Kopion
Asset Management

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Sowing & Reaping

May those who sow in tears reap with shouts of joy. Those who go out weeping, bearing the seed for sowing, will come home with shouts of joy, carrying their sheaves.

-Psalm 126:5-6

Friday, January 9, 2015

Dear Kopion Clients,

We suffered a setback in 2014, returning -9.0% (-10.1% after fees). This performance was poor on an absolute basis, and even worse relative to the S&P 500 and Russell 2000 which returned 13.7% and 4.9%, respectively. Two primary factors contributed to our results.

As you remember, during 2013 we enjoyed a phenomenal return of 62.5% (60.5% after fees) while the S&P 500 and Russell 2000 returned 32.4% and 38.8%, respectively. Our fantastic result was driven by improving outlooks and valuations across nearly our entire portfolio. When a business is on an even keel, it is easier to understand how the stock price is valuing the company because the business itself is on a steady course. When the business' performance begins to inflect, however, ascertaining this "business vs. stock price" relationship becomes much more difficult because the business has become a moving target that the stock is trying to catch up with. In some cases, the business will outpace the stock price by improving faster or for longer than investors had expected. Conversely, the stock can sometimes surpass the commercial reality of the business. This situation is referred to as a stock "getting ahead of itself." Experience has taught me to hang on tight when a business starts to improve because events can unfold dramatically better than anticipated. Indeed, I am specifically looking for companies with that type of upside. In 2014, however, it became clear that a number of our holdings had gotten ahead of themselves during 2013, and this set the stage for only modest gains in some positions and retreats in others. In fact, one such holding retreated so much that it is once again clearly undervalued. This dynamic contributed to our weak results during 2014.

The second key factor is that much of the stock market's gains during 2014 occurred in areas of the market in which Kopion does not participate. Generally speaking, businesses can be classified along two dimensions. The first is their size and the second is their industry or sector. Kopion focuses on small to medium sized firms because those tend to be earlier in their lifecycles and thus offer many years of earnings growth. With respect to sectors, most of our companies are in Information Technology, Industrials, and to a lesser extent, Energy. These three areas are relatively rich in businesses with competitive advantages that should allow them to grow their earnings for long periods of time. This stands in contrast to intensely competitive industries such as Retail, Consumer Products, or Banking where earnings can stagnate or even gradually erode over time. During 2014, our types of stocks were not in the parts of the market that were performing well. For example, large stocks performed much better than small stocks as seen by the difference in the returns of the S&P 500 and the Russell 2000. In addition, the strongest sectors during 2014 were Utilities, Healthcare, Information Technology, Consumer Staples and Financials. We only participate in one of those sectors. Furthermore, we have a relatively large position in the part of the market that performed worst: Energy. I have historically limited Energy to about 20% of our portfolio which I do not consider to be unduly large on an absolute basis. On a relative basis, however, our Energy weight is roughly twice as large as the S&P 500 and nearly four times greater than the Russell 2000's. The precipitous decline in oil prices thus had a much larger impact on our portfolio than the indices. Moreover, our four energy companies are niche businesses so their stocks declined much more during the recent round of panic selling than household names such as Exxon which are perceived to be safer. Over the long-term, I believe there are great advantages to picking stocks based solely on their individual merits and valuations as opposed to trying to mirror an index. In any given year, however, this does make our relative performance vulnerable to being out of step with the overall market as occurred in 2014.

The bright side of all this, however, is that our portfolio is now nicely value laden. Its "value content" has improved as two dynamics have occurred. The first is that many of our companies made good commercial progress during the year while their stock prices remained relatively flat. This means that their value content increased. The larger factor is that some of our stocks suffered large declines which greatly improved their risk / reward propositions. I thus trimmed positions that had held up relatively well in order to add to positions that had gone on sale. I do not know when our performance will improve, but I am very encouraged by the projected long-term returns that I see throughout the portfolio. I have "sown in tears" before, and I am hopeful that we will eventually reap with joy once again.

I want to briefly address those clients who have joined or made large deposits over the last 12-15 months. Just like a farmer experiences good and bad seasons that he cannot predict beforehand, I too experience good and bad periods. I wish that I could reliably discern when a difficult season is approaching, but timing the market is a game that cannot be won and should not be played. I thus invest new clients relatively quickly in all of our stocks whose valuations are at least "okay" from a long term perspective. If the portfolio then suffers a near-term decline, I will feel (and look) badly, but this will ultimately be a temporary problem because we own solid companies that should rebound. The alternative would be to try to time the market in hopes of dodging any declines. The problem with that approach is that if the portfolio instead rallies, I would be forced to buy at higher prices, and the new clients' performance would then lag the rest of the clients *permanently*. The choice is thus between the risk of a temporary problem and a permanent one, and the former is more prudent even though early setbacks sometimes occur.

I believe that I have been successful in the past by paying reasonable prices for growing businesses and then adding to those positions when their stocks go on sale. This is the essence of Kopion's investment process. A critical facet of this process is developing a deep knowledge of the companies in which we invest. This confers insights into each holding's risk / reward proposition and how those propositions compare to each other. While setbacks are emotionally difficult, they are ultimately a blessing because they allow us to reinvest funds on more favorable terms, and this improves the return we are likely to experience in the future.

I am so appreciative of each of you for both entrusting me with your investments and being so supportive over the last few years. Kopion has now grown into an established business and reached the point that I need to hire an associate. After considerable thought and discussion, I have decided to hire an analyst who will augment my research effort and also assume many of my administrative responsibilities. I plan to formally announce this opening in the coming weeks, and I will update you after I have brought this person onboard.

Thank you for your continued confidence and support.

Best Regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-9.0%	-10.1%	13.7%	4.9%
3 Years	21.0%	19.5%	20.4%	19.2%
5 Years	17.9%	16.5%	15.5%	15.5%
Since Inception†	20.8%	19.4%	16.3%	16.1%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-9.0%	-10.1%	13.7%	4.9%
3 Years	21.0%	19.5%	20.4%	19.2%
5 Years	17.9%	16.5%	15.5%	15.5%
10 Years	13.9%	12.5%	7.7%	7.8%

*Ending 12-31-14
†Since 8-23-09

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.