Kopion Asset Management

400 W. Louisiana St.
McKinney, TX 75069

214.425.7027

Value Packing

Thursday, July 9, 2020

Dear Kopion Clients,

During the first half of 2020, Kopion returned -13.2% before fees (-13.7% after fees). This compared to the S&P 500 and the Russell 2000, which returned -3.1% and -13.0%, respectively.

What an unwelcome and unlikely turn of events we have all been living through! The Covid-19 pandemic is a complex development that can be discussed from many angles. I will focus, however, on how the pandemic has affected the stock market, how I have responded, and some thoughts for what to expect going forward.

This past spring, as it became clear that governments around the world would attempt to control the spread of the virus through widespread lock-downs, the stock market entered a sell-off that was historic in its depth and especially its speed. From mid-February to mid-March, the S&P 500 fell 33.9% in just 23 trading days. The only other declines of this magnitude that even come close in terms of speed occurred in 1987 when the index fell 33.2% in 38 trading days and 1929 when it fell 28.8% in 42 trading days.[1]

Much of Warren Buffett's wisdom is summarized by his admonition to "Be greedy when others are fearful and fearful when others are greedy." Market panics are emotionally painful, but they offer particularly attractive opportunities for being "greedy when others are fearful" for two reasons:

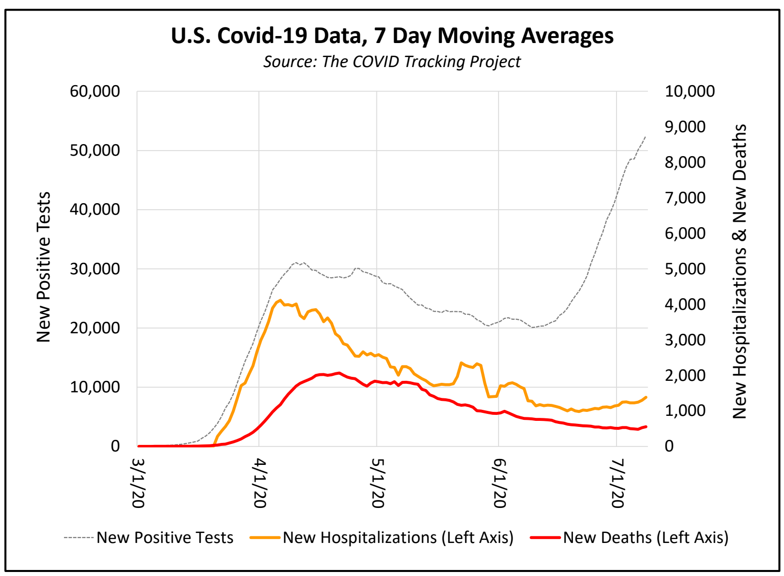
1. Stocks usually go "on sale" at deeper discounts than in a normal downturn.
2. Investors' collective risk perceptions become warped, which causes some stocks to fall much more relative to their intrinsic values than others. Almost every stock goes on sale, but some of the deals are exceptional. These dislocations provide tremendous opportunity for investors such as Kopion who have insight into these relative valuations and the discipline to execute trades accordingly.

In truth, Kopion always follows this strategy, with a goal to fill our portfolio with the best values that we can find. The pandemic, however, has been unique in terms of the number and quality of these opportunities. We have thus been unusually active in the market. I

[1] Ramkumar, Amrith, *Markets Melt Down at Fastest Pace Ever*, The Wall Street Journal., March 24, 2020.

have felt like a traveler who keeps making adjustments to his suitcase in order to pack it as densely as possible, except that instead of clothing, I've been packing deeply discounted stocks. Internally, we have thus referred to this process as "value packing." We have done this by trimming positions that held up relatively well compared to their intrinsic values and reinvesting the proceeds into other stocks whose prices had fallen dramatically and represented outstanding risk-reward propositions. This process was carried out assertively, but judiciously. For example, we deliberately spread these trades out over time in order to manage risk and avoid plowing into the cheaper stocks too early in the sell-off. This necessitated prioritizing the trades and being strategic about the order in which we executed them. The value packing process was also dynamic, as some of the stocks that we purchased earlier in the crisis rebounded sooner than we expected. These were only partial recoveries, but they still elevated those stocks to unacceptably large positions. We thus trimmed them and were able to reinvest those proceeds into other stocks that were further down the priority list and had yet to recover. I will not elaborate further, but my point is that while many other investment professionals were selling at low prices to run away from the tumult or counseling their clients to wait on the sidelines, we were deftly working our way across the battlefield and capitalizing on the best opportunities that I have seen since the Financial Crisis.

We thus finished the first half with a portfolio that is valued extremely attractively, and I believe we have some very good years ahead of us. That said, I also expect the path forward for the stock market to be a rocky one, even though I believe that the worst of this crisis is behind us. As shown by the chart[2] below, the number of Covid-19 positive tests has risen dramatically over the last month. This continues to provide a wellspring of sensational headlines for the press, but in our opinion, the testing data is fundamentally misleading. Many people with the virus have mild symptoms or none at all, leading to a large but unquantified number of cases that are clearly going undetected. This means that the true number of actual cases is *somewhere above* the dashed grey line on our chart. Policies are being made based on this testing data, but the reality is that we simply don't know how many people have been infected. The good news is that the more definitive and consequential metrics of new hospitalizations and new deaths



[2] We have used data from The COVID Tracking Project (www.covidtracking.com), taken on 7/9/20. We believe this to be the best data available, but even this information is not as straightforward as we would like. For example, the figures for New Hospitalizations on 5/1, 5/8, 5/26, 6/4 and New Deaths on 6/25 include "catch up" data for prior days. This distorts the trends by misrepresenting the timing of those hospitalizations and deaths. We have thus excluded those revisions from our moving averages in order to make the underlying trends clearer.

are rising much slower. Hospitalizations and deaths should lag positive tests, but even after adjusting for that lag, they are not rising with the number of positive tests as sharply as they did at the beginning of the crisis. There are several potential reasons for this, but I believe the most credible explanation is that the world is gaining a better understanding of who is at-risk, how to protect them, and how to treat them if they become infected. I thus expect the economy to continue reopening, but with fits and starts as government leaders grapple with confounding test data and balance the protection of lives with the protection of livelihoods.

In summary, we have an exceptionally value packed portfolio, and I am extremely encouraged by its long-term prospects. The way forward, however, will probably be turbulent and require additional perseverance. The late Irving Kahn spoke to this, saying, "The analyst must both practice, and to his client preach, patience." This advice is timeless, but it is particularly fitting at this junction. Fortunately, we are not merely waiting, but we wait with hope.

Best regards,

Terry Ledbetter, Jr., CFA