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Thinning the Herd

Wednesday, July 11, 2018

Dear Kopion Clients,

Kopion returned 4.9% before fees (4.5% after fees) during the first half of 2018. This compared to the S&P 500 and the Russell 2000, which returned 2.6% and 7.7%, respectively.

The last six months have been relatively quiet from a performance perspective, but internally, they have been quite busy on the research front. This has been due to a number of factors, but a major one has been an exceptional number of highly technical updates that we have needed to make to our financial models. As boring as this sounds, it is symptomatic of an important trend within the investment landscape, which is that research is becoming much more time-consuming. This trend has gathered little attention, but I believe that it could become consequential, especially in our corner of the stock market.

By way of background, the investment landscape has always been a noisy environment, where a cacophony of misinformation, mental shortcuts, and human emotions compete with the real, underlying facts about businesses. An investment luminary named Benjamin Graham wrote about this in the 1930s and 1940s in his classic books Security Analysis and The Intelligent Investor. The same state of affairs continues today because these dynamics are ultimately rooted in the human condition. Most people are bombarded by conflicting information, they struggle to prioritize competing desires, and most importantly, they are deeply uncomfortable holding unpopular opinions. Human nature thus tends to undermine good investment decision making. Since Graham's time, behavioral economists have come to believe that human decision making is 70% emotional and only 30% rational. Gallup research suggests that the emotional component of human decision making is 80% or higher! These dynamics led Graham to pioneer an approach called "value investing" that seeks to make investing a business-like endeavor that is as objective and disciplined as possible. Graham's protégé, Warren Buffett, then refined and improved upon Graham's work. Kopion's investment process is modeled closely after Graham's and especially Buffett's thinking.

Investing always involves an element of chance, but I believe that value investing offers compelling advantages for improving the odds of success. I also believe that only a minority of investors possess the personal make-up and professional opportunity to follow Graham's approach. Consequently, while many people *say* that they are value investors, only a minority actually *behave* that way. This has been true for a very long time.

Over the last 15 years, two structural trends have been making it even more difficult to behave like a value investor. The first of these trends involves accounting rules. One might expect such rules to be relatively static, like the laws of mathematics, but accounting rules actually morph slowly over time in an attempt to reflect new business models and practices. Such updates could be helpful, but not every change represents progress. Over the last 15 years, a series of new accounting rules have gradually obfuscated many companies' underlying earnings. This has been maddening because our government-endorsed accounting rule makers are supposed to promote clarity and transparency, but they have instead done just the opposite. I won't bore you with the details of which rules caused which distortions, but this trend has had very practical consequences. The first is that companies have been forced to provide a growing collection of supplementary data to help analysts like ourselves understand their true, underlying results. Unfortunately, however, digesting this additional information takes much longer than when results were generally straightforward right out of the box. Also note that these supplemental adjustments are not standardized across companies, which means that it is becoming more difficult to readily compare one company to another. Most analysts are required to cover relatively long rosters of stocks, and I am deeply skeptical that this can be done well, given the amount of time that is now required to understand each company's results. To be frank, most analysts' attention was probably already spread too thin. I observe this during investor conferences when analysts near me stare at stock quotes on their laptops or work through their inboxes during presentations that I have traveled hundreds of miles to hear in person. It is also evident when I speak with other analysts about one of Kopion's stocks. Some of them project the confidence of an expert, but make statements that include significant errors. This type of posturing is common and is partly due to the fact that they are expected to know such a wide range of material. All of this has led me to believe that the herd of investors who really understand what is going on is getting thinner.

More convoluted accounting rules have also had important ramifications for valuations, or rather, *perceived* valuations. From a high level, the rules that have been introduced over the last 15 years have generally reduced companies' official earnings. This makes their stocks look more expensive than they would have under the old, more straightforward accounting rules. This has diminished the usefulness of certain valuation metrics, such as standard P/E ratios and the Shiller CAPE ratio.[1] Back in college, my Greek professor taught us that "The most trivial concerns of the grammarian

[1] For a good explanation of this, see Justin Lahart's article titled "This Key Metric Rings a False Alarm," which was published in *The Wall Street Journal* on October 6, 2016. That article was written over 18 months ago, but it explains a principle that is still true. The fact that I have to refer you to an article this old illustrates how little attention this topic has received.

are more important than the weightiest ponderings of the theologian."[2] In recent years, as I have worked to untangle the implications of new accounting rules for our companies, I have come to believe that many market participants, especially among the asset allocators, probably do not fully appreciate how these new rules are overstating (and in a few cases understating) companies' valuations. Said another way, they seem to be focused on high level matters without understanding how the grammar of the market has changed.

The second structural trend that I believe is shrinking the pool of true value investors is the ongoing shift towards index funds. This is reducing the industry's collective resources for researching stocks at the same time that more complex accounting is increasing the effort required to understand them. There are generally two competing theories about where the indexing trend will lead. The first theory is that the stock pickers who survive will be exceptionally skilled, which will cause the market to become more efficient. This would lead to fewer bargains and less of a reason to own anything except index funds. The alternate theory is that because index investors essentially buy and sell stocks blindly, a rising proportion of them will make the market less efficient and advantage informed investors such as Kopion. These are just theories, and we won't know the likely outcome for many more years. That said, I hear and read about investment shops that have merged or closed in recent years, and the ranks of "in the trenches" researchers do seem to be gradually thinning. I thus believe it is more likely that the market becomes less efficient over time, which would provide more opportunities for us to find bargains.

As I have lived through these trends, I have grown in my appreciation for all of you. Your support has played a key role in providing Kopion with the freedom to perform detailed research and make highly principled investment decisions. I believe that what we are doing is increasingly rare and special, and I am thankful for your role in this endeavor.

Best regards,

Terry Ledbetter, Jr., CFA

[2] He was quoting Erasmus.

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	S&P 500	Russell 2000
1st Half of 2018	4.9%	4.3%	2.6%	7.7%
Annualized*				
1 Year	12.3%	11.0%	21.8%	14.6%
3 Years	1.1%	-0.1%	11.4%	10.0%
5 Years	8.9%	7.5%	15.8%	14.1%
Since Inception†	13.4%	12.0%	14.5%	13.9%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{Max\ Fee}$	S&P 500	Russell 2000
1st Half of 2018	4.9%	4.3%	2.6%	7.7%
Annualized*				
1 Year	12.3%	11.0%	21.8%	14.6%
3 Years	1.1%	-0.1%	11.4%	10.0%
5 Years	8.9%	7.5%	15.8%	14.1%
10 Years	8.4%	7.0%	8.5%	8.7%

*Ending 12-31-17
†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.