



## Where Are We?

Tuesday, January 8, 2013

Dear Kopion Clients,

2012 was another volatile year, but Kopion ultimately achieved excellent results, returning 19.8% before fees (18.6% after fees). The S&P 500 and Russell 2000 returned 16.0% and 16.4%, respectively.

The last three years have sometimes felt like the investing equivalent of the Bermuda Triangle as the economy and stock market have struggled to find their way from the Great Recession to a strong recovery like those that usually follow recessions. To be clear, a gradual recovery has definitely been underway, but it has been punctuated by so many crises and setbacks that the improvement has been easy to miss.

Furthermore, the accompanying volatility and the press's endless exposition of our problems has weighed so heavily on market psychology that many investors appear to have lost their capacity for optimism. Given all of these twists and turns, I think it'd be helpful to step back and discuss where we are in the grand scheme of things, both to better understand the last few years and to provide a balanced context for the future.

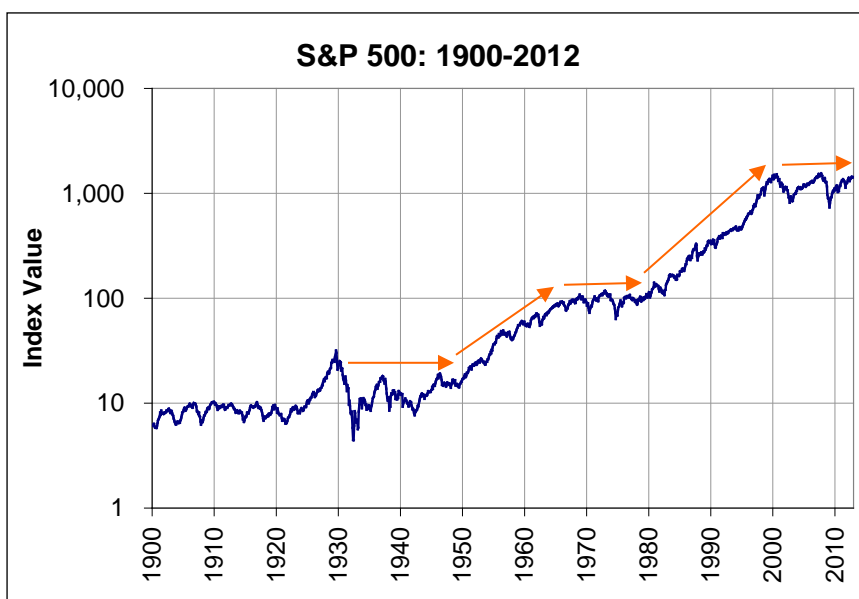
We live in a broken world where people and their governments engage in short-sighted behavior. This folly usually persists for an extended period until a crisis creates a day of reckoning and initiates a slow and painful recovery process. The 2008-2009 financial crisis was a moment of reckoning for many debt-related follies around the world. For example, beginning in the mid-1980's, US consumers began saving less, and in the mid-1990's, they began borrowing more. In the early 2000's, this trend accelerated as lenders began extending credit to weaker borrowers on looser terms. These trends were always unsustainable, but they lasted for two decades until the real estate bubble burst in 2007. More subtle examples include underfunded municipal pensions and our national entitlement programs. Those last two examples are usually not thought of as "debt," but they involve obligations to pay a specified amount at a specified time in the future, so they are essentially debt in nature. Like us, most developed countries around the world are grappling to bring private and public debts down to reasonable levels, a process usually referred to as "deleveraging."

Deleveraging, however, is a long and convoluted process for two reasons. The first is that we are economically interconnected to one another. Bob's spending is Joe's income, so as Bob cuts back to repay his debts, he reduces Joe's income. Debt

repayment thus impedes economic growth and lengthens the recovery period. The second factor is that finding a path forward involves a contentious political process because the participants disagree about the significance and source of the problem, and they know that the resolution will create winners and losers. This gives way to enormous uncertainty which encourages businesses to defer investments in new equipment and employees as they “wait and see” what will happen. For example, over the last two months, a couple of our companies have reported that their fourth quarter sales would be weaker than expected because their customers were waiting to get more visibility into matters such as the “Fiscal Cliff.” One of those companies said that they themselves were budgeting for little hiring in 2013 due to these uncertainties.

So from an economic point of view, we are five years into what is likely to be at least a decade long deleveraging process. Market psychology has been quite bad during this time because the rockiness of the recovery has amplified the vicissitudes of the market. In addition, while most these problems have been known for years, they have become much more visible as they’ve unraveled giving the press a surplus of bad news to elucidate. (Is it just me, or do you also feel unusually aware of the world’s brokenness right now?) Many investors have thus been reducing their exposure to equities as has occurred previously during other flat portions of the market’s grand cycles.

As shown by the chart on the right, stocks have historically moved in grand cycles. For example, the crash of 1929 and the Great Depression produced an entire generation of investors who disregarded stocks. By the late 1940’s, however, valuations were low which helped pave the way for a twenty year bull market that ended in the late-1960’s, by which time valuations had become high again. We appear to be well into one of the flat portions of this cycle when investors lose faith in stocks.



This exodus is illustrated by the two charts on the following page which show that investors have been withdrawing considerable funds out of equities over the last five years and have poured their investments into the bond market instead. This zeal for bonds has been in spite of extremely low yields and has arguably created a bubble in the bond market. The Wall Street Journal recently discussed these risks in an article

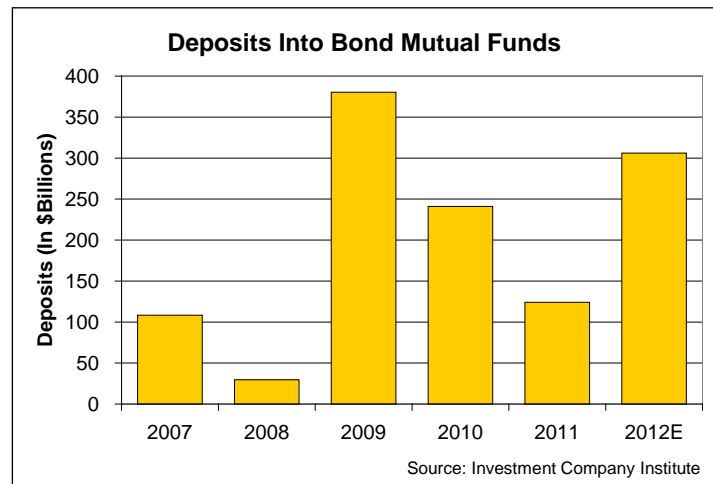
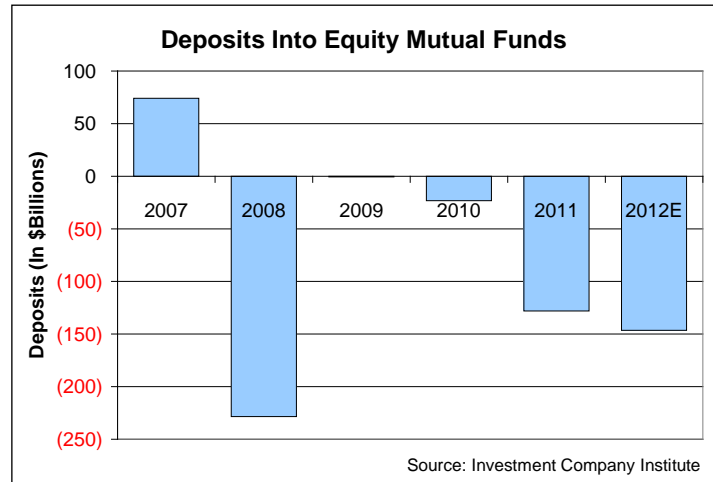
titled “Danger Lurks Inside the Bond Boom.” That article quoted a bond portfolio manager who said that, “As long as your time horizon is long enough and you can absorb some of the volatility, we think you have a better chance of preserving principal on the equity side.”<sup>1</sup> This speaks volumes about the relative valuations between these asset classes.

So we are in a period that requires an unusual amount of patience. These various challenges, however, are ultimately a blessing for us as long-term investors since we’ve been able to purchase attractive businesses as good valuations. I also want to emphasize that positive business trends continue to exist within certain industries, and these are the areas where we have invested. Indeed, one of the advantages of a concentrated portfolio such as Kopion’s is that it allows us to focus on these remaining areas of secular growth and not be dependant on the macro economy.

One of the reasons that I’ve been able to capitalize on these opportunities is that I have exceptional, long-term oriented clients. I appreciate the trust that each of you has placed in me, and you have collectively pushed Kopion’s assets under management up to \$10.9 million. This has ushered Kopion out of its start-up phase, and I thank you for helping me to reach this milestone.

Best Regards,

Terry Ledbetter, Jr., CFA



<sup>1</sup> *Danger Lurks Inside the Bond Boom* by Patrick McGee, The Wall Street Journal, December 7, 2012. Emphasis mine.

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