Kopion Asset Management

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Process vs. Outcome

The result of one particular game doesn't mean a damn thing, and that's why one of my mantras has always been "Decisions, not results." Do the right thing enough times and the results will take care of themselves in the long run.
-Amarillo Slim

Friday, July 8, 2011

Dear Kopion Clients,

Kopion enjoyed a very good first half of 2011, returning 10.9% before fees and 10.4% after fees. The S&P 500 and Russell 2000 returned 6.0% and 6.2%, respectively. It is nice to get off to a good start, but this is only six months of results which limits its meaningfulness. Indeed, as suggested by the quote above, focusing on short-term results can be counterproductive, which is the primary subject of this letter.

We live in a world that focuses on results, and this is mostly fair because results are often the direct consequence of our actions. In some cases, however, results also involve an element of chance which distorts the picture, similar to radio interference. These areas are called "probabilistic fields," and baseball offers a good example of one. Over the course of a season, a baseball player will have hundreds of times at bat with the circumstances varying each time (i.e. pitcher, number of outs, bases occupied, home / away, morale, etc.). If you only focused on a few games, it'd be easy to draw the wrong conclusion about his skill as a batter because you might be looking at a set of particularly lucky or unlucky swings. Consequently baseball fans refer to his batting *average* since this metric captures his performance against a wide range of circumstances. Importantly, batting averages are a natural outflow of the batter's aptitude and training; a disciplined, well directed training regimen is a good "process" through which to achieve more hits. Nonetheless, each at-bat experience will vary and could be classified according to the matrix on the right[1]:

	Good Outcome	**Bad Outcome**
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

For example, a sloppy batter that hits a home run when the pitcher is tired and having a bad day is benefitting from "dumb luck," even though he's had a great outcome.

Conversely, a disciplined athlete who strikes out at the hands of an exceptional pitcher is the victim of a "bad break." With enough time, however, the quality of their "processes" will prevail.

And so it is with money management. Managers who make thoughtful decisions will sometimes experience mixed results, but their good processes should lead to favorable performance over the long-term. The opposite is also true. Unfortunately, looking past individual outcomes is at odds with human nature, and there are two primary mistakes that can flow from this. The first mistake is to place too much weight on recent experience. A tragic example of this occurs during bear markets when some investors begin to extrapolate the declines in their portfolios. This leads them to believe that their portfolios are headed for zero and will motivate them to sell out at the bottom. The second mistake is to place too much weight on the success or failure of any particular stock. A few years ago, my wife demonstrated how easy it is to make this mistake when I proudly showed her our portfolio, and she immediately asked me about the one position that was in the red instead of noticing the overall gains that I had achieved. (She not only grew up as the daughter of a value investor, but she married one too. Clearly, anyone can make this mistake!) I should point out that while these two examples use negative outcomes, it is also possible to focus too much on positive results. For example, I once met a portfolio manager who touted his successful stocks, but his mediocre record indicated that he wasn't telling me about his less flattering ones.

Kopion has a well defined decision making process that keeps me focused on how companies are valued relative to their long-term prospects. This is logical since their earnings several years from now will generally determine their stock prices several years from now. This multi-year vantage point also serves as a pair of emotional guard rails that keep me from being whipped around by the month-to-month movements in stock prices. In some cases, such as 2007 and 2008, it's even necessary to look beyond annual fluctuations—"looking across the valley," so to speak. This approach is not a guarantee of success, but it is intellectually, historically, and academically sound.

Learning to focus on making good decisions instead of individual results is one of the most important lessons that I've learned during my nine years in money management, and I'm hopeful that it will prove helpful to you as well. It's also a good reminder that I'll inevitably have some setbacks, both in terms of individual stocks and seasons. While these will be uncomfortable, my process has led to good overall results thus far, and I am hopeful that it will continue to yield a good batting average in the future.

Best Regards,

Terry Ledbetter, Jr., CFA

[1] J. Edward Russo & Paul J.H. Shoemaker, Winning Decisions.

Performance Disclosures

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
1st Half of 2011	10.9%	10.2%	6.0%	6.2%
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 $_{\text{Max Fee}}$	S&P 500	Russell 2000
1st Half of 2011	10.9%	10.2%	6.0%	6.2%
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%

*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.