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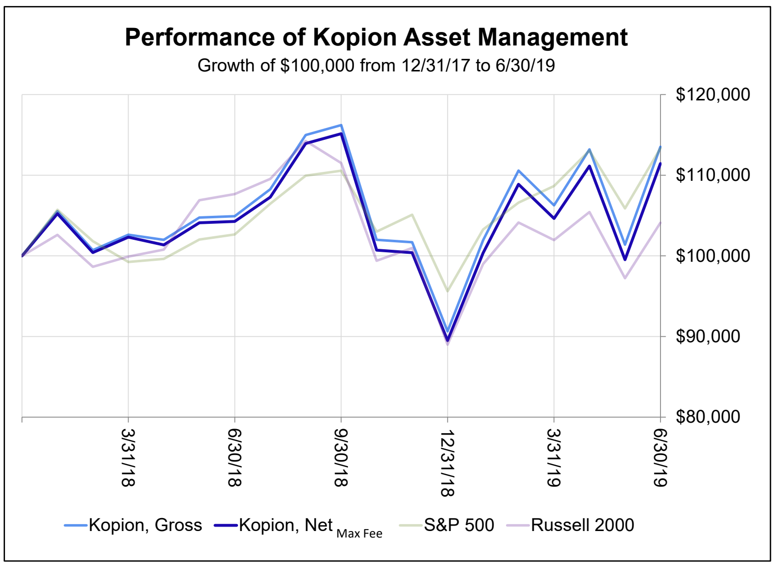
Interpreting the Last 5 Years

Friday, July 12, 2019

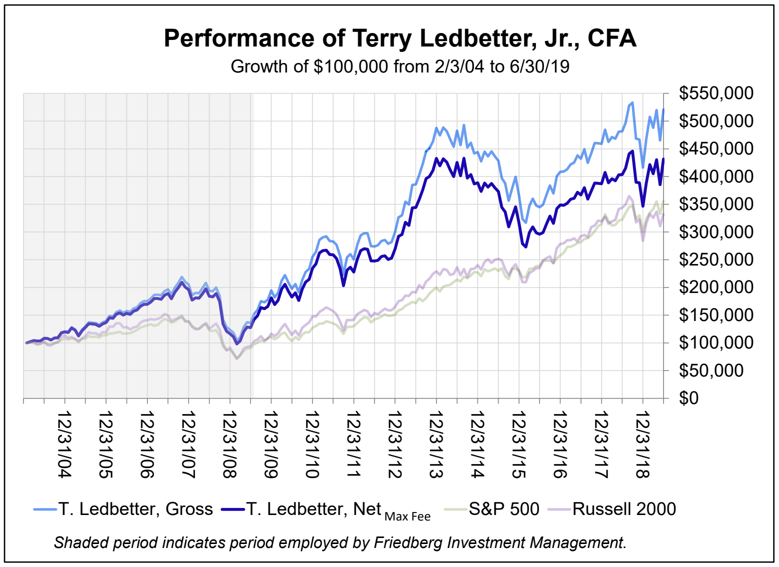
Dear Kopion Clients,

During the first half of 2019, Kopion returned 25.2% before fees (24.6% after fees). This compares to the S&P 500 and the Russell 2000, which returned 18.5% and 17.0%, respectively. These results are encouraging, but we began the year in the midst of a market panic that spoiled 2018 and caused its return to be negative. I personally thus find it more helpful to consider our results over the last 18 months in order to look across that "valley." Over that time span, Kopion's annualized return was 8.8% before fees (7.8% after fees). The S&P 500's and Russell 2000's annualized returns over that period were 8.7% and 2.7%, respectively. This is illustrated by the chart on the right.



This chart also shows that our portfolio has been quite volatile since last summer, with its value increasing or decreasing as much as 12% in a single month. I believe this reflects the tug-of-war that I described in my last client letter. To review briefly, this tug-of-war describes an active tension in the market between good business fundamentals and investor worries about how much longer the economic expansion can continue. That tension led to panic selling in late 2018 and a subsequent recovery in the first half of 2019. Anxieties have persisted through the first six months of this year, though they have become more focused on the most visible threat to economic growth: trade negotiations between the Trump administration and China. Indeed, the associated tariffs and worries about future ones have caused economic growth to moderate, especially overseas. That said, it is strongly in all parties' best interest to reach some sort of compromise—eventually. Until that point, this dispute will continue to be a source of friction that causes the economy to grow slower than it would otherwise. The upshot, however, is that a decent resolution should remove this headwind and benefit the stock market.

Now that I've provided a brief overview of the current moment in the market, I'd like to shift gears and discuss an issue that I have reflected on repeatedly in recent years. This is the question of how, after realizing stellar returns over my first decade as an investor, the last five years have been so disappointing compared to the rest of the market. This is shown by the chart on the right.



Shaded period indicates period employed by Friedberg Investment Management.

I have spent a great deal of time thinking about how to interpret the underperformance of the last five years and what that interpretation suggests for the future. Early in my career, I discovered the importance of interpreting past experiences carefully; it is surprisingly easy to misinterpret the past and thus learn the wrong lessons. Since that time, I have learned that this hazard goes well beyond investing and is part of the human condition. We are pattern-seeking creatures who desperately want to understand why things happen the way they do. For me personally, this drive comes from desires to both:

- Make better decisions in the future, largely to avoid pain.
- Find purpose in the pain of the past that would otherwise feel like a dead-weight loss.

Unfortunately, our ability to understand the world and ourselves is fallible, and this makes interpreting the past a tricky business. There are multiple reasons for this, and I will only touch upon some of the biggest challenges as I see them. The first is that our view of the world is fundamentally limited, and we sometimes don't even recognize those limitations. This gets expressed in the adage, "You don't know what you don't know." Additionally, we often fail to remember that many events in the past involved an element of chance. For example, in October 2016, the U.S. Presidential race was somewhat close, and Hillary Clinton was widely expected to win. After Donald Trump won, however, narratives began to emerge to explain his victory, and some of those explanations made his triumph seem inevitable. In truth, the race was very close, which made the outcome unpredictable. This unpredictability, however, is very difficult to remember because our minds tend to impose explanations on whatever events come to pass. These explanations are often correct directionally, but they are sometimes overly simplistic or even flat-out wrong. Another challenge to interpreting events correctly is our inherent biases, many of which aren't conscious. One of my college professors used to say that we all have "sophisticated mechanisms of self-deception." We can unwittingly develop false narratives to avoid facing painful truths. I have been guilty of this in my marriage. For years, I thought that my wife was demanding. I now, however, see that most of her "demands" were actually cries for me to show interest in her and our boys instead of devoting almost all of my attention to work. It was more comfortable to believe that her expectations were too high than face the possibility that my years of redlining at the office had hurt them.

Given these pitfalls, I have sought to be very careful as I have interpreted my lackluster returns over the last few years. Most of the reasons for this poor showing compared to the indices have already been chronicled in prior client letters. To review quickly, these included:

- Many of our stocks entering 2014 at valuations higher than I appreciated.
- A dramatic strengthening of the U.S. dollar, which caused the earnings at many of our firms to translate significantly lower.
- Situations in which our value investing process worked against us, at least in the short term.
- Kopion's relatively high exposure to the Energy industry.

To this list, I now want to add another important factor that has become clearer even though it is still playing out:

- A handful of our stocks have suffered permanent losses of value compared to what I thought they were worth back in 2014. Said another way, my estimates for these firm's intrinsic values are now structurally lower. However, I believe their stock prices have fallen so far that they have significantly overshot the reductions in their intrinsic values. I thus believe that these stocks present limited downside risk and meaningful upside from their current levels.

In very simplistic terms, our portfolio suffered major declines from the summer of 2014 to the summer of 2016. It then underwent a rebuilding process over the next three years, but this occurred unevenly across the portfolio. Most of our stocks were in what I will call "the good bucket." These stocks powered ahead and are responsible for all of the recovery in the portfolio. A minority of our stocks, however, were in what I will call "the bad bucket." These stocks have languished over the last three years and worked *against* the rebuilding process. Today, the bad bucket includes six stocks that represent a wide spectrum of investment opportunities. The riskiest part of this bucket is our two smallest holdings, which together represent only 2.2% of the portfolio. The remaining four stocks collectively represent 16.6% of the portfolio. These four stocks are suffering from extremely poor sentiment, but they are well positioned competitively and have healthy balance sheets. I thus believe that these four stocks present less risk than the smaller two.

The bad bucket previously included a seventh stock: Esterline Technologies. This is worth discussing since it provides a good example of what I am hoping for with the remaining six stocks in this bucket. Esterline's stock price peaked in the summer of 2014 at $121.48, but its business entered a significant downturn about a year later. By early 2016, its stock price had fallen to $51.76, a decline of 57.4%. Ongoing business struggles continued to dog the stock, which made Esterline a drag on our portfolio. I strongly believed that the company would eventually recover, and the stock seemed to be quite undervalued, so I gradually added to the position. That discipline was rewarded in late 2018 when Esterline announced that it was being acquired for $122.50 per share. That exit price was much lower than I had expected back in 2014, but it was a dramatic improvement from where the stock had been trading. This contributed strongly to our portfolio last year. While Esterline's outcome has been resolved, the outcomes for the rest of the bad bucket stocks are still pending. To be clear, I don't expect the remaining stocks to recover all the way back to their prior highs like Esterline did. I do, however, expect them to recover quite meaningfully from current levels, especially as a group.

In summary, the last five years have felt very long as the portfolio declined sharply and rebuilt slowly. This process is still playing out on multiple levels, but I am thankful for the progress we have made, and I'm even more grateful to have clients who have stuck with me through this time.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
1st Half of 2019	25.2%	24.5%	18.5%	17.0%
Annualized*				
1 Year	-9.4%	-10.5%	-4.4%	-11.0%
3 Years	4.3%	3.0%	9.3%	7.4%
5 Years	-3.1%	-4.3%	8.5%	4.4%
Since Inception†	10.7%	9.3%	12.3%	10.9%

Period	T Ledbetter, Gross	T Ledbetter, Net Max Fee	S&P 500	Russell 2000
1st Half of 2019	25.2%	24.5%	18.5%	17.0%
Annualized*				
1 Year	-9.4%	-10.5%	-4.4%	-11.0%
3 Years	4.3%	3.0%	9.3%	7.4%
5 Years	-3.1%	-4.3%	8.5%	4.4%
10 Years	12.9%	11.5%	13.1%	12.0%

*Ending 12-31-18
†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.