Kopion Asset Management

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Kopion's Edge

Tuesday, July 16, 2024

Dear Kopion Clients,

During the first half of 2024, Kopion returned 10.1% before fees (9.5% after fees). This compared to the Russell 2000 and the S&P 500, which returned 1.7% and 15.3%, respectively. Kopion's recent results are encouraging, but I want to remind you that investing is cyclical, and we will eventually encounter some bumps in the road. Such ebbs and flows are simply part of the journey.

Over the last several months, I have had a few opportunities to present Kopion's story to institutional investors who oversee very large asset bases. Some of them have asked, "What is Kopion's Edge?," which is their shorthand for "What advantage do you have over the dozens of other asset managers that come across my desk?" Answering this question has been a clarifying exercise, and my answer is worth sharing with all of you because it illuminates an important aspect of Kopion that I haven't discussed much previously.

Kopion's edge ultimately draws from an engineering concept known as a "design decision." When an engineer develops a new product, they have to prioritize and make trade-offs, such as a part's strength verses its weight. This same concept can be applied to an organization's structures and processes, though these are intangible design decisions that aren't always obvious. In fact, they might not even be conscious choices. An example might be helpful. At a prior firm where I worked, the portfolio manager customized the roughly 400 portfolios that he oversaw. He and the clients obviously valued that approach, but personalizing each and every portfolio introduced some drawbacks as well. The first was that so much of his time was spent reviewing and adjusting each portfolio that less time was available for research. The second was that he could not devote as much attention to each portfolio's construction as if he had standardized across only a dozen or so model portfolios. In the larger scheme of things, he was still a remarkable investor who did a fine job for our clients, and I was extremely fortunate to have him as a mentor. Nonetheless, a few of his practices underscored for me how design decisions in one area impact other areas.

When I began considering whether to open my own shop, an experienced portfolio manager counseled, "If you do this, you'll be building something. So be careful about what you build." This was profoundly important advice. It is all too easy to adopt practices that don't actually align with one's values! Fortunately, as I began to build Kopion, I was blessed with a clean sheet of paper, a clear sense of the values that I wanted to prioritize, and an extensive list of good and bad examples from which to draw. All of this led me to organize Kopion in a way that aligns everything we do around making good investment decisions. The related design decisions are largely unseen, but they are integral parts of our edge. They allow us to do work that others cannot.

> *Kopion's edge is that we have made and uphold a range of design decisions that facilitate an exceptional investment process and enable good decision-making. And we apply this edge in one of the most prospective parts of the stock market.*

There are too many design decisions to cover in the space of this letter, especially since a number of them are inter-related. I will, however, touch on a few examples:

- When I was deciding where to locate Kopion, Dallas' professional investing scene was concentrated just north of downtown, especially its hedge funds which gravitated towards The Crescent building in particular. However, I was keenly aware that emotions like fear and greed can be contagious. I thus partly chose to establish Kopion's office in a distant suburb so that we would have access to professional events while keeping a healthy distance from unhelpful noise. This has provided a good balance between hearing other perspectives while not being so surrounded by them that we become vulnerable to being swept along with the crowd.
- In a related vein, an older portfolio manager had advised me that "a good work environment is important so you can think as clearly as possible." This resonated strongly with me. Our work is highly detailed and benefits greatly from a quiet atmosphere. This is especially true since the stock market and news media introduce a certain amount of psychological noise that cannot be completely avoided. Kopion's office building was thus hand-picked to provide as good of a study environment as possible. In fact, many decades ago, it served as our town's public library.
- An entire collection of design decisions relate to standardization. For example, all of the accounts that we manage are custodied at the same broker, which streamlines a host of administrative, trading, and compliance tasks. These tasks are important, but they can detract from our principal work of investment research and decision-making. Extensive standardization keeps that type of parasitic loss to a minimum. Another example of standardization is that all of the accounts we oversee are managed to a single model portfolio. This further maximizes the amount of time that we can devote to research. This approach is very different from most firms, which make a host of exceptions in order to win and keep clients. Those exceptions invariably introduce complexity that requires ongoing attention, and take focus off of the investment effort. Most firms cope with this by adding staff, but this doesn't necessarily solve the problem as it diverts attention away from managing the portfolio to managing staff.[1]
- We focus on a type of company that we refer to as "compounders." These are businesses that should be able to grow their earnings over a long period of time

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[1] Acknowledgement: Paul Sonkin articulated the trade-off between managing a portfolio and managing staff in a November 2009 interview with *Value Investor Insight*.

under a relatively wide variety of future scenarios. We own these firms for their investment merits, but compounders offer a significant side-benefit of allowing greater research depth. Because these companies can grow for so long, we can follow them for a longer period of time, compounding our knowledge. Indeed, at the end of 2023, the tenure of our average holding was over 10½ years. This allows us to understand what we own far better than if we needed to regularly spool up on a broader, but shallower body of knowledge, as is common at other firms.

- The most important design decision that I've made has been to remain deeply involved in our research. In most cases, portfolio managers progressively delegate more research responsibility to their analysts, but this gradually separates research from decision-making. At Kopion, we use a different approach that we refer to as "co-research." This keeps me (the decider) very involved in the research process, including for the holdings where Jonathan is responsible for the heavy lifting.

Like all design decisions, ours involve trade-offs as well. For example, managing all of our accounts to a single model portfolio has reduced the number of clients for whom we are a fit and often limits the proportion of their overall funds that they entrust to us. Another limitation is that the co-research approach probably cannot scale beyond two or three professionals. This is one of the reasons that Kopion will need to begin a wait-list for new deposits when our Assets Under Management reach $200MM[2]. But these are trade-offs that I have gladly accepted. They are the foundation of our edge, and they allow you to benefit from an intentional and effective investment decision machine.

Thank you for recognizing the uniqueness of what we do and your continued support.

Best regards,

Terry Ledbetter, Jr., CFA

[2] This figure may be adjusted for inflation from a December 2023 starting point.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	Russell 2000	S&P 500
Annualized*				
1 Year	23.2%	21.6%	10.1%	24.6%
3 Years	4.0%	2.7%	-2.6%	10.0%
5 Years	12.8%	11.4%	6.9%	15.0%
10 Years	7.0%	5.7%	7.0%	12.9%

*Ending 6-30-24

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 $_{Max\ Fee}$" 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 reflect actual fees.

Kopion has provided the returns of the Russell 2000 and the S&P 500 indices in order to provide the broader stock market context of Kopion's (and Mr. Ledbetter's) returns. The Russell 2000 tracks the performance of relatively small publicly traded companies, and the S&P 500 tracks the performance of relatively large 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. Kopion (and Mr. Ledbetter) has primarily focused on small and medium sized firms, but it (and he) has also invested in some large companies as well. This is why Kopion has provided the results of both the Russell 2000 and the S&P 500. 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 Russell 2000 or the S&P 500. 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 Russell 2000 or the S&P 500.

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