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Katrina & Rita

Dear Kopion Clients,

As many of you are aware, the equity markets declined sharply in August and September, leading to steep losses during the third quarter and driving the major market indices down for the year. Year to date, the S&P 500 and Russell 2000 are down 8.7% and 17.0%, respectively. As seen in the Russell 2000's performance, the sell off has been especially pronounced among smaller firms like the ones that Kopion gravitates towards, and year to date, Kopion's average account is down 12.7% before fees (-13.3% after fees). It's also important to note that Kopion's performance was strongest early in the year, especially during January. Consequently, accounts that came on board after this have experienced all of the recent decline with less, if any of the strong performance from earlier in the year to offset it. The performance for those accounts has accordingly been worse than Kopion's year to date results because of the timing with which they happened to come on board.

The market's current tempest reminds me a lot of Hurricane Rita, which struck Houston in September 2005. Just a month earlier, Hurricane Katrina had devastated New Orleans, and while Rita was a significant storm, it was the fresh memories of Katrina that motivated a super-sized evacuation out of Houston. Unfortunately, few people stopped to consider whether there were any factors that might make Houston less vulnerable than New Orleans had been such as not being below sea level and not being so close to a large body of water. Likewise, the stock market's losses of 2008 and early 2009 are still very fresh in most investors' minds which has led to panic selling and a response that is very disproportionate to the economic figures and corporate earnings that have been reported over the last three months.

To be fair, some economic reports have pointed to slower economic growth. There have been numerous other metrics, however, that indicate the expansion is still underway and the overall environment has not significantly changed. The press has offered a decidedly pessimistic interpretation of these reports, trumping negative data points and barely regarding positive ones. For example, The Wall Street Journal yesterday ran an article with the ominous headline: "Factory-Goods Orders Show Decline." The details of the article, however, revealed that orders only declined 0.2% from the prior month and the more important "Nondefense capital goods orders excluding aircraft" figure rose 0.9% over the prior month.[1] The press has also ignored basic qualifications such as the natural tendency of a recovery to decelerate as it

[1] Jeff Bater and Andrew Ackerman, *Factory-Goods Orders Show Decline*, The Wall Street Journal, September 5, 2011 Print Edition.

matures and the inherent volatility of economic indicators. The market has reflected this negative bias as well with a tendency to assimilate bad news and filter out good news. To date, however, the preponderance of the facts (i.e. corporate earnings reports and updates, automobile sales, retail sales, etc.) indicate that the economy continues to gradually advance.

My chief concern is that all of the negativism discussed above could eventually alter spending patterns and turn a prospective downturn into an actual one. Some have described this as "talking ourselves into a recession." This is certainly possible, just as it was possible in September 2005 that Hurricane Rita might devastate Houston. As it turned out, however, Rita did relatively little physical damage to the city, though the 10-20 hours spent in bumper to bumper traffic did take a toll on the hundreds of thousands of motorists who tried to evacuate.

I believe that a number of factors make another deep and sustained economic downturn less likely. Recessions are often created and amplified by consumers and businesses who cut back on their spending plans. This takes many forms, ranging from deferring new equipment purchases to reducing inventory and staff. The global economy entered 2008 with normal conditions in nearly all of these areas. Today, however, inventories and staffing levels are already lean and equipment purchases that could be deferred have now already been deferred for two or three years. Furthermore, most corporate balance sheets are now strong which leaves companies much better prepared to endure a downturn without needing to cut staff. I do not want to offer a forecast for the economy or the market, nor do I mean to diminish the significant structural problems that the world is currently working through. I did, however, want to explain why the market and our portfolios have performed so poorly. I also wanted to offer a more balanced perspective than the aggressively spun news that I've read and suspect that you are hearing as well.

Market downturns such as this one are not uncommon, though they often have a lower profile since they don't usually fit as neatly within the boundaries of the calendar as this one has. Just last year, the S&P 500 declined 15.6% from April 23 through July 2. This decline, however, was preceded and followed by advances which obscured the size of the decline when you looked at the market on a month to month or quarter to quarter basis. Furthermore, the market rallied later in the year when it became apparent that the mixed economic signals of that time did not presage a "double dip" like many had feared. The S&P 500 finished 2010 with a positive 15.1% return for the year, even though that performance included a negative 15.6% interlude from late April to early July. As was the case that time, my focus continues to be on investing in attractive businesses which should perform well over the long term, even though there will be inevitable setbacks along the way.

Thank you for your patience and confidence as we ride out this storm.

Best Regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
YTD 2011*	-12.7%	-13.5%	-8.7%	-17.0%
Annualized†				
1 Year	31.2%	29.6%	15.1%	26.9%
Since Inception‡	40.5%	39.1%	18.5%	26.2%

Period	T Ledbetter, Gross	T Ledbetter, Net Max Fee	S&P 500	Russell 2000
YTD 2011*	-12.7%	-13.5%	-8.7%	-17.0%
Annualized†				
1 Year	31.2%	29.6%	15.1%	26.9%
3 Years	7.6%	6.2%	-2.9%	2.2%
5 Years	12.8%	11.4%	2.3%	4.5%
Since Inception§	14.5%	13.2%	3.6%	5.8%

*Through 9-30-11
†Ending 12-31-10
‡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.