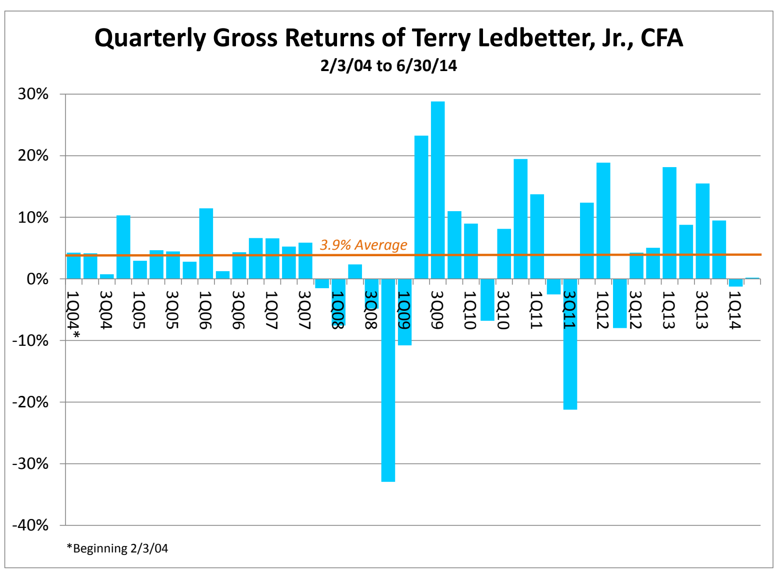
The Average Misconception

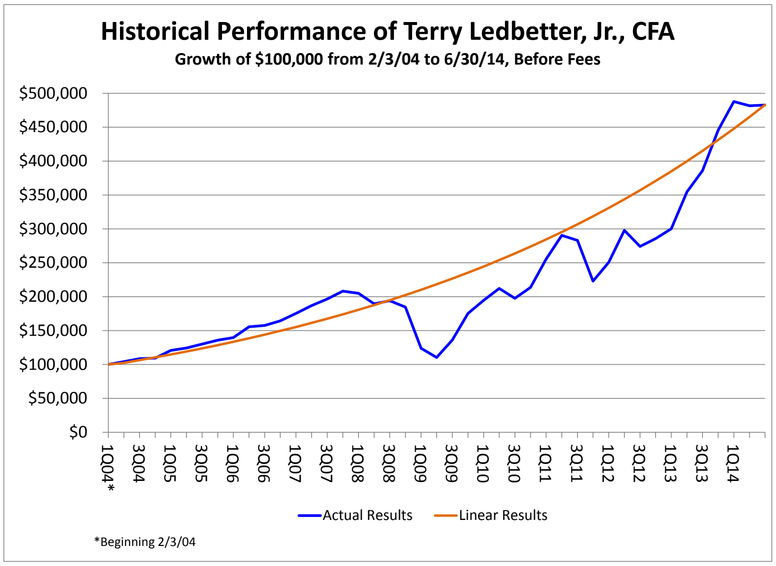
Thursday, July 3, 2014

Dear Kopion Clients,

Kopion returned -1.1% during the first half of 2014 (-1.5% after fees). This compared to the S&P 500 and Russell 2000 which returned +7.1% and +3.2%, respectively, so Kopion's results were soft on both an absolute and a relative basis. While this is undesirable, it is also not completely surprising coming off of Kopion's meteoric 2013 performance when we returned 60.9% after fees while the S&P 500 and Russell 2000 returned 32.4% and 38.8%, respectively. This ebb and flow of returns is an inherent part of investing, and it occurs both on an absolute basis and compared to the indices. This dynamic, however, can be easy to forget because when many of us were introduced to the stock market, we were told to expect something like returns of 9% per year. What was not always effectively communicated, however, was that this number was an *average* and what we'd actually experience would be a jumble of very good years, rather painful ones and some duds. Said another way, equity returns are "non-linear." This concept is a critical one because it provides the context through which to interpret results that can vary dramatically from quarter to quarter and year to year. Understanding non-linearity also helps us to overcome our "Recency Bias," which is the natural human tendency to place too much emphasis on the most recent results and lose sight of the big picture. In investing, Recency Bias often leads people to become either too optimistic or too pessimistic depending on their investments' most recent results.



The chart to the right shows my quarterly returns since I began managing my first diversified investment account on February 3, 2004. The average quarterly return over this period was 3.9% which is shown as an orange line on this chart, but as you'll notice, all of the quarters were either above or below this average; none of them actually realized a return of 3.9%. In addition, I even suffered some prolonged periods of negative returns.



A more common way to illustrate this phenomenon is by looking at how the value of a $100,000 account would have changed over this period. The chart on the right presents the data in this manner, with the blue line showing the actual change in the value of such an account and the orange line showing the linear, averaged change in its value.[1] So while the *average return* is a helpful reference point, it can be misleading if we assume that most of the data points are close to the average. My college finance professor made this point by saying, “Mike and I run an average of four miles a day. . . Mike runs eight.”

This volatility has many sources, but one of the primary ones is market psychology. Businesses’ earnings and prospects do change over time, but these gradual changes are greatly amplified in their stock prices by how investors are feeling at any given moment. FMC Technologies is one of our core holdings, and its recent stock price movements illustrate this point. FMC is the leading manufacturer of complex valves and related components that are used to control the flow of oil from underwater wells, and they also have attractive franchises other types of oil field equipment. FMC’s stock began the year around $52.20. This was somewhat light from a valuation perspective as most investors were concerned about the company’s profitability which had been depressed for several quarters. These concerns intensified during January and February when major oil companies began to fret about the cost of their offshore projects, and this drove FMC’s stock down to about $48.30. Around that time, I concluded that the stock was attractive enough to justify increasing our position, so I bought more in early February at about $50.45. Over the next four months, the market regained its confidence in this business which drove the price up to about $62.00. As with all of our companies, I follow FMC very closely, and in my opinion, nothing meaningful changed about the business’ long-term prospects during this period. What did change was investor sentiment about its stock. This is how the stock market works, and I believe that exploiting these types of opportunities is one of the reasons that I have been able to outperform the market over time. Importantly, I have not outperformed the market *all* of the time, and the first half of 2014 is an example of this.

[1] In order to illustrate these concepts more clearly, I’ve excluded some of the information that is normally required by SEC regulations when presenting historical performance. I’ve thus added complete performance information at the end of this letter to comply with these regulations.

One of the reasons that Kopion underperformed during the first half of 2014 is that some of the stocks that contributed to our phenomenal 2013 results gave back some of those gains during the first six months of this year. The outlooks for most of those businesses remain good, but the market's sentiment towards them has cooled for various reasons. The silver lining to all of this is that I've been able to add to those positions at attractive prices over the last six months. Incidentally, FMC recovered so quickly after we bought more in February that it had become too large of a position by June and needed to be pared back, especially since its risk / reward proposition had weakened as its stock price had improved. The proceeds from that sale were reinvested into some of our other stocks that had sold off. I do not want to leave you with the impression that all of my trades are successful, especially in the short term. Some of them take years to pay off, and some of them never pay off, either because my analysis turns out to be flawed or I am simply unlucky. Nonetheless, I have been right more often than I have been wrong, and FMC is a recent example of how volatility is a blessing for investors who have done their homework and have the courage to act on their convictions.

My outlook for the portfolio has not changed since my last client letter. I am encouraged that the economy is steadily building momentum, and I am eager to see how our companies' investments over the last several years will pay off as the economy improves. I am also encouraged by anecdotal evidence that many investors remain ambivalent about the stock market. That said, it would still be normal and healthy for the market to have some type of setback. Indeed, the Russell 2000, which tracks small companies like the ones that Kopion focuses on, was down 9.3% from its most recent high at one point during the first half, though that setback was relatively brief. Regardless of what comes to pass, however, I remain committed to making long-term decisions and riding out the market's short-term fluctuations.

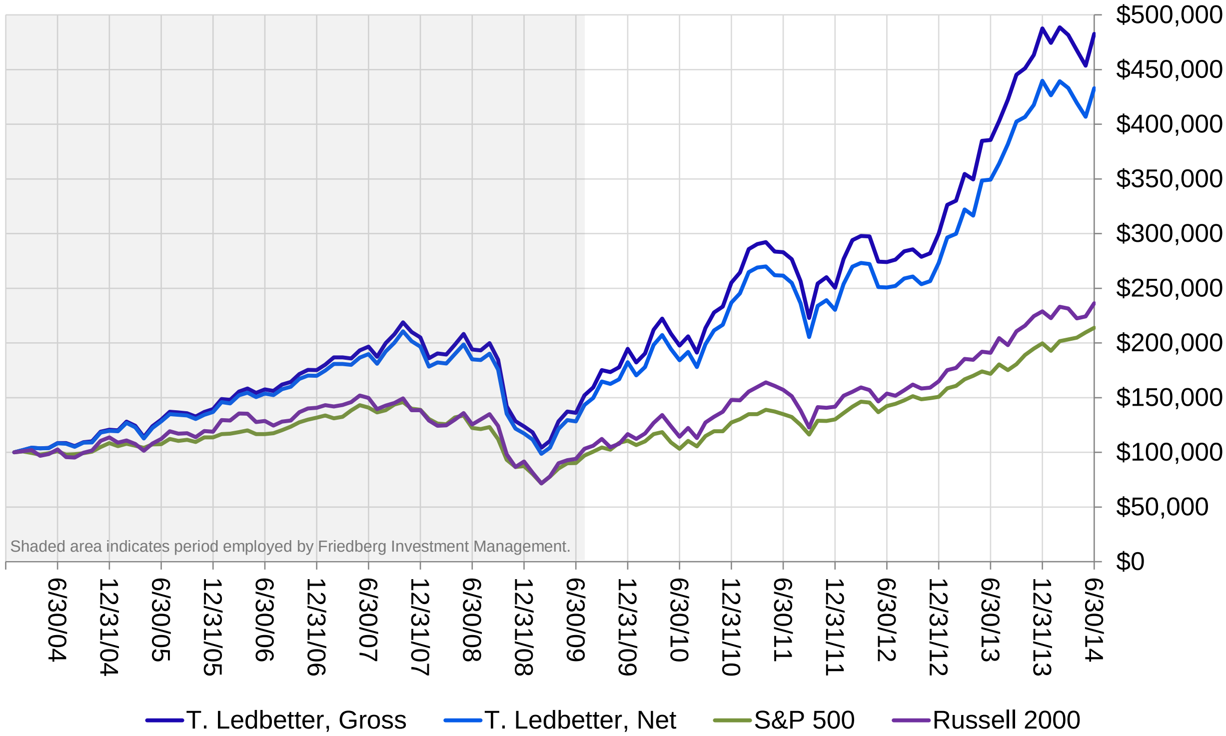
Thank you for your continued confidence and support.

Best Regards,

Terry Ledbetter, Jr., CFA

Historical Performance of Terry Ledbetter, Jr., CFA

Growth of $100,000 from 2/3/04 to 6/30/14



Historical Returns of Terry Ledbetter, Jr., CFA

Period	T. Ledbetter Gross	T. Ledbetter Net	S&P 500	Russell 2000	T. Ledbetter, Net +/- S&P 500	T. Ledbetter, Net +/- Russell 2000
2004[1]	20.7%	19.7%	8.4%	13.7%	11.3%	6.0%
2005	15.7%	14.4%	4.9%	4.6%	9.5%	9.9%
2006	25.6%	24.2%	15.8%	18.4%	8.4%	5.8%
2007	17.0%	15.7%	5.5%	-1.6%	10.2%	17.2%
2008	-39.6%	-40.4%	-37.0%	-33.8%	-3.4%	-6.6%
2009	57.2%	55.5%	26.5%	27.2%	29.0%	28.3%
2010	31.2%	29.9%	15.1%	26.9%	14.8%	3.0%
2011	-1.9%	-2.8%	2.1%	-4.2%	-4.9%	1.4%
2012	19.8%	18.6%	16.0%	16.4%	2.6%	2.2%
2013	62.5%	60.9%	32.4%	38.8%	28.5%	22.1%
2014 YTD[2]	-1.1%	-1.5%	7.1%	3.2%	-8.7%	-4.7%
Cumulative	382.6%	333.0%	114.0%	136.3%	219.0%	196.6%
Annualized						
3 Years	19.5%	18.3%	16.6%	14.6%	1.7%	3.7%
5 Years	28.8%	27.5%	18.8%	20.2%	8.7%	7.3%
Since Inception[1]	16.3%	15.1%	7.6%	8.6%	7.5%	6.5%

[1] Beginning 2-3-04

[2] Through 6-30-14

Performance Disclosures

Past performance does not guarantee future results. Investments with Kopion may lose value.
The performance information cited in this presentation 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. Historical performance results include all of the diversified investment accounts managed by Terry Ledbetter, Jr. since 2/3/04 which is when he began managing his first diversified investment account. Dividend and interest income in these accounts was reinvested. Returns for these accounts have been asset-weighted to calculate Mr. Ledbetter's 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 which were carved out of larger accounts in order to exclude assets such as mutual funds that Mr. Ledbetter did not manage directly.

The performance figures cited in this presentation represent Mr. Ledbetter's Time Weighted Return (TWR). The TWR makes 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. The TWR thus allows for performance comparisons between Mr. Ledbetter's history and market indices.

The performance figures cited in this presentation include 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 fee rates are listed on the slide titled, "Kopion's Management Fee." Mr. Ledbetter was employed by Friedberg Investment Management (FIM) from 7/1/02 through 7/31/09, and FIM's management fee rates were different from Kopion's. In order to provide a better depiction of the impact of Kopion's fees, this presentation uses Kopion's fee rates for all periods presented including those during which Mr. Ledbetter was employed by FIM.

Kopion has provided the returns of the S&P 500 and the Russell 2000 indices in order to provide the broader market context of Mr. Ledbetter's returns. The S&P 500 tracks the performance of relatively large publically traded companies, and the Russell 2000 tracks the performance of relatively small 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 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 S&P 500 and Russell 2000. From 2/3/04 through 6/30/14, Mr. Ledbetter's monthly net returns were 36% and 1% more volatile than the S&P 500's and Russell 2000's, respectively. For the three years ending 6/30/14, Mr. Ledbetter's monthly net returns were 54% and 11% more volatile than the S&P 500's and Russell 2000's, respectively.

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