Kopion Asset Management

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Anticipation

Friday, January 13, 2023

Dear Kopion Clients,

During 2022, Kopion returned -17.1% before fees (-18.1% after fees). This compared to the S&P 500 and the Russell 2000, which returned -18.1% and -20.4%, respectively.

In my prior client letters, I noted how a major unintended consequence of pandemic-era government policies has been the high inflation that we're experiencing. This has led many central banks to raise interest rates, in some cases quite aggressively. Today, the investment community almost universally expects these two dynamics to lead to a recession. This isn't surprising since a number of prior business cycles followed this pattern: rising inflation, followed by rising interest rates, ending in a recession. In industry parlance, the latter stages of this pattern have long been referred to as "the Fed taking away the punch bowl." Today, this expectation of a recession has been reinforced by a number of economic indicators that are already weakening. One of my mentors, however, taught me that "if we are going to compare, we must also contrast," and this particular downcycle has some unique, and in our case encouraging features.

The first is that while inflation is most often caused by too much demand, today's inflation has sprung from too little supply. Fortunately, the supply situation is improving, which should help ease inflation and could temper a potential downturn. For example, global auto production has been depressed for three years now, primarily due to a shortage of semiconductor chips. This has led to a relative scarcity of new automobiles and thus pent up demand. Consequently, while the automotive industry usually weakens during a recession, the current downcycle seems likely to receive some level of support from prospective car buyers who have been waiting on the sidelines until dealer inventories improve. In other industries, component shortages have led to growing backlogs of unfilled orders. Three of our companies have found themselves in this particular situation. Even if those firms receive fewer orders in 2023, their revenues could actually increase because they're finally receiving the components needed to fulfill orders that their customers placed in 2022.

The second unique feature of the impending slowdown relates to the labor market. Hiring and retaining workers was extraordinarily difficult for most companies as they emerged from the pandemic. They thus seem likely to cut jobs more selectively than they would during a normal recession, which would keep payrolls and the associated consumer spending healthier than it otherwise would be.

In my (Terry's) opinion, the most unique feature of the presumed recession is how anticipated it has been. This might be the most widely anticipated recession in U.S. history. In the summer of 2022, we began seeing detailed professional forecasts for a recession to occur in the second half of 2023 or the first half of 2024—18 to 24 months in the future. By the fall of 2022, these far-sighted recession predictions had grown more common. And by the end of the year, we were hearing people outside of the business world talk about an impending recession. Such broad anticipation does create a risk that we might collectively "talk ourselves into" a pullback that is worse than it would be otherwise. The silver lining of this widespread anticipation, however, is that a recession already appears to be largely reflected in stock prices even though the actual matter remains unsettled. Moreover, as investors have struggled to draw a bead on the trajectory of the downturn, stocks within our portfolio have sometimes moved quite differently from one another. This has provided additional opportunities for us to "value pack" the portfolio.

While we are certainly aware of trends in the broader economy and stock market, our primary focus is on the individual companies we have invested in. This touches on a critical difference between Kopion and the indices. Passive investing in indices is a bet on the overall economy, including the less desirable parts. Kopion, by contrast, targets individual businesses that we believe are resilient and can succeed over a broad range of future scenarios. That isn't to say that these firms will always succeed or that their journeys will be smooth. Nonetheless, this approach has always appealed to me, especially since it also allows us to weight each position based on its individual risk-reward proposition. (Indexing, by contrast, usually weights positions simply based on their sizes in the stock market.)

With respect to our companies' fundamentals, I'm really encouraged by their outlooks, even though a recession is possible in the near-term. They all have their own underlying dynamics and are at different parts in their stories, but I'll offer a couple of examples. TechnipFMC is an oil services company that we have owned for many years. This company has long been the clear leader in its niche, but it has significantly extended its competitive lead during the recent energy downcycle. Today, its part of the oil industry is entering what appears to be a long-awaited, multi-year upturn, and TechnipFMC now offers a value proposition that is unrivaled in the industry. Another example from our portfolio is a company named Varonis. Varonis has developed a suite of extremely sophisticated software that allows companies to lock-down their data so that it is only accessible on a "need to know" basis. That might sound simple, but this is a profoundly difficult problem for most organizations to solve. Most large companies don't even know where all of their sensitive data is located. Moreover, new data is created every day and the associated file structures keep changing. This has created gaping security vulnerabilities, and those weaknesses are expanding as most companies extend their use of cloud applications. Varonis is the only company we have found that can address this problem on the scale that most businesses need. It has been growing for years, and we expect this to continue as they improve their products and as prospective users increasingly recognize just how vulnerable they have become. So our companies keep chugging along, and we're encouraged by their progress.

What is less clear is how that progress will be reflected in their stock prices. In my letter for the first half of 2022, I discussed the transition to higher interest rates and its implications for stock valuations. I won't repeat all of that here, but suffice to say that 2022's stock market downturn appears to have already adjusted for higher interest rates—and then some. I felt that our portfolio was attractively valued at the end of 2021, and it was even cheaper at the end of 2022, even after adjusting for higher interest rates.

In conclusion, Kopion's returns for 2022 were disappointing, but there are too many positives for us to be discouraged. The coming year could be rocky as the stock market continues to anticipate a recession, but things look bright for our companies on the other side of, and even during, that presumptive valley.

Thank you for being our client and for your ongoing support.

Best regards,

Terry Ledbetter, Jr., CFA
Jonathan Lindstrom, CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	S&P 500	Russell 2000
Annualized*				
1 Year	-17.1%	-18.2%	-18.1%	-20.4%
3 Years	5.2%	3.9%	7.7%	3.1%
5 Years	6.7%	5.4%	9.4%	4.1%
10 Years	7.8%	6.5%	12.6%	9.0%

*Ending 12-31-22

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 $_{Max\ Fee}$" 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 reflect 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.