Kopion Asset Management

502 W. Hunt St.
McKinney, TX 75069

214.425.7027

Ride the Storm

Tuesday, October 6, 2015

Dear Kopion Clients,

Kopion suffered additional declines during the third quarter, and our Year to Date return is now -19.7% (-20.3% after fees). This is considerably worse than the S&P 500 and Russell 2000, which have returned -5.3% and -7.7%, respectively. So even though it is my custom to write to you only twice a year, I felt that these results warranted some commentary.

There have been three key factors behind our continued poor performance. The first is that Kopion focuses on specific parts of the market, and these are the among the areas that have performed the worst in recent quarters. The most extreme of these has been the energy sector. However, we also have a concentration in the industrial sector, and that has hurt us as well. Moreover, we have relatively little exposure to the parts of the market that have been holding up, such as the healthcare sector. This dynamic is a continuation of the same trends that hurt our performance in 2014.

I believe that the second factor behind our recent results stems from how my investment process is working during a period of extended weakness. As a value investor, I seek to make our portfolio as value-laden as possible in order to maximize our long-term returns. This is achieved by judiciously adding to positions that have declined. In healthy markets, this behavior is often quickly rewarded. Conversely, in acutely weak markets, our stocks can fall so rapidly that I end up adding to our weakest positions closer to the bottom. In those cases, it takes longer for our discipline to be rewarded, but our performance doesn't usually suffer large additional losses because much of the decline has already played out. The last 21 months, however, have presented a completely different scenario: a gradual, protracted, and widespread decline among our holdings. This means that when I have added to our beaten down stocks, instead of having a positive or neutral impact in the short-term, those purchases have resulted in incremental losses because I have increased our exposure to the stocks that have kept going down. While this has amplified the pain in the short-term, my decisions have still enhanced the portfolio's projected long-term return.

The third factor relates to the sheer number of our stocks that have suffered these types of protracted declines. We usually only have one to three companies in this category, so their impact is less perceptible. Unfortunately, we currently have about eight. (This includes our four energy stocks and four of our other holdings.) Moreover, market sentiment has ranged from skeptical to negative, which means that these stocks have been penalized more than they would be under normal circumstances.

These three factors have led to a very large “drawdown” in the value of our portfolios since Kopion’s peak in March, 2014. Some investors make the mistake of equating drawdowns to risk, erroneously extrapolating the most recent declines in the value of their portfolios. This definition of risk, however, centers around psychological pain. I believe that risk is better defined as the likelihood of a permanent capital loss. Such an impairment can occur on two levels, either for an individual stock or for the entire portfolio. An individual stock is impaired when the prospects of its underlying business deteriorate irreversibly. Adequate diversification, however, prevents this type of permanent loss from marring the entire portfolio. The overall portfolio, however, can be impaired if an investor buckles under the emotional pain of a drawdown and chooses to liquidate his entire portfolio at low prices. In this case, he is essentially converting a drawdown into an unnecessary permanent loss. This is the tragic fate of investors who cannot ride out the market’s storms. For its part, Kopion has periodically suffered large drawdowns, and I have also experienced a handful of individual stock impairments over the course of my career. I believe, however, that our risk of a portfolio-level impairment is low because we focus on high-quality, durable businesses, and I am careful about the prices that I pay for them.

Given the declines that we have sustained and especially the additions that I have made to our weaker positions, our portfolio is now very value-laden. Our current circumstances bear many similarities to the third quarter of 2011, which incidentally was the only other time that I felt warranted a “special edition” client letter. In both cases, the economy sent mixed signals, the press put an especially negative spin on events, and the market gravitated strongly towards these pessimistic interpretations. As was the case back then, I do not know how much longer we will have to ride the storm before our patience and discipline are rewarded. But I do know that the portfolio is both sound and highly value-laden, and I continue to expect good results in the coming years.

Thank you for your patience, support and trust.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
YTD 2015*	-19.7%	-20.5%	-5.3%	-7.7%
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 Max Fee	S&P 500	Russell 2000
YTD 2015*	-19.7%	-20.5%	-5.3%	-7.7%
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%

*Through 9-30-15
†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.