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Tug of War

Monday, January 14, 2019

Dear Kopion Clients,

Kopion ended 2018 down 9.4% before fees (-10.2% after fees). This compared to the S&P 500 and the Russell 2000, which returned -4.4% and -11.0%, respectively. These results were a major reversal from the strong returns that we had enjoyed through the first nine months of the year.

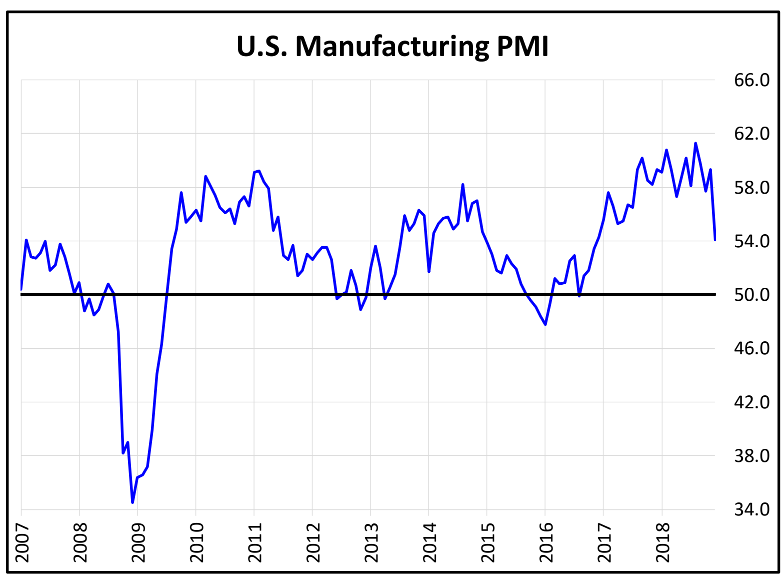
In order to understand this turnaround and provide the context for my 2019 outlook, I'd like to turn back the clock to early 2018. At that time, the global economy was gaining steam, but instead of being heartened, many investors were nervous about how much longer the stock market could continue to rise. This was a peculiar combination: encouraging data + widespread anxiety. The pairing was largely caused by the fact that the economy had not endured an official recession since the Financial Crisis. As mentioned in my prior letters, the economic recovery since the Crisis has been much slower than prior ones, and it was also punctuated by a mini-downturn in 2015 and 2016. Most commentators, however, have ignored those types of considerations and simply focused on the raw length of the expansion. Along with the economy, the stock market's recovery after the Crisis was also gradual and included setbacks of its own. For example, the S&P 500 experienced a 19.4% drawdown during 2011. None of the market's pullbacks, however, were deep enough to cross the -20.0% threshold that denotes an official bear market. Consequently, commentators repeatedly stated that the economic expansion and bull market had gone unabated for 8 years, even though that was only true in the most technical sense. They also cited impressive-sounding figures about how much the market had soared since its bottom in March 2009. Those particular figures ignored the fact that the prior bear market had been so ravaging that the S&P 500 had to increase 131% just to get back to its prior peak and that it took over five years to do so. Most of the market commentary was being framed in a way that begged the question, "How much longer can this go on?" This was important because the way that people frame an issue often has an enormous bearing on the conclusions that they will draw. I once heard an engineer explain that, "a problem properly framed is a problem half solved." The converse is also true: viewing an issue in the wrong way typically leads to incorrect or unhelpful conclusions.

The market thus entered 2018 predisposed to believe that a downturn was somewhere around the corner, and this produced a tug of war between widespread fears that the market would soon roll-over and the fact that corporate results were actually increasing nicely. The positive aspect of this tension is that it discouraged excessive risk-taking, which can often precede a large downturn. Unfortunately, it also meant that a large number of investors had their eye on the door and were prepared to leave at the slightest sign of trouble.

This tug of war continued over the first nine months of 2018. As of September 30, the “encouraging data” side was winning, which drove stock prices higher. At that point, the S&P 500 and the Russell 2000 had increased 10.6% and 11.5%, respectively. Kopion was doing even better and had returned 16.2% before fees (15.4% after fees). Our success was being driven by strong results at many of our companies and budding recoveries at some of the ones that had struggled and weighed on our performance in recent years. Our perseverance was finally being rewarded.

In October, however, the “widespread anxiety” side of the tug of war asserted itself strongly, as a few modest negative developments triggered a stampede out of the stock market. This produced a breathtaking pullback, and by the time the market reached its lowest point, the S&P 500 and Russell 2000 had plunged 19.8% and 27.2%, respectively, from their peaks. (Kopion’s decline from its peak was also 27.2%.) I want to point out that the S&P 500’s decline was still shy of the -20.0% that qualifies as a bear market, which means that we are still technically in a bull market. This is yet another example of how limited the strict definitions used by many commentators can be.

The market’s pullback felt especially violent within the context of the actual, fundamental data. My favorite leading economic indicator is the U.S. Manufacturing Purchasing Managers Index (PMI), and it illustrates this point quite well. This is a broad gauge of how manufacturers in the world’s leading economy are expanding their businesses through actions such as hiring and buying new equipment. PMI readings over 50.0 indicate expansion, and readings below 50.0 mean that manufacturers are pulling back. Said another way, the PMI shows whether manufacturers are investing to grow their businesses and by how much.



Over the last 50 years, the PMI has averaged 52.6. As shown by the chart on the right, beginning in late 2017, it up-shifted into the high-50’s and low-60’s for over a year. This was a relatively long period of strong growth. In December 2018, the PMI down-shifted to 54.1, which led to headlines such as “The First Economic Data From December Is In, and It Shows Trouble.”[1] That particular article focused on the fact that the PMI had fallen to a 15-month

[1] Sheetz, Michael, “The First Economic Data from December Is In, and It Shows Trouble,” CNBC.com, January 2, 2019.

low. This sounds ominous on the surface, but it misses important points. For example, prior readings were unusually strong, and 54.1 is still a good result that indicates manufacturers are expanding. Besides the PMI, there have been other indications that the economy is indeed slowing down—not shrinking, just slowing from 2018's fast pace. In my opinion, such a moderation is healthy since it will help prevent businesses and consumers from becoming overextended.

Focusing in on our portfolio, I have been very encouraged by the progress that our companies have made during 2018 as well as their outlooks for the next few years. Our firms have good long-term prospects, but the rate at which they make actual progress ebbs and flows. In recent years, we had quite a few firms that were making only modest progress or were even in the midst of setbacks. During 2018, however, I observed widespread improvement. In fact, as I worked through most of our firms' 3rd quarter earnings reports, I often scratched my head as to how so many of their stocks could be falling when they had so recently posted such good results. As of this writing, our portfolio has bounced up significantly from its lowest point, but it still remains well off of its high. I thus believe that this peculiar combination of good business fundamentals and much lower stock prices has made our portfolio very attractively valued. To be fair, it is possible that the economy could transition into an actual decline. Even if that occurs, however, our portfolio is currently low enough that it already reflects at least some portion of a potential economic downturn. Said another way, our stocks have already experienced a considerable decline even though it is too early to know whether that is warranted. Conversely, if an economic downturn fails to materialize, our portfolio now has even more up-side potential.

The economy will probably moderate in 2019, which is common after a spurt of strong growth, such as during 2018. Indeed, a moderation is even more likely against the backdrop of today's pessimistic headlines and the recent tumble in the stock market. Both of those factors could make corporate decision makers more cautious, which would lead to slower growth. This environment will certainly impact our companies, but I would be surprised if it is significant enough to derail the encouraging progress that they were reporting just two months ago. And just to reiterate, their stock prices already reflect the potential for a meaningful slowdown.

In summary, 2018 was a disappointing and enigmatic year. Our firms reported strong results and encouraging outlooks, but this was overwhelmed by what appears to be a classic stock market panic. I am thus cautiously optimistic about our portfolio in 2019 and excited about our companies' long-term prospects.

Thank you for your patience and support during this time.

Best regards,

Terry Ledbetter, Jr., CFA

Performance Disclosures

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-9.4%	-10.5%	-4.4%	-11.0%
3 Years	4.3%	3.0%	9.3%	7.4%
5 Years	-3.1%	-4.3%	8.5%	4.4%
Since Inception†	10.7%	9.3%	12.3%	10.9%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-9.4%	-10.5%	-4.4%	-11.0%
3 Years	4.3%	3.0%	9.3%	7.4%
5 Years	-3.1%	-4.3%	8.5%	4.4%
10 Years	12.9%	11.5%	13.1%	12.0%

*Ending 12-31-18
†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.