Kopion Asset Management

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Status Report

Wednesday, July 13, 2016

Dear Kopion Clients,

As you will remember, we entered a stormy market last summer. This environment continued through the first half of 2016 with the market lurching from one potential crisis to another. The first of these was a slowdown in the Chinese economy, followed by acutely low oil prices and most recently, Britain's decision to leave the European Union. Like the rest of the market, Kopion's portfolio fell sharply in early 2016. We then recovered almost all of that decline, only to be dealt another setback by the British referendum at the end of June. In the end, Kopion finished the first half of the year down 5.9% before fees (-6.4% after fees). The S&P 500 and Russell 2000 returned +3.8% and +2.2%, respectively.

The S&P 500 finished the first half near its all-time high, but that belies widespread anxiety throughout the market. For example, cash is the most defensive asset, and fund managers have allocated an average of 5.7% of their portfolios to cash, which is the highest level in nearly 15 years. In a similar vein, allocations to equities are at four year lows, reflecting a level of risk aversion usually seen during recessions.[1] Even among equities, investors are favoring sectors such as utilities that they perceive to be safer. (This has ironically pushed the valuation of utility stocks to their highest level in at least 20 years.)[2] Many investors have thus moved away from small companies like the ones that Kopion focuses on in favor of larger, more defensive ones. Because we have remained in a very difficult environment for our types of stocks, I decided to provide a brief "status report" on the main factors that have been afflicting our portfolio:

Low Oil Prices

Oil prices remain quite low, which has led to additional declines in development spending across the globe. For example, the number of rigs that are actively drilling in the US has plummeted about 77% from its peak, and a staggering 69% of the fracing equipment in the US has been idled. Global oil production thus began declining early this year. This has led to a modest recovery in oil prices, and a variety of factors suggest that this improvement will continue, albeit

[1] Ben Eisen, "Fund Managers Are Stockpiling Cash," The Wall Street Journal, June 14, 2016.
[2] Ken Brown, "Desperate for Yield? Utility Stocks Are More Dangerous Than They Look," The Wall Street Journal, July 6, 2016.

unevenly. I am thus cautiously optimistic that the worst of the oil downturn has passed for our energy stocks.

The Strong US Dollar
The strength of the US dollar has been a stiff headwind for many of our companies because it has caused their international revenues and earnings to translate into fewer US dollars. This can be thought of as a “foreign exchange penalty.” In recent months, this penalty has become much smaller, and if exchange rates hold steady, it should dissipate over the balance of the year. I am thus hopeful on this front as well.

Higher Risk Aversion
As mentioned previously, this headwind intensified during the first half. Investors’ emotions are inherently unpredictable, which makes it impossible to know when the market will become less edgy. That said, we seem most likely to face continued challenges in this area as investors grapple with various sources of uncertainty such as Britain’s departure from the European Union and a US Presidential election that promises to be more like a demolition derby.

Tough Luck
Alfred and I are extremely diligent in our research efforts, but the year to year results of that work are sometimes affected by luck. As some of you might remember, at the end of 2013, I noted that part of that year’s phenomenal performance was due to good luck. Over the last couple of years, however, I believe that we have been dealt a surprising amount of bad luck as an unusual number of our companies have suffered temporary setbacks. Furthermore, the market’s heightened risk aversion has amplified the declines in those stocks. Fortunately, each of these companies is making concrete progress overcoming their individual challenges.

There are thus preliminary signs that we may be turning a corner with some of these headwinds, but others seem likely to persist. The good news, however, is that this adversity has provided opportunities to judiciously add to some positions at incredible bargain prices.

In summary, we continue to make the best of what has been a very difficult hand, and I believe that from a long-term perspective, our portfolio has tremendous upside. In addition, I recognize that this has been an uncomfortable and protracted season, and I greatly appreciate all of your patience, support and trust through this time.

Best regards,

Terry Ledbetter, Jr., CFA