



## Dear Fellow Equity-Income Fund Shareholder:

In this letter we would like to address three questions about the investment environment:

1. How did we get here?
2. Where are we now?
3. Where do we go from here?

Before diving into these questions we want to provide the usual update on performance for the first half of the year which will give some context to our commentary.

### First Half of 2009 in Review

For the six months ended June 30<sup>th</sup>, the Investor Class of the FAM Equity-Income Fund was up by +3.67%. The S&P 500 Index(+3.2%), and the Russell 2000 Index (+2.6%), both recorded a gain over the same period. The market is beginning to recover from the crash last fall and is significantly higher than the low set on March 9<sup>th</sup> of this year.

During the first half of the year we initiated positions in two new holdings and added to several others. Since we went into the downturn with a sizeable cash balance we were able to take advantage of attractive prices during the market's retreat.

### How did we get here?

Over the last several years the lending standards of financial institutions declined. The prime example is home mortgages. In the old days, a prospective homeowner had to put 20% down on the house and then could borrow the remaining 80%. This changed in the late '90s where the prospective homeowner could get a home equity loan for 15% or even 20% in some cases. The buyer no longer had to come up with a down payment. Why would the banks do this? They assumed that home prices always go up so the collateral was getting more valuable over time. Effectively, the bank was lending against the asset, not the borrower. This devolved further with "no-doc loans," commonly called "liar loans," where the borrower did not have to show any proof of income. This ultimately led to millions of people buying homes who could not really afford them.

Once the economy started to weaken the housing market began to unravel. Prices started to decline and the mortgage securities that were sold to investors as "AAA investments" started seeing defaults. Once investors realized that these mortgage-backed securities were riskier than they thought, they started dumping them on the market which further collapsed the prices. Several



hedge funds had difficulty meeting redemptions and were forced to close. These assets were quickly considered toxic and brought into question the viability of any institution that held them on their balance sheet. The problem was that the market had grown so large for these securities that nearly every financial institution had some on their balance sheets. This led to a far-reaching liquidity crunch because financial institutions would not lend to other financial institutions because they were afraid they would not get paid back. Since the free flow of money through our financial system is like the blood flowing through our veins, once the distrust on Wall Street peaked and all short-term lending stopped, the economy seized up.

The worries started with sub-prime mortgage securities but ended up affecting all debt securities. This forced the consolidation of many of the largest investment banks and the liquidation of others. Because the problem was so large and the government couldn't rescue every bank, one of them had to fail. Lehman Brothers failed in mid September 2008. This sent shock waves through the system and led the economy to a screeching halt. The commercial paper market dried up and auction rate securities no longer had an active market. We even saw a money market mutual fund "break the buck", the standard price per share, which nearly prompted a run on the entire banking system had the Federal Reserve not stepped in to temporarily guarantee them. This was one of the scariest moments on Wall Street. Thankfully, though, due to swift action by the Federal Reserve and the Treasury Department, the downward spiral was stopped.

As all these events unfolded in the credit markets, the stock market was also taking its lumps. After Lehman Brothers filed for bankruptcy, the stock market sold off. The decline was led by financial stocks, but no sector was immune. Once the decline started, investors ran for the exits. The faster the market fell, the more people wanted to get out. This prompted forced selling by mutual funds to meet investor redemptions as well as margin calls to corporate CEOs who borrowed money to invest in the stock of their own company. Forced selling means that shares of stock were sold not because people wanted to sell, but because they *had* to sell. This resulted in severe price declines in stocks which drove valuations down to unprecedented levels. The bottom line is that panic is what brought the market down to its lowest levels.

Despite our deliberate actions to avoid the risky sub-prime mortgage market, we were not able to avoid the near collapse of the financial system and the resulting decline in stocks. We own companies that have exceptional financial strength and durable competitive advantages, but they were not spared. The market prices of companies in the Fund were quickly taken down along with the market.



### Where are we now?

We think the worst of the recession is behind us. Certain economic indicators have stopped declining and we see some stabilization. The National Bureau of Economic Research, the private body charged with determining the onset of a recession as well as its endpoint, stated that the current recession started in December of 2007. This means we are now 19 months into the recession. The Bureau research also indicates that since 1919 there have been 28 recessions, with the average recession lasting 13 months and the worst of those being the Great Depression which lasted 43 months. We do think that this period is more severe than the typical recession, so let's say it will be twice as long as the average or 26 months. This rudimentary estimate also lines up with the consensus forecast of economic growth resuming in the third quarter of this year.

As for the financial system, the markets have stabilized and rebounded dramatically off their lows. Financial institutions have been able to shore up their balance sheets by selling stock in the open market as investors were willing to purchase the stock. This is a huge sign of investor confidence in these institutions. Note that this was private capital looking for attractive investment returns – it was not government bailout money. One of the reasons the financial institutions were selling stock was to pay back the government. This is a good thing.

We also see positive things happening on the consumer front. Consumers are deleveraging by paying down credit cards and refinancing mortgages to lower interest rates. Consumer confidence has improved significantly and is almost back to the levels of last summer. Since consumer spending is two-thirds of our economy, it's important that this number has improved.

Finally, we see signs that housing is bottoming. Both the California and Florida Association of Realtors reports showed home prices in California and Florida increased in the month of May. While there are many markets still to turn, California and Florida are ground zero for the housing market. Additionally, the Housing Affordability Index is at all-time high levels, especially for first time buyers.

As for the Fund, we are sticking with our strategy of owning companies with compelling long-term economics, strong fundamentals, with little or no debt. We like companies that generate more cash than they need and don't have to raise money in order to fund their growth; we call this strategy "Own the Winners." Additionally we took advantage of the opportunity to put cash to work at attractive valuations and we still have cash at the ready to purchase other opportunities as



they come along. In other words, we are well prepared. The Fund's performance recovered along with the market; in fact, the second quarter of 2009 was the best performance quarter in the Fund's 13 years. That was a nice surprise after the magnitude of the decline in the market.

### Where are we going?

The economy will grow again. We expect that 2010 will show positive Gross Domestic Product (GDP) growth. Much of the growth will be from easy comparisons against 2009. Longer term, we believe that nominal GDP growth will likely be below what we saw over the last 20 years which averaged 5.3%, or 2.7% after inflation. Inflation will likely be higher than in the past, but not out of control. It's hard to have high levels of inflation with low capacity utilization and high unemployment.

We expect equity returns going forward will be mid to high single digit. While this is below the high teens returns of the 1980s and 1990s, it's well ahead of the dismal returns of the last decade where the S&P 500 lost -20.1% of its value and annualized at -2.2%.

The rough calculus behind our **assumptions** follows:

- If GDP grows at 2% the companies in the Fund should be able to grow revenues at twice the rate of GDP growth, or at 4%, because they can acquire other companies and grow internationally as well.
- Since they have cut expenses through this downturn they will emerge more profitable once revenues start growing again. This means that earnings should grow faster than revenues. Thus, we could see 6% earnings growth.
- We should also see an increase in valuations as the world economy stabilizes and starts growing again. That may get us to an 8% return for equities.

If our **assumptions** come true, it will be a wonderful investment environment. Some of the excesses of the last 20 years have been wrung out of the system; consumers and businesses are now behaving responsibly, and strict lending standards at banks are back. With these positive dynamics, equity returns should be well above all competing alternatives. Remember, we are starting from historically low valuations.



### Best and Worst performers in the period

The best performing company in the portfolio was Meredith Corp. which gained +52% in the first half of the year contributing \$1.3 million to the value of the Fund. The company was hard hit last year as advertising budgets shrank which reduced their revenue and profitability. This was an industrywide phenomenon and not confined to Meredith. Meredith was the worst performing company in the Fund last year and we said in the annual report that we expected advertising rates to improve in a better economy. We are getting closer to a better economy and investors realized that the stock was too cheap last year.

Ross Stores was the next best performing stock in the portfolio gaining +30.6% in the period and contributing \$0.926 million to the value of the Fund. Ross is a discount retailer which is benefitting from consumers aggressively seeking bargains. Same store sales for the company have been up nicely over the strong results last year. Management has also raised guidance for the year and now expects to grow earnings 15% for the full year. That is amazing performance for a retailer in the worst retail climate of the last 50 years. Ross is one of the largest holdings in the Fund and we took the opportunity to trim the position when the stock was trading near its all-time high.

The worst performing company in the Fund was General Electric, which declined in value by -25% over the period, but only hurt the value of the Fund by \$0.557 million since it was a small position. Earnings are expected to be down significantly this year and possibly next year as well. The stock has been punished because the earnings performance is worse than the market overall and the dividend was cut to conserve cash.

The second worst performing company for the period was McGrath Rentcorp which declined -8.8% and affected the value of the Fund by \$0.413 million. This company is being penalized because the California fiscal condition is in shambles. McGrath's primary business is renting modular classrooms. Their largest market is California although they also have a large presence in Texas and are growing Florida and the Mid-Atlantic states. We added to our position since the company was trading well below net rental assets, which has historically been a good price to buy shares of this company. The balance sheet has only a modest amount of leverage and management can sell rental assets to raise cash in a pinch. We believe the management team of McGrath is very good.



## A few final thoughts

This has been a challenging environment. It's difficult to keep emotions in check and look at investments dispassionately. However, all the great investors including Sir John Templeton, Warren Buffett, and Peter Lynch give the same advice - have a plan and stick to it. We are sticking with our time-tested strategy of owning businesses that are conservatively managed.

We look at the Fund as a collection of businesses, not stocks. These businesses will generate free cash flow this year, which we expect will grow over time. We talk to the managements of our companies regularly and they tell us they are aggressively looking for opportunities where competitors have had to scale back or exit the market altogether because of financial difficulties.

In terms of the macro environment, we believe the darkest days are behind us. That is not to say that the market cannot give back some of the ground that we made up in the second quarter. Though the market may remain volatile, our outlook for the next twelve months is better than the last twelve, and our outlook for the twelve months after that is even better!

We are working diligently on your behalf. We appreciate your continued support.

Sincerely,

Paul C. Hogan, CFA  
Co-Manager

Thomas O. Putnam  
Co-Manager

### Average Annual Total Returns as of June 30, 2009

	1-Year	3-Year	5-Year	10-Year	Life of Fund (4/1/96)
<b>FAM Equity-Income Fund</b>					
(Investor Shares)	-19.87%	-8.67%	-2.67%	3.38%	5.75%
(Advisor Shares)*	-20.85%	-9.62%	-3.65%	N/A	*
S&P 500 Index	-26.15%	-8.23%	-2.25%	-2.24%	8.57%
Russell 2000 Index	-25.01%	-9.89%	-1.71%	2.38%	7.71%

\*FAM Equity-Income Fund Advisor Shares were launched on July 1, 2003. The return since inception is -1.56%

The graph and performance table do not reflect the deduction of taxes that a shareholder would pay on Fund distributions or the redemption of Fund shares. This information represents past performance of the FAM Equity-Income Fund and is not indicative of future results.