Kopion
Asset Management

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Who Let The Dogs Out?!

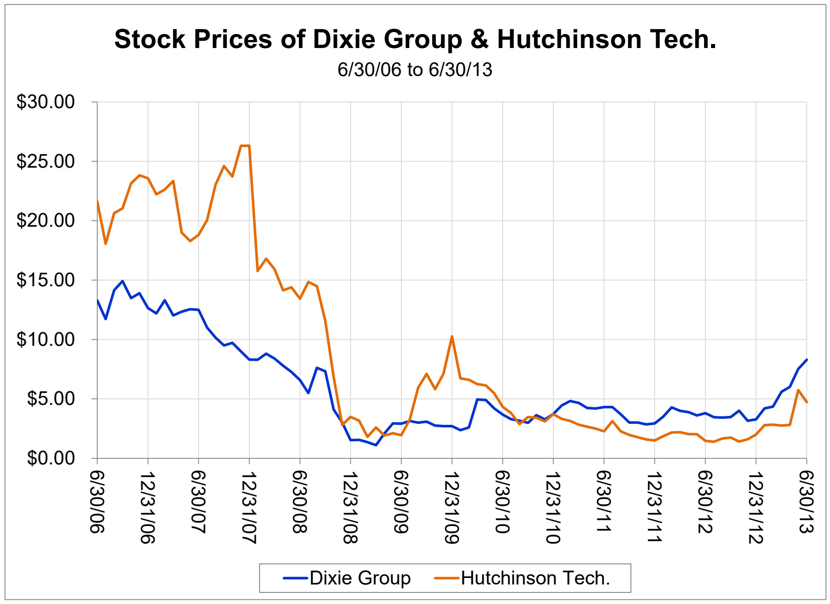
Tuesday, July 9, 2013

Dear Kopion Clients,

Kopion turned in an exceptional performance during the first half of 2013, returning 28.5% before fees (27.9% after fees). The S&P 500 and Russell 2000 returned 13.8% and 15.9%, respectively. While these results are very encouraging and reflect a large step forward for our portfolios, it is important to remember that rapid gains are sometimes followed by declines that erode the gains down to more normal levels. That said, most of our positions are reasonably valued, and the economy appears to finally be building some momentum, which both support the current level of our portfolios. Nonetheless, experience has taught me that you can never tell when a setback is lurking right around the corner, so it is best to view gains soberly.

Kopion's outperformance during the first half came from strong recoveries in what had previously been two of the most troublesome stocks that I've ever owned: The Dixie Group and Hutchinson Technologies. It is from this vantage point of redemption that I'd like to discuss a subject that is important for clients to understand, but painful for portfolio managers to discuss: problem stocks (the investing equivalent of "problem children"). Indeed, problem stocks can represent such eyesores that many portfolio managers will simply unload them in order to avoid the embarrassment of having to discuss them. Portfolio managers are also worried that problem stocks will raise broader questions about their judgment. This approach, however, is flawed because those declines are already indelibly etched onto the return history, and selling stocks at distressed prices converts a temporary loss into a permanent one. I can readily attest to the pain of hanging onto troubled stocks, but I nonetheless believe that persevering through these situations is usually the most rational decision, and it can eventually create some terrific opportunities as I will demonstrate below.

I initially purchased both The Dixie Group and Hutchinson Technologies during the summer of 2006. The Dixie Group manufactures high-end carpet, and Hutchinson produces an extremely advanced component for hard disk drives. Both of these companies possessed some attractive characteristics, including leadership positions within their respective niches. I expected new home sales to collapse as the housing bubble burst, but I thought that Dixie would be insulated from this since 90% of their sales came from replacement demand. The housing downturn, however, also severely depressed existing home sales which ensnared Dixie because carpet is often replaced shortly before or after a home is sold. In Hutchinson's case, I failed to identify some dynamics that would depress pricing within its industry and also undermine its dominant leadership position. I consequently suffered staggering losses in both of these stocks, and during early 2009, one of my former co-workers remarked, "Terry, these stocks aren't just dogs, they're *super dogs*!" And from a stock price perspective, he was right—they had been left for dead. This is shown in the chart below which presents their stock prices from the time that I bought them until now.

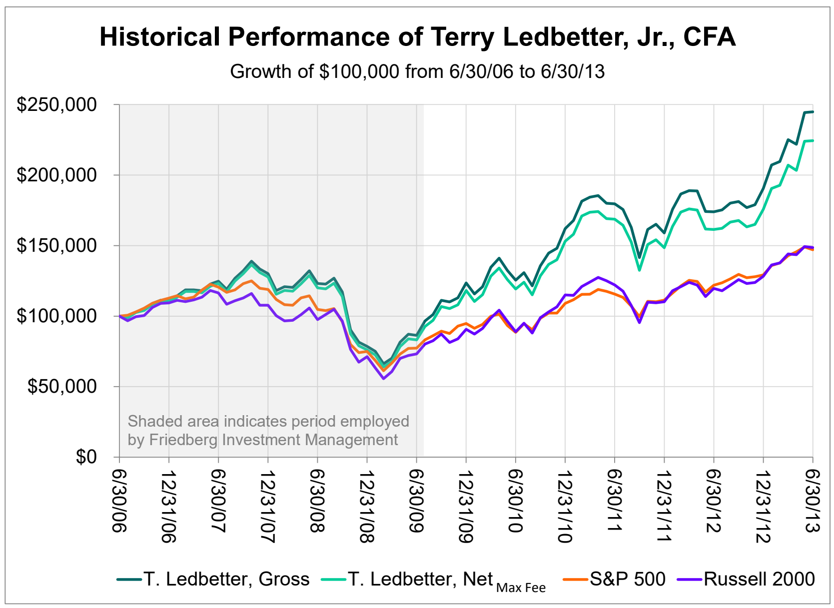


As dismal as things appeared at that time, however, Dixie and Hutchinson seemed likely to survive, and if that proved true, their returns were likely to be spectacular from early 2009's depressed levels. During normal times, my spreadsheet models (i.e. appraisals) usually show my stocks to have "expected returns" of 8-15% annualized over the next 3-5 years. As stocks' prices fall, their upside or expected returns usually increase. During early 2009, most of my stocks had fallen so much that their expected returns had risen to roughly 30-40% annualized. Dixie and Hutchinson, however, had fallen so precipitously that their expected returns were about 70-80% annualized! If I had sold them, I'd thus be degrading the expected return of the portfolio because I'd be exchanging a stock with an 80% expected return for another one with just a 40% expected return. This would also convert temporary losses into permanent ones. Lastly, I figured that even if I was wrong and I ended up riding both of these stocks to $0.00, most of the financial damage had already been done; at $1.00, the stocks had little remaining downside, but enormous upside. Consequently, the main risk was reputational (i.e. looking stupid for holding them to the bitter end) as opposed to financial (i.e. incurring significant additional losses). Consequently, I chose to hang on.

From 2009 through 2011, Dixie Group and Hutchinson's businesses continued to struggle, and their stocks' caused 75% of my heartburn even though they only represented about 15% of my portfolio. As their stories unfolded, however, I grew increasingly confident that they would indeed recover, so I accumulated more shares of both stocks at dirt cheap prices. The second half of 2012 marked a turning point for both of these businesses, and their stock prices more than doubled during the first half of 2013. While we are admittedly early in each of these "comeback stories," and my decisions have yet to be fully validated, things are now playing out as expected. Furthermore, both of these companies significantly improved their cost structures and market positions during their respective downturns, and I am excited to see how they perform over the next couple of years as they benefit from those improvements.

My analytical mistakes with Dixie and Hutchinson taught me some painful lessons, but my investment process prevented me from compounding those errors by selling the stocks at depressed prices. The silver lining to this situation was that closely following those companies through their downturns allowed me to recognize and robustly capitalize on their recoveries. I should also mention that I've had other problem stocks that did not merit such perseverance. In those cases, I discovered flaws in my analysis that meant throwing in the towel was a better decision than waiting out the storm. Fortunately, however, those situations have been relatively infrequent as my upfront analysis is quite thorough and most of our holdings are in high quality businesses.

While the magnitude of these two misadventures will hopefully not be repeated, I am doubtful that I will successfully steer clear of all problem stocks in the future. I thus wanted to explain why it's usually best to persevere through these situations. I also wanted to point out that I was still able to achieve excellent overall returns despite the headwinds created by those two problem stocks. This is shown by the chart on the right which plots my performance over the same time period as the previous chart that showed Dixie and Hutchinson's stock prices since the time that I bought them.



Thanks for your continued confidence and support.

Best Regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
1st Half of 2013	28.5%	27.7%	13.8%	15.9%
Annualized*				
1 Year	19.8%	18.3%	16.0%	16.4%
3 Years	15.5%	14.1%	10.9%	12.2%
Since Inception†	20.4%	19.0%	12.7%	13.5%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
1st Half of 2013	28.5%	27.7%	13.8%	15.9%
Annualized*				
1 Year	19.8%	18.3%	16.0%	16.4%
3 Years	15.5%	14.1%	10.9%	12.2%
5 Years	7.9%	6.6%	1.7%	3.6%
Since Inception‡	13.1%	11.8%	4.7%	5.8%

*Ending 12-31-12
†Since 8-23-09
‡Since 2-3-04

Past performance does not guarantee future results. Investments with Kopion may lose value.

Terry Ledbetter, Jr. began managing his first diversified investment account on 2-4-04 while employed by Friedberg Investment Management (FIM). Mr. Ledbetter left FIM on 7-31-09 and founded Kopion Asset Management, LLC (Kopion), which became a legal entity on 8-24-09. Importantly, when Mr. Ledbetter founded Kopion, he continued to manage the same accounts that he had been managing while employed by FIM. The accounts, investment strategy, and investment process all remained the same. The performance information cited throughout Kopion's marketing materials includes all of the diversified investment accounts managed directly by Mr. Ledbetter since 2-4-04, which is when he began managing his first diversified investment account. This information is provided for both Mr. Ledbetter's entire performance history as well as for the portion of Mr. Ledbetter's performance history that occurred after Kopion was founded and became a legal entity.

The performance information cited throughout Kopion's marketing materials has been thoroughly documented, and it has been calculated using normal industry protocols, which are described in more detail below. This information has not, however, been audited by an independent third party. Dividend and interest income in these accounts was reinvested. Returns for these accounts have been asset-weighted to calculate historical returns. Said another way, the accounts were aggregated into a single group and then performance was calculated for that single group. This group includes some sub-accounts and securities that were carved out of larger accounts in order to exclude assets like mutual funds that Mr. Ledbetter did not manage directly. Those mutual funds were managed by professionals at third party firms, and Mr. Ledbetter's involvement was limited to being a passive shareholder of those mutual funds. In addition, some of those mutual funds followed fixed income strategies, which were very different from the strategy used by Mr. Ledbetter when he was employed by FIM and later at Kopion.

Performance information that includes assets like mutual funds that were not managed directly is available, and Kopion will provide it promptly upon request.

Kopion reports its Time Weighted Returns (TWRs). TWRs make adjustments for deposits and withdrawals so that those transactions do not influence performance results. Consequently, deposits do not increase the return, and withdrawals do not decrease the return. TWRs thus allow for performance comparisons between Kopion's (and Mr. Ledbetter's) history and market indices.

Kopion reports both "gross returns" (which are returns before Kopion's management fee) and "net returns" (which are returns after deducting Kopion's management fee). Kopion's management fee schedule is graduated, which means that the fee rate begins to decrease after an account's dollar value exceeds a certain threshold. The label "Net $_{\text{Max Fee}}$" indicates that the net returns being presented reflect Kopion's maximum fee rate for all periods presented. The words "net" or "after fees" without the words "Max Fee" in subscript lettering indicates that the net returns being discussed reflects actual fees.

Kopion has provided the returns of the S&P 500 and the Russell 2000 indices in order to provide the broader stock market context of Kopion's (and Mr. Ledbetter's) returns. The S&P 500 tracks the performance of relatively large publicly traded companies, and the Russell 2000 tracks the performance of relatively small ones. Kopion does not "benchmark" its portfolio against indices in the traditional sense of carefully managing the portfolio for comparison against a specific index. Instead, these two indices are used as broad indicators of the stock market's performance. Mr. Ledbetter has primarily focused on small and medium sized firms, but he has also invested in some large companies as well. This is why Kopion has provided the results of both the S&P 500 and Russell 2000. These indices cannot be invested in directly, but mutual funds and exchange-traded funds that track these indices ("index funds") are available in the market. Kopion's (and Mr. Ledbetter's) investment strategy carries more risk than investing in an index fund that tracks either the S&P 500 or the Russell 2000. This is primarily because Kopion's (and Mr. Ledbetter's) strategy involves investing in a relatively small number of stocks and those stocks are primarily for small to medium sized companies. This approach results in greater volatility and greater risk of capital loss than index funds tracking either the S&P 500 or the Russell 2000.

Indices' performance figures have been obtained from sources believed to be reliable.