Kopion Asset Management

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No Rain, No Rainbows

Wednesday, January 4, 2012

Dear Kopion Clients,

Kopion posted an middling performance in 2011, returning -1.9% before fees and -2.8% after fees. The S&P 500 and Russell 2000 returned +2.1% and -4.2%, respectively. Kopion's portfolio got off to a very strong start in 2011 as economic clouds were parting and our companies began to get credit for the tremendous progress they had made during the downturn. In the late spring, however, overcast conditions returned with renewed concerns about the economy, and by late summer, the market had entered an extended period of stormy weather as Greece's debt problems metastasized into a complex European financial crisis. This led to sharp declines in the equity markets which our stocks, of course, participated in. These stock price declines, however, are not reflective of the ongoing commercial progress at most of our companies. Indeed, most of our companies benefit from unique trends that make them "all-weather businesses," if you will.

Kopion focuses on firms that are benefitting from specific secular growth trends that allow them to grow somewhat independently of the economy. Consequently, their earnings tend to hold up better than average during recessions, and they are able to outpace the overall economy during periods of expansion. BorgWarner is an example of one such firm as it produces a wide range of automotive components like turbochargers that increase fuel economy and lower emissions without compromising vehicle performance. BorgWarner is thus a prime beneficiary of structurally higher oil prices and tightening emissions standards, both of which are forcing automakers to expand their use of these components. Consequently, when vehicle sales fell during the recession, BorgWarner's decline was shallower than the industry's, and it has also rebounded much faster in the recovery because its growth is being propelled by something greater than overall economic growth. Tim Manganello, the company's Chairman and CEO summarized this nicely in the company's 2011 third quarter earnings release:

> *While the markets have been evaluating macroeconomic events and assessing downside risk to vehicle production, the outlook for our business has remained strong. . . Our growth is tied to the industry's adoption of leading edge power train technology, a long-term trend that will occur despite near-term market conditions.*

I should add that BorgWarner is not simply benefitting from this trend, but it is also helping to facilitate it by developing the technologies that enable better fuel economy. Nearly every one of Kopion's companies is benefitting from or enabling trends like this and have shown continued progress in 2011 through measures such as increasing orders and successful new product introductions. Unfortunately, this has not been reflected in their stock prices. If you look at the companies that we've held for the entire year (which is over 90% of the portfolio), their average earnings are expected to grow roughly 16% in 2011 and then roughly 20% in 2012. These results stand in stark contrast to their average stock price which fell 6.5% in 2011 despite the fact that most of them entered the year with reasonable valuations.

So the market ignored the fundamentals of our companies during the second half of 2011 which is often the case during periods of market anxiety. This was disappointing, but it came with two benefits. The first was that the second half of the year was an extremely volatile time in the market which presented many opportunities to shift money out of stocks that were holding up relatively well and into ones that had declined sharply. We thus enter 2012 with a more value-laden portfolio. The "value-content" of our portfolio has also improved with the passage of time as we move into another year of higher earnings and yet the average stock prices are moderately lower than a year ago.

Sadly, the process of becoming more value-laden is usually a painful one, but it comes with the prospect of better returns in the future. Many years ago, my wife and I vacationed on a small island that was home to only three hotels, three restaurants and a small hospital, the latter of which we ended up having to visit. The hospital was nearly deserted, but we eventually found a nurse named Ken who sported a ponytail and regaled us with tales of his military days in San Antonio while we waited for the doctor. Eventually, Dr. Gasper arrived at our examination room. He was wearing swim trunks and a white T-shirt that read "No Rain, No Rainbows"—a proverb that I've found to be very appropriate for value investing. I am disappointed that 2011 ended on such a rainy note, but encouraged by the values that I see in the portfolio and the developments that are occurring among our companies.

I do not know when the sun will come out for the equity markets as the structural problems facing the world's economies and governments lack straightforward answers. These kind of problems, however, have always existed, and the global economy has nonetheless been able to gradually advance in spite of them. This creates opportunities for the participating companies, and especially the types of firms that Kopion focuses on which are "on the right side" of progress.

Thanks for your patience and continued confidence.

Best Regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max Fee}$	S&P 500	Russell 2000
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
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.