Kopion Asset Management

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Asynchronous

Monday, January 22, 2024

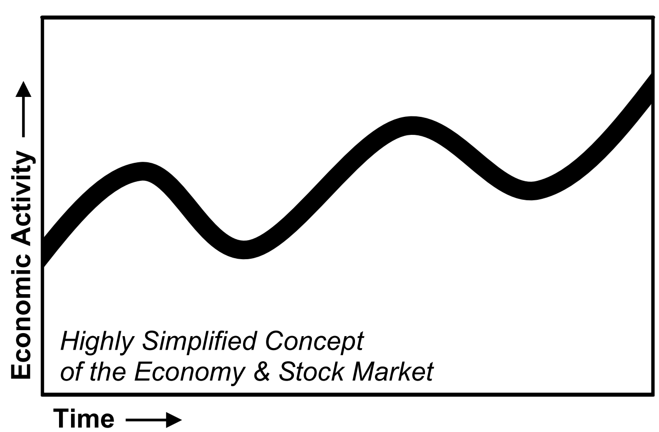
Dear Kopion Clients,

Kopion finished 2023 with a bang, and when the clock stopped, our return for the year was 36.0% before fees (34.6% after fees). The Russell 2000 and S&P 500 returned 16.9% and 26.3%, respectively. This was a very encouraging result, but as you might remember, we entered 2023 from a low point. We personally thus find it helpful to consider our performance over a two year period in order to "look across the valley" that we were treading when we entered 2023. Over the last two years, Kopion's annualized return was 6.2% before fees (5.0% after fees) while the Russell 2000 and S&P 500 have returned -3.6% and 1.7% annually, respectively.

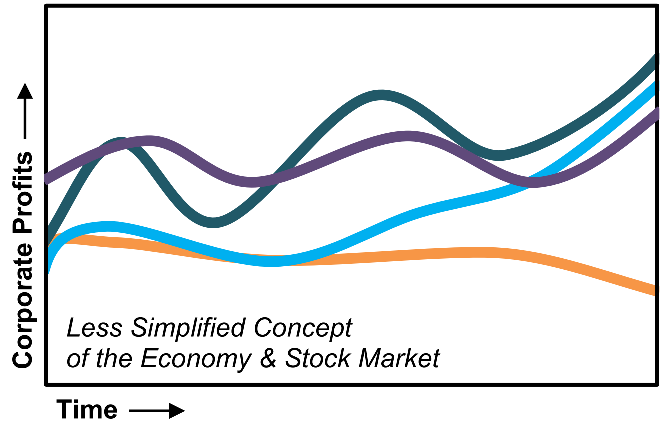
A key way that we as humans navigate the complexity of the world is by making generalizations. This is natural, but we can get into trouble when we:

a) Oversimplify a situation, or
b) Begin to confuse generalizations with reality itself.

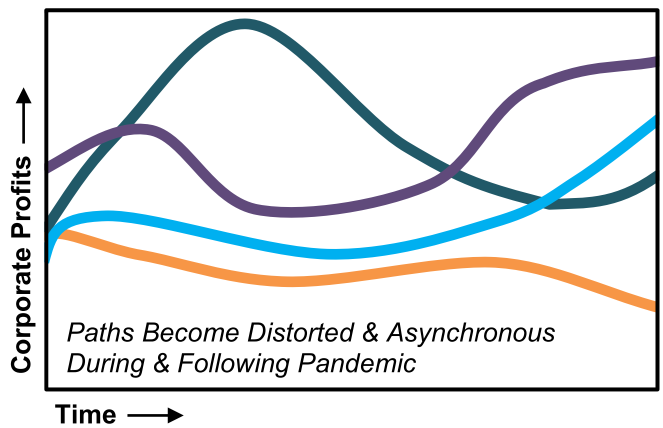
We believe that these pitfalls are fairly common among stock market participants, including both the actual investors and the financial press that writes about the market. To be fair, financial writers face an inherent tension between providing enough detail to describe a situation accurately while simplifying enough to respect readers' time and interest. We experience this tension every time we write a client letter. Albert Einstein reportedly touched on this problem as it related to scientific theories by saying that "everything should be made as simple as possible, but not simpler." We resonate with that sentiment and are fortunate to have worked in professional contexts that have allowed us to burrow into the details. Financial commentators and many professional investors, however, often seem hard-pressed to reduce the economy and stock market—which feature tremendous complexity and countless multi-dimensional feedback loops—into a simplistic monolithic cycle. The diagram on the right illustrates this approach.



There is some validity to that approach, but it has a way of overlooking the significant variations among actual companies. Some businesses are on upward trajectories, others are in structural decline, and yet others are reinventing themselves to move onto a better path. Their speeds along their respective paths change and they don't move together in perfect unison. This is conceptualized in the first diagram on the right.



One of the unexpected consequences of the pandemic and related government policies was to further vary companies' paths by making them distorted and asynchronous. We have illustrated this in the second diagram on the right.



A couple of examples from our portfolio might be helpful:

1) Cognex produces machine vision cameras that equip computers with "eyes" to see the world and a "brain" to interpret what is seen. These cameras have historically been used to help automate a wide variety of industrial tasks such as inspecting parts for defects. Leading up to the pandemic, Cognex was gaining traction in a new application: replacing laser-based bar-code readers, especially in e-commerce fulfilment centers. The meteoric growth of e-commerce during the pandemic drove a two year wave of orders from customers like Amazon.com that more than offset declines elsewhere in Cognex's business. This led to record revenues in 2020 and 2021. Perhaps unsurprisingly, that e-commerce demand got ahead of itself, and Cognex's results have since been in a slump relative to 2021. The long-term outlook for this business, however, is arguably even better than before, and we took advantage of Cognex's languishing stock price in 2023 to buy more shares and increase its weight in the portfolio.

2) Tennant Company experienced the opposite pattern. Tennant makes floor cleaning equipment for very large spaces such as Wal-Mart stores and airports. During the pandemic years, Tennant suffered as customers initially deferred purchases and the company later struggled to obtain parts for the orders that it did receive. Those parts started becoming more readily available in 2023, leading to record results as the company began working down a tremendous backlog that had accumulated when parts were scarce. In our opinion, however, Tennant's stock price got ahead of itself late in 2023, and we thus gradually demoted it to a smaller weight in the portfolio.

Critically, Kopion is able to make these types of decisions because the preponderance of our time is spent studying individual businesses and maintaining valuation models that allow us to relate how a given company's prospects compare to its stock price. We then size each position based on how strong of a value it presents on a risk-adjusted basis.

Market pundits continue to debate whether a recession is still likely or if the economy will simply slow down. We would point out, however, that some of our companies have been experiencing recessionary conditions for 12 months already while others may face them in the near future. Their results are more out of sync than usual. We thus believe that market pundits' generalizations are more oversimplified than usual. Fortunately, Kopion doesn't have to go along with those generalized views of the world and is free to focus on promising individual companies that present good values.

In a somewhat related vein, I (Terry) have now accumulated nearly 20 years of performance history, and at this point, my investment strategy has produced returns that are moderately asynchronous to the broader stock market. I firmly believe in Kopion's strategy on a standalone basis, and all of my personal long-term investments continue to be invested according to Kopion's model portfolio. That said, our asynchrony provides an added diversification benefit for those of you who also have investments elsewhere.

Lastly, I wanted to provide a brief update regarding when Kopion will close to new deposits. Most of the new companies that are qualifying for inclusion in our portfolio continue to be smaller firms that offer less liquidity from a trading perspective. I've thus concluded that Kopion will need to close to new deposits when our Assets Under Management reach $200M.[1] (We finished 2023 around $135M.)

Thank you for your continued trust and support.

Best regards,

Terry Ledbetter, Jr., CFA
Jonathan Lindstrom, CFA

[1] This $200M figure may be adjusted for inflation from a December 2023 starting point.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	Russell 2000	S&P 500
Annualized*				
1 Year	36.0%	34.4%	16.9%	26.3%
3 Years	7.9%	6.5%	2.2%	10.0%
5 Years	15.8%	14.3%	10.0%	15.7%
10 Years	5.9%	4.6%	7.2%	12.0%

*Ending 12-31-23

Past performance does not guarantee future results. Investments with Kopion may lose value.

Terry Ledbetter, Jr. began managing his first diversified investment account on 2-4-04 while employed by Friedberg Investment Management (FIM). Mr. Ledbetter left FIM on 7-31-09 and founded Kopion Asset Management, LLC (Kopion), which became a legal entity on 8-24-09. Importantly, when Mr. Ledbetter founded Kopion, he continued to manage the same accounts that he had been managing while employed by FIM. The accounts, investment strategy, and investment process all remained the same. The performance information cited throughout Kopion's marketing materials includes all of the diversified investment accounts managed directly by Mr. Ledbetter since 2-4-04, which is when he began managing his first diversified investment account. This information is provided for both Mr. Ledbetter's entire performance history as well as for the portion of Mr. Ledbetter's performance history that occurred after Kopion was founded and became a legal entity.

The performance information cited throughout Kopion's marketing materials has been thoroughly documented, and it has been calculated using normal industry protocols, which are described in more detail below. This information has not, however, been audited by an independent third party. Dividend and interest income in these accounts was reinvested. Returns for these accounts have been asset-weighted to calculate historical returns. Said another way, the accounts were aggregated into a single group and then performance was calculated for that single group. This group includes some sub-accounts and securities that were carved out of larger accounts in order to exclude assets like mutual funds that Mr. Ledbetter did not manage directly. Those mutual funds were managed by professionals at third party firms, and Mr. Ledbetter's involvement was limited to being a passive shareholder of those mutual funds. In addition, some of those mutual funds followed fixed income strategies, which were very different from the strategy used by Mr. Ledbetter when he was employed by FIM and later at Kopion. Performance information that includes assets like mutual funds that were not managed directly is available, and Kopion will provide it promptly upon request.

Kopion reports its Time Weighted Returns (TWRs). TWRs make adjustments for deposits and withdrawals so that those transactions do not influence performance results. Consequently, deposits do not increase the return, and withdrawals do not decrease the return. TWRs thus allow for performance comparisons between Kopion's (and Mr. Ledbetter's) history and market indices.

Kopion reports both "gross returns" (which are returns before Kopion's management fee) and "net returns" (which are returns after deducting Kopion's management fee). Kopion's management fee schedule is graduated, which means that the fee rate begins to decrease after an account's dollar value exceeds a certain threshold. The label "Net $_{Max\ Fee}$" indicates that the net returns being presented reflect Kopion's maximum fee rate for all periods presented. The words "net" or "after fees" without the words "Max Fee" in subscript lettering indicates that the net returns being discussed reflect actual fees.

Kopion has provided the returns of the Russell 2000 and the S&P 500 indices in order to provide the broader stock market context of Kopion's (and Mr. Ledbetter's) returns. The Russell 2000 tracks the performance of relatively small publicly traded companies, and the S&P 500 tracks the performance of relatively large ones.

Kopion does not “benchmark” its portfolio against indices in the traditional sense of carefully managing the portfolio for comparison against a specific index. Instead, these two indices are used as broad indicators of the stock market’s performance. Mr. Ledbetter has primarily focused on small and medium sized firms, but he has also invested in some large companies as well. This is why Kopion has provided the results of both the Russell 2000 and the S&P 500. These indices cannot be invested in directly, but mutual funds and exchange-traded funds that track these indices (“index funds”) are available in the market. Kopion’s (and Mr. Ledbetter’s) investment strategy carries more risk than investing in an index fund that tracks either the Russell 2000 or the S&P 500. This is primarily because Kopion’s (and Mr. Ledbetter’s) strategy involves investing in a relatively small number of stocks and those stocks are primarily for small to medium sized companies. This approach results in greater volatility and greater risk of capital loss than index funds tracking either the Russell 2000 or the S&P 500.

Indices’ performance figures have been obtained from sources believed to be reliable.