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Fast-Forward

Monday, January 18, 2021

Dear Kopion Clients,

2020 was an incredibly unusual year for the stock market and the world at-large, with several developments that I had never seen or heard of previously. Virtually every government in the world imposed dramatic restrictions to slow the spread of a poorly understood virus. Crude oil prices briefly fell to -$37.00. (Negative!) And multiple highly effective vaccines were developed in just 9 months even though vaccine development usually requires 10-15 years. These events translated into a compressed odyssey in the stock market, with the steepest decline in history being followed by new all-time highs just eight months later. Kopion's investment process served us particularly well during this period, enabling us to navigate an incredibly complicated environment and capitalize on an exceptional number of opportunities. In the end, Kopion finished 2020 with a return of 26.4% before fees (25.0% after fees). This compared to the S&P 500 and the Russell 2000, which returned 18.4% and 20.0%, respectively.

As discussed in my prior letter, the pandemic presented us with extraordinary opportunities to "value pack" the portfolio. Undervalued stocks are similar to beach balls that have been pushed underwater: the deeper you push them down, the more forcefully they want to spring back to the surface. In early November, the pharmaceutical companies began releasing a steady stream of incredibly positive news about Covid vaccines. This put the end of the recession in-sight, which caused stocks, and our value-packed portfolio in particular, to spring upwards.

The rally in our portfolio that began in November has continued strongly into January, and we are carefully watching for stocks that may have risen too far, too fast. Such a determination, however, is more difficult than normal due to a confluence of trends in the economy and the stock market itself. During the pandemic, a number of existing trends accelerated dramatically. It was like watching part of a movie in fast-forward. Below are a few examples:

- In the early months of the pandemic, the proportion of U.S. retail sales that occurred through eCommerce increased from roughly 16% to about 33%.[1] eCommerce grew more within a few months than over the prior 10 years combined!

[1] PROS Holdings 3rd Quarter 2020 Earnings Conference Call, October 29, 2020.

- Cloud computing enjoyed a massive surge of adoption as myriad companies were forced to shift their employees to remote work within a matter of weeks.
- In the mid-2010's, many investors increasingly began to favor technology companies. This preference went into over-drive during the pandemic partly because those companies were often direct beneficiaries of fast-forwarded trends. By mid-October, this acceleration had elevated the Technology sector to an even larger percentage of the S&P 500 than it attained during the Technology Bubble of 2000[2].
- A multi-year shift away from small stocks gained speed in the earlier stages of the pandemic. At its worst point, this pushed their valuations down to a roughly 20% discount to large stocks[3] even though small stocks have historically traded at a modest premium.

These and other developments have important implications for how different companies and their stocks will emerge from the pandemic. Not all trends, however, are created equal, and I thus find it helpful to categorize recent shifts as follows:

Trends That Have Been Fast-Forwarded Permanently
The pandemic has forced companies to accelerate the adoption of certain practices that they previously resisted. For example, leading up to the pandemic, TV viewership had been shifting towards online streaming services for years. TV studios, however, were leery of the streaming platforms and only sold ad space on them begrudgingly. The studios instead favored their historic practice of selling ad space primarily over traditional networks. This old approach became much less viable during the pandemic, which essentially forced the studios to sell more ad space through the streaming services. The results were much better than they expected, which has put the migration of ad sales to streaming platforms roughly two years ahead of prior expectations.[4]

Trends That Will Partially Revert
Certain behaviors have become widespread during the pandemic, but they are still inferior to the old way of doing things. Examples include attending school virtually, buying groceries online, and conducting large meetings via Zoom. To be clear, the adoption of some of these practices has been permanently advanced, but their current use is artificially high and will ease after the pandemic.

Trends That Will Surprise
I believe that Corona-Time will produce some surprise trends that are just starting to emerge. For example, the broader acceptance of remote work has lowered the all-in cost and disruption associated with moving a business. This was recently illustrated by the software giant Oracle, which announced that it will relocate its corporate headquarters from California to Texas but allow its employees who want to stay in California to remain with the company by working remotely. I expect that broader use

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[2] Amrith Ramkumar, "Tech's Sway Over Markets Nears Record," The Wall Street Journal., October 19, 2020.
[3] Karen Langley, "Small Stocks Lead Market Charge Ahead," The Wall Street Journal., December 14, 2020.
[4] Magnite Inc. 2nd Quarter Earnings Conference Call, August 10, 2020; Magnite Inc. 3rd Quarter 2020 Earnings Conference Call, November 9, 2020.

of remote work will also allow more employees at other firms who would like to relocate to do so. Niche real estate businesses have even arisen to cater to these migrations.[5] This has implications for property values, the fiscal health of state and local governments, and a further polarization of our country. We are thus watching for trends like this that could emerge more clearly in the wake of the pandemic.

In summary, our value packing process during the first nine months of 2020 squarely positioned our portfolio for an economic recovery and other emerging trends, including some that were fast-forwarded during the pandemic. Those decisions are now clearly being rewarded. The current recovery, however, seems likely to be unique in two ways. The first is that it will probably be stronger than normal since many activities have been constrained largely by government fiat. The second and more complicating factor is that certain parts of the economy will be significantly different going forward due to trends that have been permanently fast-forwarded. I thus expect 2021 to be another volatile year in the stock market, and I encourage you to remain emotionally prepared for potential pull-backs in our portfolio. That said, the last few months have demonstrated that one can never tell when the market will make its next surge upwards. Fully participating in those rallies is essential to realizing good long-term results, and this makes staying the course paramount even though it requires accepting occasional bad times to participate in the good ones.

Thank you for your continued support.

Best regards,

Terry Ledbetter, Jr., CFA

P.S. Kopion is “tax conscious, but investment driven,” and our strategy is usually relatively tax efficient. Unfortunately, a number of factors in 2020 made it more difficult to manage your tax exposures than normal. Please know that we did our best on this front for every taxable account.

[5] Molly Hennessy-Fiske, “Ready to move, Californians tour their top destination: Texas,” The Los Angeles Times, January 22, 2020. See also www.conservativemove.com.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	S&P 500	Russell 2000
Annualized*				
1 Year	26.4%	24.8%	18.4%	20.0%
3 Years	14.5%	13.1%	14.2%	10.2%
5 Years	13.5%	12.1%	15.2%	13.3%
10 Years	10.4%	9.1%	13.9%	11.2%

*Ending 12-31-20

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 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.