Punch

Newsletter
Third Quarter 2020

Investing and Learning

Howard Punch
President and CIO

Do we really learn from our mistakes? It depends on the mistake.

The year was 1984. I had a solid three or four months under my belt as a stockbroker for a well-known Wall Street firm. Back in those days, the young brokers were placed out in a large boardroom, and we each had desks and our own phones, but we had to share a computer called a Quotron with a similarly inexperienced broker. My manager had me sit next to a fellow who didn't really need a job because he married into substantial wealth. He would generally get to the office at around 10:00 am and spend his days on the phone figuring out tennis dates for the evening and exchanging stock tips with his friends from "the club" while hogging the Quotron. I was just getting started, didn't have many clients, and the ones I did have mostly invested in tax-free municipal bonds. At the time, I thought recommending stocks was something for brokers who were a bit more seasoned.

The stock tips my Quotron partner would share were more than enticing. I had my student loans paid off at that point and had started a small portfolio of my own filled with comparatively boring stuff. What could it hurt to try one of his hot picks, right? So, I bit. And I also told a few family members and friends. I mean, why shouldn't they get a piece of the action too? The stock took off, and after several weeks, it became a significant part of my little account. I was feeling pretty good, my family members and friends were happy, and I didn't have to do a stitch of research! Then, *the article* was published.

In the mid-80s, there was a columnist for Barron's named Alan Abelson who published a column that appeared each weekend. Alan was a cerebral curmudgeon who prided himself on exposing the fiction that might exist at companies whose stock prices were ascending more rapidly than others. Toward the end of his article my hot stock got a mention, and it wasn't good. That Monday morning shares of the company opened down more than 50%, and my friends and family were calling. (My Quotron partner decided not to come in that day.) By the end of the day, the shares lost most of their value, and I got out.

Mistakes are part of the business. They are tuition for stock market participants...especially new ones. But it was tough to have perspective back then. I just felt pain and embarrassment. Looking back now, I can see how this was a very valuable mistake because of the humiliation factor. The lost money was one thing—and if that was all it was, I may not have learned my lesson—but I knew I didn't want to feel this humiliation again. I was trying to get rich quick, take a shortcut, and I got burned. Worse, I hurt others. A few phone calls and I probably could have figured out what Alan Abelson learned about this investment. I was lucky that this didn't happen later when I had many more clients who would have been burned by my laziness and poor judgement. It was a rookie mistake that I have never forgotten.

> *"Success is a lousy teacher. It seduces smart people into thinking they can't lose."*
>
> *Bill Gates*

Continued on the next page...

This Year's Rookie Class

The confluence of events this year has invited new participants into the stock market. Covid-19 has allowed many workers to conduct their work activities from home without the normal daily interference. Many workers have opened their first stock or options trading accounts during this time frame. We welcome them. According to CNBC, the major online brokers—Schwab, E*Trade, and Robinhood—saw new accounts grow as much as 170% in the first quarter when stocks experienced the fastest bear market and the worst first quarter in history. Since that point, things have turned up. They have turned up quickly. Our guess is that many of these new investors have experienced early success.

New investors generally like to be well positioned for what has already happened. If what's happening keeps happening, they are fine and can ride the wave. The "wave," in this case, is the cycle of owning popular technology and consumer companies. And this trend has been a particularly long one. The price chart below illustrates the trajectory of the stock market's five most popular companies since 2012. The acronym FAAGM stands for Facebook, Apple, Amazon, Google, and Microsoft. Clearly these companies have been great bets since 2012, have benefitted from the trends inspired by the pandemic, and now make up *roughly a quarter* of the S&P 500 Index. Will this continue? We don't know. New and old investors are clearly betting that it will.

Bank of America's monthly fund manager survey finds that 74% of professional managers say owning U.S. tech stocks is the most "crowded trade." That's the highest reading since the survey started asking the question in December 2013. While our strategies have some exposure to a few of these popular companies, we are not going overboard or becoming complacent. Our case for a while is not that these companies won't do well, it's that they won't be the only ones that succeed. The biggest mistakes seem to be made at turning points in leadership in the market: too many investors betting too much on the same thing taking place, and then it doesn't. Most investors extrapolate; we regard this as a geometric term, not an investment strategy.

Investing is Hard

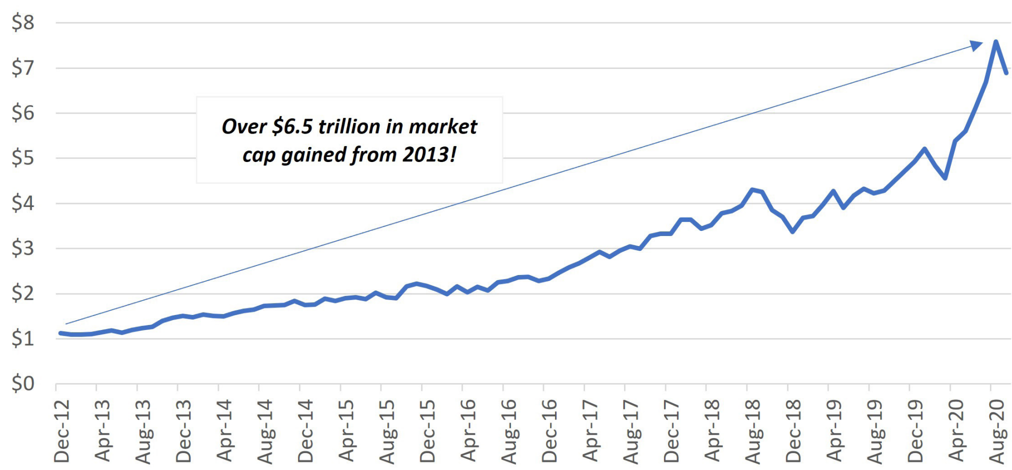
"If you're great in this business, you're right six times out of ten."

Peter Lynch

Everybody eventually makes mistakes and so will this new generation of investors. Some may even learn from them. My early mistakes I have never forgotten, and I have made many more since. Our team regularly reviews contributors and detractors to our strategies' long-term performance and, for the detractors, wrestles through what went wrong in our thinking. Per Mr. Lynch's words above, we understand that mistakes are part of everybody's investment experience, but we try to learn from each one of them.

We've said this before: Investing is hard. Most of the errors we see investors make are behavioral mistakes that fail to acknowledge these words. Investors who internalize these words in every market environment may have a better chance of enjoying a full measure of success. Assume that it will always be difficult to make money in the markets, and then be surprised when it is easy. Not the other way around.

FAAGM Aggregate Market Capitalization
(In Trillions USD)



Note: FAAGM stands for Facebook, Apple, Amazon, Google, and Microsoft.
Source: Punch & Associates and Bloomberg.

Punch Income Strategy

The Behavior Gap

John Carraux, CFA
Managing Partner

Recent studies highlight the pitfalls of market timing in fixed income.

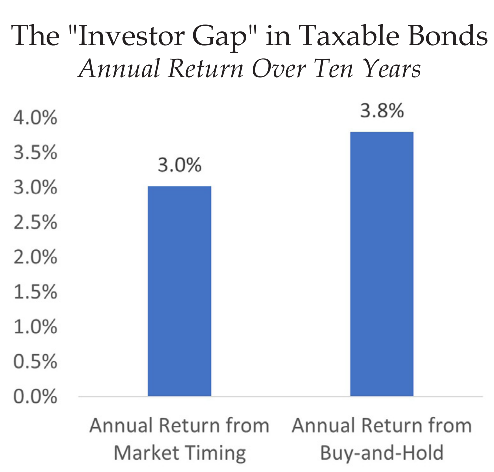
Although instinct may tell us that now is the time to sell what hasn't worked lately and buy what has, history tells us that this may not be the best choice. It pays to "mind the gap."

In the summer of 2013, municipal bond investors were nervous. Interest rates had doubled in a matter of months, both the city of Detroit and the commonwealth of Puerto Rico had filed for bankruptcy, and in short order, investors yanked over $60 billion out of municipal bond funds. The S&P Municipal Bond Index fell over 6% for the year.

By the end of the following year, interest rates settled down, credit fears abated, and the asset class began to repair itself. The index ended 2014 with a 9% total return for the year, more than making up for the prior year's losses. Capital began to flow back into municipal bonds, although most of the inflows took place after the rebound had already begun.

The 2013-14 episode for the municipal bond market is not unlike patterns we have seen in other asset classes over time. When markets decline, investors tend to see "red flags" and sell. As markets rise, investors view these increased prices as an "all clear" sign and buy. This is the opposite of "buy low, sell high," but it is nonetheless how many investors are tempted to react as we watch markets gyrate.

A recent study by investment research firm Morningstar confirms this pattern of behavior and quantifies its effect on portfolios. The study, "Mind the Gap," tracks the difference in returns between investors who traded in and out of investments over time and those who simply stuck with their plan and made no changes. The results are not particularly surprising: attempts to time markets, particularly in equity funds and municipal bond funds, lead to lower returns over time.



It may be surprising, however, to hear that municipal bonds and taxable bonds saw one of the widest return gaps among the groups tracked by Morningstar. Normally, we associate market timing with equities, tech stocks, and the like—not fixed income. According to the study, taxable bond investors who attempted to time the market underperformed by 0.8% annually, which is significant compared to the 3.8% annual return the asset class provided to begin with.

Part of the reason for this behavior may be explained by the environment in which we presently operate. In an era of low interest rates, fixed income securities tend to be more volatile in general. And with the looming fear of rising inflation and higher interest rates—which have so far failed to materialize—investors may have an itchy trigger finger if they see rates hint at an increase.

Today we find ourselves in a highly unusual market environment for income securities, one in which many have performed poorly this year. Even securities like utilities, preferred stocks, and real estate investment trusts continue to languish behind other areas of the market. A recovery in prices likely hinges on an economic recovery and life beginning to return to normal.

Although instinct may tell us that now is the time to sell what hasn't worked lately and buy what has, history tells us that this may not be the best choice. It pays to "mind the gap."

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

YOLO: Staying Focused on What Matters

Paul Dwyer, CFA
Director of Research

Ignoring the noise in order to invest for the future.

After more than six months of working from home, I continually need to decide if "live to eat" or "eat to live" is my defining consumption habit. Whether trying to avoid another trip to the pantry or determine if lunch should be a healthy salad or a juicy burger with fries, it can be a battle to stay focused on what matters. This challenge is compounded, as the "live to eat" crowd appears to have more fun in the moment. My future self will be grateful for some discipline today, but that doesn't make the battle easier.

We saw plenty of market activity in the third quarter that could lead long term investors astray. Stuck at home, many people flocked to the stock market to occupy their extra time. Online message boards exploded in popularity with discussions around the hot stock of the day, along with phrases like "YOLO" (you only live once) tagged to videos encouraging others to day trade. Observing from the outside, the day traders appear to be enjoying themselves, but the only clear winners we see are the trading platforms enjoying the surge in volume and, thus, their profits.

In our opinion, a YOLO philosophy is fine for sports betting, but in the stock market, it is best thought of as an indulgence like chocolate cake. Punch's Large Cap Strategy is a "fruits and vegetables" approach, as we focus on long term capital appreciation. In our opinion, the healthiest place to look for future additions to the portfolio is in businesses with solid fundamentals but, for one reason or another, are out of favor in the minds of other investors today.

As shown in the nearby chart, value stocks are glaringly out of favor. Simplistically, value stocks' valuations are more dependent on current earnings, where growth stocks' valuations are focused on future earnings (earnings that have not yet occurred, but people are optimistic that they will). Not since February 2000 has the performance discrepancy between growth and value stocks been so wide. While it is nearly impossible to time a change in sentiment, what is also clear from the chart is that, when sentiment turns, it can turn in a hurry. After February 2000, value recouped all its underperformance (growth gave back all of its outperformance) within 12 months after the cycle turned.

Look no further than the leaders of today's growth stocks to see the power of owning value stocks. A big reason for the recent relative outperformance of growth stocks is because its leaders started as value stocks. Two of today's biggest growth companies traded on classic value metrics back in 2013. Both were priced around 10x earnings and had over 20% of their market capitalization in cash. Today, both trade around 30x earnings.

Not all growth stocks will be terrible performers in the future, nor will all value stocks be home runs. Our favorite investments are companies that start as value stocks and transition to growth stocks over time, and that has certainly been the case in many of our portfolio's best performers. As we look for new companies to own, we will focus on out of favor companies in order to benefit from strong underlying fundamentals as well as any renewed sense of enthusiasm in their businesses.

Focusing on out of favor companies also helps guard against recency bias. This year has repeatedly demonstrated how quickly change occurs and how hard it is to anticipate. Based on growth stocks' recent outperformance, it appears that confidence in the future is euphoric for some companies, and it has all but disappeared for others. It is hard to imagine what disrupts today's leading growth companies, but great businesses don't always make great stocks, especially if valuations reflect their greatness. The fact that disruption is unimaginable is also a key risk to their future stock success – probability of disruption is not factored anywhere into the valuation.

Our goal is to compound capital at attractive rates while minimizing risk. Investing in healthy companies where expectations are low can go a long way in ensuring that the future is not a disappointment. After all, YOLO, and we want to make sure our clients' future selves also enjoy the result.

Relative Price Index

Large Cap Value / Large Cap Growth

Note: Russell 1000 Value Index / Russell 1000 Growth Index as of August 1992 (indexes' inception). Source: Punch & Associates and Bloomberg.

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

One for the History Books

John Carraux, CFA
Managing Partner

Pandemic conditions create investment challenges—and opportunities.

Along with all the other historical records set this year, we would like to add one more.

For a brief few days at the beginning of September, the market value of one company—Apple Inc.—was greater than the market value of the entire Russell 2000 Index, which represents the 2,000 smallest public companies in the United States. If you had a spare $2.3 trillion, you could either own all of Apple, or you could own all of Papa John's Pizza, WD-40, iRobot, La-Z-Boy, Del Monte, and 1,995 other companies.

The pandemic of 2020 has upended many businesses and industries while rewarding others in unexpected ways, and nowhere is that more apparent than in the extreme concentration of market value among a very small handful of stocks, many of which are prime beneficiaries of lock-down orders, social distancing, and work-from-home arrangements.

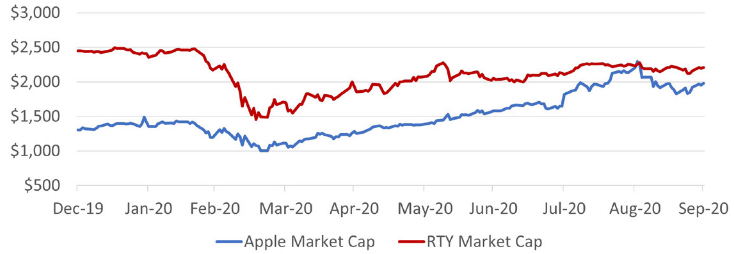
Some have referred to this as a "K-shaped" economic recovery: while the largest technology companies are doing well today, many others are not. The recovery is by no means uniform.

Apple, one of the most respected companies in the country, is not a cheap stock. Today, shares trade at 35x price-to-earnings and 7x price-to-sales. Despite its label as a growth company, earnings per share grew only 4% in 2019 and since 2015 the company's operating income is actually down. If Apple were a bond, it would have a paltry 3% yield.

The Russell 2000, by contrast, trades at a more reasonable 17x price-to-earnings and 1.1x price-to-sales. While earnings for the index are projected to be flat in 2020, the outlook for 2021 earnings is 11% growth. In bond terms, the earnings yield on the index is a respectable 6%.

The disparity in performance between groups of stocks this year is also one for the record books. The difference between small cap growth (up 4% in 2020) and small cap value (down 22%) has not been this wide since the dot-com bubble of 2000. Companies like manufacturers, banks, and utilities all depend on a return to economic normalcy for their businesses (and their share prices) to recover from the pandemic effects. In contrast, many technology companies benefit now, but may be hurt later, once COVID-19 gets under control and normal patterns of living resume.

Market Capitalization (in billions)
Apple Inc. versus Russell 2000 Index



Source: Punch & Associates and Bloomberg.

In the Punch Small Cap Strategy, our research team has been busy uncovering new investment ideas despite the limitations of travel today. Many meetings and site visits have gone virtual, and there is no shortage of activity in monitoring current portfolio companies and sleuthing new ones. Unlike Apple, with 43 brokerage analysts publishing recommendations on its stock, the average Punch company has only five analysts, which provides us ample opportunity to get to know the company better than other investors. In the third quarter, we added three new companies to the strategy and exited one.

While a return to normalcy is impossible to predict, we believe that many high-quality small cap stocks are being unfairly punished in this COVID era and that, over time, this value will be recognized. In the meantime, we are hard at work identifying those companies that we believe may do well over the next three to five years.

Some have referred to this as a "K-shaped" economic recovery: while the largest technology companies are doing well today, many others are not. The recovery is by no means uniform.

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

A Guide to Resilience: Preparing for Difficult Circumstances

Jessica Johnson, JD
Managaing Partner

In America today, we avoid suffering as part of our individual and collective identities. We have whitewashed our history and focus on prosperity, success, and abundance. We are a nation of winners, and to belong, we encourage living in the American Dream. We polish our resumes, and our social media profiles shine. Culturally, we are inclined to live a storybook existence.

Despite our desired narrative, we know that everyone faces challenge and loss in life. For generations, our ancestors have encountered substantial adversity. Some have survived these challenges and, in many cases, thrived in their aftermath. Early civilizations, living without modern day medicine and the ease of a well-developed economy, viewed suffering as the origin of knowledge. An Ancient Greek dramatist famously wrote, "Wisdom comes alone through suffering." A Japanese proverb says that "only through suffering and sorrow do we acquire the wisdom not found in books."

Our reality is that all of us at some point in life face difficult situations. Those challenges could be financial, physical, emotional, or relational. No one is immune; there is no vaccine against grief. To feel sadness, sorrow, and loss is to be human. While we may find comfort in realizing that we are not alone in our challenges, we have a hard time reconciling our American social narrative with the pain we feel at times.

How can we better prepare ourselves—and our children—to handle the inevitable adversities of life? Is it possible to prepare for future loss, so that we may weather the experience more successfully? While it may be difficult to manufacture true hardship, is there a way to develop habits and teach ourselves to embody certain behaviors and characteristics that lead to greater resilience?

Embracing Vulnerability

A few years ago, I received a terrifying health diagnosis. I spent the first few days after hearing from the doctor in a fog. I took long walks alone, trying to understand and internalize the news. Eventually, I began confiding in others—first family, then friends, then coworkers. As I shared the situation, amazingly, people responded with grace, affirmation, and offers of support. Openness about my condition removed much of the fear and isolation I felt in those early days.

Acknowledging a struggle or difficult situation is the first important step to working through suffering. But embracing vulnerability sounds incredibly scary. Author Brené Brown insightfully observes that vulnerability is not a sign of weakness, but rather one of *strength*. She describes the state of being vulnerable as the most accurate way to measure courage. Opening up to family and friends for support is vital to weathering the storm. We are designed to live in community for exactly these types of situations.

We should acknowledge at this point that "suffering" can include a wide array of experiences, not just the direst of situations involving our mortality. Very real challenge may involve disconnect in relationships or missed financial expectations. As advisors, we're privileged to encounter some of the most important issues in life with our clients, and we encourage you to include us in your support community. Our role is to travel with you through the many terrains of life–to listen when you need an ear, cheer when you have good news, help navigate rough waters, and celebrate milestones along the way. We have a very unique vantage point in this role, having gotten to know you and your family and listened to you describe your values, goals, and hopes for the future.

Finding Purpose

A few months into my freshman year of college, I had my first up close and personal experience with tragedy when my father died suddenly. I was lost in grief but, with the support of my amazing mother, committed to continuing my education several hundred miles away from home. I quickly found out that some of my fellow students had already learned the bittersweet lessons of coping with loss. The next summer when a friend encountered a similar situation within her own family, we met for coffee and talked for hours, observing the ways in which our losses were similar and finding comfort in our shared experiences. I realized then that, because I had been through the depths of grief in my own life, I could have a genuine empathy for others. That empathy still is a powerful tool in relationship with others, and it became for me one of the silver linings of the very dark storm clouds of losing my dad. Many of you may have had this same observation after going through a difficult time. Finding purpose in the aftermath of pain brings healing and amplifies the knowledge that even our darkest days need not go to waste.

Our mission at Punch is to help families and institutions steward resources with clarity and purpose. Often, those who more easily define purpose are those who have had life experiences which inform their priorities. Are there events from your past that share your view of money? We've observed that people who identify and articulate *purpose* for their wealth have a relatively high degree of conviction during times of uncertainty. If you haven't come to an understanding of the purpose for your resources, we would welcome a conversation with you on this topic.

Developing Resilience

Despite our cultural determination to disassociate with suffering, we work with many parents and grandparents who feel their children have it too easy and will struggle because they lack adversity in life. The parents know that they developed some of their own most important skills (e.g. a strong work ethic) by facing situations in which they lacked resources or had to figure it out on their own. They developed problem solving skills because they had no choice but to solve the problem. They worked hard and eventually learned to save money because they experienced what it felt like to go without. Some of the stories these families still tell today involve living on little-to-nothing and getting by nonetheless.

Is it possible to develop resilience without going through real hardship? In a recent article entitled "What Makes Some People More Resilient Than Others," a journalist reports recent research that indicates resilient people share the following characteristics:

1. Realistic optimism;
2. A moral compass;
3. Belief in something greater than themselves, often in the form of spiritual beliefs or concern for others;
4. Cognitive and emotional flexibility; and
5. Social connectedness.

If you're compelled, take a moment to write down these characteristics and reflect on whether they are true of you and your family members. You may even want to engage your family in a conversation about how these attributes show up in your daily lives and how you can foster them to a greater degree. Going through this exercise may help you prepare for future circumstances requiring resilience.

During this year's economic uncertainty, those of our clients who weathered the stock market volatility well included those who had been through wild markets in the past. Perhaps the resiliency trait they drew upon was one of *realistic* optimism. As Jason Zweig put it in the book Your Money and Your Brain:

> *...the only incontrovertible evidence that the past offers about the financial markets is that they will surprise us in the future. The corollary to this historical law is that the future will most brutally surprise those who are the most certain they understand it.... So the best way to immunize yourself against being surprised is to* ***expect*** *to be surprised.*

If we embrace the reality of future adversity, the certainty of the unknown, and the existence of the unknowable, we may be in a better position to navigate emotional volatility when we face rollercoaster markets.

Getting Organized

While it may be impossible to fully prepare for difficulties in life, we can take steps to make challenges easier to navigate. I am currently helping extended family traverse health issues and adjustments to living accommodations. In circumstances like these, I want to spend my time tending to the relationships I have with them, not battling disorganization in financial matters. The last thing I want to do is dig for passwords and account information.

One of the greatest gifts you can give your family is a clear, simplified balance sheet that you have coordinated with your estate plan. Your Punch team can help with this goal. A close second to the organized balance sheet is a decluttered home. These are matters that are within your power today. You might also want to take some of the time you have with your children or grandchildren to foster the characteristics described above found in resilient people.

My grandparents owned an old farmstead in north central Iowa. Family lore says that the house was originally a stagecoach stop in the 1800's. Framed on the farmhouse wall, just inside the creaking metal screen porch door, was the Serenity Prayer:

> *God, grant me the serenity to accept the things*
> *I cannot change,*
> *courage to change the things I can,*
> *and wisdom to know the difference.*

May we be like those of our ancestors who survived and *thrived* when facing adversity. May we make intentional choices to embrace vulnerability, find purpose, develop resilience, and get organized. We are ready and willing to help you accept the unchangeable and change the unacceptable. Invite us into these processes with you so that we can encourage you with realistic optimism as you increase your family's chances for successful outcomes.

Welcome Candice and Nia!

We're pleased to introduce the most recent additions to the Punch team; Candice Larson and Nia Harris. Candice works with the team as an Executive Assistant and Nia Harris as an Associate with the Wealth Strategies Group.

Candice Larson
Executive Assistant

Nia Harris
Associate, Wealth Strategies Group

The Integrated Investor

Earlier this year, we introduced "The Integrated Investor," an approachable forum about money, investing, planning opportunities, and meaning. The Integrated Investor is a new forum through which we endeavor to bring you timely and relevant insights and information so that you might find clarity and perspective in your financial life. You can find all of the episodes on our website, www.punchinvest.com.

Episode 1
History Rhymes: Volatile Markets and Our Response

Episode 2
Roth IRA Conversions: Buying Out the Government's Share

Episode 3
Investment Philosophy

Episode 4
Money and Politics

Episode 5
Navigating Behavioral Tendencies

Availability During the Coronavirus Pandemic

In the midst of the current pandemic, we continue to work remotely for the time being. However, 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.

Punch Contacts

WEALTH STRATEGIES GROUP

Andy Matysik
Managing Partner
andy@punchinvest.com

Jessica Johnson, JD
Managing Partner
jjohnson@punchinvest.com

Angie Pierce, CFP
Director, Wealth Strategies
angie@punchinvest.com

Ruth Langworthy, JD
Advisor, Wealth Strategies
rlangworthy@punchinvest.com

OPERATIONS GROUP

Andrea Barkley
Senior Operations Analyst
abarkley@punchinvest.com

Danielle Fischer
Operations Analyst
danielle@punchinvest.com

Miraya Gran
Operations Analyst
mgran@punchinvest.com

Steve Geier
Research Associate
steve@punchinvest.com

Client Portal Announcement

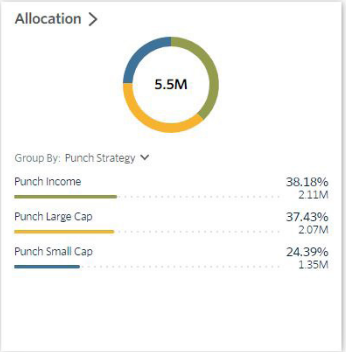
We are in the process of rolling out our client portal. Our portal is directly integrated with our portfolio accounting and performance software, offering you more clarity and transparency around your financial situation. The platform will enable you to:

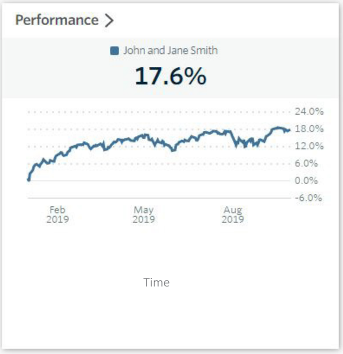
- View performance, asset allocation, holdings, projected income, and transactions by portfolio or individual accounts in an intuitive format;
- Link outside accounts and add private assets and liabilities to allow aggregated net worth reporting;
- View the most recent portfolio and account data and 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.

Phone: (952) 224-4350

Email: clientreporting@punchinvest.com





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