Kopion Asset Management

400 W. Louisiana St.
McKinney, TX 75069

214.425.7027

About That Cycle. . .

Monday, January 15, 2018

Dear Kopion Clients,

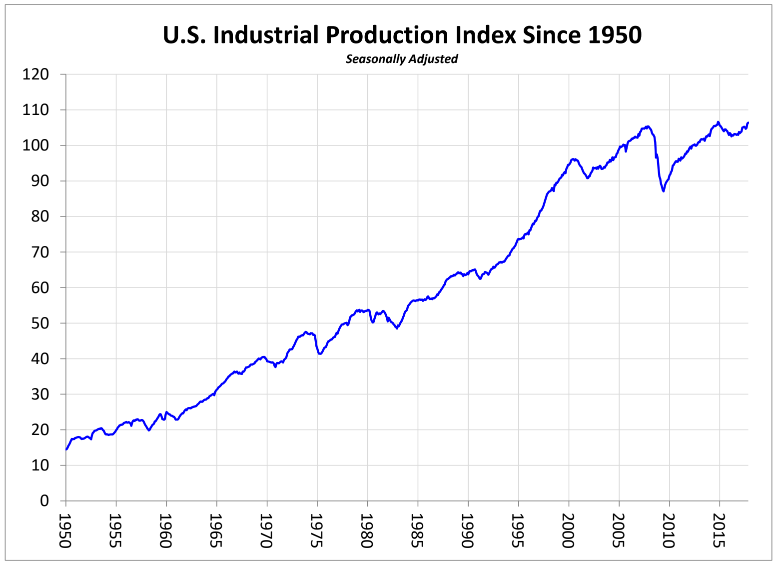
Kopion returned 12.3% before fees (11.3% after fees) during 2017. This performance was solid on an absolute basis, but it trailed the S&P 500 and the Russell 2000, which returned 21.8% and 14.6%, respectively.

The stock market is at an interesting, but somewhat confusing juncture, and to some extent, the same could be said about our portfolio. The overall market has performed quite well over the last few years, but because it generally moves in cycles, many observers are grappling with how much longer the current upcycle might last. The truth is that no one knows the answer to this question, and our current location in the market cycle will only become clear at some point in the future. (This is always the case.) Nonetheless, I wanted to provide you with some important context about our place within this cycle. This is not only because this topic is timely, but also because I have come across misinformation about this issue in the press, and I do not want you to be misled. Towards the end of this letter, I will address how our portfolio fits within this context.

THE SLOW-COOKER EXPANSION

Back when I was in college in the late 1990's, my economics professors taught us that the economy is a type of "virtuous cycle": individuals spend, which encourages businesses to invest and hire, which enables more individuals to spend, and so forth. The resulting up-trend, however, is punctuated by recessions that are typically caused by one of two factors. The most common is the natural tendency for businesses and consumers to become overconfident during the good times and thus overextended. One relatively recent example of this was the speculative homebuilding that occurred during the mid-2000's. This pushed housing supply well above the number of people who actually needed to buy a house and eventually led to a dramatic decline in homebuilding. Recessions can also be caused by random shocks such as the Arab Oil Embargo, though those types of recessions are more rare and impossible to foresee.

Historically, most recessions have been vaguely similar in their depth and duration, which is why economists refer to this phenomenon as the "business cycle." One metric that illustrates these cycles is U.S. Industrial Production, shown on the right. The first 55 years of this trend is upward with occasional recessions of somewhat comparable depth and length. Note, however, that the downturn after the Financial Crisis was much deeper and much longer than the preceding ones. Said another way, prior recessions were like modest car wrecks that necessitated a trip to the ER, but the most recent one was a serious crash that led to the ICU, followed by rehab.

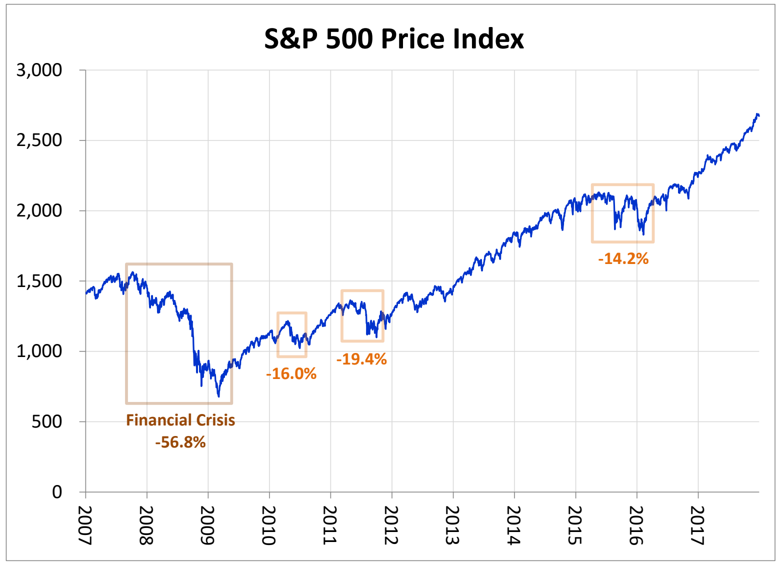


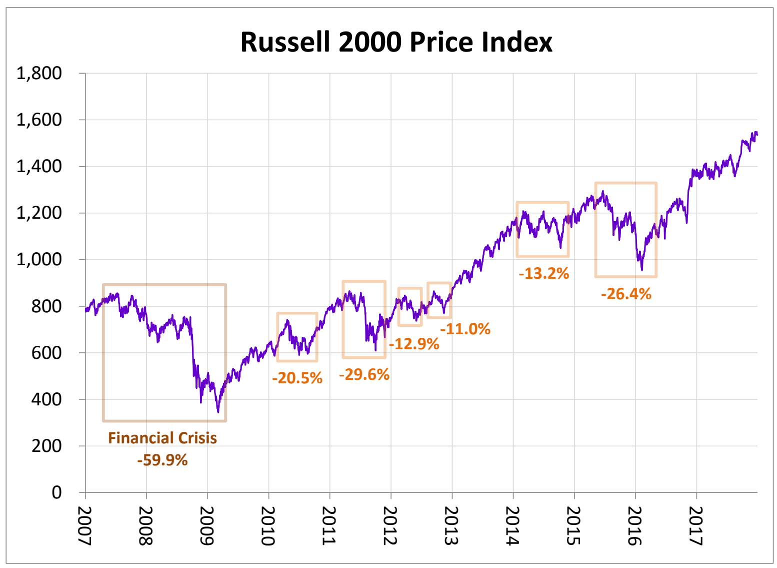
Critically, the virtuous cycle of economic growth is founded on confidence about the future, which encourages individuals to spend and businesses to invest. But in the aftermath of the Financial Crisis, the economy was deprived of this confidence more than in prior recessions. This prevented the virtuous cycle from building momentum, which led to anemic growth that was vulnerable to mini-slowdowns, such as the decline in Industrial Production that occurred in 2015 and 2016. During 2017, however, economic confidence returned, and this appears to have reignited the virtuous cycle. Conditions increasingly feel like the "old normal," which is a very attractive prospect for our portfolio. For example, many of our companies have re-engineered their cost structures to become more scalable, but realizing the fruits of those investments requires revenue growth. We are now back in an environment where revenue growth will be more achievable so that the benefits of those and other investments can be attained.

THE STOCK MARKET DURING THIS PERIOD

During the Financial Crisis, the S&P 500 and the Russell 2000 plunged 56.8% and 59.9% from their highs, representing their worst declines in history outside of the Great Depression. The sheer magnitude of those declines set the stage for commensurately large rebounds, but their recoveries to their previous highs were still punctuated by 2 to 4 setbacks, depending on which index you are considering. There were then additional setbacks as the market grinded its way to new highs. These various setbacks are highlighted in the two charts on the next page.

To provide some context for these setbacks, during the early 1990's recession, the S&P 500 and the Russell 2000 declined 19.9% and 34.3%, respectively. So as the market recovered from the depths of the Financial Crisis, one of its declines was almost as bad as the drawdown in the early 1990's recession. I have repeatedly read in the press and similar commentary that the current bull market has gone unabated since the Financial Crisis, implying that a downturn is years overdue. As shown by the charts on the right, however, the market has endured a number of setbacks over the last several years. In addition, most of the overall uptrend has been a cautious grind as opposed to an optimistic surge.





Where To From Here?

Assessing the valuation of the indices and even our portfolio is currently more difficult than normal. This is because the economy is improving significantly, which makes it easy to underestimate the earnings of the underlying businesses, especially given the scalability improvements mentioned earlier. My best estimate is that the general market is modestly overvalued. I believe that our portfolio, by contrast, is modestly undervalued, and our weak relative performance in recent years seems to corroborate that. As I have written in prior letters, this underperformance has been partly due to an unusual number of our companies encountering business challenges around the same time. Many of those firms appear to be on the cusp of significant improvement, but this has only been partially reflected in their stock prices. This is part of why I believe that the value content of our portfolio is higher than the general market's. I will get more visibility into this over the next few months as our companies issue their preliminary 2018 forecasts and later begin reporting results within this much stronger environment.

STAYING THE COURSE

A robust stock market usually heartens investors, but the current bull market has engendered some hand-wringing and anxiety. This residual caution, however, suggests that the market is not at frothy levels. More importantly, I see relatively few signs in the real economy that businesses and consumers are spending aggressively in ways that would cause the economy to get ahead of itself and set the stage for a recession.

To be sure, the stock market will eventually endure a significant setback, and it is important to be emotionally prepared for that. The timing of that drawdown, however, is fundamentally unpredictable, in part because economic cycles are irregular. The word "cycle" connotes a sense of symmetry and thus predictability, but cycles in the real world are asymmetric and include mini-cycles within them. The stock market setbacks since 2009 and the Industrial Production decline in 2015 and 2016 are examples of such mini-cycles. Ironically, this ambiguity makes it important to stay the course as an investor during good times in much the same way that it is important to stay the course during bad times. I am deeply appreciative that you have stayed the course with Kopion over the last few years, and I am cautiously optimistic that we will continue to build upon our recent gains in 2018.

Thank you for your continued trust and support.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	12.3%	11.0%	21.8%	14.6%
3 Years	1.1%	-0.1%	11.4%	10.0%
5 Years	8.9%	7.5%	15.8%	14.1%
Since Inception†	13.4%	12.0%	14.5%	13.9%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	12.3%	11.0%	21.8%	14.6%
3 Years	1.1%	-0.1%	11.4%	10.0%
5 Years	8.9%	7.5%	15.8%	14.1%
10 Years	8.4%	7.0%	8.5%	8.7%

*Ending 12-31-17
†Since 8-23-09

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.