



FENIMORE
Asset Management, Inc.

MANAGER OF THE FAM FUNDS

384 North Grand Street, PO Box 310

Cobleskill, New York 12043

(800) 721-5391

www.fenimoreasset.com

Client Gathering: May 5, 2010 **Q&A – Research Team**

Q1: Medicare and Social Security are bankrupt. How is the government going to bail them out when it is so debt-laden?

A: John Fox – The bigger picture is that we had an economic collapse and the only way to forestall that collapse was to have the government insert itself into the situation. This includes the Federal Government, Federal Reserve, and all of the things we've been talking about over the last couple of years with TARP, low interest rates, money fund guarantees, etcetera. Consequently, our deficit went from small, reasonable, and manageable to very large and overwhelming. Typically in a recession tax revenues go down and government spending goes up because people are on unemployment, food stamps, and other types of services. So what we think will happen is that the flywheel of the economy, which we see getting better, will get going. That will reduce government spending to some extent. It will increase tax revenues because more people are going to be working and the numbers that just look insurmountable right now will get better. The other part to the answer is that we won't receive Social Security and we'll be paying for our Medicare in the future. So we think as the economy improves things will continue to look better, but the "rich" will not be getting these benefits from the government.

Q2: Can you explain in simple terms: What is the SEC doing to Goldman Sachs? What did sub-prime mortgages do to the economy? What is Warren Buffett's defense for Goldman Sachs?

A: Tom Putnam – Those are all very tough questions. I think we have to separate what the investment banking world is all about from what's going on with the SEC. Investment banking is a transaction process; they create products. In this case Goldman Sachs, and other Wall Street investment banks, created collateralized debt obligations known as securitized mortgages. They sold these products and were also on the other side of the transaction with their involvement in credit default swaps on these particular types of mortgage securities. Their job was to find buyers for each of these products. That's what Goldman did. In this particular case they may have had help from John Paulson who is a big hedge fund investor. In this basket of mortgages they selected a large amount of sub-prime mortgages; sub-primes are bad mortgages, especially if housing prices start to go down because people don't have much collateral in the mortgages so they can let them go. They created this basket, sold it, and a big bank had an arm that was an insurance company that guaranteed the mortgages. When the mortgages went bust as the housing prices started to decline, the bank was the guarantor and since the mortgages were worthless, their insurance company had to pay. And that's the essence of the transaction. Now I can't speak for the SEC's case, whether it's a good case or a bad case, or whether there was fraud involved.

John Fox – After the crash of 1929, they put the Chairman of the New York Stock Exchange in jail and the CEO of the largest bank in Cleveland, which was the precursor to Citigroup, so this is a normal part of the cycle.

Tom Putnam – Charlie Munger, who is Warren's Vice Chairman, had a statement in the *Wall Street Journal* last Friday which I thought was pretty straight on. I can't quote it exactly, but he said he thought there probably wasn't anything illegal about the transaction, but that the whole investment banking industry had lost their moral moorings. So it is a question of whether they were skirting the edge of something that they

perhaps shouldn't have even gotten near. But when investment bankers and brokers are in the thick of these things with a product that is in high demand, then they'll sell just about anything sometimes.

Eric Elbell – As I understand Buffett's position it comes down to a term that some of you may be familiar with, and that is the Latin term "caveat emptor" which translated means "let the buyer beware." I think that's where Buffett's defense of the transaction comes into play. Actually, it should come into play in any financial transaction or investment. That is what we do at Fenimore every day and why we are all employed. Before we invest in a business we feel that we need to do our homework to understand it fully. We need to understand the side of trade that we are taking and that's what I think Buffett's argument is. These were two adult parties; each party should have had their eyes wide open going into the transaction. Again, whether Goldman's actions were socially acceptable or not, I don't know.

Q3: How are we going to get true reform without dealing with Fannie Mae and Freddie Mac?

Andrew Boord – We are not dealing with Fannie and Freddie. Congress has failed to point out that they are responsible for a huge portion of the mess. As a society we have to determine if we want everyone to have a cheaper mortgage by having the government write most of the mortgages in our country which they are today through the FHA with Fannie or Freddie. If the government is going to keep mortgage rates lower than they otherwise would be, then that probably instills some misallocation of capital and probably some losses over time. As a shameless free-market person, I think it is a horrible idea.

John Fox – I agree — we are not going to deal with Fannie and Freddie. They are 95% of the mortgage market in this country. They do serve a purpose in that a thirty-year fixed rate mortgage is not a terrific loan for a bank to make. There is a potential of what happened in 1990 and 1991 that if I loan Tom money at 5% for thirty years, which I think is about the current price, and short-term rates go to 6%, then I'm now insolvent as a bank because I'm paying my depositors more than they are paying me. It does provide liquidity for the mortgage market and that helps the banking system. Obviously they pushed the envelope too far, but our housing market needs them to complete transactions — 95% of all mortgages written today are backed by Fannie and Freddie. So they are here to stay.

Q4: Will you please explain derivatives?

Tom Putnam – Derivatives are a bad word and Buffett has called them "products of mass destruction." That is primarily true and the result of the financial crisis indicates that. But a derivative contract could be a futures contract which has a totally different meaning. For example, if you are a farmer growing corn and you put the seed in the ground now, and you are not going to harvest it for months, you may think that the price of corn today is pretty good. As a result, you are going to lock in at that price by buying a futures contract — that is a proper use of a derivatives contract. It takes some of the risk out of it. Now the price of corn at harvest may be higher than what the farmer locked in at, so somebody else gains from the contract. This happens in energy and a lot of industries throughout our country; these are appropriate derivatives contracts. But when you get into the investment and financial worlds, there are all kinds of derivatives just like the credit default swaps where people are purely speculative and don't make proper use of these contracts. Whether all those are appropriate is another question which I can't answer. The opaqueness of some of these derivatives did create problems during the financial crisis.

Q5: Aside from the example that was given of Bed Bath & Beyond, how do you account for growth in the retail companies in which Fenimore is invested during the economic downturn?

Eric Elbell – The way that Ross Stores did it is that the consumer could go to Macy's and buy a sweater or to Ross Stores and buy that same sweater, but for 40% less. So Macy's lost a lot of customers through the downturn because the customer needed a bargain. Consumers liked to find that bargain before, but during the recession they really had to find it so they went to Ross Stores — Ross grew through this whole period. Ross' same-store sales were very, very strong through the period and they build a certain number of new stores each year. If for example Ross can get 6% growth through new stores and same-store sales are maybe 2%, then that is 8% revenue growth. As the company gets bigger they get a little more profitable so maybe their bottom line grows by 10%. And because they are so profitable, they buy back shares every

year and they are buying back let's say at least 2%, so now that 10% net income because they are buying back 2%, becomes 12% earnings per share. So that is how they did it and margins went through the roof with all the volume that they saw.

For those that are not familiar with same-store sales, basically it is the growth rate for a retailer if you exclude the growth they gained by opening new stores, so it is a core growth rate. The retail businesses we invest in still suffered a small decline, except for Ross, but because they were so profitable on the balance sheet, they were still able to get through this period and come out the other end in good shape.

Tom Putnam – And the consumer didn't stop buying, the consumer just got smarter. So thank you for getting smarter and keep it up!

Paul Hogan – Last year the consumer retrenched a little bit with everything going on in the economy and what they saw in the media so people probably weren't going out and spending a lot. More recently, retail sales have jumped and it has been much more broad-based. My theory is that tax refunds are up about 10% this year so the consumer is spending and feeling better about the economy.