



Competing Realities

Monday, July 2, 2012

Dear Kopion Clients,

Our portfolios got off to a tremendous start during the first quarter, increasing 18.9% before fees (18.6% after fees) which was well ahead of the S&P 500 and Russell 2000 which rose 12.6% and 12.4%, respectively. The second quarter, however, witnessed a “rerun” of the same macroeconomic worries that precipitated declines during the springs of 2010 and 2011. This drove declines in our portfolios so that Kopion’s YTD return now stands at 9.4% before fees (8.9% after fees). YTD, the S&P 500 and Russell 2000 have returned 9.5% and 8.5%, respectively. Our YTD performance has been a combination of very strong returns for some stocks and very poor returns for others which provided numerous opportunities to shift funds into undervalued positions. So while our portfolios are once again largely in the grip of macroeconomic concerns, they are also quite value laden and the underlying businesses continue to progress.

Kopion’s outstanding first quarter, followed by a poor second quarter reflects the tug of war between two intertwined, but sometimes competing realities: Commercial Reality and Price Reality.¹ Commercial Reality represents the actual businesses that underlie our stocks, and it is based on substantive issues such as the companies’ competitive positions, long-term growth opportunities, and concrete results. Kopion focuses heavily on Commercial Reality, and I thus spend most of my time rummaging around “under the hood” of these businesses to understand them as best as I can. Importantly, as with cars, the exterior of a business is sometimes an imperfect proxy for the health of the engine. For example, our largest position is National Instruments which makes tools that scientists and engineers use to develop new products, create prototypes, and test finished goods as they roll down factory assembly lines. On the outside, National Instruments looks like a good company with unique products. What would be easy for a casual observer to miss, however, is that National Instruments’ products are so differentiated that they are revolutionizing their industry, and a number of dynamics are pushing their industry close to a tipping point that favors National Instruments. For example, the company’s average order size has been \$3,000 to \$4,000 in recent years, and they define “large orders” as anything over \$20,000. During the first quarter of 2012, however, they received a +\$27,000,000 order which suggests that the industry

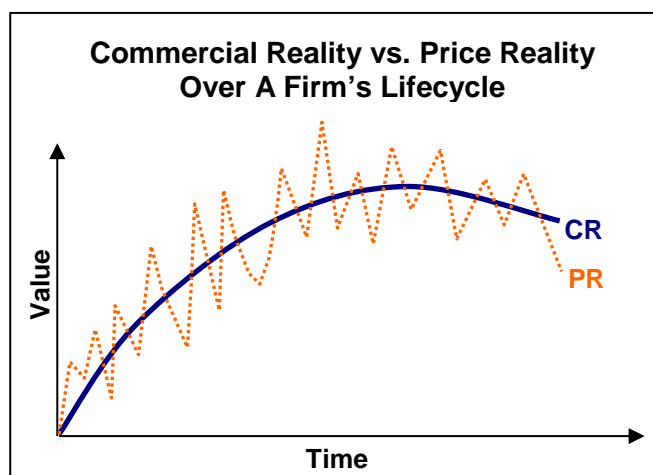
¹ Over the years, various investment professionals have used different labels and analogies to describe this concept, but this particular version was developed by Tom Lewis of High Road Value Research.

shift towards their products is accelerating. So while National instruments looks like a Lexus on the outside, it looks like a Porsche under the hood. I have unfortunately also encountered the opposite situation. I once invested in a dollar store chain called “99 Cents Only,” which had enjoyed tremendous success in California but stumbled when they expanded into Texas. I thought that their troubles would be short lived, but if I had looked more carefully, I would have realized that the company was really suffering from an unscalable infrastructure and a structurally more competitive market in Texas, both of which presented major problems. So what looked like an Audi that needed a tune up was in fact a Volkswagen in need of serious engine work. These are all examples of fundamental details underlying a stock’s Commercial Reality.

Every stock, however, also has a Price Reality which is reflected by its stock price. In one sense, Price Reality is the more objective of the two realities since it reflects the value at which the stock can be immediately liquidated, and it is *supposed* to reflect Commercial Reality. The problem, however, is that Price Reality tends to focus on near-term results, and it is often distorted by a number of other factors such as market psychology, price momentum, and macroeconomic issues. These can render Price Reality a *less reliable* gauge of value in the short-term. For example, one of our companies, Stratasys, has traded at prices ranging from \$18 to \$54 per share in just the last ten months illustrating how unreliable Price Reality can be as a metric.

The influence of macroeconomic concerns on Price Reality has grown dramatically since the 2008 / 2009 crash when macroeconomic events precipitated the second worst bear market in U.S. history. One of the legacies of the crash has thus been a heightened sensitivity to economic indicators, and the market has since suffered numerous setbacks that were triggered by various causes of “economic uncertainty.” I personally believe that this whole concept of “economic uncertainty” is fundamentally flawed since the future is always uncertain and what is really changing is peoples’ awareness of this uncertainty and how imaginative they are about the negative scenarios. Furthermore, the government economic data upon which these assessments are often based is not nearly as predictive as the press presents it to be because the global economy is a profoundly complex system that confounds even professional economists. My former boss once pointed out that economists usually “talk with both hands” since they often say, “On the one hand. . . but on the other hand. . .”. This reflects the ambiguities of the macro economy. As a practical matter, however, economic uncertainty has become a prominent feature of Price Reality, and it manifested itself again during the second quarter.

Over the long term, Commercial Reality and Price Reality are intertwined, and while Price Reality is influenced by noise in the short-term, it ultimately follows Commercial Reality over a firm’s lifecycle as shown on the right:



I believe that each investor's behavior ultimately boils down to which of these realities they have the most faith in. Given the amount of media bombardment that most people experience, our pattern-seeking natures, the comfort of going along with the crowd, and the amount of time required to study Commercial Reality, it is not surprising that many investors end up placing some degree of credence in Price Reality.

Over the last decade, stock prices have become significantly more volatile than they had been historically which is emotionally uncomfortable since it presents us with more setbacks than we'd like. It is ultimately, however, a blessing since it is creating more frequent and larger gaps between Commercial Reality and Price Reality which I believe I am exploiting. I am doing this by reducing positions that have appreciated more than I am comfortable with, and then reinvesting those gains into other positions that have sold off sharply and thus present excellent values. Undervalued companies tend to be more volatile, so this shift could lead to a bumpier ride in the coming quarters, but it is the right investment decision, and I am hopeful that it will underpin good long-term returns.

Thank you for your continued confidence in Kopion.

Best Regards,

Terry Ledbetter, Jr., CFA