Katrina & Rita

Thursday, October 6, 2011

Dear Kopion Clients,

As many of you are aware, the equity markets declined sharply in August and September, leading to steep losses during the third quarter and driving the major market indices down for the year. Year to date, the S&P 500 and Russell 2000 are down 8.7% and 17.0%, respectively. As seen in the Russell 2000's performance, the sell off has been especially pronounced among smaller firms like the ones that Kopion gravitates towards, and year to date, Kopion's average account is down 12.7% before fees (-13.3% after fees). It's also important to note that Kopion's performance was strongest early in the year, especially during January. Consequently, accounts that came on board after this have experienced all of the recent decline with less, if any of the strong performance from earlier in the year to offset it. The performance for those accounts has accordingly been worse than Kopion's year to date results because of the timing with which they happened to come on board.

The market's current tempest reminds me a lot of Hurricane Rita, which struck Houston in September 2005. Just a month earlier, Hurricane Katrina had devastated New Orleans, and while Rita was a significant storm, it was the fresh memories of Katrina that motivated a super-sized evacuation out of Houston. Unfortunately, few people stopped to consider whether there were any factors that might make Houston less vulnerable than New Orleans had been such as not being below sea level and not being so close to a large body of water. Likewise, the stock market's losses of 2008 and early 2009 are still very fresh in most investors' minds which has led to panic selling and a response that is very disproportionate to the economic figures and corporate earnings that have been reported over the last three months.

To be fair, some economic reports have pointed to slower economic growth. There have been numerous other metrics, however, that indicate the expansion is still underway and the overall environment has not significantly changed. The press has offered a decidedly pessimistic interpretation of these reports, trumping negative data points and barely regarding positive ones. For example, The Wall Street Journal yesterday ran an article with the ominous headline: "Factory-Goods Orders Show Decline." The details of the article, however, revealed that orders only declined 0.2% from the prior month and the more important "Nondefense capital goods orders excluding aircraft" figure rose 0.9% over the prior month.[1] The press has

[1] Jeff Bater and Andrew Ackerman, *Factory-Goods Orders Show Decline*, The Wall Street Journal, September 5, 2011 Print Edition.

also ignored basic qualifications such as the natural tendency of a recovery to decelerate as it matures and the inherent volatility of economic indicators. The market has reflected this negative bias as well with a tendency to assimilate bad news and filter out good news. To date, however, the preponderance of the facts (i.e. corporate earnings reports and updates, automobile sales, retail sales, etc.) indicate that the economy continues to gradually advance.

My chief concern is that all of the negativism discussed above could eventually alter spending patterns and turn a prospective downturn into an actual one. Some have described this as "talking ourselves into a recession." This is certainly possible, just as it was possible in September 2005 that Hurricane Rita might devastate Houston. As it turned out, however, Rita did relatively little physical damage to the city, though the 10-20 hours spent in bumper to bumper traffic did take a toll on the hundreds of thousands of motorists who tried to evacuate.

I believe that a number of factors make another deep and sustained economic downturn less likely. Recessions are often created and amplified by consumers and businesses who cut back on their spending plans. This takes many forms, ranging from deferring new equipment purchases to reducing inventory and staff. The global economy entered 2008 with normal conditions in nearly all of these areas. Today, however, inventories and staffing levels are already lean and equipment purchases that could be deferred have now already been deferred for two or three years. Furthermore, most corporate balance sheets are now strong which leaves companies much better prepared to endure a downturn without needing to cut staff. I do not want to offer a forecast for the economy or the market, nor do I mean to diminish the significant structural problems that the world is currently working through. I did, however, want to explain why the market and our portfolios have performed so poorly. I also wanted to offer a more balanced perspective than the aggressively spun news that I've read and suspect that you are hearing as well.

Market downturns such as this one are not uncommon, though they often have a lower profile since they don't usually fit as neatly within the boundaries of the calendar as this one has. Just last year, the S&P 500 declined 15.6% from April 23 through July 2. This decline, however, was preceded and followed by advances which obscured the size of the decline when you looked at the market on a month to month or quarter to quarter basis. Furthermore, the market rallied later in the year when it became apparent that the mixed economic signals of that time did not presage a "double dip" like many had feared. The S&P 500 finished 2010 with a positive 15.1% return for the year, even though that performance included a negative 15.6% interlude from late April to early July. As was the case that time, my focus continues to be on investing in attractive businesses which should perform well over the long term, even though there will be inevitable setbacks along the way.

Thank you for your patience and confidence as we ride out this storm.

Best Regards,

Terry Ledbetter, Jr., CFA

Past performance does not guarantee future results. Indices' performance figures have been obtained from sources believed to be reliable.