebra running away from the lion you're not thinking about what you're going to do in two weeks. You're thinking about the next twenty seconds trying to survive. If I stress you, not just in markets but in any context, that's why we say don't make decisions when you're stressed. Why? Because you're only thinking in the here and now and its very difficult to think in the long term.*

He goes on to describe three conditions that lead to stress in a situation:

- Lack of predictability and control;
- Absence of outlets to let off steam; and
- Perception that things are getting worse.

It's hard to tell anyone to stop feeling stressed. It would be like telling a depressed person to stop feeling depressed. The best-case scenario may be to get people to recognize markets go through periods of volatility. Historically, they have always recovered. So don't take your stress out on your portfolio.

4. *Recognize the real changes*

Covid-19 has accelerated trends that were already firmly in place prior to the pandemic's spread. Online shopping (especially groceries) and entertainment, gaming, virtual or augmented reality, digital tools for home and office, touchless technology, software-as-a-service, artificial intelligence, robotics, telemedicine, and plant-based proteins all have seen solid bumps in their trends during the pandemic. More negative trends have appeared in areas like commercial office space, energy, brick and mortar retail, and urban residential real estate. Some industries have a clear near-term negative impact but the long term is still nebulous, including finance, travel, elective surgery, and live events, among others.

Note that simply identifying a company that benefits from a positive trend or avoiding a company that suffers from a negative one doesn't assure investment success. A lot of what goes into our process is examining how a company is valued in the market and figuring how out how much of its potential future is already accounted for based on its current price tag. A common stock market proverb says that if everybody knows something, it's not worth knowing.

5. *Accept volatility as a new reality*

"I get knocked down, but I get up again.
You are never gonna keep me down."

- Chumbawumba, Tubthumping

Watching Covid-19 play out in society can be frustrating. It seems that with business closures, re-openings, and re-closures we are taking two steps forward and one step back. The markets quickly inhale this news and respond with high volatility. Volatility is the market's way of expressing that it has more questions than answers. We expect that this volatility will remain high until a clear-cut solution to the pandemic is discovered and widely available.

6. *Value investing is not dead*

"What the wise do in the beginning,
fools do in the end."

- Warren Buffett

Many investors recognize that certain industries are benefitting from a Covid-19 induced trend. The pandemic has changed a lot—investors are willing to pay just about any price to participate in these positive trends mentioned above. We have seen this before, and it doesn't end with a ticker tape parade for these late trend-followers. While it doesn't seem so now, the price you pay for a security will matter later. And this realization for many investors may not come in the near term but it may come suddenly.

7. *Have faith*

Faith is perhaps the most important point I have to share and a fitting place to conclude. In an article entitled "Strategic Faith," Dan Egan, Director of Behavioral Science and Investing at Betterment, compared adhering to an investment philosophy to religious faith. He writes:

> *The benefits of religion don't seem to depend on the exact theology. The details of the story aren't critical. But belief in the story is.*
>
> *What if a critical ingredient to being a successful investor isn't exactly which strategy you follow? It's that you have faith in that strategy?*
>
> *By faith I mean the ability to take the leap into risking your money without guarantees, and to continue to adhere to the strategy, even in the face of disappointing results.*
>
> *Markets must crash. Active strategies must underperform. Chasing performance produces lower returns. Buffett underperformed by 67% at one point. Even a clairvoyant who knew exactly what stocks would perform best would get fired, because the journey would be so terrifying.*
>
> *An investor without a faith is doomed.*

In a perfect world every investor would outperform the benchmark over any measurable period. Unfortunately, markets don't reward a dedicated investment philosophy in this way. Those that worship at the altar of price momentum have won a number of converts lately. We don't know whether we are in a late stage for this type of behavior, but we certainly don't seem to be in the early innings.

Sticking to one investment philosophy is both emotionally difficult and extremely important. We sleep well at night knowing that we engage in a deep research process for investments that we believe haven't been overly exploited by the crowd, and this is where we place our faith. Thank you for yours.

Availability During the Coronavirus Pandemic

As Minnesota moves to slowly ease restrictions, we are continuing to adhere to the state's Stay Safe MN guidelines. Although we continue to work remotely for the time being, we want to remind you that we are here for you. While our office space is closed, we are readily available to assist you. We are available by phone, video chat or for in person meetings outside of our office with proper social distancing.

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Punch Income Strategy

On the Mend

John Carraux, CFA, CIC
Managing Partner

Credit markets slowly heal from the effects of COVID-19

Going about my daily life these days, even in its altered form, it is refreshing to see signs of normalcy starting to emerge. Neighbors are out enjoying the warm weather, street traffic is slowly building, and restaurant patios are encouragingly full. On the surface, things very much appear to be on the path to recovery.

Look deeper, though, and we know that we still have a long way to go before getting back to "life before the virus." Last week, I stopped by a shopping mall, and I could have yelled in the corridor without anyone noticing. My morning commute is still shorter than it ever has been, and more than once I have failed to recognize a friend or neighbor because of their large face mask covering.

Financial markets reflect these same dichotomies. On the one hand, equity markets rebounded surprisingly quickly from the steep declines in the first quarter, driven largely by technology and healthcare companies that directly benefit from the nature of this crisis (Amazon, Clorox, and Netflix come to mind). On the other hand, many traditionally defensive companies remain in the doldrums. The Dow Jones Select Dividend Index (made up largely of utilities, telecommunication companies, and financial institutions) is still down 22% year-to-date.

Income asset classes are also more of a mixed bag than it would at first appear. Despite the Federal Reserve pledging almost limitless support for credit markets, some areas like closed-end funds (CEFs), business development companies (BDCs), and real estate investment trusts (REITs) have lagged, as investors wait to gain more clarity into an eventual recovery. These asset classes outperformed broader credit markets in 2019 (+24%, +31%, and +29%, respectively) but have given up some of those gains in 2020 (-11%,-24%, and -14%, respectively).

The good news right now is that both the Federal Reserve and Congress are acting swiftly and boldly, more so than in the 2008 crisis, to support the economy, and this support seems nearly limitless. Chair Jay Powell is firmly committed to providing a bridge for the economy to reach the other side of this virus chasm without widespread damage to companies and investors. We also know that we are spending massive amounts of resources on healthcare solutions to the crisis, although the timing of a treatment or vaccine is impossible to predict.

The volatility in income asset classes this year has been difficult to stomach at times, but it is important to remember why we take the approach we do to investing for income in the first place. With treasury bond yields diving towards zero, returns on traditional fixed income securities are likely to be low for the foreseeable future. They may provide some ballast to a portfolio during times of crisis but can do little in the way of providing current income or higher long-term total returns. At last count, 30-year Treasury bonds provided nominal yields of only 1.4% and negligible (or negative) real yields after taxes and inflation.

Where does that leave the average income investor who needs cashflow from a portfolio but also wants to avoid taking undue risk in order to achieve it? This question is urgently relevant in these times of extreme uncertainty.

We believe that an income approach to investing right now must be two-sided. First, portfolios must incorporate a healthy amount of defensive securities that will provide some sure footing and can be re-invested as opportunities emerge. We have above-average "dry powder" holdings in cash and short-term securities today for this reason. Second, we are actively looking for dislocations in markets where investors appear to be overly discounting likely risks. Many income securities today trade at large discounts to their fair value because of this uncertainty.

In the second quarter, we exited several investments impacted by the unique nature of the crisis and added to other positions for which we believe markets are taking too pessimistic a view on their path to recovery. While we expect that cashflow from the portfolio will likely be down 5-10% this year, we are actively rotating into positions with above-average yields to increase payouts over time. We are also realizing tax losses where appropriate in order to improve the after-tax return of the strategy for taxable portfolios.

As life slowly returns to normal, we know that the path forward will not be smooth. By playing both offense and defense during these uncertain times in financial markets, we hope to position clients for long-term total returns from both income and price appreciation.

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

Too Far, Too Fast?

Paul Dwyer, CFA
Director of Research

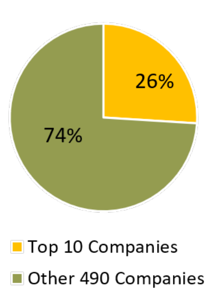
A look at the S&P 500 Index's performance in a challenging macro environment

Picture a beautiful mallard duck floating on a serene Minnesota lake surface. In this quintessential summer sight, there is relative calm above the surface of the water, but below the surface, there is a lot of churning and activity. The same can be said for one of the flagship yardsticks for the stock market, the S&P 500 Index, in 2020. At quarter's end, the S&P 500 is basically at the same place where it started the year, as it is "only" down three percent year to date. Considering the year's events and where markets were 90 days ago, it is easy to do a double take and ask, "Have we come too far, too fast?" Perhaps concerns are eased from realizing that the S&P's performance is less a reflection on the state of the world and more about index composition and construction.

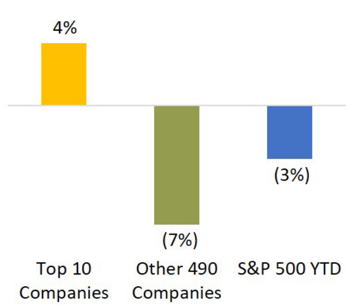
Most indices, including the S&P 500 Index, are market capitalization-weighted indices, meaning the biggest companies have the most impact on index performance. Technology trends that were in place prior to COVID-19 accelerated during the pandemic, and the companies which were leading those trends were already some of the biggest in the index before the downturn. Those companies have driven the return for the headline (reported) numbers, but as we look deeper into the index, we find that many companies' stock prices are still lower since the beginning the year.

The below charts show how dominant the largest companies in the index have become in weight and impact on returns. The top ten companies made up approximately 26% of the index composition by weight, and they contributed more than 100% of the S&P's return year to date. The other 490 companies made up 74% of the index and were negative detractors to performance with an average decline of 12%.

S&P 500 Weighting Breakdown



S&P 500 Contribution to Return



Source: Bloomberg. S&P 500 year to date (YTD) Total Return as of June 30, 2020.

We have reasons for optimism related to this wide dispersion in the marketplace. One of those reasons is the potential for additional stock market recovery driven by the 74% of S&P 500 Index companies that have averaged double-digit declines so far this year. Another reason for optimism could be that the wide dispersion within the market today may create opportunities for active managers like Punch & Associates to achieve strong risk adjusted returns over time.

A second consideration for "too far, too fast?" is how challenging it can be to time the market. Over the last six months, we have seen one of the steepest stock market declines in history immediately followed by one of the best 50-day stock market performances ever. The response of Aswath Damodaran, finance professor at New York University's Stern School of Business, to the concerns raised about the stock market's performance in the face of all that 2020 is experiencing resonated with me. He said, "When your narrative for the economy clashes with that of the market, humility is the best option."

We agree that humility is important in investing, and we do not think it is prudent to make broad market timing calls. By being long-term owners of businesses, our returns should reflect the earning power of our companies over time. We manage risk not by timing the market, but rather by ensuring that clients' asset allocations are appropriately set, so they can sustain the unpredictable (but inevitable) short-term volatility and remain long-term owners.

Plenty of pessimism remains in the marketplace, but that could be an opportunity to use contrarianism as a tool. As with any indicator, it is important to understand the underlying assumptions. In the case of a relatively flat S&P 500 Index, it is less about the global economy and more about the top ten companies that have been net beneficiaries of the current environment. At Punch & Associates we will continue to focus on the "knowable." Owning companies with sound business models, strong management, and solid balance sheets at reasonable valuations best positions our clients for attractive returns over the long-term.

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

Not So Obvious

John Carraux, CFA, CIC
Managing Partner

The unexpected consequences of COVID-19 on small cap stocks

A few weeks ago, I caught up with a friend whom I hadn't seen since the beginning of the pandemic outbreak early in the year. While maintaining appropriate social distancing, it was wonderful to spend time with someone not in my immediate household.

This friend of mine is married with a couple of kids and had been furloughed due to the pandemic. Expecting the worst, I asked how they were getting along financially. He perked up and responded, "This pandemic is the best thing to happen to us in years!" Not only was he making more money unemployed than working, but also, he had repaid some debt and bolstered savings with their family's federal stimulus check. I was surprised but glad to hear it.

In some ways, the unique nature of this health crisis and ensuing economic downturn has knock-on effects that few of us could have predicted. It is also unlike any recession anyone has seen before.

Some areas of the economy are obvious beneficiaries of virus fears and stay-at-home orders. For example, an e-commerce retailer that sells unique handmade goods that saw its sales double in the month of April, as consumers were couch surfing rather than mall walking. A home healthcare company should see stronger demand as the elderly may be reluctant to move into assisted living or long-term care facilities. Healthcare and technology-related companies are benefiting the most from this pandemic.

Surprisingly, perhaps, many consumer-related businesses are also seeing relatively strong demand today, in part because of government stimulus but also because Americans today have more free time and more discretionary spending after saving money on things like restaurants, travel, and entertainment (concerts, movies, etc.). We have been surprised by the strength in boat sales, golf equipment orders, and the sharp rebound in new and used car sales. New home construction also remains above expectations as housing supply is tight, and some urban dwellers are beginning to look for more space in the suburbs.

Of course, there will be structural changes on the other side of this recession that will herald a new, more difficult reality for some companies. The need for commercial office space and the layout of workspaces will certainly shift as companies see the benefit of work-from-home arrangements. Small businesses (especially restaurants and retail stores) will likely struggle, as Americans increasingly adopt online shopping and delivery habits. Media consumption and advertising trends may also accelerate away from linear television and toward on-demand and social media.

While small cap stocks fell harder in the first quarter of 2020 than large caps, they rebounded faster in the second quarter... Small cap value stocks are particularly attractive as their valuation is among the lowest in decades.

While small cap stocks fell harder in the first quarter of 2020 than large caps, they rebounded faster in the second quarter. These companies, which tend to be more economically sensitive and more domestic than global, continue to reflect concerns over the durability of the economic recovery. The Russell 2000 Index is off 13% on a year-to-date basis while the S&P 500 Index is down 3%. We believe that, after several years of lagging performance, small caps are an inexpensive investment in advance of an eventual economic recovery. Small cap value stocks are particularly attractive as their valuation is among the lowest in decades. While the way Americans live their lives after this pandemic will certainly be different, it may also continue in expected ways. We are working hard to figure out which businesses will benefit long-term and focus our efforts on your behalf accordingly.

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

Mistakes are Made in Moments

The value of a behavioral accountability partner

Andy Matysik
Managing Partner

You likely have encountered the adage that we should worry about what we can control and not obsess about the things that are outside of our control. We might easily nod in agreement with this bit of wisdom, but implementing it in our daily lives can be very hard. At times, the world seems to conspire to derail even the most well-thought-out planning. Many factors can impede a long-term plan, and often, we cannot change these realities (think recessions, destructive weather events, or sudden health crises), but one area in which we can—and absolutely should—endeavor to take control is in our *behavior*. Constructive investor behavior is a key ingredient to a successful long-term investment plan. Often, investors become their own worst enemy when they fail to manage their response to investment volatility.

Our group has a 37-year history of advising clients of various temperaments, objectives, and attitudes towards risk. While guiding people with different personality types through varied market conditions, we have noted that no one is immune to mistakes, and people often get tripped up during times of heightened emotion. Investors are predictably irrational, and mistakes are made in moments when we are tired, lose focus, operate out of fear, or are tempted to do something we wouldn't do under normal circumstances.

When we are tired…

In December 2008, President Clinton said, "In my long political career, most of the mistakes I made, I made when I was too tired…[y]ou make better decisions when you're not too tired." I remember hearing him say this in an interview, and something about hearing a person admit this from a position of such responsibility and influence resonated with me. I began to more closely tie *fatigue* to the propensity to make mistakes, and I began to prioritize getting adequate sleep.

When we lose focus…

When the deluge of news and data attacks us or we are confronted with a crisis, we naturally shorten our vision to the immediate term. We quickly lose sight of our long-term goals and the stated purpose for our wealth. In our view, we must maintain an investment posture that mirrors not only the goals we are working to accomplish but also the timeframe in which we are hoping to accomplish them. We have difficulty seeing the more meaningful and relevant long-term horizon if we are hyper-focused on the next six to 24 months.

When we operate out of fear…

Fear is one of the primary human motivators. We could view fear as a gift, I suppose, for purposes of survival. When we operate from a fear-based mindset, we are quite literally using a distinct part and function of our brains that we would not use in a more rational state. When making decisions from this place, the only goal is survival. Long-term goals are not within our field of vision. If we are fearful, we should be aware that we may be inclined to make decisions out of instinct rather than logic, and these decisions could have significant long-term implications for our well-being. We should acknowledge that we are thinking and feeling this way and try to understand what is driving our heighted reaction, so that it does not become an over-reaction.

When we become tempted…

In 2010, Rolf Dobelli released an article entitled "Avoid News." In it, he asserts that "news misleads us systematically, massively increases cognitive errors, and it manipulates us."

He goes on to write that news can be toxic to your body: "News constantly triggers the limbic system. Panicky stories spur the release of cascades of glucocorticoid (cortisol). This deregulates your immune system and inhibits the release of growth hormones. In other words, your body finds itself in a state of chronic stress…. *News consumers risk impairing their physical health*. The other potential side effects of news include fear, aggression, tunnel-vision and desensitization."

"Personally, I worry that, with everyone wearing masks, readers won't be able to tell who in the cartoon is speaking."

For those of us struggling with an addiction to news, it may be helpful to remind ourselves that the newsroom has no idea who you are, what you are trying to accomplish, what your risk tolerance is, what your income needs are, or when you plan on using your money. But you know the answers to those questions, and you discuss those answers with us each time we meet. Together, we have designed a financial, investment, and estate plan that will help you meet those goals, no matter the tenor of the daily news at any given time.

In building out asset allocation models for clients, we account for eventualities like recessions, bear markets, interest rate shocks, inflation, commodity price volatility, currency fluctuations, and the like. We forecast based not just on the *possibility* that these challenges will occur but based on the *probability*—the certainty—that they will. In short, your investment mix has already contemplated the eventuality that the stock market will go through some very difficult periods during your years as an investor.

The current year has tested our resolve, caused us to question many things, and for some, it has even tempted us to throw the playbook out the window. At Punch, our objective is the proper and successful fulfillment of what you have told us is important to you: Not just getting you from "point A" to "point B" taking into account your goals and risk tolerance, but knowing you along the way. We believe that staying in relationship as you work through seasons of life allows you the benefit of objective expertise during stormy times. Most often, this spans several years, even decades. In some cases, we are planning for multiple generations. While we do not operate with perfect clarity, we seek to be a ballast for your family through the uncertainty. Especially in times like these, we should renew together our focus on your qualitative goals.

As we navigate the current pandemic, a dedicated and trusted ally can help instill the patience, accountability, and discipline that is relevant to you and your family's needs. We are honored to live, endure, and celebrate a multitude of "moments" with you over our lifetimes, and we seek to counsel you through the moments when you need to make critical decisions along the way. Our focus is on your whole picture and your entire financial life. We are humbled to partner with you in this way.

Client Portal Announcement

We are in the process of rolling out our client portal. Our portal is directly integrated with our portfolio accounting and performance software, offering you more clarity and transparency around your financial situation. The 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 contact Steve Geier if you are interested in accessing the portal.

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