Emerging Manager Focus
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Punch & Associates' Recent Interview Regarding Small Cap Investment Process & Philosophy with Emerging Manager Focus

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For immediate release:

MINNEAPOLIS, Minn., July 1 -- Punch & Associates was recently interviewed by Emerging Manager Focus, A Focus Point Press Publication. The transcript of the interview follows, and the full interview can be found at the following link: http://www.focuspointpress.com/pubs/emerging_manager_focus/.

What about your investment approach makes it successful, and how does Punch apply this strategy to its own philosophy to make the firm successful?

Punch and Associates Investment Management Inc. is a small- and micro- cap money manager based in Minneapolis, Minnesota. We allocate capital to public companies on behalf of our clients, who include both high net worth individuals and institutions. The firm was founded in 2002 and today manages approximately $350 million.

Our approach to investing in small- and micro- cap companies is successful because it focuses on what matters when trying to value individual companies within the context of ever-changing investor tastes: seeing past the noise of what is popular at the moment and identifying value with independent judgment. We view the stock market as a collection of investors' preferences and not as a precise judge of value. Because markets have a tendency to be irrational, we begin our search for investments in those areas where extreme investor behavior has created conditions where a stock's price is most likely to be significantly different than its fair value. Such areas include stocks or groups of stocks that have declined substantially, stocks that are experiencing investor apathy, and areas where fundamentals may be misunderstood. We then look for companies that have durable business models, the financial wherewithal to endure almost any economic scenario, and low investor expectations. We analyze these companies with the view to holding them for a very long time or until investor preferences create excessively optimistic valuations.

We believe the initial conditions—when you are seeding an investment—matter: regardless of how successful a company is, regardless of how impeccably researched that target is, if you pay too much, you lower your odds of success. By patiently accumulating high-quality companies with a view to long-term ownership when their valuations are depressed because of other investors' inability to look beyond near-term, we believe we can continue to produce above-average returns over time.

Since inception, your firm has gone through different stages. What is your projected next stage?

We are largely a high net worth shop and our focus is on being better, not bigger. Our next stage of growth has been to appeal to a select number of long-term oriented institutional clients. We believe our firm has been successful over time in large part because we enjoy relationships with wonderful clients who have been with us, in some cases, for decades. We have observed that the great investment managers with limited capacity have become great and stayed great because they have clients who are patient and understand the approach these managers take with their money. The manager does not feel compelled to change their approach for any one client or market circumstance. We have been engaged in dialogue with such institutions of late and have enjoyed the process of articulating what we believe is a unique and durable investment philosophy.

What factors affect your performance and how do you protect yourself from these risk factors?

Plain old stock picking is the core of our investment process. This entails minimizing risk in two ways. First, we actively avoid those areas of the market where valuations are most optimistic. Periodically the market can favor one sector or industry for a prolonged period of time. Since we are unwilling to chase valuations, we can lag in the types of markets that are driven disproportionately by such optimism, but we are also rarely around when the party comes to a crashing halt. While we tend to lag in straight-up markets, we also usually outperform in down markets.

Second, we invest in businesses that have proven and consistent operating histories and that are not reliant on the capital markets to fund their businesses. Simply by avoiding the potential for a business to be brought to its knees during periods of duress, we can employ a long-term orientation and increase our positions in companies when their stock prices are depressed.

We do not attempt to time the market and we generally maintain only small amounts of cash, so we are subject to the whims of the market over shorter periods of time.

Do you see other managers entering into this field?

Within the small-cap universe, our focus is on the smallest of small companies. Our small cap strategy considers any company with a market capitalization under $2 billion, but we spend the vast majority of our research time looking at companies under $500 million in market cap. The median market cap of our small-cap portfolio today is approximately $500 million, while the average small cap manager in the U.S. has a median market cap that is nearly double that figure. The reason we focus on this segment of the market is that there is a natural barrier to entry for larger, more sophisticated money managers to exploit what we think are significant opportunities in this space. Most money managers aim to grow their assets under management over time, and as one's pool of capital expands it become increasingly difficult to put money to work in very small companies. Investing here also makes less of an impact on significantly larger portfolios. As a result, there is a dearth of investor attention, both from the buy-side and the sell-side, on small- and micro-cap companies, and we see that as a structural competitive advantage to managers like ourselves who spend our days looking for undervalued, high-quality companies in this niche universe.

What is the composition of your portfolio?

Our portfolio is relatively concentrated, holding between 30 and 50 companies at any given point in time. We spend a great deal of time searching out underpriced stocks and doing our own research on companies that may only have a small handful of investors doing this type of research. We believe this work, and the conclusions we come to, are unique and valuable. Therefore we want to make this effort count for our clients and concentrate our portfolios in our best and highest conviction ideas.

Our portfolio companies share a number of characteristics that are reflective of our philosophy. Nearly all (over 90%) are profitable on an operating basis and have a consistent history of generating profits, indicating that they are proven businesses run by capable managers. Our companies typically are not highly leveraged (20% average debt-to-cap) and are growing over time (26% average EPS growth recently). We attempt to limit our downside by avoiding speculative businesses, businesses whose success will depend on a binary event (e.g. biotech and development-stage companies), and stocks whose valuation reflects optimistic expectations for the future.

While our average holding period is 2 to 3 years, we have companies in the portfolio today that we have owned for over a decade. When we initiate a new position, we take the view that we are going to own the business for a very long time.

What type of competition is there is this type of space, and what is the potential for emerging managers in this type of investment?

When we evaluate companies as potential investments, we look for businesses that have found a way to consistently limit their competitors' ability to compete. We get especially excited when a company enjoys a structural advantage or when they can do something that no one else can do.

We believe that our firm and our small-cap strategy enjoy some of these characteristics. Investing in small- and micro-cap stocks requires significant time and resources because few investors are focused on the space. The reason that many investors do not pay attention to this space is that as managers' assets grow, it becomes increasingly difficult and cumbersome to allocate capital to less liquid and under-researched companies. With a higher level of assets under management, the contour of their portfolio, at some point, needs to change: either more names need to be included in the portfolio, diluting the impact of any single idea, or larger companies need to be included, forcing the portfolio to drift into a more-efficiently priced universe.

The reason that sell-side researchers and investment bankers pay less attention to small- and micro-cap companies is that it is less profitable for them to do so: trading volumes are smaller and investment banking deals are smaller and less frequent.

Our willingness and ability to search out and value companies in this space is something that few other investors do, and we consider it an ongoing reason that this segment of the market is fertile ground for generating above-average returns.

Do you have any suggestions for emerging managers in the market today?

Our success as a firm is due in large part to our clients. We are fortunate to have attracted a group of clients over the past twenty-five years who are patient, committed investors and who trust us and share our investment philosophy. Emerging managers need to pay close attention to the type of clients they are willing to work with in partnership because the long-term success of a firm, and the integrity of one's strategy, depends on it.

About Punch:

Formed in 2002, Punch & Associates is a Minneapolis-based boutique asset manager specializing in small- and micro-cap investing. The firm is located in Edina, MN and manages approximately $350 million in assets for institutions and high-net-worth individuals.

Contact: Andrew J. Matysik, Managing Partner

Punch & Associates Investment Management, Inc.

3601 West 76th Street, Suite 225, Edina, MN 55435

(800) 241-5552 | www.punchinvest.com

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