Punch

Newsletter
Second Quarter 2021

Would You Rather...?

Tax planning opportunities in uncertain times

Jessica Johnson, JD
Managing Partner

A typical summer day when I was a preteen went something like this: In the morning, I called my friends from our landline phone in the kitchen to coordinate a meeting place. I would fill up my backpack, jump on my bike, and then ride away from my house with no helmet, no cell phone, and no plan, because those things didn't exist back then. My parents were completely comfortable with this approach to life. They wished me well and told me to be home for dinner. I was compliant and usually didn't return early unless I was bleeding.

Once in a while, my friends and I would play a game called "Would You Rather?" One person would ask a question involving two impossible choices, and the other friends had to answer which one they'd pick. "Would you rather know the future or be able to fly?" "Would you rather cut your hair into a mullet or have only one song on your mixtape for the rest of your life?" "Would you rather part with control of your assets forever or have the government tax your wealth at more than 50% after you die?" (Ok, I admit that the last question didn't really come up in preteen conversation, but it's more relevant today than you might think.)

Congress is considering several proposed tax law changes, and depending on the version Congress enacts, you and your family could be in a different financial situation than you might expect. The proposals increase taxes on wages, capital gains, gifts to family, and estates. Most of them would be effective sometime later this year or early next. As a result, you may have a short window of opportunity this year to engage in tax planning before the law changes. Even if the law stays the same, some of the planning ideas may still be beneficial to reduce taxes over time.

"Knowing the Future"

1. Income Tax on Wages and Capital Gains

Current proposals would increase the top marginal income tax rate from 37% to 39.6% for families earning more than $400,000 annually. Congress is also considering limitations to itemized deductions and increasing the payroll tax.

The "worst case scenario" proposals increase the top capital gains tax rate to 39.6% and impose new deemed realization events retroactively to January 1, 2021. Many commentators believe that we are likely to see a more modest increase in

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the top capital gains rate (perhaps between 25% and 30%) and that retroactive application is unlikely. Congress is considering limiting 1031 exchange treatment for real estate to a maximum deferral of $500,000. Proposals also include eliminating the step-up in cost basis that has traditionally been available at the death of a person owning appreciated property.

2. Gift and Estate Taxes

If Congress does nothing, current law rolls back the federal gift and estate tax exclusion from $11.7 million per person to approximately $6.2 million per person at the end of 2025. Current proposals include reducing the estate tax exclusion to $3.5 million per person next year, raising the federal estate tax rate to 45% for most taxable estates, and limiting lifetime gifts to a total of $1 million per person before imposing a gift tax. Annual exclusion gifting rules will likely remain the same, meaning that anyone can gift up to $15,000 per year to any other person without facing a reporting requirement on a gift tax return.

Congress is also considering eliminating the benefits of certain tax efficient wealth transfer techniques such as grantor retained annuity trusts, valuation discounts available for gifts of certain illiquid or closely-held assets, and grantor trusts (in which the person contributing property to a trust remains the "owner" for income tax purposes).

"Ability to Fly" (Should You Take Action This Year?)

Many of our client families are asking whether they should do something before a tax law change takes effect. Unfortunately, we have no universal answer or planning technique that works for everyone. Each family should consider their unique circumstances, balance sheet, and existing financial and estate plan with advisors. We encourage you to reach out to us to help review your situation and coordinate conversations with your accountant and estate planning attorney. Time is of the essence, and those who wait until year-end may have limited options.

We are currently navigating many financial planning conversations with tax changes in mind. The families who are taking action have the following common characteristics:

- **Balance sheet.** If a family has significant assets in excess of the lowest proposed federal estate tax exclusion ($3.5 million per person, $7 million for a married couple) and the clients likely won't spend those assets during their lifetimes, we are reviewing options to transfer assets to use up some or all of the potentially expiring exclusion.
- **Age.** Clients who are older are less likely to see favorable tax changes again in their lifetimes. Older clients also tend to have greater conviction and certainty regarding how, when, and in what amounts their beneficiaries should receive assets. These clients seem to have an easier time making irrevocable decisions today.
- **Certainty in purpose of assets.** A high level of certainty in the purpose of your money and terms of your estate plan (family, charity, not government) lends itself well to making planning decisions today.

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Welcome, Luke!

Data Management Analyst

Luke LeMier joined Punch & Associates in April. Luke is a member of Punch's dynamic Operations team as a Data Management Analyst. He honed his client-focused process and performance improvement skills in past roles in the health care and insurance industries. He also brings extensive Salesforce administration experience to the firm. He will be using his skills to streamline and enhance our operations practices and maintain client information on an integrated basis across our systems.

Luke is completing an MBA in Leadership and Project Management. When he is not working or studying, he enjoys making the most of Minnesota's lakes, spending time in the outdoors camping and hiking. Luke also loves to travel both domestically and internationally with Barcelona as a favorite destination.

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Plan of Attack

First, everyone should get organized, regardless of balance sheet, age, or certainty level. The essential elements to organization start with a clear, up-to-date balance sheet that includes information about the ownership of assets and current beneficiary designations. If you've never put together a comprehensive balance sheet, we can help.

You should also have estate planning documents in place that you've reviewed with your advisory team within the past three to five years. While legalese can feel like a foreign language, we think it's important for you to have a good understanding of how your estate plan works. Who are your beneficiaries? How and when do they receive assets? Are your beneficiary designations consistent with the terms of your will or revocable trust? Who is designated to make important financial and health care decisions if you are unable to do so?

Next, depending on your situation, you might consider making gifts to family members either outright or in trust this year to capture the high available lifetime gift exclusion. Some of our clients are accelerating the inheritance for their children by transferring significant assets to them this year. Many families are exploring spousal lifetime access trusts ("SLATs"). These gifting vehicles have the dual benefit of allowing your spouse to access assets for his or her benefit if needed during lifetime while still counting trust contributions as complete gifts.

For purposes of income tax planning, some clients are considering taking capital gains this year at what could be a discount to higher tax rates next year. Other clients are considering converting a traditional 401(k) or IRA to a Roth IRA by paying ordinary income tax on the account's current balance now so that future distributions will be income tax free. Some account holders pursuing Roth conversion now may benefit from years or decades of future tax-free growth. For clients intentionally increasing their taxable income through these strategies, we are often in conversation about whether to make a charitable gift to offset some of the tax impact.

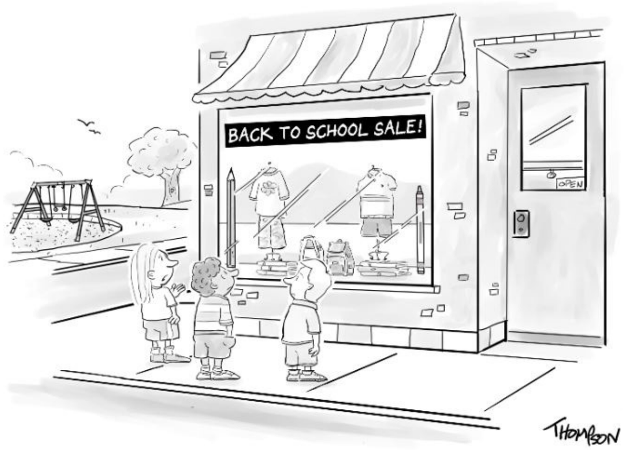
Choosing Amid Uncertainty

How do we plan when we don't know the future? At some level, we never know the future and we can't predict it, but we can make educated and informed assumptions. For example, we think it's likely that taxes in some shape or form will increase in the near term. How can we make wise decisions in the midst of this probable but uncertain situation regarding future tax law?

After you are organized and understand the possible tax changes and current planning opportunities, we move into a conversation about the purpose of your assets. You have three possible beneficiaries of your wealth: family, charity, and the government. At the end of a tax year or at death, most of our clients would prefer to benefit family and charity and leave the government as little as possible. Financial, investment, and estate planning are all fluid in nature. Laws, markets, your balance sheet, and your family will change over time.

And so we ask you: Would you rather unintentionally direct more of your assets to taxes or preserve your wealth for family and charity? Our mission is to enable families to steward resources with clarity and purpose. Allow us to help you organize and prepare for the future. This year, you may have a short window of time to take advantage of certain planning opportunities. We invite you into a conversation about how to preserve more assets for your children and grandchildren and for your community.

Punch & Associates does not provide legal, accounting, or tax advice, and accordingly encourages clients and potential clients to consult professional advisers with respect to these matters.



"Nothing like capitalism to ruin a perfectly nice summer vacation."

Punch Income Strategy

Beyond Bonds

John Carraux, CFA©, CIC©
Managing Partner

Taking a flexible approach to investing in a bear market for bonds

In the midst of a bear market in bonds, we think it makes sense to look "beyond bonds" once in a while.

Most of us will not soon forget what it felt like to live through March of 2020, when stock markets were in free fall and few assets were spared from the declines. During the panic, cash and treasury bonds were "safe havens" amid the storm, and many investors who dumped stocks during the crisis fled to their relative stability.

Today, as the pandemic begins to fade into memory, these ultra-safe assets have been left behind. In the second quarter of 2021, long-term treasury bonds officially entered bear market territory (commonly defined as a decline of 20% or more in price). Over the past year, the aggregate bond market has produced a negative total return.

Despite these price declines, yields are still well below historical averages. The 10-year Treasury note currently offers around 1.5%, compared to its average of 2.0% over the past decade and 3.5% over the past 25 years. A return to more normalized levels of interest rates would mean further price declines for bonds still.

In this type of environment, investors who need income are forced to look elsewhere. In the Punch Income Strategy, we take a flexible approach to investing. While rates are low, we look beyond traditional fixed income to other areas of public markets where we believe the risk and reward equation is more attractive.

In the second quarter, we initiated a new position in the common equity of one of the largest telecommunications companies in the country. After the company announced a significant restructuring and a dividend cut in May, frustrated shareholders voted with their feet and sold, sending the stock down more than 10%. We took notice and started to get interested.

We believe that, after the announcement and subsequent stock price decline, the shares became attractively priced with a dividend yield that was over 5%. This yield is double that of investment grade corporate bonds today. With a stronger and more focused business supporting it, this new dividend should be sustainable and may increase over time.

During the quarter we also increased our position in a publicly traded real estate investment trust (REIT) whose chairman is a well-regarded national real estate investor and one of the company's largest shareholders. This REIT announced a large acquisition in the quarter but has not yet announced a dividend. We believe that the share price today, which is close to reflecting only the cash on the company's balance sheet, does not reflect the anticipated dividend and growth potential of the company.

The Punch Income Strategy today is a mix of approximately 40% equity and 60% debt and has a yield of over 6.0%. With 40 individual holdings, we take a targeted approach to finding unique income-generating securities that we believe have strong total return potential over time. In the midst of a bear market in bonds, we think it makes sense to look "beyond bonds" once in a while.

Punch Income Strategy Holdings

Asset Class	Weighting
Debt Closed-end Funds	26.2%
Corporate Bonds	16.8%
Real Estate Investment Trusts	15.3%
Dividend-paying Stocks	13.1%
Business Development Corp's	11.3%
Equity Closed-end Funds	6.5%
Preferred Stocks	6.0%
Cash	3.2%
Municipal Bonds	1.5%

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

Diligence and Persistence

Consistent and focused effort accomplishes great things.

Paul Dwyer, CFA©
Portfolio Manager & Director of Research

"Don't sweep things under the rug, you'll just end up with a lumpy rug."

– Emma Lovewell, Peloton Instructor

Last winter, I bought a Peloton bike. With an app counting workouts, an instructor setting the pace, and my brother-in-law making it known that he was crushing me, I have valuable accountability guardrails that can be hard to find while working from home.

Investing and exercise have a lot of similarities: consistent effort compounds into meaningful improvement over time, pace setting to avoids injury, and addressing challenges head on is critical.

As seen in the nearby chart, value investors have been riding uphill over the past decade. Year to date, value outperformed growth by 4%, although underperformance in the second quarter partially offset strong outperformance in the first. Given the past decade's track record, the question we hear now is, "Was first quarter an anomaly or a change in market sentiment?" Given the ongoing level of skepticism and the length of past cycles, we think value investing has more open road ahead.

We often discuss "value" versus "growth" investing despite the fact our discipline involves more than just buying stocks solely on low valuations. We love when our companies grow. The Large Cap Strategy is a blend of growth and value, but our focus on downside protection results in a value tilt. Avoiding too much risk is imperative in surviving the "growth cliffs." Also seen in the chart, riding off the growth cliff of 2000-2001 was a disaster and took over a decade to recover.

We think we improve our odds of achieving attractive risk-adjusted returns by finding misunderstood situations. Despite some of the seemingly "get rich quick" and "can't lose" schemes in the market today, we stay in our lane to avoid risk of permanent losses.

One potential misunderstanding we are analyzing as the pandemic moves into the rearview mirror is determining which companies with a COVID-19 earnings boost can sustain profitability. In the second quarter, we purchased a company that we think can reproduce its 2020 results, while the stock's valuation implies less optimism. As its COVID related business declines, we think earnings will benefit from a recent acquisition funded by its COVID earnings windfall, and we think strengthened customer relationships will drive an increased level of business activity. Also, COVID-19 negatively impacted some of the company's segments, and earning should grow as those segments recover. If we are right, we were able to add a company that is a global leader in its industry to the portfolio at an attractive price.

In investing, like exercise, there are days in which we put in the work, but progress is less obvious. In my experience, just because results do not appear instantaneously does not mean we haven't built a strong foundation for a portfolio. The key with investing, like biking, is to keep riding. We will be ready for intervals, flat roads, or brutal switchbacks. No doubt there will be stumbles along the way. If history is any guide, we look forward to the feeling of the wind (finally!) at our back.

Relative Performance of Growth vs. Value

Note: Russell 1000 Growth vs. Russell 1000 Value.

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

The Opposite of Meme

John Carraux, CFA©, CIC©
Managing Partner

Shares of many cyclical small cap companies appear attractive today.

Definition of a "meme stock" from UrbanDictionary.com:

"A stock whose price keeps going up beyond a point that makes logical sense, which may or may not result in a steep drop later when the hype dies down."

This year has brought several new words into the investment lexicon. "Meme stock" is certainly one of them. "Stonks" is another (look it up on reddit). The meteoric and inexplicable ascent of meme stocks like Gamestop and AMC have upended traditional notions of investing and, as a group, these stonks have accounted for a significant portion of the performance of several indexes this year.

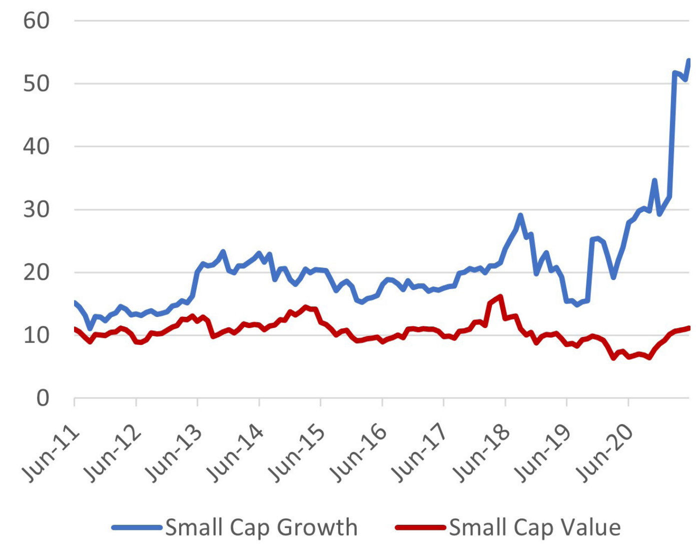
As irrational as some of these stock moves have been, equally puzzling to us are the low valuations that can be found in today's market on some of the more prosaic (but profitable) companies. While many of these companies do not have the hype or pizzazz of an electric vehicle maker or a space travel company, their businesses are nonetheless established, profitable, and growing. That is more than many meme stocks can say.

Many of these stocks can be called "value" stocks insofar as they are slower-growing, more established businesses and tend to be more cyclical (that is, they do well when the economy is doing well). On a price-to-cashflow basis, this group trades below its average valuation over the past decade, meaning that they are cheap.

By contrast, "growth" stocks–those that tend to be faster-growing but are also more speculative and sometimes unprofitable–are twice as expensive as their historical average. This group includes many meme stonks.

In the Punch Small Cap strategy, we own several cyclical companies that trade at what we believe are attractive valuations. Boat manufacturers, home builders, and auto dealers are just some examples of businesses currently held that trade at below-average multiples of earnings and are seeing strong sales and earnings growth. These companies have recognizable brands, customer loyalty, and reputable management.

Price to Cash Flow Multiples



Source: Bloomberg LP

Part of these stocks' cheapness may reflect expectations that the post-pandemic boom may not last too terribly long. We disagree. The dramatic life changes that we all have experienced over the past eighteen months will likely alter habits and lifestyles for years to come. More time with family, more focus on one's home, and more spending in general will probably last awhile. We believe that some of these companies will benefit from those changed preferences and priorities.

Consider that personal savings hit an all-time record in the U.S. last year at 30% of average income, and it has remained above 15% since the pandemic began. Consumer spending has rebounded to 2019 levels but is still only back to a pre-pandemic trend line. Anecdotal evidence from consumer-related companies suggest that there are no signs of "buyer fatigue" in sight.

The disparity in valuation between "to the moon" meme stonks and underappreciated cyclical stocks is stark today, and we think that those two groups have significantly different risk and reward characteristics. When the hype dies down, we may find out what those differences are.

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.

Alignment

Howard Punch
President and CIO

> *"Show me the incentive and I will show you the outcome."*
>
> *– Charlie Munger*

Incentives drive behavior. It pays to understand how people in business are compensated or how they are otherwise incentivized to behave. Take an example of incentives gone wrong from the 1800s:

> During the British colonial rule of India, the government began to worry about the number of venomous cobras in Delhi, and so it instituted a reward for every dead snake brought to its officials. In a wonderful demonstration of the importance of second order thinking, Indian citizens dutifully complied and began breeding venomous snakes to kill and bring to the British. By the time the experiment was over, the snake problem was worse than when it began. The Raj government had gotten exactly what it asked for.

The incentives that tend to work best are those that align the interests of all vested parties. Consider the following expressions: rowing the boat in the same direction, eating your own cooking, and putting your money where your mouth is.....or, have you heard this one? "I'm not only the Hair Club president, but I'm also a client."

How Do We Invest Our Personal Money?

Clients frequently ask what I own in my own accounts. My reply? Look in the accounts we are managing for you. That's what I own. That's what all the employees of Punch own. We can't imagine investing any other way. We research each company as though our own money is at stake because it literally is. Our gains and losses are intimately linked with those of our clients.

One might think it is an industry standard for professional money managers to own the same investments as their clients, but according to a 2020 Morningstar study, less than 20% of fund managers had a material investment in their own fund. (You might wonder what the other 80% are doing with their own money...?)

Just as you are right to expect that our incentives are aligned with yours, we have the same expectation for the leaders of the companies we own. With each company we research, we want to know that the management team has the same incentives that we do. We want to know they are on our side as shareowners, and we avoid companies with management incentives that are misaligned with the shareholders.

A simple way for us to determine whether management teams are aligned with their investors is to examine how much stock the executives at the company own. Have they been consistent buyers, or are they routine sellers? Is their compensation package more valuable than their equity position? If it is, they could be incentivized to protect their job at the expense of shareholders. Not good.

Alignment is one of the core tenets of our investment philosophy at Punch. We sleep better knowing this marriage of interests exists, and our hope is that our clients do too. It's not a coincidence that one of our largest, most successful holdings has a management team that owns nearly one-third of the company, and they continue to be consistent buyers with their

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Office Reopening

We are happy to announce that our office is now open, by appointment, for client meetings. Please contact us if you would like to schedule a meeting. In addition, we continue to be available by phone, video chat, or for in person meetings outside of our office.

Phone: (952) 224-4350

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personal funds. We believe the best results are born out of alignment; the worst outcomes come from bad incentives. By *following the money*, we can anticipate the behavior of others.

The following are some examples of incentive systems and potential conflicts which determine why some management teams behave the way they do.

The Agency Problem

> *"You can't make a good deal with a bad person."*
>
> *– Warren Buffett*

As shareowners, we can't make every little business decision on a day-to-day basis. We rely on management teams to operate their business, and we rely on the board of directors to hold management accountable for executing their mission. They are agents for us, the shareowners. Our experience has shown us that these management teams and boards don't always act in the best interests of the shareowners. This is the agency problem. Examining the character of these decision makers for a corporation—and the incentives put in place—is a research step I frequently ignored early in my career (and always with regrettable consequences).

From the outside looking in, the agency problem can manifest itself in a number of ways, but at its core, it happens when the management of a public company pursues its own economic self-interest ahead of shareowners' interests. Country club memberships, corporate jets, golden parachutes, or long-term employment contracts may hint strongly at the "mercenary behavior" we discussed last quarter. At a minimum, these perquisites must be clearly defended by everyone in the C-suite and on the board. The agency problem is evident at every public company. We have observed that some handle it more successfully than others.

Big vs. Successful

Some managers of public companies get paid more to increase the size of their company, not for producing results for their shareholders. This incentive can lead to a less-than-thoughtful acquisition strategy or to doing dilutive stock offerings. We call many of these self-aggrandizing managers "empire builders," because they often put their own ego and financial interests ahead of the success of their shareholders. Recognizing these tendencies prior to committing capital can head off years of frustration and potential underperformance in a stock with this type of operator at the helm.

Conversely, when we see a management team that behaves in the opposite way of an empire builder, we take notice. It's unusual, but some management teams are willing to *shrink* in order to create shareholder value. American business is constantly changing, and shrinking an enterprise through asset sales and stock-buybacks can make sense under the right conditions. Teams that behave in this uncommon way will often get our research team's attention.

Long-term vs. Short-term

The "Hail Mary" pass is a last-ditch attempt of a losing football team to snatch victory from the jaws of defeat. You hope your team is never forced into this situation, because it is rare that this strategy succeeds. According to Kevin Seifert of ESPN, only 9.7% of Hail Mary attempts have been completed successfully over the last 10 seasons in the NFL.

We view investing as a long-term endeavor. We have seen management teams, however, that seem to be incentivized to throw a succession of Hail Mary passes. Their boards have allowed incentive plans that encourage this behavior and protect insiders in the event of an incompletion or interception. Short term CEO goals that sacrifice the long-term success of a corporation are issues to be wary of when investing. In many cases, the CEO places his or her own interests above those of the group. This can be a sign of a weak board or one that is not independent.

A Confidence Game

Prior to last year, we couldn't have been confident that we'd be able to generate a substantially positive return while experiencing a global pandemic. One can never be certain about returns from year to year. What gave us some measure of confidence when the pandemic was pulling the rug out from under us was the shared incentives that we had with the leadership of the companies in which we were invested. We knew them and we trusted their motives. We viewed each share of stock as a long-term ownership stake in a company filled with real people who care about our shared future. Had we been investing in companies where management treated their role as just an income source (and treated the company as their personal piggy bank) rather than as steward of resources and talent, we might have had a different emotional experience. Similarly, because we at Punch personally own the same investments that you own, you can have the confidence that we share incentives and outcomes. We are focused stewards of our respective resources.

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Save the Date!

Wednesday, September 22nd

We are excited to announce that we will be hosting a Summer Client Appreciation Event on Wednesday, September 22nd, at CHS Field!

More information will be available in the coming weeks.

CHS Field
360 North Broadway Street,
Saint Paul, Minnesota 55101

Summer at Punch!


John and his family visiting Washington DC!


Angie's boys enjoying fishing and baseball!


Danielle and her family visiting Orr, Minnesota!


Paul and his kids visiting Lake Vermilion!


Steve visiting Hawaii, and Maine with his family!


Miraya and her family visiting Gooseberry Falls and Duluth!

Andy and his family enjoying the outdoors!


Jessica's kids spending time on Minnesota's lakes!