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Inflation Edition

Thursday, July 21, 2022

Dear Kopion Clients,

During the first half of 2022, Kopion returned -20.4% before fees (-20.8% after fees). The S&P 500 and the Russell 2000 fell 20.0% and 23.4%, respectively.

The stock market has been grappling with two complex and inter-related issues:

1. High inflation and especially the higher interest rates that governments will use to bring inflation back down to normal levels.
2. The potential that inflation and higher interest rates will lead to a recession and thus reduce corporate earnings.

These concerns are quite valid when looking out over the next 12-24 months. As we will explain below, however, we believe that these factors are less significant over the longer-term, especially for Kopion's portfolio. We thus remain encouraged as we look across both the actual valley of the stock market and the presumptive valley many expect for the economy.

Headline inflation is running at its highest level in over 40 years due to many factors. Governments' responses to the pandemic created highly uneven production and spending patterns, which led to imbalances of supply and demand for goods and now also for labor. Demographic trends and changing social norms are also adding to labor shortages. The global energy industry has under-invested in new oil supplies for several years, and the U.S. housing industry has under-invested in new supply for over a decade. These are just some of the factors that have contributed to the high inflation we're experiencing.

The greatest risk posed by today's inflation is that it could transition into a self-reinforcing cycle of rising prices and rising wages, which is what happened in the 1970's. Today's circumstances, however, feature some important differences from that time. One is that during the 1970's, a much higher proportion of the U.S. workforce was unionized and enjoyed automatic wage increases tied to inflation. Today, by contrast, employers are raising wages to retain workers, but not enough to fully offset inflation. This is eroding employees' purchasing power, and there is already evidence that this is reducing demand and could help slow inflation. Another important difference is that some of today's inflation is a direct consequence of pandemic-induced mis-matches between supply and demand across various industries. There are preliminary signs that these are already being

rectified in certain areas, and while broad improvement will likely be slow, these challenges are definitely surmountable over the medium-term.

The most powerful force for curbing inflation today is the U.S. Federal Reserve and other central banks that are determined to avoid the wage-price spiral of the 1970's by raising interest rates aggressively. This is a major concern for the stock market because interest rates influence stock prices indirectly through corporate profits and directly through business valuations:

1. Corporate Profits—As interest rates rise, some projects, such as constructing new buildings, become harder to finance. This causes them to be put on hold, which slows overall activity. Indeed, this is central banks' current goal: slow economic activity enough to quell inflation.
2. Valuations—The interest rate on long-term U.S. Treasury bonds is a key variable in the equations that finance professionals use to value stocks and bonds. According to finance theory, interest rates should have a direct negative relationship with stock valuations. All other things being equal, rising interest rates should lead to falling stock valuations.

Critically, however, these relationships are not mechanical. For example, some parts of the economy are much more sensitive to interest rates than others. Housing prices and construction projects are very sensitive to interest rates. By contrast, many corporate projects that make sense at a 4% interest rate will still make sense at a 7% interest rate.

On the valuation front, the rate on long-term U.S. Treasuries is just one of four key variables that influence stock valuations.[1] Furthermore, we would argue that the interest rate variable's connection to stock valuations has weakened over the last 15 years as interest rates fell to levels that were low by historic standards and often seemed unsustainable.[2] Legendary value investor Joel Greenblatt encouraged investors to use a *minimum* interest rate of 6% for valuation purposes even if the actual rate was much lower. Doing so would provide an essential margin-of-safety in the event that interest rates reverted back to their historic levels. This kind of thinking seems to have been widespread because many stock valuations behaved similarly to what Greenblatt advocated, decoupling from interest rates as rates fell to extremely low levels. To be fair, there were cases in the last few years where ultra-low interest rates were used to rationalize very high valuations for certain growth stocks. That argument, however, was hardly applied universally throughout the market. A few of our stocks were caught up in that trend, but we systematically reduced those exposures and reinvested the proceeds in positions with more conventional valuations. In our opinion, this put us on relatively good footing going into 2022 since our portfolio was already valued in a way that could absorb the impact of higher interest rates, similar to what Greenblatt advocated. The present bear market, however, has been generally indiscriminate, which has pulled our stocks down as well. Because we began the year at a more normal starting point, however, the current market decline has pushed our stocks down to extremely attractive levels. This has created a "value packing" opportunity, similar to what we experienced at the beginning of the

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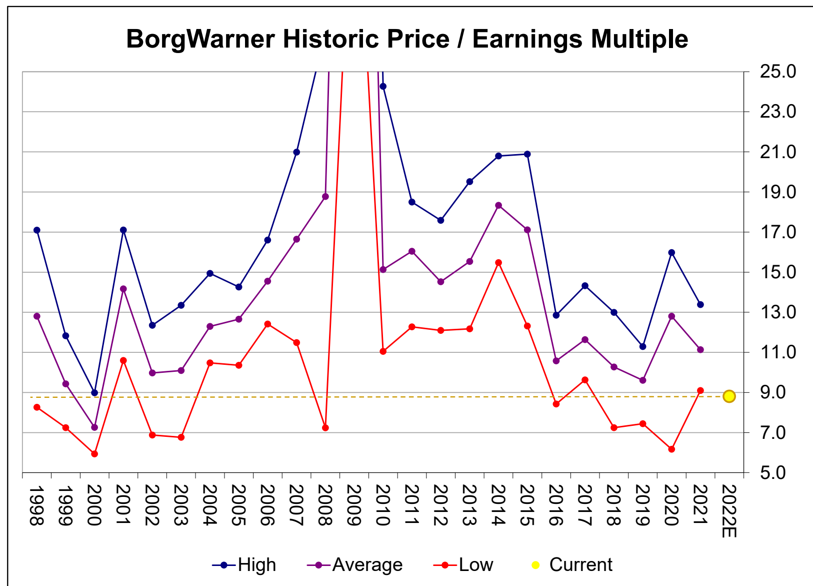
[1] The other three key variables are the risk premium, estimated current earnings, and expected earnings growth.
[2] See the chart in the appendix for more context.

pandemic. As we worked to maximize the value content of the portfolio during the first half, we were fortunate to have one of our core holdings, Points.com, be acquired for a 52% premium. The related proceeds bolstered our ability to add to several other positions that had fallen to bargain prices.

One of our largest holdings, BorgWarner, offers an encouraging example of our portfolio's current positioning. BorgWarner makes technologically sophisticated auto parts, including for electric vehicles. The stock is trading at one of its lower valuations since the late 1990's as shown by the yellow dot in the chart below. A lower Price / Earnings (P/E) multiple means a lower valuation for a stock, very similar to how a lower Price per Square Foot indicates a lower valuation for a house. The 2002-2003 period offers a helpful comparison. In those years, the interest rate on the 10 Yr. Treasury was in the 4-5% range, and BorgWarner's average P/E multiple was 10.0x. Today's P/E multiple is 8.8x—12% *lower* than the 2002-2003 period even though the 10 Yr. Treasury is only about 3% today. Remember that lower interest rates should mean *higher* valuations, but that's not what we have here. Moreover, today's lower multiple is on depressed earnings, which further improves the risk vs. reward proposition. In 2022, the company's sales and earnings are being constrained by the semiconductor chip shortage, which is forcing many prospective car buyers to delay their purchases. The associated pent-up demand should help BorgWarner do well in the coming years, even if they include a recession. In summary, BorgWarner's low current multiple, especially on depressed earnings, provides us with a margin-of-safety even if interest rates rise significantly from here.



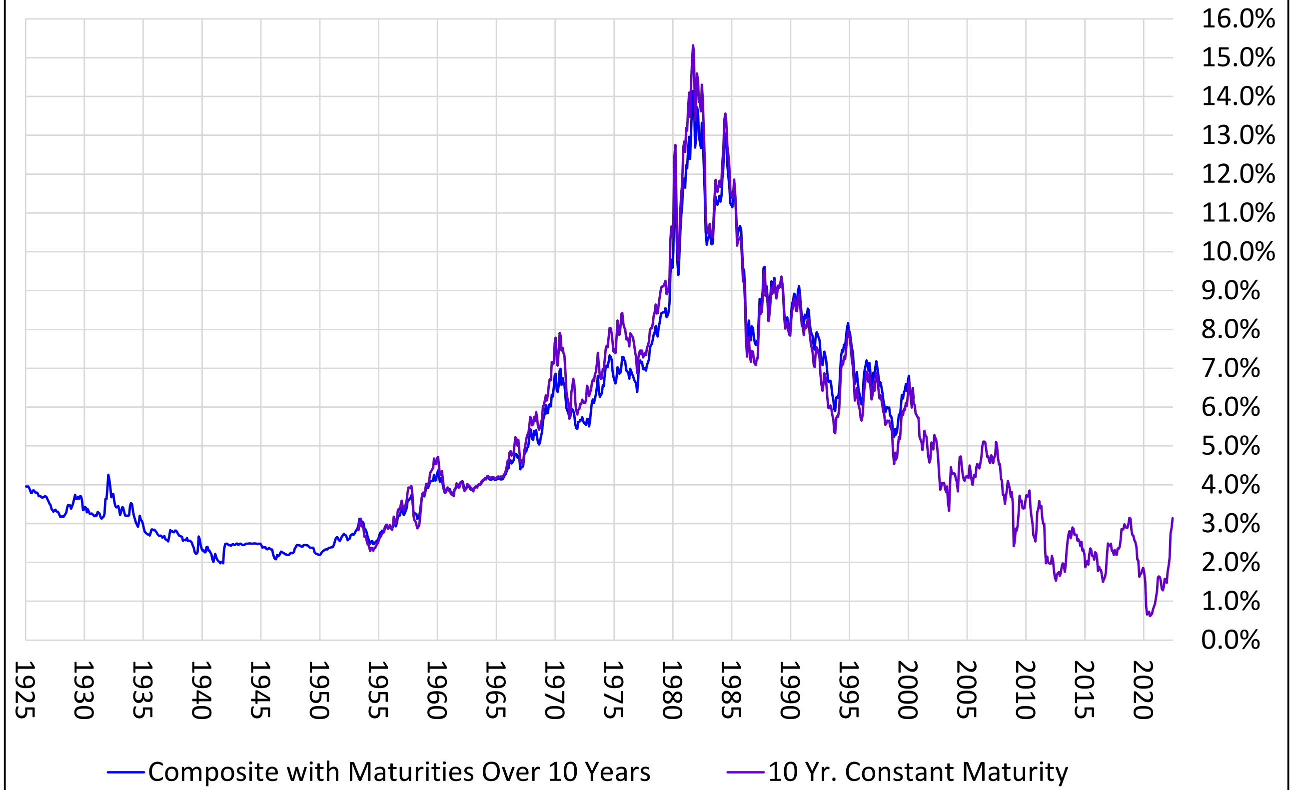
Positioning like this makes us excited about our portfolio's potential over the next few years despite the possibility of higher interest rates or even a recession. So while results could remain rocky in the months ahead, we remain well positioned for the long-term.

Thank you for your continued confidence and support.

Best regards,

Terry Ledbetter, Jr., CFA
Jonathan Lindstrom, CFA

APPENDIX



PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max Fee}$	S&P 500	Russell 2000
1st Half of 2022	-20.4%	-20.9%	-20.0%	-23.4%
Annualized*				
1 Year	11.3%	10.0%	28.7%	14.8%
3 Years	22.6%	21.2%	26.1%	20.0%
5 Years	13.4%	12.0%	18.5%	12.0%
10 Years	11.8%	10.5%	16.6%	13.2%

*Ending 12-31-21

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.