The Kopion Manifesto

Monday, July 6, 2015

Dear Kopion Clients,

Kopion ended the first half of 2015 on a low point, returning -3.5% before fees (-3.9% after fees). This compared to the S&P 500 and Russell 2000, which returned +1.2% and +4.8%, respectively. For over a decade now, I have adhered to a well-defined and rigorous investment process that has produced good results over the long-term, but the short-term results can vary dramatically, which is admittedly vexing. For example, 2012 and 2013 were fantastic years, but the 18 months since then have been disappointing. Moreover, new clients sometimes join at what later proves to be a rocky season which causes their initial experience with Kopion to be frustrating. The world's best investors and authors who have studied them say that the path to long-term success lies in finding a sound approach and sticking to it through thick and thin. I have thus stuck to my process through this barren time. Importantly, while these times are frustrating, they are certainly not idle, and the bargain prices that they offer have historically laid the foundation for better times to come. Indeed, we enjoyed such an opportunity during the first half when one of our largest positions, Informatica, was acquired at a premium which provided ample funds to reinvest into beaten down holdings. I cannot predict when our fortunes will improve, but I do know that we have a value-laden portfolio that I expect to perform well over the next several years—even if we are dealt additional setbacks in the near-term.

Because we've gone through such a tough stretch and also to help you understand where Kopion is headed, I'd like to take a step back to address two big picture questions:

1. Why invest in individual stocks, especially when index funds outperform most stock pickers?
2. What enables certain stock pickers to outperform over the long run, and what have I done to maximize Kopion's chances of success on that front?

Why Most Funds Underperform

The best place to start in answering these questions is with an understanding of asset management as a business. From the outside, Portfolio Managers (PM's) can look like a homogeneous group because they often say similar things to one another. But after

13 years in the business, I have observed a wide range of behaviors, temperaments, abilities, and organizational structures that can foster or stymie good decision making. This is critical because while most investors think they are hiring a PM to make good returns, they are actually hiring him to make good decisions. This is because investing is a probabilistic field where results cannot be guaranteed, but where good decision making greatly improves the odds of success over time.

In my opinion, much of the investment industry is broken, and its structural problems lie along two interrelated dimensions:

1. The size of the funds.
2. The structures of the teams that manage them.

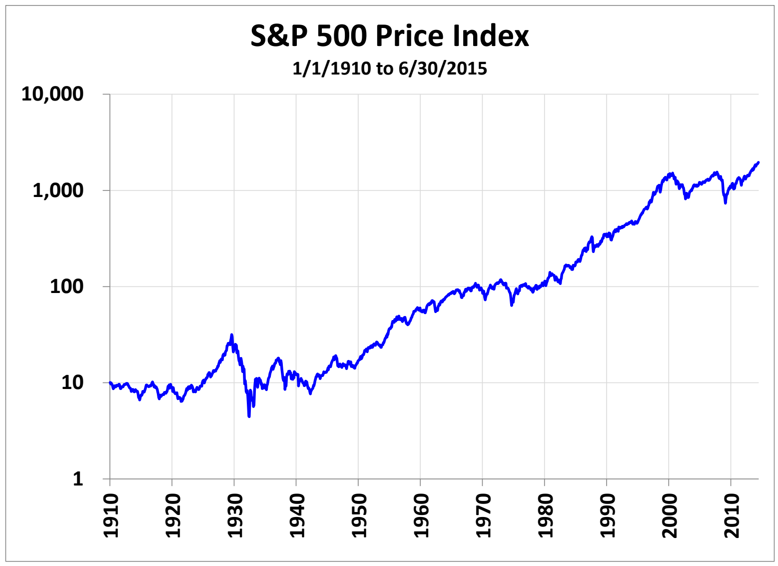
Much of the time, a gifted analyst will be promoted to a PM role, and in the beginning, he will still continue to function like an analyst, doing firsthand research that is directly applied to investment decisions. In addition, he is typically investing in the most fertile parts of the stock market—small, up-and-coming businesses that have abundant growth opportunities but are relatively neglected by the investment community. This often leads to good returns that attract additional assets to manage, especially in the institutional world where databases such as Morningstar make it easy for financial planners and wealth managers to find high performing funds. As the fund grows, however, two important dynamics start to occur. First, the PM will be forced to own many more stocks and eventually to own larger stocks. Second, this growing roster of positions will become too broad for any one individual to cover which will force the PM to delegate his research responsibilities to analysts. This PM-analyst hierarchy is the normal organizational structure within the industry, but it divorces research from the actual decision making. The most important and difficult investment decisions occur after a stock has declined, but the decoupling of research and decision making means that the PM will be using secondhand information at the precise moment that he needs a strong command of the facts. This leaves him highly vulnerable to succumbing to fear and selling at undervalued prices which usually results in a <u>permanent</u> loss of capital.

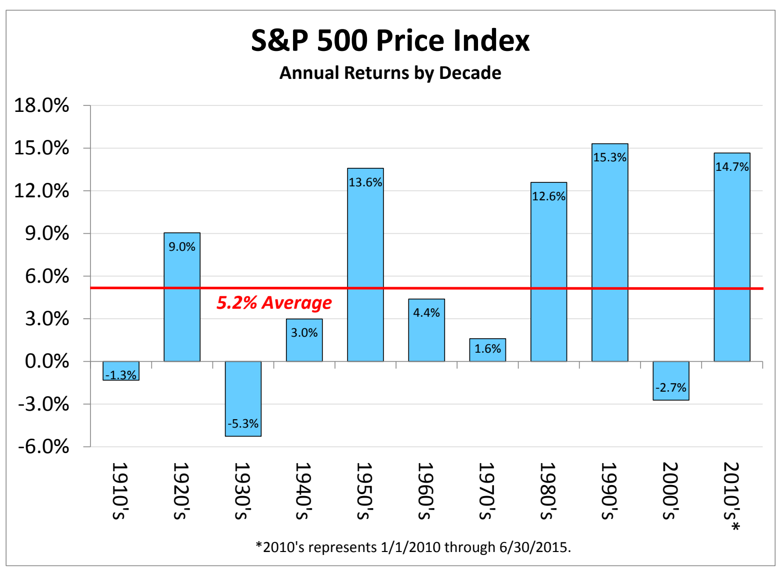
In other cases, funds are deliberately designed to be highly diversified because the fund companies want to market their funds to an investor base that tends to focus on performance relative to an index. These PM's thus construct their portfolios in a way that essentially mimics the index. I once spoke to a technology analyst at a large mutual fund company whose PM had told him, "I know that Microsoft probably won't be a good investment, but it's a big part of the index so I'm going to own it anyway." This is analogous to a truck that has a big engine but a worn out clutch. While the analyst "engine" might generate fantastic research, much of the resulting insights will be lost at the PM level and never make it into the portfolio. The PM, however, will continue to have a lucrative job that he won't be at risk of losing because he'll never do much worse than the index.

Scenarios like these are paths of least resistance within the industry, and I believe they are the primary reason that most funds underperform the indices over time, particularly after management fees and expenses are factored in. From a mathematical perspective, it is difficult to outperform the index if you are highly diversified and especially if you are shadowing the index. As this phenomena has become more widely recognized, index funds have enjoyed a surge of popularity, but I believe the root causes of underperformance remain widely misunderstood. Most pundits have concluded that PM's are simply unable to outperform the indices, but I believe this underperformance is more likely due to the abundance of funds that are "managed to the index." A few years ago, two academics reached a similar conclusion, writing that "the poor overall performance of mutual fund managers in the past is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to over-diversify."[1]

THE LIMITATIONS OF INDEXING

Indexing is a great fit for investors whose chief goal is to avoid underperforming an index, but it ignores the questions of how desirable that return will be and from where it will come. The stock market has risen over the very long term, but this ascent has been punctuated by entire decades of poor returns as shown by the charts on the right. In addition, the stock market has only risen 5.2% annually over the last 105½ years if you exclude dividends. While the decades of weak performance were difficult for all stock investors, I still find it preferable to target specific opportunities rather than blindly investing in a market that has historically stagnated for many years at a time.





Let's next address the question of where equity indices' returns come from. Over the long-term, indexing is essentially a bet on general economic growth, and that is in turn dependent on productivity gains and population growth. Prior to the widespread availability of birth control, population growth was a structural phenomenon, and the period following World War 2 was a particularly robust time for both population growth and productivity gains. Key

[1] Cohen, R., Polk, C., and Silli, B. (2009) *Best Ideas*, working paper.

contributors to rising productivity during that era were rising college admission rates and gigantic leaps in automation. These factors underpinned much of the stock market's gains during the postwar period. Moving forward, however, population growth will eventually become a headwind because birth rates have fallen across the world for a variety of reasons. These adverse demographic trends defy easy solutions, but in the medium term, this headwind will probably be masked by rising productivity and standards of living throughout the developing world. In my opinion, however, this backdrop increases the appeal of cherry picking companies that can benefit from discrete trends instead of being entirely dependent on general economic growth. For example, Ford's growth is dependent on global vehicle sales, so if demographics cause the auto market to stagnate, Ford will stagnate as well. BorgWarner, by contrast, sells components such as turbochargers that are enjoying higher adoption every year, so even if the vehicle market flattens, turbocharger use will likely continue to grow.

I have a final concern with indexing that is admittedly intuitive as opposed to empirical—I am simply not comfortable investing in things that I cannot forecast with a reasonable degree of confidence. There are plenty of businesses that I can study and get my mind around, but the macro economy is inscrutable. The global economy will probably continue to grow, but macro investing has so many open-ended questions. For example, China's one-child policy has translated into terrible demographics for that country, and its working age population peaked in 2011. Will this derail China's growth or will productivity gains more than offset the impact of a shrinking workforce? Here's another one: Most of the world's nations have serious public liabilities, both in the form of traditional debt as well as underfunded pensions and entitlement programs. Will this result in lower growth in the medium term or will most countries successfully ignore these problems for many decades? No one knows the answers to these types of questions, but I can tell you exactly how a company such as National Instruments is revolutionizing their industry and how they will continue taking marketshare from their competitors for years to come.

KOPION 2.0

I have thus built Kopion around researching individual stocks and directly applying that research to investment decisions. Over the last couple of years, it has become clear that I will not be able to realize my goals for Kopion, including my research goals, if I continue to work alone. I thus recently hired Alfred Cheng as an analyst, though the analyst role at Kopion will look quite different than the traditional PM-analyst hierarchy described above. Kopion currently owns 17 stocks, and as a solo practice, I have struggled to cover more than 18 companies in depth. I have come to believe that a more optimal number would be 20-24, and I thus want to move towards an approach that I refer to as "co-research." Under this arrangement, each stock will be covered by a "primary analyst" who performs the tedious, time-consuming work as well as a "supporting analyst" who leverages that research to maintain his own working knowledge of that company. For example, I will be the primary analyst for stocks #1-12, and the supporting analyst for stocks #13-24. Alfred, by contrast, will be the supporting analyst for stocks #1-12 and the primary analyst for stocks #13-24. This model will take a few years to realize as Alfred comes up to speed on all of our holdings and matures as an analyst. In the end, however, this arrangement will allow me to modestly expand the number of stocks that Kopion owns while still maintaining a strong knowledge of each stock and also avoiding other problems that commonly ensnare investment teams. In order to avoid the size problem that I touched upon earlier, I have decided to close Kopion to new deposits once Assets Under Management reach $400 million. (This figure may be adjusted for inflation.)

I offered Alfred this position after conducting a thorough search that included working with nine universities, conducting eight multi-hour interviews, running five candidates through formal aptitude assessments, and interviewing Alfred's references. I first got to know Alfred in 2002 when he was a computer programmer at a technology consultancy in Houston, and I followed his progress as he transitioned to a successful legal career during which he was made a partner at an international law firm. Early in our relationship, Alfred showed an unusually high interest in my work, and I can still remember showing him through some of my research around 2003. During the summer of 2010, Alfred decided to become a Kopion client after hearing me lament that my stocks had sold off. This may sound insignificant, but many people find it emotionally difficult to invest after results have been poor even though those are often the best opportunities. This was one of a number of instances in which Alfred displayed even-headed thinking in the midst of uncertain circumstances. I will not go into more details at this time, but I am extremely grateful to be joined by an individual of such exceptional character and ability.

This has been a disappointing season for all of us and especially those who have joined in the last 18 months. Nonetheless, I am convinced that my process is sound and that it will eventually prove its merit once again. Thank you for your patience during this period.

Best regards,

Terry Ledbetter, Jr., CFA