Kopion Asset Management

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PANIC-20

Thursday, March 12, 2020

Dear Kopion Clients,

I wanted to share my thoughts on the Coronavirus, its economic impact, and the related panic that is underway in the stock market. We have been following these developments for about a month now, and there is quite a bit that I could discuss. The purpose of this letter, however, is not to provide you with analysis, but rather to offer perspective and encouragement. I will thus keep my comments relatively brief.

From all we have read and heard, COVID-19 is similar to the flu except that it is a new illness, which means that no one is immune to it. This makes it easier for the virus to spread. From a public health standpoint, the risk is thus that a large percentage of the population could contract the illness, which would overwhelm healthcare systems' ability to treat them. Conceptually, in a worst-case scenario, the number of fatalities would remain small as a percent of the world's population, but on an absolute basis, they could reach into the millions. World leaders of all types (government, business, education, and religious) are taking decisive steps to avoid that scenario by redirecting or postponing many activities in order to minimize the spread of the illness. The stock market has taken these and related developments extremely poorly and entered a bona-fide panic. By one measure, the steepness of the market's current dive is near record levels, second only to its sharpest decline during the Great Depression.[1] This is a staggering market response within the context of what is actually happening in the real world.

Despite the hysteria around the Coronavirus, the fatality rate appears to be low, at just 1-2% or lower, and some people seem to be contracting COVID-19 without displaying significant symptoms.[2] The majority of the economic impact is thus not coming from the illness itself but the actions being taken to prevent its spread such as travel bans, event cancelations, and self-quarantining.

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[1] Otani, Akane and Karen Langley, *Dow's 11-Year Bull Market Ends*, The Wall Street Journal, March 12, 2020.
[2] McKay, Betsy, *Coronavirus vs. Flu: Which Virus is Deadlier?*, The Wall Street Journal, online version: updated March 10, 2020.

The key questions are thus:

1. <u>How deeply</u> will this “hunkering down” disrupt economic activity, and
2. For <u>how long</u>?

No one knows the answers to those questions, but I am encouraged that:

A. Much activity is adapting as opposed to grinding to a halt (i.e. working from home).
B. The economy was relatively strong going into the Coronavirus. This is a much more favorable setup than a shock like the 9-11 terrorist attacks, which added further downward momentum to a recession that was already underway.
C. After the virus has been contained, economic activity will probably be able to spring back relatively quickly. That stands in contrast to events like a financial crisis where the underlying causes can linger for years and make the recovery much more gradual.
D. Key governments appear ready to prevent a significant economic collapse.
E. The containment measures that are dampening activity for the moment will ensure that the worst-case public health scenario is avoided, which will also prevent some of the more negative economic scenarios.

The stock market is now well into bear market territory, and our portfolio has been pummeled along with everything else. The sell-off has been breathtaking in its speed and breadth. As one friend put it, “Fear is even more contagious than the virus itself.” One glaring example of the amount of anxiety in the market is the yield on 10 Year U.S. Treasury Notes, which have fallen below 0.9%. This means that some investors are choosing the guarantee of safety in exchange for earning just 0.9% annually for ten years! Inflation is usually about 2%, so they will almost certainly lose money after inflation. The degree of foreboding is that intense. Our stocks are currently being valued in a way that assumes their earnings will be very weak for a few years (i.e. a downturn that is deep and long). Such an outcome is technically possible, but for the reasons that I outlined above, I believe it to be unlikely. I am thus hopeful that things will look much better a year from now—possibly even sooner. Furthermore, after the dust settles, today’s prices are likely to look like amazing bargains, and this makes it even more important to stay the course. Hang in there everybody!

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
YTD 2020*	-33.0%	-33.2%	-22.9%	-32.5%
Annualized†				
1 Year	31.1%	29.6%	31.5%	25.5%
3 Years	10.1%	8.8%	15.3%	8.6%
5 Years	4.2%	2.9%	11.7%	8.2%
10 Years	10.9%	9.5%	13.6%	11.8%

*Through 3-12-20
†Ending 12-31-19

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.