# Ride the Storm

Tuesday, October 6, 2015

Dear Kopion Clients,

Kopion suffered additional declines during the third quarter, and our Year to Date return is now -19.7% (-20.3% after fees). This is considerably worse than the S&P 500 and Russell 2000, which have returned -5.3% and -7.7%, respectively. So even though it is my custom to write to you only twice a year, I felt that these results warranted some commentary.

There have been three key factors behind our continued poor performance. The first is that Kopion focuses on specific parts of the market, and these are the among the areas that have performed the worst in recent quarters. The most extreme of these has been the energy sector. However, we also have a concentration in the industrial sector, and that has hurt us as well. Moreover, we have relatively little exposure to the parts of the market that have been holding up, such as the healthcare sector. This dynamic is a continuation of the same trends that hurt our performance in 2014.

I believe that the second factor behind our recent results stems from how my investment process is working during a period of extended weakness. As a value investor, I seek to make our portfolio as value-laden as possible in order to maximize our long-term returns. This is achieved by judiciously adding to positions that have declined. In healthy markets, this behavior is often quickly rewarded. Conversely, in acutely weak markets, our stocks can fall so rapidly that I end up adding to our weakest positions closer to the bottom. In those cases, it takes longer for our discipline to be rewarded, but our performance doesn't usually suffer large additional losses because much of the decline has already played out. The last 21 months, however, have presented a completely different scenario: a gradual, protracted, and widespread decline among our holdings. This means that when I have added to our beaten down stocks, instead of having a positive or neutral impact in the short-term, those purchases have resulted in incremental losses because I have increased our exposure to the stocks that have kept going down. While this has amplified the pain in the short-term, my decisions have still enhanced the portfolio's projected long-term return.

The third factor relates to the sheer number of our stocks that have suffered these types of protracted declines. We usually only have one to three companies in this category, so their impact is less perceptible.  Unfortunately, we currently have about eight.  (This includes our four energy stocks and four of our other holdings.)  Moreover, market sentiment has ranged from skeptical to negative, which means that these stocks have been penalized more than they would be under normal circumstances.

These three factors have led to a very large "drawdown" in the value of our portfolios since Kopion's peak in March, 2014.  Some investors make the mistake of equating drawdowns to risk, erroneously extrapolating the most recent declines in the value of their portfolios.  This definition of risk, however, centers around psychological pain.  I believe that risk is better defined as the likelihood of a permanent capital loss.  Such an impairment can occur on two levels, either for an individual stock or for the entire portfolio.  An individual stock is impaired when the prospects of its underlying business deteriorate irreversibly.  Adequate diversification, however, prevents this type of permanent loss from marring the entire portfolio.  The overall portfolio, however, can be impaired if an investor buckles under the emotional pain of a drawdown and chooses to liquidate his entire portfolio at low prices.  In this case, he is essentially converting a drawdown into an unnecessary permanent loss.  This is the tragic fate of investors who cannot ride out the market's storms.  For its part, Kopion has periodically suffered large drawdowns, and I have also experienced a handful of individual stock impairments over the course of my career.  I believe, however, that our risk of a portfolio-level impairment is low because we focus on high-quality, durable businesses, and I am careful about the prices that I pay for them.

Given the declines that we have sustained and especially the additions that I have made to our weaker positions, our portfolio is now very value-laden.  Our current circumstances bear many similarities to the third quarter of 2011, which incidentally was the only other time that I felt warranted a "special edition" client letter.  In both cases, the economy sent mixed signals, the press put an especially negative spin on events, and the market gravitated strongly towards these pessimistic interpretations.  As was the case back then, I do not know how much longer we will have to ride the storm before our patience and discipline are rewarded.  But I do know that the portfolio is both sound and highly value-laden, and I continue to expect good results in the coming years.

Thank you for your patience, support and trust.

Best regards,

Terry Ledbetter, Jr., CFA