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Value Packing

Thursday, July 9, 2020

Dear Kopion Clients,

During the first half of 2020, Kopion returned -13.2% before fees (-13.7% after fees). This compared to the S&P 500 and the Russell 2000, which returned -3.1% and -13.0%, respectively.

What an unwelcome and unlikely turn of events we have all been living through! The Covid-19 pandemic is a complex development that can be discussed from many angles. I will focus, however, on how the pandemic has affected the stock market, how I have responded, and some thoughts for what to expect going forward.

This past spring, as it became clear that governments around the world would attempt to control the spread of the virus through widespread lock-downs, the stock market entered a sell-off that was historic in its depth and especially its speed. From mid-February to mid-March, the S&P 500 fell 33.9% in just 23 trading days. The only other declines of this magnitude that even come close in terms of speed occurred in 1987 when the index fell 33.2% in 38 trading days and 1929 when it fell 28.8% in 42 trading days.[1]

Much of Warren Buffett's wisdom is summarized by his admonition to "Be greedy when others are fearful and fearful when others are greedy." Market panics are emotionally painful, but they offer particularly attractive opportunities for being "greedy when others are fearful" for two reasons:

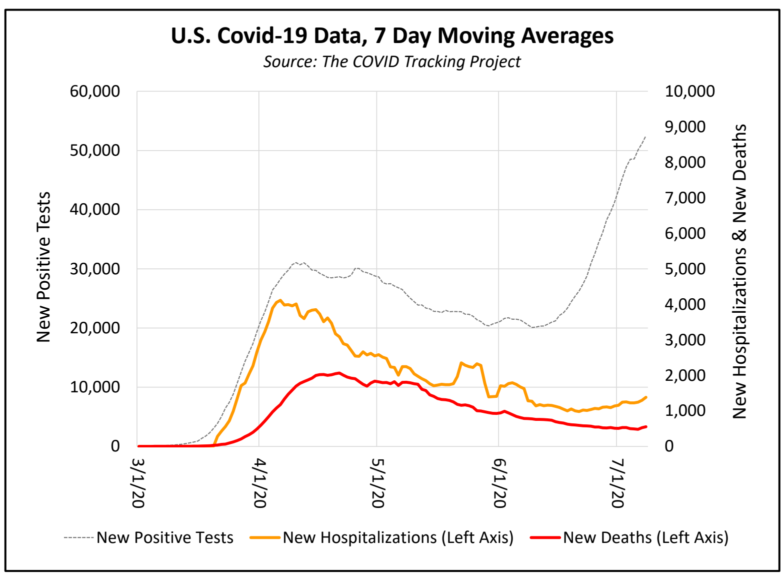
1. Stocks usually go "on sale" at deeper discounts than in a normal downturn.
2. Investors' collective risk perceptions become warped, which causes some stocks to fall much more relative to their intrinsic values than others. Almost every stock goes on sale, but some of the deals are exceptional. These dislocations provide tremendous opportunity for investors such as Kopion who have insight into these relative valuations and the discipline to execute trades accordingly.

In truth, Kopion always follows this strategy, with a goal to fill our portfolio with the best values that we can find. The pandemic, however, has been unique in terms of the number and quality of these opportunities. We have thus been unusually active in the market. I

[1] Ramkumar, Amrith, *Markets Melt Down at Fastest Pace Ever*, The Wall Street Journal., March 24, 2020.

have felt like a traveler who keeps making adjustments to his suitcase in order to pack it as densely as possible, except that instead of clothing, I've been packing deeply discounted stocks. Internally, we have thus referred to this process as "value packing." We have done this by trimming positions that held up relatively well compared to their intrinsic values and reinvesting the proceeds into other stocks whose prices had fallen dramatically and represented outstanding risk-reward propositions. This process was carried out assertively, but judiciously. For example, we deliberately spread these trades out over time in order to manage risk and avoid plowing into the cheaper stocks too early in the sell-off. This necessitated prioritizing the trades and being strategic about the order in which we executed them. The value packing process was also dynamic, as some of the stocks that we purchased earlier in the crisis rebounded sooner than we expected. These were only partial recoveries, but they still elevated those stocks to unacceptably large positions. We thus trimmed them and were able to reinvest those proceeds into other stocks that were further down the priority list and had yet to recover. I will not elaborate further, but my point is that while many other investment professionals were selling at low prices to run away from the tumult or counseling their clients to wait on the sidelines, we were deftly working our way across the battlefield and capitalizing on the best opportunities that I have seen since the Financial Crisis.

We thus finished the first half with a portfolio that is valued extremely attractively, and I believe we have some very good years ahead of us. That said, I also expect the path forward for the stock market to be a rocky one, even though I believe that the worst of this crisis is behind us. As shown by the chart[2] below, the number of Covid-19 positive tests has risen dramatically over the last month. This continues to provide a wellspring of sensational headlines for the press, but in our opinion, the testing data is fundamentally misleading. Many people with the virus have mild symptoms or none at all, leading to a large but unquantified number of cases that are clearly going undetected. This means that the true number of actual cases is *somewhere above* the dashed grey line on our chart. Policies are being made based on this testing data, but the reality is that we simply don't know how many people have been infected. The good news is that the more definitive and consequential metrics of new hospitalizations and new deaths



[2] We have used data from The COVID Tracking Project (www.covidtracking.com), taken on 7/9/20. We believe this to be the best data available, but even this information is not as straightforward as we would like. For example, the figures for New Hospitalizations on 5/1, 5/8, 5/26, 6/4 and New Deaths on 6/25 include "catch up" data for prior days. This distorts the trends by misrepresenting the timing of those hospitalizations and deaths. We have thus excluded those revisions from our moving averages in order to make the underlying trends clearer.

are rising much slower. Hospitalizations and deaths should lag positive tests, but even after adjusting for that lag, they are not rising with the number of positive tests as sharply as they did at the beginning of the crisis. There are several potential reasons for this, but I believe the most credible explanation is that the world is gaining a better understanding of who is at-risk, how to protect them, and how to treat them if they become infected. I thus expect the economy to continue reopening, but with fits and starts as government leaders grapple with confounding test data and balance the protection of lives with the protection of livelihoods.

In summary, we have an exceptionally value packed portfolio, and I am extremely encouraged by its long-term prospects. The way forward, however, will probably be turbulent and require additional perseverance. The late Irving Kahn spoke to this, saying, “The analyst must both practice, and to his client preach, patience.” This advice is timeless, but it is particularly fitting at this junction. Fortunately, we are not merely waiting, but we wait with hope.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{Max\ Fee}$	S&P 500	Russell 2000
1st Half of 2020	-13.2%	-13.7%	-3.1%	-13.0%
Annualized*				
1 Year	31.1%	29.6%	31.5%	25.5%
3 Years	10.1%	8.8%	15.3%	8.6%
5 Years	4.2%	2.9%	11.7%	8.2%
10 Years	10.9%	9.5%	13.6%	11.8%

*Ending 12-31-19

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 $_{Max\ Fee}$" 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.