Kopion Asset Management

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Competing Realities

Monday, July 2, 2012

Dear Kopion Clients,

Our portfolios got off to a tremendous start during the first quarter, increasing 18.9% before fees (18.6% after fees) which was well ahead of the S&P 500 and Russell 2000 which rose 12.6% and 12.4%, respectively. The second quarter, however, witnessed a "rerun" of the same macroeconomic worries that precipitated declines during the springs of 2010 and 2011. This drove declines in our portfolios so that Kopion's YTD return now stands at 9.4% before fees (8.9% after fees). YTD, the S&P 500 and Russell 2000 have returned 9.5% and 8.5%, respectively. Our YTD performance has been a combination of very strong returns for some stocks and very poor returns for others which provided numerous opportunities to shift funds into undervalued positions. So while our portfolios are once again largely in the grip of macroeconomic concerns, they are also quite value laden and the underlying businesses continue to progress.

Kopion's outstanding first quarter, followed by a poor second quarter reflects the tug of war between two intertwined, but sometimes competing realities: Commercial Reality and Price Reality.[1] Commercial Reality represents the actual businesses that underlie our stocks, and it is based on substantive issues such as the companies' competitive positions, long-term growth opportunities, and concrete results. Kopion focuses heavily on Commercial Reality, and I thus spend most of my time rummaging around "under the hood" of these businesses to understand them as best as I can. Importantly, as with cars, the exterior of a business is sometimes an imperfect proxy for the health of the engine. For example, our largest position is National Instruments which makes tools that scientists and engineers use to develop new products, create prototypes, and test finished goods as they roll down factory assembly lines. On the outside, National Instruments looks like a good company with unique products. What would be easy for a casual observer to miss, however, is that National Instruments' products are so differentiated that they are revolutionizing their industry, and a number of dynamics are pushing their industry close to a tipping point that favors National Instruments. For example, the company's average order size has been $3,000 to $4,000 in recent years, and they define "large orders" as anything over $20,000. During the first quarter of 2012, however, they received a +$27,000,000 order which suggests that the industry

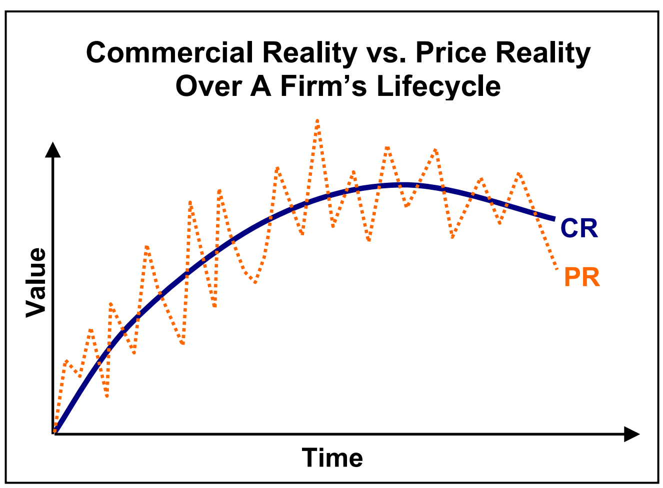
[1] Over the years, various investment professionals have used different labels and analogies to describe this concept, but this particular version was developed by Tom Lewis of High Road Value Research.

shift towards their products is accelerating. So while National instruments looks like a Lexus on the outside, it looks like a Porsche under the hood. I have unfortunately also encountered the opposite situation. I once invested in a dollar store chain called "99 Cents Only," which had enjoyed tremendous success in California but stumbled when they expanded into Texas. I thought that their troubles would be short lived, but if I had looked more carefully, I would have realized that the company was really suffering from an unscalable infrastructure and a structurally more competitive market in Texas, both of which presented major problems. So what looked like an Audi that needed a tune up was in fact a Volkswagen in need of serious engine work. These are all examples of fundamental details underlying a stock's Commercial Reality.

Every stock, however, also has a Price Reality which is reflected by its stock price. In one sense, Price Reality is the more objective of the two realities since it reflects the value at which the stock can be immediately liquidated, and it is *supposed* to reflect Commercial Reality. The problem, however, is that Price Reality tends to focus on near-term results, and it is often distorted by a number of other factors such as market psychology, price momentum, and macroeconomic issues. These can render Price Reality a *less reliable* gauge of value in the short-term. For example, one of our companies, Stratasys, has traded at prices ranging from $18 to $54 per share in just the last ten months illustrating how unreliable Price Reality can be as a metric.

The influence of macroeconomic concerns on Price Reality has grown dramatically since the 2008 / 2009 crash when macroeconomic events precipitated the second worst bear market in U.S. history. One of the legacies of the crash has thus been a heightened sensitivity to economic indicators, and the market has since suffered numerous setbacks that were triggered by various causes of "economic uncertainty." I personally believe that this whole concept of "economic uncertainly" is fundamentally flawed since the future is always uncertain and what is really changing is peoples' awareness of this uncertainty and how imaginative they are about the negative scenarios. Furthermore, the government economic data upon which these assessments are often based is not nearly as predictive as the press presents it to be because the global economy is a profoundly complex system that confounds even professional economists. My former boss once pointed out that economists usually "talk with both hands" since they often say, "On the one hand. . . but on the other hand. . .". This reflects the ambiguities of the macro economy. As a practical matter, however, economic uncertainty has become a prominent feature of Price Reality, and it manifested itself again during the second quarter.

Over the long term, Commercial Reality and Price Reality are intertwined, and while Price Reality is influenced by noise in the short-term, it ultimately follows Commercial Reality over a firm's lifecycle as shown on the right:



I believe that each investor's behavior ultimately boils down to which of these realities they have the most faith in. Given the amount of media bombardment that most people experience, our pattern-seeking natures, the comfort of going along with the crowd, and the amount of time required to study Commercial Reality, it is not surprising that many investors end up placing some degree of credence in Price Reality.

Over the last decade, stock prices have become significantly more volatile than they had been historically which is emotionally uncomfortable since it presents us with more setbacks than we'd like. It is ultimately, however, a blessing since it is creating more frequent and larger gaps between Commercial Reality and Price Reality which I believe I am exploiting. I am doing this by reducing positions that have appreciated more than I am comfortable with, and then reinvesting those gains into other positions that have sold off sharply and thus present excellent values. Undervalued companies tend to be more volatile, so this shift could lead to a bumpier ride in the coming quarters, but it is the right investment decision, and I am hopeful that it will underpin good long-term returns.

Thank you for your continued confidence in Kopion.

Best Regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
1st Half of 2012	9.4%	8.7%	9.5%	8.5%
Annualized*				
1 Year	-1.9%	-3.0%	2.1%	-4.2%
Since Inception†	20.6%	19.3%	11.3%	12.3%

Period	T Ledbetter, Gross	T Ledbetter, Net Max Fee	S&P 500	Russell 2000
1st Half of 2012	9.4%	8.7%	9.5%	8.5%
Annualized*				
1 Year	-1.9%	-3.0%	2.1%	-4.2%
3 Years	26.5%	25.0%	14.1%	15.6%
5 Years	7.4%	6.1%	-0.2%	0.2%
Since Inception‡	12.3%	11.0%	3.4%	4.5%

*Ending 12-31-11
†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.