Punch

Newsletter
First Quarter 2021

Mercenaries or Missionaries?

Howard Punch
President and CIO

I have always been a Minnesota Twins fan. The height of my "fandom" was probably during my teenage years when the team may have been at its worst. In those days, we had little to cheer for other than another batting title for Rod Carew. During the 1976 season, Butch Wynegar was a rookie catcher who surprised everybody by batting over .300 for the first half of the season and being named to the American League All-Star team. I remember watching a commercial featuring Wynegar saying he loved the game of baseball so much he would play for nothing. Butch knew what he loved and why.

Al Dunlap had a storied career in business. In 1963, after serving in the United States Army for three years, he began a business career that took him through a dozen different companies with no single job lasting more than five years. "Chainsaw Al," as he was dubbed, earned a reputation as a hard-nosed turnaround expert. He would commonly enter a lead role within a troubled enterprise and lay off a massive number of workers to save the company money. His quickest "hit" was in 1994 when he became CEO of Scott Paper. Within days of accepting the role, he announced a layoff of over 11,000 workers. This decision awarded Dunlap over $100 million in salary, equity awards, and other compensation after he sold the company to Kimberly-Clark just one year later in 1995. The following year, Chainsaw Al was placed in a similar position with Sunbeam, a struggling appliance maker. Dunlap applied the same playbook, and the shares quickly rose over 70%. It was soon discovered, however, that his reputed turnarounds were elaborate frauds, and his career ended after their auditors uncovered a massive accounting scandal that forced the company into bankruptcy. Chainsaw Al was quite literally a hired gun. A mercenary.

We meet all kinds of people in our lives. Butch Wynegar was on a mission to play ball. Chainsaw Al didn't care whether it was paper or appliances...he was out to make the most money possible in the shortest amount of time. A "get rich quick" disposition rarely ends well. Dunlap's career reminds me of what Warren Buffet used to say about the importance of hiring people with integrity, energy, and intelligence. He said that "...if they don't have the first, the last two will kill you."

The "People Factor" in Investing

"People don't buy WHAT you do; they buy WHY you do it."

- Simon Sinnek

We have been analyzing management teams and putting "people first" in our research process since the founding of our firm almost 20 years ago. We prioritize this—almost selfishly—so we can sleep at night. Most people wouldn't let someone they don't know watch their house while they're on vacation, yet millions of people invest billions of dollars into companies when they don't know who is running them or what motivates them. To many, stocks are identified merely as ticker symbols in an app or numbers in a spreadsheet. We approach every investment with the mindset that we are going to be long-term owners of the enterprise. Therefore, it serves us well to know and have confidence in the operators of these businesses. One of the most challenging (and fulfilling) aspects of our work as a research team is assessing management. We like to discover their skills, their business philosophy, their values, their candor, the culture they are trying to build, and, most of all, *why* they are doing what they are doing. What gets them excited? These qualities are generally

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characteristics that quantitative screens fail to capture. We ask lots of questions to determine whether we should go into business with these folks. Remember that Enron was a company that "screened well" for profitability before proving to be one of the greatest corporate deceptions in history.

ESG

We get asked occasionally where we stand on ESG. ESG stands for Environmental, Social, and Governance and is a responsible investing movement that holds companies to a standard which goes beyond simply maximizing shareholder value (a concept put forth by the Friedman Doctrine[3]). A landmark study entitled "Who Cares Wins" coined the term ESG in 2005. ESG factors cover a wide spectrum of issues that are not part of traditional financial analysis yet may have financial relevance. These factors might include: how corporations respond to climate change; how good they are with water management; how effective their health and safety policies are in the protection against accidents; how they manage their supply chains; how they treat their workers; and, whether they have a corporate culture that builds trust and fosters innovation.

We believed in the foundations of ESG well before it became a well-worn acronym. The "G" in ESG, *Governance*, has always been a lynchpin in our process for vetting companies as potential investments for our clients. Governance = People. Our research—whether an investment gets into a Punch portfolio—*begins* (and sometimes *ends*) with the people. People are the ones that determine the "E" and the "S," so it makes sense to start there. To us, they should be interviewed like you would interview somebody who is applying for an important job. You should know how they are incentivized, how they intend to serve the world, and whether they are aligned with you as a shareowner. Despite the presence of social media and tools like Glassdoor, you can't easily see most of what happens inside a corporation. Good and bad things can happen well before they ever end up hitting the balance sheet or the income statement. Once you understand the business, understanding the people can help you gain comfort with how the numbers may change, positively or negatively.

ESG started as an authentic movement with the intention of getting companies and investors to come together and make the world a safer, cleaner, and better place. While we believe in the foundations of ESG, we also must point out that Wall Street is doing what it always does with a concept that people are buying: It is selling the hell out of it. Blackrock's ESG Aware USA ETF (ESGU) has gone from $180 million in assets to over $15 billion in just two years. Most of the larger ESG funds look alarmingly similar to an S&P 500 Index fund. This has been a pretty decent index to emulate for 10 years, but I wonder if the popularity of these funds would diminish if their performance starts to lag. History has shown that investors can demonstrate mercenary behavior as well.

Many more ESG products are being introduced daily, some by people who view ESG as a religion, and some by those who see it as a marketing opportunity. In the end, a movement conceived with such good intentions might be dominated by a crowd that is simply following the money. They might be mercenaries masquerading as missionaries.

Beware of Too Many Mercenaries

Principled operators of public companies who have a missionary zeal for what they are doing are difficult to find (but are worth looking for). Mercenaries, on the other hand, can be quite easy to find…especially when a corner of the stock market gets hot and investment bankers get involved and start "fanning the flame." With parts of the stock market up over 100% in the last year and with Reddit and Robinhood investors re-writing the rules on how to get rich quicker, one should become acutely aware of mercenary management teams. If you are trafficking in some of these hot areas, you can't swing a dead cat without knocking over a herd of mercenaries. Many of these folks will scatter like cockroaches when a trend dies out, and they will scurry to a new area that promises overnight riches. We actively try to avoid these types of operators.

John Doerr, a legendary venture capitalist at Kleiner Perkins Caufield & Byers, is famous for making some of the world's best investments including early stakes in Compaq, Genentech, Google, and Amazon. A Harvard Business Review article summarized an event where John spoke about the difference between mercenaries and missionaries in business:

> Mercenaries are opportunistic. They're all about the pitch and the deal and are eager to sprint for short-term payoffs. Missionaries, on the other hand, are strategic. They're all about the big idea and partnerships that last, and they understand that this business of innovation is something that takes a long time—it's a marathon, not a sprint. Mercenaries have a lust for making money, while missionaries have a lust for making meaning.

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Bet on the Missionary

As for Butch Wynegar? He didn't play baseball for nothing, and he didn't finish a storybook career as a Minnesota Twin. After making his second All-Star team in 1977, Butch's batting average tailed off. Twins mercenary owner Calvin Griffith unceremoniously traded Butch to the Yankees in 1982 to unload his hefty contract after a sub-par season in 1981. Wynegar got his revenge, batting nearly .300 over the next two seasons for the Yankees before injuries caught up with him, halting his playing career prematurely.

We get particularly excited when we find a good business managed by a principled leader with a missionary enthusiasm. We feel we are giving our clients the best chance to succeed if we fill portfolios with companies led by good people in whom we believe. Our calling is to find these missionaries before others do.

"Grandma, why are all of your photos from 2020 screenshots?"

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, CFP©
Advisor, Wealth Strategies
rlangworthy@punchinvest.com

Ryan Punch, CFP©
Associate, Wealth Strategies
rpunch@punchinvest.com

Candice Larson
Executive Assistant, Wealth Strategies
clarson@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
Director of Technology Experience
steve@punchinvest.com

Punch Income Strategy

A New Paradigm

John Carraux, CFA©, CIC©
Managing Partner

Positioning income investors ahead of higher interest rates and inflation

You don't have to look hard today to find signs that inflation is picking up all around us. Whether it is at the gas station, the grocery store, or the local hardware shop, the cost of goods and services, broadly, seems to be marching higher. Even large ticket items like cars, homes, and sporting goods—when they're not out of stock—are becoming more expensive. Should investors be worried?

The perception that inflation is heating up is real, and statistics confirm that many prices are, in fact, rising. The Bloomberg Commodity Index (which includes a broad basket of commodities like natural gas, copper, and coffee) has risen 40% over the past year. Some of the recent inflation pressures are simply a return to pre-pandemic prices, though, as this index is at the same level it was in early 2019. As we lap the historic low points of early 2020, when the predominant worry was *deflation*, not *inflation*, prices look and feel elevated.

Still, the U.S. has just unleashed the most fiscal and monetary stimulus in the history of the country (more than any war or crisis ever), and the speed at which money is flowing through the economy is likely to pick up meaningfully this year. As the economy reopens and consumers increase their spending, inflation could rise and bring interest rates along with it. Rising inflation and interest rates erode the value of dividends and interest and are generally associated with lower bond prices. Long-term treasury bonds are already in a bear market as compared to one year ago, having declined over 20%.

While we think it is unlikely that "runaway inflation" (of the sort seen in the 1970s) is a near-term possibility, we are still positioning income portfolios for the likelihood that interest rates will continue their recent ascent. We are avoiding long-term, low-coupon, fixed-rate investments and have been increasing exposure to areas that could *benefit* from higher rates including floating rate loans, timberland real estate investment trusts, and convertible bonds. While energy pipelines and MLPs had a terrible year in 2020, we think they are also particularly well-situated today with attractive valuations and stable payouts to shareholders.

Income investors have had a bumpy ride over the past couple of years as the pandemic took an unexpected toll on many businesses. Some investments which are normally defensive and conservative in nature were hit hardest. Our view is that the Punch Income portfolio is well-positioned for both an economic recovery and higher interest rates over the next several years. While life may not quickly go back to "normal" after the pandemic, things are at least moving in that direction, and 2021 may end up surprising many investors with its economic strength.

"While we think it is unlikely that 'runaway inflation' (of the sort seen in the 1970s) is a near-term possibility, we are still positioning income portfolios for the likelihood that interest rates will continue their recent ascent."

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

Looking Past Fear

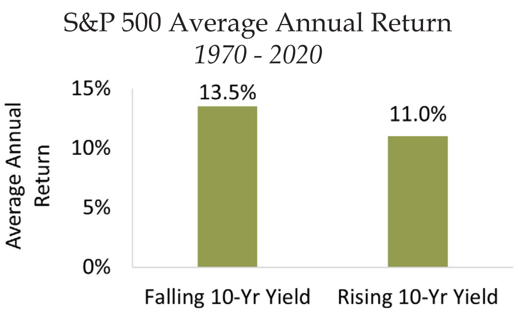
Paul Dwyer, CFA©
Portfolio Manager

How short-term market concerns can create long-term investing opportunities

I am grateful that many kids were able to maintain a sense of normalcy this year despite the pandemic with the continuation of organized sports. My twin boys played soccer and hockey, masks and all, and it was fun to watch them enjoy themselves and continue to develop as players. They are finally at an age where they really understand the flow of a game. Later this year, my four-year-old daughter will start soccer, which will likely be a mob of children swarming the ball and not spreading out much (unless you count the child that stops to pick dandelions). It is noticeable how the better players start anticipating where the play is going in a game and positioning themselves in the right spot ahead of others.

We apply this same anticipatory exercise with investing. Opportunities occur when the focus for most investors is on where the ball is currently and not where the play is going. What is "obvious" is likely already old news.

For example, we bought one of our largest positions in the Punch Large Cap Strategy when we thought investor concerns over the trend towards "cord cutting" (consumers ditching their expensive cable bills and switching to streaming services like Netflix and Hulu) was getting too much attention. We believed that this media company, with its strong track record and significant library of owned content, could be successful with its own brand-new streaming offering, a point that many investors were not willing to concede at the time. Sometimes it pays to think differently than the crowd, and sometimes value is best found by embracing what many perceive to be a dated concept.



Rising interest rates are a growing concern of some stock market participants, and while this view may eventually prove to be right, our opinion is that the equity market is overly discounting these fears today. Whether interest rates rise or fall in a given year, the S&P 500 Index has historically produced a double-digit average annual return since 1970, and the difference in returns is not significantly different in either case (see nearby chart).

If interest rates rise, we believe that the Punch Large Cap Strategy could do well on a relative basis for several reasons. First, we are overweight companies in the financial sector which tend to benefit from higher rates. Second, seven of the top ten companies in the strategy are classified as "cyclicals" which tend to do better when the economy is improving (rising interest rates often signal an improving economy). Finally, we favor companies in the Large Cap Strategy that are self-funding, meaning they generate enough capital internally to fund investments without raising outside capital. As the cost of outside capital increases with higher rates, these financially self-sufficient companies should benefit.

In the first quarter, we added a new position in a building products distribution company to the Punch Large Cap Strategy, as concerns over rising interest rates were likely pressuring the stock price. Rising interest rates historically are not great for housing-related investments. Our view, however, is that the low level from which rates are starting today and the hugely favorable demographic trends in housing could offset any demand pressure from more expensive mortgages. Time will tell, but we think the building distributor's ability to service customers well and operate efficiently, along with the health of the broader economy, will have a larger impact on the company's future value than the movement in interest rates.

I grew up playing on the same sports fields in the same town as my kids do today. Back then, it was my dad shouting things from the sidelines like, "Spread out!" and, "Look for the open player!" Thirty years later, I am doing the same thing. Just as kids will always love to play sports (and parents will always take it too seriously), there will always be some short-term event in investing that causes concern. Our job is to weigh near-term concerns against the long-term direction for businesses in hopes of finding the next investment opportunity. By focusing on the years to come, we hope to bring home more than the proverbial participation trophy at season-end.

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

Doggone Crazy

The differences between investing and speculating in a pandemic

John Carraux, CFA©, CIC©
Managing Partner

A few weekends ago, one of my son's thirteen-year-old friends stopped me on his way to the neighborhood skate park. "You work in investments, right?" he asked. "So how have you done on GameStop?" I patiently explained that my work is investing, not gambling, and that I have never traded GameStop or any other stock just because I found it on an internet message board. Brushing off my lecture, or perhaps not really grasping the nuances, he asked my opinion on Dogecoin, a cryptocurrency that bills itself as "the fun and friendly internet currency" and whose logo is a Japanese dog. "I told my parents to buy it," he proudly declared, "and it's up like ten times since then." He has certainly outperformed anything I own over the past two weeks.

"Serious investing that is meant to build permanent wealth over a lifetime requires intelligence, a healthy appreciation for risk, an even temperament, and a large dose of patience."

Stories like these abound today. Suddenly, everyone is a stock market genius, and even thirteen-year-olds double or triple their money in days. One cannot help but think back to the shoeshine boys of the roaring 1920s with their hot stock tips and hours spent near the ticker tape to wonder if this is an ill omen for the stock market. The saga of GameStop—a dying mall-based retailer of video game cartridges that was briefly worth more than Delta Air Lines in January—is the poster child for the excesses, irrationality, and downright lunacy that exists in pockets of the market today.

The proximate causes of this madness of the crowds are not hard to identify. A bored, underemployed, locked-down investing public was offered commission-free trading by online brokers like Robinhood that purposefully created a casino-like experience for their "investors." This gamification of investing has hoodwinked a whole generation of young investors who did not experience the great financial crisis of 2008-09 (and who may not have even been alive in 1999-2000) into thinking that the stock market is a giant roulette wheel. We all know how this story ends for these folks…the house always wins.

The distinction between investing and speculating is an important one. Benjamin Graham, the father of value investing, elucidated in 1934: "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return." A speculative operation, then, would be the opposite: no analysis, no safety of principal, and a return based purely on chance. Serious investing that is meant to build permanent wealth over a lifetime requires intelligence, a healthy appreciation for risk, an even temperament, and a large dose of patience.

While this should surprise no one, it's worth saying that we do not own GameStop or any other such companies in the Punch Small Cap Strategy. While we do focus on smaller publicly traded companies, we do not invest in penny stocks or speculative enterprises. We look to own a diversified portfolio of small cap companies with long histories of growth, profitability, and cash flow that are well-capitalized and run by management teams who themselves have track records of success. We also seek to acquire their shares when we believe prices offer a margin of safety. In all cases, we rely on our best reason, analysis, and judgment to attempt to produce a "satisfactory return" over time.

While obvious pockets of excess exist in the market today, we are not having difficulty finding compelling, reasonably priced investment ideas, particularly in the small cap

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arena. In the first quarter, we added three new companies to the portfolio that we are excited about owning for years to come.

The first is a healthcare technology company that provides critical software to hospitals for things like staff scheduling, safety credentialing, and training. Founded in 1990, the company has grown in every year but two since going public over twenty years ago and has been consistently profitable since 2004. The CEO of the company (who is also its founder) is the largest shareholder, and we have found him to be a passionate, energetic, and bright leader.

The second is a natural foods grocery chain based in the southwest with an innovative store layout that resembles a farmers' market. Founded a decade ago, the company has 360 stores nationwide and has plans to double their store locations in the coming years. This mission-driven company seeks to provide neighborhoods with fresh, healthy, and natural foods at competitive prices and, during the pandemic of 2020, the company had its best financial results ever.

Finally, we took a position in a shipping company in the first quarter that we think could benefit from industry consolidation and the upheaval in global supply chains in the wake of the pandemic. Shares appear undervalued to us today, and investors may be underappreciating positive changes in this industry.

In all these cases, our team of research analysts and portfolio managers has spent significant time, energy, and attention getting to know these businesses and their management teams well, and in our view, we've made well-reasoned, professional judgements on their prospects in the years to come. Investing is difficult, important work whose risks and potential returns should not be taken lightly. We would favor our approach over Dogecoin any day.

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.

Congratulations, Miraya!

On February 26, Miraya Gran and her husband Andy welcomed their daughter, Isla, into their family!

"No, I found my ball. I'm looking for the golf course."

Wealth Strategies Group

Budgeting is Not a Four-Letter Word

Angie Pierce, CFP©
Director, Wealth Strategies

Getting organized to reach a financial milestone

Last summer, my youngest son got wind of a neighbor girl selling painted rocks. Given this was all the rage in the neighborhood, he absolutely had to have one. Fearful that he might miss the best pick, he bolted upstairs, found his Star Wars-themed wallet, and eagerly ran out the door to buy the perfectly painted rock. When he returned, he opened his palm to reveal a small, gray rock with a bright yellow smiley face painted on its surface. I could see the pride in his eyes when he showed it to me. The sweet, little entrepreneur selling rocks had a good read on her audience with my youngest son. She managed to sell the "happy rock" for TWENTY dollars! My son purchased a painted rock from a six-year-old for twenty dollars, no questions asked. I will not get into the details of the conversation that followed, but given my career, I am sure you can imagine all the lessons that he learned.

The power of being prepared and understanding your spending is priceless regardless of stage of life. Successfully managing your spending and personal cash flow is key to meeting your short- and long-term financial goals. An organized budget can help relieve feelings of uncertainty and can give you confidence that you are using your financial resources as effectively as possible.

As we navigate through life, we know we will have unexpected financial surprises. Sometimes these are opportunities like an exciting new business venture, a beautiful new property, or a "happy rock." Other times they are less fortunate such as a medical diagnosis, loss of a job, or a global pandemic. Regardless of circumstance, preparing financially for the unexpected can greatly impact the outcomes of these unforeseen events. Your financial safety net begins with a sufficient cash reserve.

The past year tested us on multiple levels and brought maintaining an appropriate cash balance to the forefront of our attention. When we are prepared and have cash available in a savings account, we can navigate large, unforeseen expenses without having to liquidate securities in an investment account at an inopportune time. Selling securities in a bad market can have long-term, negative effects on your financial plan. Cash also allows you to take advantage of opportunities as they arise by pursuing investment when stocks are inexpensive.

Advisors in our Wealth Strategies Group at Punch work with individuals and families like yours to help you to organize your cash flow plan, including determining the right amount of cash to keep on hand. When we begin a conversation about cash flow, we ask our clients to thoughtfully consider several key questions:

When was the last time you felt the freedom of budgeting and defining your cash flow?

Many people view working through a budget as a painful process, but creating and living within a budget can offer freedom in spending decisions and reduced friction in money conversations at home. I recently worked with a family struggling to wrap their minds around income, expenses, saving, and retirement planning. They are high income earners, modest spenders, and decent savers, yet they were still overwhelmed. Through intentional conversations and intuitive planning tools, we were able to help provide clarity around their goals.

Our first step was determining this family's budget. As we worked through their spending, they realized quickly that this was the culprit of their unease. A lot like other families, they did not have a good understanding of where their money was going each month. The exercise of having an organized, thoughtful, and structured budget has allowed them to build a sufficient emergency cash fund, invest systematically, comfortably plan for retirement, and sleep soundly at night.

Cash flow planning is fluid over time, and you should monitor and review your income and expenses regularly. Allow us to help you and keep you accountable along the way. The peace of mind and freedom that come from an organized budget is priceless.

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Do you have any known upcoming large purchases outside of your regular spending?

Answering this question is important as it will likely have a direct impact on your cash on hand. If you do have known upcoming large expenses, and the cash is already on hand and earmarked, consider putting the saving in a separate account from your other emergency funds. If you do not already have cash earmarked, we will walk with you through options and help you determine the best way to fund your upcoming need.

Do you find yourself having large, unexpected tax bills each year?

If you are a prisoner to unexpected large tax bills, you know the April 15th payment due date can be hard to stomach. You can avoid this type of surprise with thoughtful planning. We work directly with your tax preparer to help avoid or anticipate these large bills. Staying in frequent communication regarding income, employee benefits, and large capital gains help to mitigate the tax shock that comes along with these events. Please bring us into these conversations so we can collaborate with your other advisers to come up with the most efficient plan for you and your family.

Do you typically have excess cash each month in your checking account?

For many individuals and couples, everyday spending often absorbs money deposited into a checking. If you have residual cash in your checking account each month, you are ahead of the curve! As you prepare your budget, you will determine the amount of excess you have each month. Depending on your goals and needs, we encourage transferring this amount systematically to your savings account or investing the excess before you can spend it. Working together to regularly analyze your budget offers tremendous advantages through intentionality and self-discipline.

Do you feel you have too much cash on the sidelines and wonder when is the right time to put it to work?

"People always tell me, 'You should have your money working for you.' I've decided, I think I'll do the work. I'm going to let my money relax. Because who knows what your money has been through before it got to you?"

- Jerry Seinfeld

Having too much cash on the sidelines can leave you feeling like you are missing opportunities. Once we have thoughtfully considered all the questions above, we can get to a better understanding of the appropriate amount of cash reserve that fits your specific situation. We will work together on the best investment options for any excess cash savings you have accumulated. Depending on the time horizon and specific needs for your investments, the long-term approach is that time ***in*** the market is better than tim***ing*** the market. A diversified portfolio of investments should present attractive returns over time, allowing your hard-earned money to be productive in helping you meet your goals.

Getting a grip on your cash flow is essential to maintaining healthy finances. Whether you are taking advantage of opportunities or navigating a cash need at an inopportune time, we want to partner with you in creating a solid plan for you and your family. Allow yourself to plan and budget for expenses so that "happy rocks" do not get in your way. We look forward to discussing this with you in more detail soon.

Availability During the Coronavirus Pandemic

We continue to work remotely during the pandemic. 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.

Phone: (952) 224-4350

Toll Free: (800) 241-5552

info@punchinvest.com