Chairman's Commentary

July 2009

Dear Fellow Shareholder:

The S&P 500 Index was up 3.2% for the first six months of 2009 and the Funds performance was in-line with the market. While the returns do not look exciting, we are reminded of the analogy of a duck coasting across a pond. On the surface it doesn't look like much is happening, but below the duck is paddling furiously. The same can be said of the market and the economy. While the first six months seemed uneventful, we know they were anything but!

Following the difficult market in 2008, 2009 did not start any better. January and February of this year were disappointing; through February '09 the S&P 500 was down -19%. Widespread selling continued into the first week of March before it abruptly stopped for three reasons. First, investor sentiment hit "maximum pessimism." We could tell by the industry data on mutual fund money flows that investors were in total panic. Even a casual social encounter outside of the office turned into a discussion of "Where's the bottom?" Second, stock prices became totally disconnected from economic reality. In simple terms, they were cheap. Third, we began to read some encouraging economic news. The first piece of "good" news was that existing home sales were better than predicted. This was followed in quick succession by other pieces of economic news that were also better than expected. The combination of extremely low prices and economic news that indicated we were not falling into an abyss instilled some confidence and lit the proverbial fire under the stock market. Since the close on March 9th, the market is up more than 35% as of June 30, 2009. You may not realize it, but the quarter that just ended on June 30, 2009 was the best quarter in the market since the fourth quarter of 1998.

While we love to talk about stocks, we know from the recent questions you've posed that you are probably more interested in our view on the economy rather than individual securities. And our thoughts can be stated simply – the economy is not getting significantly worse. However, we cannot yet say with confidence that it is getting much better. We do believe that the free-fall we experienced after the collapse of Lehman Brothers in September 2008 has ended. This was due to the unprecedented actions of the Federal Reserve and the dynamic, natural market forces of the resilient United States. While all of us will differ in our feelings about the government's involvement in our economy – it was necessary. Many of the programs put forth by the Federal Reserve have been helpful and productive in buttressing our financial system. For example, the guarantee of money market funds and bank deposits, the TARP funding provided to banks, and the TALF facility for the securitization market have all proven very successful thus far.

We can say with relative certainty that the worst of the financial crisis is behind us, and we now turn our attention to a "regular old recession." Our look into the real economy is through the lens of American business. Every quarter we monitor the financial results of dozens of companies. In addition, we talk to the management teams of the companies we own. These discussions—and the related financial reports—tell us that the level of economic activity has stabilized. The economy dropped sharply in the fourth quarter of last year and, in our opinion, is now forming a new bottom from which growth can springboard into the future. Since the drop was so fast and so severe you probably will not see real evidence of growth until the fourth quarter of this year. One economic indicator that you might be watching that will not tell you when things are getting better is the unemployment rate. Improvement in unemployment is always a lagging indicator. In every recession since the 1970s the stock market has risen significantly **before** the unemployment number gets better. We expect the same this time.

While you may not be focused on individual stocks at this particular point, <u>we are</u>. We continue to meet face-to-face with management teams at the companies in which we invest your capital. We are also diligently analyzing company financial statements and detailed industry reports. None of this is new, but it remains our highest priority as it ensures that the companies in your portfolio are best suited to weather the current downturn. As we have articulated for the last year, our strategy is to "own the winners" coming out of this economic decline. Examples of these are the companies we own on your behalf that are competing against weak businesses or businesses that are impaired by debt. Since our companies do not have the financial pressure of excessive debt, they can focus on taking advantage of the hardships of competitors. In addition to a strong financial position at the company level, we believe the Funds are invested with some of the best managers in American business. For example, we would nominate the managements at Berkshire Hathaway, Donaldson, Markel, Knight Transportation, and John Wiley as the very best in their respective industries.

Our sense is that many members of the investing public are disillusioned about stocks. This is not surprising as investors in the broad market (as measured by the S&P 500) have earned -2.2% per year for the last decade. This return means that $100,000 invested on June 30, 1999 is now worth $80,055. The paltry return of the market is not a result of our country experiencing poor economic growth. Rather, the reason is that the prices investors paid for stocks were just too high. For example, on June 30, 1999 the market was valued at 27 times current year earnings. This is the highest price paid for stocks in the last twenty years. Some of the popular stocks of that decade were even more expensive. For example, General Electric, Microsoft, and Pfizer were valued at 36, 59, and 44 times earnings, respectively. These are extremely high valuations and it is virtually impossible to make a good return from these prices. The current market landscape is different. In today's market you can buy a diversified group of high-quality businesses at less than 14 times earnings.

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While the economy still has more ground to make up before fully recovering, we are more optimistic today due to the reported economic data over the last two quarters, the financial strength of your portfolio companies, and the recent rally in the stock market. We firmly believe that the combination of favorable stock prices and sound companies will create value and positive returns over time.

On behalf of the Research Team here at Fenimore, we thank you for your continued trust and confidence through this challenging period in financial history.

Sincerely,

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