Sideshow

A theme of 2010 and what it could mean for the future

Wednesday, January 5, 2011

Kopion enjoyed an outstanding year in 2010, posting a full year return of 29.9% after fees. (The S&P 500 and Russell 2000 returned 15.1% and 26.9%, respectively.) While I am delighted to report this result, I'd like to remind everyone that Kopion will have both good and bad seasons, and I do not expect to outperform the market indices every year. Rather, my commitment is to a thoughtful decision making process, and this will hopefully generate good results over the very long term.

The macro economy continued to be a grand sideshow for many investors in 2010, which is somewhat understandable given the depth of the 2008-2009 recession and ongoing weakness in 2010. This preoccupation with broad economic indicators was enabled by the confounding nature of these metrics since they send mixed signals during the early and later parts of a downturn. Furthermore, economic anxiety was reinforced by widespread news coverage that has an uncanny ability to amplify bad news. Greece was a great example of the sideshow, as an economy smaller than Massachusetts' threatened to set off a chain of European defaults and precipitated two major pullbacks in the US stock market. Numerous news articles declared that stock picking and valuation were no longer relevant since major macro forces were now driving the markets, and even some prominent value investors began to dabble in macro investing. This widespread distraction was helpful to fundamental investors like Kopion that kept their eyes on the ball.

While I follow macroeconomic news, I am chiefly concerned with the specific developments that affect our companies, most of which are niche businesses benefitting from specific secular trends, some of which they themselves are pioneering. While the downturn created something of a pause in the visible progress of our companies, internal progress continued in a multitude of forms. In some cases, maintaining sizable R&D budgets allowed them to distance themselves from competitors who were being forced to retrench. In others, breakthrough developments validated their technology and have presented game changing opportunities. In yet others, our companies quietly established customer acceptance and early momentum with impressive new platforms that they had launched just before the economy rolled over. In still others, the downturn forced them to retool parts of their businesses which will now allow them to scale more efficiently in the upturn. And in almost all cases, the underlying trends continued to quietly progress. But many of these things were underappreciated since most investors' eyes were on the sideshow.

As we entered the fourth quarter the markets began to undergo a sea change as the economic data became consistently positive and the progress that our companies made during the downturn started to become more apparent. Importantly, whenever the environment is changing, there is often an ongoing lag between the real world and investors' perception of it. In this case, three consecutive years of disappointment have created a heavy psychological anchor restraining most people's expectations. For example, one of our companies, II-VI ("Two-Six") finishes it's Fiscal Year in June, so it was the first of our companies to make any projections that included 2011. In August, they forecast FY11 earnings per share of $1.60. Being aware of the lag phenomenon described above, I tried to get ahead of the curve and my modeling suggested that they'd earn around $1.76. Then two and a half months later, II-VI raised its FY11 estimate to $2.05. This was a huge increase, especially this early in their fiscal year, and it serves as a reminder of how easy it is to underestimate results when you're coming out of a downturn—even when you're consciously trying to overcome psychological anchors.

Many of our companies reported improving business momentum in their third quarter conference calls, and the economic news has improved significantly since that time, which suggests to me that we are indeed on the cusp of significant earnings improvement. Consequently, I have been unusually aggressive in the speed with which I've invested new accounts. The market was very strong in late 2010, which could set the stage for some choppiness in the first half of 2011. Still, given the long term value that I see in most of our holdings, and the tendency to underestimate their performance as the economy improves, I'd rather accept the risk of some short-term setbacks than put new accounts at the risk of missing out on a long-term upswing. The former would be a short-term problem, whereas the latter would be a permanent one.

So I am hopeful that in 2011 attention will turn from the sideshow and back to the main event, that is the tremendous progress that our companies made during the downturn.

Thank you for your interest and continued confidence in me.

Best Regards,

Terry Ledbetter, Jr.