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Thinning the Herd

Wednesday, July 11, 2018

Dear Kopion Clients,

Kopion returned 4.9% before fees (4.5% after fees) during the first half of 2018. This compared to the S&P 500 and the Russell 2000, which returned 2.7% and 7.7%, respectively.

The last six months have been relatively quiet from a performance perspective, but internally, they have been quite busy on the research front. This has been due to a number of factors, but a major one has been an exceptional number of highly technical updates that we have needed to make to our financial models. As boring as this sounds, it is symptomatic of an important trend within the investment landscape, which is that research is becoming much more time-consuming. This trend has gathered little attention, but I believe that it could become consequential, especially in our corner of the stock market.

By way of background, the investment landscape has always been a noisy environment, where a cacophony of misinformation, mental shortcuts, and human emotions compete with the real, underlying facts about businesses. An investment luminary named Benjamin Graham wrote about this in the 1930s and 1940s in his classic books Security Analysis and The Intelligent Investor. The same state of affairs continues today because these dynamics are ultimately rooted in the human condition. Most people are bombarded by conflicting information, they struggle to prioritize competing desires, and most importantly, they are deeply uncomfortable holding unpopular opinions. Human nature thus tends to undermine good investment decision making. Since Graham's time, behavioral economists have come to believe that human decision making is 70% emotional and only 30% rational. Gallup research suggests that the emotional component of human decision making is 80% or higher! These dynamics led Graham to pioneer an approach called "value investing" that seeks to make investing a business-like endeavor that is as objective and disciplined as possible. Graham's protégé, Warren Buffett, then refined and improved upon Graham's work. Kopion's investment process is modeled closely after Graham's and especially Buffett's thinking.

Investing always involves an element of chance, but I believe that value investing offers compelling advantages for improving the odds of success. I also believe that only a minority of investors possess the personal make-up and professional opportunity to follow Graham's approach. Consequently, while many people say that they are value investors, only a minority actually behave that way. This has been true for a very long time.

Over the last 15 years, two structural trends have been making it even more difficult to behave like a value investor. The first of these trends involves accounting rules. One might expect such rules to be relatively static, like the laws of mathematics, but accounting rules actually morph slowly over time in an attempt to reflect new business models and practices. Such updates could be helpful, but not every change represents progress. Over the last 15 years, a series of new accounting rules have gradually obfuscated many companies' underlying earnings. This has been maddening because our government-endorsed accounting rule makers are supposed to promote clarity and transparency, but they have instead done just the opposite. I won't bore you with the details of which rules caused which distortions, but this trend has had very practical consequences. The first is that companies have been forced to provide a growing collection of supplementary data to help analysts like ourselves understand their true, underlying results. Unfortunately, however, digesting this additional information takes much longer than when results were generally straightforward right out of the box. Also note that these supplemental adjustments are not standardized across companies, which means that it is becoming more difficult to readily compare one company to another. Most analysts are required to cover relatively long rosters of stocks, and I am deeply skeptical that this can be done well, given the amount of time that is now required to understand each company's results. To be frank, most analysts' attention was probably already spread too thin. I observe this during investor conferences when analysts near me stare at stock quotes on their laptops or work through their inboxes during presentations that I have traveled hundreds of miles to hear in person. It is also evident when I speak with other analysts about one of Kopion's stocks. Some of them project the confidence of an expert, but make statements that include significant errors. This type of posturing is common and is partly due to the fact that they are expected to know such a wide range of material. All of this has led me to believe that the herd of investors who really understand what is going on is getting thinner.

More convoluted accounting rules have also had important ramifications for valuations, or rather, perceived valuations. From a high level, the rules that have been introduced over the last 15 years have generally reduced companies' official earnings. This makes their stocks look more expensive than they would have under the old, more straightforward accounting rules. This has diminished the usefulness of certain valuation metrics, such as standard P/E ratios and the Shiller CAPE ratio.¹ Back in college, my Greek professor taught us that "The most trivial concerns of the grammarian

¹ For a good explanation of this, see Justin Lahart's article titled "This Key Metric Rings a False Alarm," which was published in *The Wall Street Journal* on October 6, 2016. That article was written over 18 months ago, but it explains a principle that is still true. The fact that I have to refer you to an article this old illustrates how little attention this topic has received.

are more important than the weightiest ponderings of the theologian.”² In recent years, as I have worked to untangle the implications of new accounting rules for our companies, I have come to believe that many market participants, especially among the asset allocators, probably do not fully appreciate how these new rules are overstating (and in a few cases understating) companies’ valuations. Said another way, they seem to be focused on high level matters without understanding how the grammar of the market has changed.

The second structural trend that I believe is shrinking the pool of true value investors is the ongoing shift towards index funds. This is reducing the industry’s collective resources for researching stocks at the same time that more complex accounting is increasing the effort required to understand them. There are generally two competing theories about where the indexing trend will lead. The first theory is that the stock pickers who survive will be exceptionally skilled, which will cause the market to become more efficient. This would lead to fewer bargains and less of a reason to own anything except index funds. The alternate theory is that because index investors essentially buy and sell stocks blindly, a rising proportion of them will make the market less efficient and advantage informed investors such as Kopion. These are just theories, and we won’t know the likely outcome for many more years. That said, I hear and read about investment shops that have merged or closed in recent years, and the ranks of “in the trenches” researchers do seem to be gradually thinning. I thus believe it is more likely that the market becomes less efficient over time, which would provide more opportunities for us to find bargains.

As I have lived through these trends, I have grown in my appreciation for all of you. Your support has played a key role in providing Kopion with the freedom to perform detailed research and make highly principled investment decisions. I believe that what we are doing is increasingly rare and special, and I am thankful for your role in this endeavor.

Best regards,

Terry Ledbetter, Jr., CFA

Past performance does not guarantee future results. Indices’ performance figures have been obtained from sources believed to be reliable.

² He was quoting Erasmus.