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Break on Through?

Monday, January 9, 2017

Dear Kopion Clients,

During 2016, Kopion returned 11.5% before fees (10.5% after fees). The S&P 500 and Russell 2000 returned 12.0% and 21.3%, respectively.

Looking Back

Kopion does not benchmark against an index in the traditional sense, but it was still very disappointing to underperform both the S&P 500 and Russell 2000 for a third consecutive year. Our fortunes, however, did clearly begin to improve during the second half of 2016. As you might remember, our portfolio entered a very difficult season during the summer of 2014. Around that time, an unusual number of our stocks began to suffer temporary setbacks. Moreover, when I would seize upon opportunities to add to these positions at low prices, they would sell off even more, further punishing the portfolio. That environment persisted through the middle of 2016, by which point we had systematically added to a surprising number of very beaten down positions. The broader stock market was roughly flat over that 24 month period, but I was hearing anecdotally and through the news about other investment firms that were also performing poorly. A few of those firms had even decided to close their doors, which presumably left their clients marooned with battered portfolios and no one to guide them towards a recovery. It was a vexing and arduous season with challenges on multiple fronts. I understood the primary challenges to our portfolio and explained them in my last two client letters, but I struggled to account for how we could be buffeted by so many afflictions within a single season and why that season was lasting for so long. During the second half of 2016, however, the portfolio entered a begrudging recovery that built strength in the final months of the year. This included partial rebounds in some of our most beaten down positions. The portfolio also began to behave more normally. For example, whenever I added to undervalued positions during the second half, those trades were usually neutral or positive in the short-term instead of declining even further, like they frequently had during the prior 24 months.

I believe that there are two uncomfortable but important lessons from this experience. The first is that the stock market is sometimes inscrutable, even bordering mysterious. As I mentioned above, I never arrived at a satisfactory conclusion as to why so many things had gone wrong at the same time. In the same vein, it is difficult to know why the portfolio began to turn around when it did. These vagaries can be unsettling, but I believe that it is best to be honest about them. Benjamin Graham touched upon this in 1955 during a testimony that he gave to the US Senate's Committee on Banking and Currency. The Committee asked Graham what caused undervalued stocks to eventually rise up to their intrinsic values. Graham replied, "That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. We know from experience that eventually the market catches up with value. It realizes it in one way or another."

The second key lesson is a corollary to the first: Given the vagaries of investing in the market, it is critical that investors remain steadfast and not lose heart during difficult times. Perseverance is *the* key attribute that allows investors to avoid selling at low prices during foggy times and eventually make their way to clearer and brighter vistas. Benjamin Graham touched upon this as well during his testimony to the U.S. Senate. He explained, "I think our success is due to our having established sound principles of purchase and sale of securities, *and having followed them consistently through all kinds of markets* [emphasis added]."

Looking Forward

During the second half of 2016, Kopion returned 18.6% before fees (18.0% after fees). This compared to the S&P 500 and Russell 2000, which returned 7.8% and 18.7%, respectively. It is unhelpful to focus on a single year's results, and even more so to focus on a single half's results. Nonetheless, I wanted to mention these figures as I believe they demonstrate the recovery that has begun in our portfolio. Additional recovery from here is likely to be uneven, but the outlook is brightening. Signs of general economic improvement are becoming stronger and more widespread. This should eventually translate into better earnings growth for our companies. It is also likely to result in a more reasonable stock market environment, unlike the mine-field that we traversed from the summer of 2014 through the summer of 2016. These economic improvements have been widely recognized, but sentiment still includes some lingering skepticism, which suggests that the market is not far ahead of itself.

What I find most encouraging is that many of our companies' competitive positions and cost structures have improved in recent years. Over the last two years, the benefits of these improvements have been masked by a spotty economic environment and a tremendous strengthening in the US dollar. Better economic growth, however, should allow these improvements to become more visible. The outlook for the oil market continues to improve as well, albeit gradually. Our energy stocks are generally poised to benefit later in this industry's upcycle, so their contribution to our 2016 return was fairly modest. I am hopeful, however, that this cluster of positions will finally become an advantage for our portfolio in 2017.

Staffing Change

I'd like to shift gears to bring you up to speed on a staffing change that is underway at Kopion. As you may remember, before Alfred Cheng joined Kopion as an Analyst during the summer of 2015, he was a partner with an international law firm. Alfred performed well here, but he received an exceptional offer to return to law and ultimately decided to accept it. Fortunately, however, Alfred was able to stay with Kopion through the end of December, which allowed us to lay the ground work for a very smooth transition. He and his wife will also remain Kopion clients.

Alfred will soon be succeeded by Jonathan Lindstrom who graduated from Wheaton College last month. During his time at Wheaton, Jonathan accumulated an impressive roster of experiences and achievements that are quite relevant to Kopion. These included an internship as a municipal bond analyst, participating in Wheaton's student-managed investment fund, and earning a 3.98 GPA with a Major in Economics and a Minor in Mathematics. This was all achieved despite working a part-time job for all seven semesters of his undergraduate program. I am thrilled that I will once again be joined by a person of exceptional character and ability, and I am looking forward to his contributions.

Break on Through?

The last three years have been humbling from a return perspective. This experience has also increased my respect for great investors of the past who endured their own multi-year slumps. I recently learned that John Maynard Keynes was another such model investor. Keynes is best known for his economic theory, but he was also an accomplished value investor who achieved excellent long-term returns despite enduring prolonged seasons of underperformance and repeated setbacks. Keynes invested before and throughout the Great Depression, which gave him a deep understanding of the emotional difficulties of staying the course. Those experiences led him to postulate that investors should perhaps view their relationship with stocks like a commitment to marriage![1] He recognized what I am coming to understand much more deeply: Intelligence and hard work are important, but they are only valuable if an investor has the courage to persevere through the hard times, including the long and foggy ones. Fortitude alone enables investors to avoid selling at low prices and eventually break on through to the other side. It is too early to know definitively, but our portfolio is recovering, and I am hopeful that the clouds over us are finally parting. Thank you for your fortitude and support through this time.

Best regards,

Terry Ledbetter, Jr., CFA

[1] Zweig, Jason. "John Maynard Keynes: Courage Is the Key to Investing." The Wall Street Journal, October 14, 2016.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
Annualized*				
1 Year	11.5%	10.1%	12.0%	21.3%
3 Years	-5.7%	-6.9%	8.9%	6.7%
5 Years	10.3%	8.9%	14.7%	14.5%
Since Inception†	13.5%	12.1%	13.6%	13.8%

Period	T Ledbetter, Gross	T Ledbetter, Net Max Fee	S&P 500	Russell 2000
Annualized*				
1 Year	11.5%	10.1%	12.0%	21.3%
3 Years	-5.7%	-6.9%	8.9%	6.7%
5 Years	10.3%	8.9%	14.7%	14.5%
10 Years	8.8%	7.5%	6.9%	7.1%

*Ending 12-31-16
†Since 8-23-09

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 $_{\text{Max Fee}}$" 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 reflects actual fees.

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

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