Kopion Asset Management

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Sideshow

A theme of 2010 and what it could mean for the future

Kopion enjoyed an outstanding year in 2010, posting a full year return of 29.9% after fees. (The S&P 500 and Russell 2000 returned 15.1% and 26.9%, respectively.) While I am delighted to report this result, I'd like to remind everyone that Kopion will have both good and bad seasons, and I do not expect to outperform the market indices every year. Rather, my commitment is to a thoughtful decision making process, and this will hopefully generate good results over the very long term.

The macro economy continued to be a grand sideshow for many investors in 2010, which is somewhat understandable given the depth of the 2008-2009 recession and ongoing weakness in 2010. This preoccupation with broad economic indicators was enabled by the confounding nature of these metrics since they send mixed signals during the early and later parts of a downturn. Furthermore, economic anxiety was reinforced by widespread news coverage that has an uncanny ability to amplify bad news. Greece was a great example of the sideshow, as an economy smaller than Massachusetts' threatened to set off a chain of European defaults and precipitated two major pullbacks in the US stock market. Numerous news articles declared that stock picking and valuation were no longer relevant since major macro forces were now driving the markets, and even some prominent value investors began to dabble in macro investing. This widespread distraction was helpful to fundamental investors like Kopion that kept their eyes on the ball.

While I follow macroeconomic news, I am chiefly concerned with the specific developments that affect our companies, most of which are niche businesses benefitting from specific secular trends, some of which they themselves are pioneering. While the downturn created something of a pause in the visible progress of our companies, internal progress continued in a multitude of forms. In some cases, maintaining sizable R&D budgets allowed them to distance themselves from competitors who were being forced to retrench. In others, breakthrough developments validated their technology and have presented game changing opportunities. In yet others, our companies quietly established customer acceptance and early momentum with impressive new platforms that they had launched just before the economy rolled over. In still others, the downturn forced them to retool parts of their businesses which will now allow them to scale more efficiently in the upturn. And in almost all cases, the underlying trends continued to quietly progress. But many of these things were underappreciated since most investors' eyes were on the sideshow.

As we entered the fourth quarter the markets began to undergo a sea change as the economic data became consistently positive and the progress that our companies made during the downturn started to become more apparent. Importantly, whenever the environment is changing, there is often an ongoing lag between the real world and investors' perception of it. In this case, three consecutive years of disappointment have created a heavy psychological anchor restraining most people's expectations. For example, one of our companies, II-VI ("Two-Six") finishes it's Fiscal Year in June, so it was the first of our companies to make any projections that included 2011. In August, they forecast FY11 earnings per share of $1.60. Being aware of the lag phenomenon described above, I tried to get ahead of the curve and my modeling suggested that they'd earn around $1.76. Then two and a half months later, II-VI raised its FY11 estimate to $2.05. This was a huge increase, especially this early in their fiscal year, and it serves as a reminder of how easy it is to underestimate results when you're coming out of a downturn—even when you're consciously trying to overcome psychological anchors.

Many of our companies reported improving business momentum in their third quarter conference calls, and the economic news has improved significantly since that time, which suggests to me that we are indeed on the cusp of significant earnings improvement. Consequently, I have been unusually aggressive in the speed with which I've invested new accounts. The market was very strong in late 2010, which could set the stage for some choppiness in the first half of 2011. Still, given the long term value that I see in most of our holdings, and the tendency to underestimate their performance as the economy improves, I'd rather accept the risk of some short-term setbacks than put new accounts at the risk of missing out on a long-term upswing. The former would be a short-term problem, whereas the latter would be a permanent one.

So I am hopeful that in 2011 attention will turn from the sideshow and back to the main event, that is the tremendous progress that our companies made during the downturn.

Thank you for your interest and continued confidence in me.

Best Regards,

Terry Ledbetter, Jr.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
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
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.