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Value Investor INSIGHT

The Leading Authority on Value Investing

Down to Business

Staying out of trouble isn't the most exhilarating investment stance, especially in bull markets, but it's one that has certainly served John Fox well over time.

INVESTOR INSIGHT

John Fox
Fenimore Asset Management

Investment Focus: Seeks value-compounding businesses to hold long-term when short-term stress in the overall market or their particular industry creates bargains.

It's no coincidence that Fenimore Asset Management "takes the perspective of the long-term business person over the short-term trader," says John Fox. The upstate New York firm was founded in 1974 by Thomas Putnam to run his family's money after the successful sale of its long-held textile company. "It's always been business-first approach," says Fox, Fenimore's chief investment officer.

Fox has proven a worthy steward of the strategy. The FAM Value Fund he has co-managed since 2000, with Tom Putnam, has earned a net annualized 8.4%, versus 3.8% for the S&P 500. More active than usual due to recent volatility, he's finding value today in such areas as physician networks, used cars, commercial real estate and regional banking.

Inside this Issue

Investor Insight: John Fox

John Fox of Fenimore Asset Management explains why he doesn't believe investing in quality is a crowded trade, what about his buy-and-hold strategy may need rethinking, why he owns a number of money managers, why he owns more Markel than Berkshire Hathaway, and why he sees upside in Mednax, CarMax, FRP Holdings and South State Corp.

Maybe it's just the people we speak with, but it seems like almost everyone these days leads with how they only invest in high-quality companies. You're no exception. Is there a risk that's a crowded trade?

John Fox: I think it is who you're speaking with, because we don't think it's the case that everyone is looking for quality. Eighteen months ago we did a comprehensive study of what had worked in the market from late 2007 through mid-2014. In it we defined quality according to four financial metrics, return on equity, total debt as a percentage of equity, EBITDA margin, and cash flow from operations as a percentage of capital spending. Using those metrics for the components of the Russell 2000, Russell Midcap and S&P 500 indexes (excluding financials), we ranked the stocks based on quality, following obvious principles like a higher return on equity or EBITDA margin is better than a lower one, or a lower debt/equity ratio is better than a higher debt/equity ratio.

We then separated that ranking into quartiles and looked at how the stocks in each performed over time. The results were quite clear. During the bear-market phase from late 2007 through the first quarter of 2009, the highest-quality quartile outperformed in each index. During the bull market measured from March 2009 through June 2014, the stocks in the lowest-quality quartile outperformed by a large measure, regardless of market cap. In the S&P 500, for example, the lowest-quality stocks rose an average 278%, while the highest-quality stocks were up 196%. So as a general rule, quality doesn't appear to be a universal focus.

In our case, we focus on good businesses we understand because it makes everything easier. A company earning good returns and high margins and generating cash has things going for it that give you confidence it can compound value over time. Such businesses with strong balance sheets are likely to do much better in down markets. All that means as an investor is you can hold for a long time and are less likely to get scared out of the market when times are bad. That makes much more sense to us than trading in and out and trying to time the market.

Describe a classic example or two of companies that attract you.

JF: A company we've had in the portfolio since 1991 is Brown & Brown [BRO], an insurance-agency business that has grown from one agency headquartered in Daytona Beach, Florida to a national player selling multiple insurance lines in more than 30 states. We put a lot of emphasis on management, and Hyatt Brown is a dynamic, charismatic leader who ran the business for more than 50 years before turning it over to his eldest son in 2009. It's a relatively simple business with operating margins in excess of 30%, and that generates tremendous free cash flow that has been reinvested in acquisitions and organic growth and, more so recently, returned to shareholders. Last year cash flow from operations was about $400 million and capital expenditures to keep it going were around $20 million. With the right management, good things tend to happen in such cases for shareholders.

Markel [MKL], the insurer, is another long-time holding. We like the industry and believe the management team is first-rate, with excellent integrity and a long and successful track record as capital allocators. That manifests itself in many ways, but one would be how they pay themselves, with corporate executives' incentive pay primarily tied to growth in book value per share, and underwriters paid based on profitability, not volume. When we find a management team this good we expect to invest in them for a long time.

We see you own a bigger stake in Markel than another long-time holding, Berkshire Hathaway. Why?

JF: The compounding characteristics are relatively similar, although Markel is more of a pure insurance company. The insurance operation is the primary source of profit and book-value growth, which has been enhanced over time through returns on the large equity portfolio managed by Tom Gayner. Five years ago they also started making control investments in non-insurance operating companies, although that piece of the business isn't nearly as prominent as it is at Berkshire.

Based purely on valuation, we think Berkshire today is a bit cheaper than Markel. Why it's not a bigger position probably has the most to do with the age of the CEO. Rightly or wrongly, there's a good chance that when Warren Buffett is no longer in charge, for at least a short period that will have a negative impact on the stock. We'd rather not be overly exposed to that.

Where do you tend to look for ideas?

JF: The short answer is everywhere, but it helps that we know what we're looking for. If it's levered, not generating cash or in a business we don't understand, we can eliminate it pretty quickly.

We screen on a combination of quality – pretty much as we defined it in the study I mentioned earlier – and valuation. We look at what's down 30% or more from 52-week highs. We look at what other people we respect own. We read a lot and go to conferences. We track things like spinoffs, restructurings and reorganizations. There's always something going on in an industry or at individual companies that is worth looking into. I imagine all this is relatively consistent with what other value investors do.

What's your take today on energy?

JF: We're traditionally slow to invest in energy companies, given that the cash generated from operations in any given year often doesn't cover what has to be put back into capital spending just to keep production flat. When we do invest, it tends to be in exploration and production companies that focus on return on capital rather than growth, which eliminates most of the industry. EOG Resources [EOG] is one that does fit that profile, and we've done well with in the past and continue to own it.

Are you by chance looking at Silver Run Acquisition [SRAQU]?

[*Editor's Note:* Silver Run raised $500 million last month to invest in beaten-down oil and gas assets and is headed by Mark Papa, who is credited with EOG's considerable success. Offered at $10, the shares now trade at $10.45.]

JF: We are following it, yes. He did an exceptional job building EOG after it separated from Enron in 1999. I don't know if it's something we'd buy prior to their actually putting money to work, but it is a stock we're keeping an eye on, for sure.

We have put some money to work in industrials whose fortunes are tied to energy. An example is Franklin Electric [FELE], which sounds like a utility but is a leading manufacturer of water- and fuel-pumping systems. Its profitability and returns on capital over time have been excellent, but the shares fell fairly sharply last summer and again late in the year due to exposure to the oil-and-gas industry. Cash from operations last year was around $100 million, against which it had only $26 million in capital expenditures. The stock has come back a bit, but this falls for us in the category of investing in an excellent company at a weak part of the cycle.

Are any other sectors on your idea radar?

JF: We have invested recently in a few real estate investment trusts, but I wouldn't call those sector bets. We were introduced to one, Retail Opportunity Investments [ROIC], at a conference last June where we heard a presentation from the CEO, Stuart Tanz, that just resonated with us. He has been involved with West Coast real estate for 30 years, including building Pan Pacific Retail Properties, which owned shopping centers with grocery-store anchors and was sold at the exactly the right time to Kimco Realty in 2006. He's doing the same thing with ROIC, focused on urban areas in the west including L.A., San Francisco, Portland and Seattle. These are markets where new development is limited so rent growth is strong. We also expect the company to build value over time through acquisition. When the stock traded off in the latter half of last year along with most REITs, we took advantage.

ON BUYING AND HOLDING:

Our turnover over time averages 10% per year. Some years people ask me what I'm doing all day.

Describe your buy discipline.

JF: We arrive at a fair value for every stock, typically using a discounted cash flow analysis that assumes discount rates no lower than 8%. When something trades at a discount to fair value, we also look carefully at how the current valuation metrics compare to historical levels. If we can buy something at a 15-20% discount, say, earnings are growing at 6-7% per year and the stock trades in the bottom quintile of its historical valuation, if we're close on our analysis that math typically works out pretty well for us.

You're more of a buy-and-hold investor than many we speak with today. Describe the basic rationale for that.

JF: Our turnover over time averages 10% per year. The highest I can remember was around 18%, with the low closer to 5%. Some years people ask me what I'm doing all day.

The rationale is simple. Selling is harder than buying, so we love to find well-managed companies with attractive businesses when their stocks are undervalued and then let management compound value over time.

In cases where we've basically gotten the business right, we have identified red flags that can signal that it's time to exit. A stock hitting 125% of our estimate of fair value, for example, is a clear danger sign. Another is one up 50% or more in less that two years, especially when the increase comes more from a higher valuation than increased earnings. These are all triggers for us to revisit the thesis and valuation and we'll typically start trimming and then get out completely.

In cases where we've gotten the business wrong, we work hard to create an environment where mistakes aren't swept under the rug but are surfaced and examined right away. Part of working as a team is trying to help each other, not tear each other down when things go wrong. Address the issue, learn from it and move on.

What's a recent example in which you had to do that?

JF: We had taken a position in Fossil [FOSL], the watch and accessories maker, after its stock had fallen roughly 50% from its high and we thought market concerns about the competitive threat from wearables like the Apple Watch and Fitbit were being overdone. The company seemed to generate a lot of cash earnings and we expected it to continue to do so with its traditional business. But then they announced the $260 million purchase of Misfit, a maker of Internet-connected watches and devices, which didn't instill confidence about the traditional watch business. We also were so far off in our earnings expectations given Fossil's latest earnings results that we had to cut sharply our estimate of intrinsic value. The stock fell below our cost and we took our loss late last year.

Describe your bull case for healthcare-services provider Mednax [MD].

JF: The company was started by a physician who is still the CEO, Roger Medel, to run neonatal intensive-care units at hospitals. There are four million babies born annually in the U.S. and 11% of them need some type of special neonatal care. With babies born 365 days a year and 24 hours a day, hospitals need doctors available at all times with specialized expertise in treating newborns. To do that, they frequently outsource the care to a local doctor group with that expertise.

Mednax has grown successfully over the years by acquiring these specialized doctor groups, touting the fact that it is a physician-led company that takes away much of the burden of dealing with insurance companies and hospital administrators. Over time it has also built a highly valuable database of clinical outcomes that helps its doctors develop best practices and addresses new regulation focused on improving the quality of outcomes through data. That's all part of the value proposition to individual doctor groups.

Several years ago the company decided it needed a second growth platform and pursued a similar strategy in acquiring local groups of anesthesiologists who had comparable relationships with hospitals. While the margins aren't quite as high, this business has grown well but still has plenty of green field ahead. To give you a sense of the potential, there are about 5,300 doctors practicing in hospital neonatal intensive-care units, 1,100 of which work for Mednax. On the anesthesiology side there are more than 50,000 doctors, only 1,150 of which work for Mednax.

The company has added a third growth leg. Last year it paid $500 million for vRad, which provides virtual radiology services to hospitals. It gets a foot in the door providing off-hour services to emergency rooms, say, who can send x-rays, MRIs or other images at 2 a.m. to be read by vRad radiologists who participate in real time in the treatment. Once a relationship is established, the company looks to expand it and provide services full time.

We've talked about the importance of companies generating free cash flow, having management that allocates it well, and having reinvestment opportunities for growth. All of those are present and accounted for in Mednax. Cash from operations was $369 million last year, with capex spending only $27 million.

What would make something like this attractively priced?

JF: The primary rap on the company appears to be a perceived decline – which we don't believe is permanent – in its organic growth rate, from 3-4% to closer to 2%. We think the bigger issue has been the recent negativity around healthcare stocks after a very strong run. There are high-profile issues around drug pricing. Hospital stocks have pulled back as the exuberance around the Affordable Care Act has subsided. Mednax shares just seemed to have been pulled down with the rest.

Now trading at just over $65, how are you valuing the shares?

JF: The stock trades at about 15x consensus earnings estimates for this year. This is

INVESTMENT SNAPSHOT

Mednax
(NYSE: MD)

Business: Provider of newborn, maternal-fetal, pediatric, anesthesia and radiological healthcare services through a network of specialist physicians in the United States.

Share Information (@3/30/16):

Price	**65.34**
52-Week Range	61.40 – 86.09
Dividend Yield	0.0%
Market Cap	$6.00 billion

Financials (TTM):

Revenue	$2.78 billion
Operating Profit Margin	20.1%
Net Profit Margin	12.1%

Valuation Metrics
(@3/30/16):

	MD	S&P 500
P/E (TTM)	18.2	23.5
Forward P/E (Est.)	15.2	17.5

Largest Institutional Owners
(@12/31/15):

Company	% Owned
T. Rowe Price	7.9%
Vanguard Group	7.1%
BlackRock	6.7%
Clifton Park Capital	4.3%
William Blair Inv Mgmt	3.8%

Short Interest (as of 3/15/16):

Shares Short/Float	8.4%

MD PRICE HISTORY

THE BOTTOM LINE

John Fox believes the company's shares reflect concerns about its organic growth and about healthcare profitability overall that aren't warranted. From earnings growth, the closing of the discount to his fair-value estimate and modest multiple expansion, he expects to earn low- to mid-double-digit annual returns on the stock from today's level.

Sources: Company reports, other publicly available information

a case like I mentioned earlier where we think we're buying at a discount to current fair value, the shares trade at the low end of their historical valuation, and we believe earnings can grow nicely from here.

Assuming 3% organic revenue growth, 5% annual growth from acquisitions – which we consider conservative – and flat margins, we arrive at a discounted-cash-flow fair value estimate of around $70 per share. So the current discount isn't that high, but with earnings growth that we expect to be closer to 10% annually and some expansion in the multiple as the growth story plays out, we'll have a perfectly acceptable return over the next few years. It will be even better if the radiology business thrives, which we haven't really included in our estimates.

Your next idea, CarMax [KMX], seems to have consistent value-investor interest but goes out of favor from time to time in the market. Explain your view on it today.

JF: You likely know the background: the company was started as a division of Circuit City, the big-box retailer, as it was dreaming up other concepts to which it could apply the big-box concept. The value proposition from the beginning was to offer unsurpassed inventory, certified to meet high quality standards, sold at fixed prices with no haggling, and with transparent financing. From one store in Richmond, Virginia there are now nearly 160 across the country and counting.

The company still has considerable growth upside in rolling out new stores in unpenetrated markets. There are 40 million-plus used cars sold every year – vs. 17 to 18 million new – and CarMax sells about 600,000. They don't talk about an ultimate goal, but have said they plan to open 13-16 new stores per year. If they keep that up, the store base would be 50% bigger in the next five or six years.

One could argue that the competition has yet to slow CarMax down. Why is that?

JF: Number one, it's a big market, so there's plenty of room to grow even with strong competition. Number two, leopards don't change their spots. The typical car dealer is so used to doing business the way it always has that real change comes very slowly. I just bought a new car, from a good dealership, but even there it was a runaround and reinforced for me how unpleasant it is to buy a car. Finally, CarMax continues to build its information advantage. It has a time series of data unmatched by the competition, which gives it an edge in what it pays for cars, how it prices, how it promotes and how it manages inventory. If gas prices go up 50 cents and the season changes from summer to fall, they know how that impacts demand for SUVs in a particular zip code. I think that's a huge advantage.

It's not that other players in the business like Asbury Automotive, Sonic Automotive or Lithia Motors haven't been trying, but the evidence to date is that CarMax has carved out a defendable niche.

With all these positives, the shares are off 33% from their 52-week high and short interest is 16% of the float. Why?

JF: There are a couple primary issues. One is that a surge in the number of off-lease

INVESTMENT SNAPSHOT

CarMax
(NYSE: KMX)

Business: Acquires, sells, finances and services used cars through nearly 160 retail superstores located in the United States; known for its unique "no-haggle" sales process.

Share Information (@3/30/16):

Price	**50.81**
52-Week Range	41.25 – 75.40
Dividend Yield	0.0%
Market Cap	$9.94 billion

Financials (TTM):

Revenue	$14.96 billion
Operating Profit Margin	7.0%
Net Profit Margin	4.2%

Valuation Metrics
(@3/30/16):

	KMX	S&P 500
P/E (TTM)	17.0	23.5
Forward P/E (Est.)	15.1	17.5

Largest Institutional Owners
(@12/31/15):

Company	% Owned
T. Rowe Price	14.5%
Vanguard Group	8.7%
Primecap Mgmt	7.0%
Baillie Gifford & Co	4.7%
Davis Adv	4.6%

Short Interest (as of 3/15/16):

Shares Short/Float	16.0%

KMX PRICE HISTORY

THE BOTTOM LINE

While its shares at times go out of favor for near-term reasons such as trends in the number of off-lease vehicles and concerns over the auto-financing credit cycle, John Fox argues that the company's long-term growth prospects are fully intact and that its stock from today's level can generate solid double-digit annual returns for some time to come.

Sources: Company reports, other publicly available information

vehicles in the near term will depress used-car prices. That's likely absolutely correct, and that will negatively impact margins on cars already in inventory. But that's an issue that tends to adjust relatively quickly as inventory sells down and the company pays less for the cars it brings in. We don't at all consider this a problem for the long-term profitability of CarMax.

We also think the stock has been weak out of concern that the credit cycle in auto retail is turning down. That's hit the sector across the board, but the extent of the impact on CarMax isn't so obvious. It doesn't make subprime loans, is transparent in its securitizations, and there are no signs for it of deteriorating credit quality. If auto financing overall becomes less available, you may actually see people buy fewer new cars and move to used cars because they're more affordable. Again, we consider this a short-term issue and one that isn't necessarily that much of a headwind for CarMax.

How inexpensive do you consider the shares at today's $50.80 price?

JF: Our DCF value today is $58, so the discount here is a bit higher than it is for Mednax. Assuming no margin expansion, we'd expect a solid-double-digit annual return from 10% revenue growth translating to the bottom line and the discount to fair value closing. The P/E today on forward consensus earnings of $3.35 per share is only 15x. The average P/E in recent years has been closer to 18x.

Turning to more of a quirky small cap, describe your investment thesis for FRP Holdings [FRPH].

JF: FRP in this case stands for Florida Rock Properties, an aggregates company based in Jacksonville, Florida that was run very ably by the Baker family prior to their selling that business at the top of the market in 2007 to Vulcan Materials. John Baker, then the CEO, moved over to FRP Holdings along with his CFO, John Milton, and they've been building it with the same shareholder focus since.

The company has three primary assets. One is commercial real estate, consisting primarily of warehouses around Baltimore-Washington International Airport. Occupancy rates are strong, they're opening maybe one new property per year, and the existing portfolio generates about $21 million per year in net operating income.

The next asset is a set of well-located quarries in Florida and Georgia on which FRP receives mining royalties. This business was hurt in the crisis but has come back nicely, driven by construction of housing and commercial real estate. In the last fiscal year the division generated $5.6 million in EBITDA on $6 million in revenue. It also isn't standing still, with a new quarry coming on line soon in Florida.

The final key asset is 6.5 acres on the water in Washington, D.C., across from the Nationals' ballpark. There's a tremendous amount of development going on in the area and FRP has partnered with third parties like MRP Realty to develop both residential and commercial projects. The first phase, Dock 79, broke ground in December 2014 and is scheduled to deliver late this year, starting the conversion of a non-income-producing property into a income-producing one.

INVESTMENT SNAPSHOT

FRP Holdings
(Nasdaq: FRPH)

Business: Ownership, development and rental of commercial office and warehouse properties as well as land leased to mining companies in exchange for royalties.

Share Information (@3/30/16):

Price	**36.00**
52-Week Range	27.64 – 37.88
Dividend Yield	0.0%
Market Cap	$354.3 million

Financials (TTM):

Revenue	$29.9 million
Operating Profit Margin	55.0%
Net Profit Margin	43.3%

Valuation Metrics
(@3/30/16):

	FRPH	S&P 500
P/E (TTM)	27.4	23.5
Forward P/E (Est.)	n/a	17.5

Largest Institutional Owners
(@12/31/15):

Company	% Owned
Royce & Assoc	9.4%
T. Rowe Price	8.8%
BlackRock	3.8%
Charles D. Hyman & Co	3.3%
Dimensional Fund Adv	3.3%

Short Interest (as of 3/15/16):

Shares Short/Float	2.4%

FRPH PRICE HISTORY

THE BOTTOM LINE

John Fox considers the company an "undiscovered gem," with disparate assets trading at a discount to their conservatively estimated value and a management team with a long track record of shareholder value creation. His sum-of-the-parts estimate of intrinsic value is $42 per share, with what he considers options on the upside in each business line.

Sources: Company reports, other publicly available information

With the shares at a recent $36, what do you think the market is missing?

JF: We've arrived at what we think are conservative values for each piece of the company. The warehouse business we capitalize at a 7% cap rate – embarrassingly high in this environment – to arrive at a $300 million current value. We put a 15x EBITDA multiple on the mining royalty stream, adding another $84 million. The D.C. Navy Yard development we value on a mostly undeveloped basis at around $60 million. Adding in some other odds and ends, including land for residential development in Florida, and subtracting $42 million in debt, we get to an equity value today of $42 per share.

Each piece of the business has growth potential from here, most dramatically the D.C. real estate. Couple all that with a management team we've known for 15 years that has a long track record of unlocking shareholder value, and we think this is kind of an undiscovered gem.

Is South State Corp. [SSB] typical of the type of bank that attracts your attention?

JF: We've been active in banks, particularly coming out of the financial crisis when we opened a bank-only strategy to take advantage of the dislocation in the industry at the time. We sometimes go bigger, but we usually invest in smaller regional banks like SSB that have relatively run-of-the-mill business models focused on providing capital to local economies through commercial, real estate and auto loans.

We first met management at a conference in 2009 when they laid out what we thought was an intelligent plan to double its $2 per share in earnings through M&A of local banks, starting in its home state of South Carolina. Since the end of 2008 the company has added $6.4 billion in assets through acquisition and built up strong local franchises in good markets such as Columbia, Myrtle Beach, Charleston, Hilton Head, and into Georgia and North Carolina. Earnings have indeed doubled, to an annual run rate based on the latest quarter of around $4.20 per share.

Banking is more or less a commodity business, making management that much more important. As SSB has grown, the leadership has remained highly focused on profitability. Its pre-tax, pre-provision profit as a percentage of assets is above 2%, versus a peer norm of closer to 1.5%. Management skill will also come into play as the company manages what is a highly liquid balance sheet. SSB has $1.6 billion in cash and short-term investments that aren't earning much right now, but can be put to work to generate organic lending growth or fund acquisitions without the need to raise deposits or borrow money. We expect that to prove to be a key competitive advantage.

The stock, at just under $64, trades at 2.3x tangible book value. Is that cheap?

JF: We liked the stock even better when it hit $60 last month, but we think the compounding here will work in our favor. The company earns 15-16% returns on tangible equity and has a dividend payout ratio of 25%, so we see book value growing at maybe 11% per year. We think the current multiple of tangible book is perfectly reasonable for a bank with this return profile,

INVESTMENT SNAPSHOT

South State Corp.
(Nasdaq: SSB)

Business: Bank holding company operating under various brand names that serve local communities located primarily in South Carolina, Georgia and North Carolina.

Share Information (@3/30/16):

Price	**63.91**
52-Week Range	59.19 – 81.80
Dividend Yield	1.7%
Market Cap	$1.53 billion

Financials (TTM):

Revenue	$437.5 million
Operating Profit Margin	41.1%
Net Profit Margin	22.7%

Valuation Metrics
(@3/30/16):

	SSB	S&P 500
P/E (TTM)	15.5	23.5
Forward P/E (Est.)	14.4	17.5

Largest Institutional Owners
(@12/31/15):

Company	% Owned
BlackRock	6.5%
Vanguard Group	6.4%
Dimensional Fund Adv	3.9%
Goldman Sachs Asset Mgmt	2.9%
Wellington Mgmt	2.8%

Short Interest (as of 3/15/16):

Shares Short/Float	4.3%

SSB PRICE HISTORY

THE BOTTOM LINE

The company has expanded while maintaining a keen focus on profitability and retaining a highly liquid balance sheet that can be used to fund organic lending growth and future acquisitions, says John Fox. He expects to earn off just the current tangible equity base at least 13% annually on his share position, with upside as assets continue to grow.

Sources: Company reports, other publicly available information

so if they just keep plugging along we'll earn 11% a year on the stock plus another close to 2% in dividends. Stepped-up asset growth as they deploy the balance sheet would provide upside from there. It may not sound particularly sophisticated, but that works for us.

The biggest risk?

JF: There is the potential that interest rates stay where they are for a long time and that weighs on the ROEs and multiples of banks like SSB. We recognize that as a risk, but given the bank's profitability, it should still be able to nicely grow book value per share. We also believe the odds favor interest rates moving up from here, which could help a lot.

In general, how much weight do you put on your macro views in constructing your portfolio?

JF: We are macro aware, but we don't make macro predictions that translate directly into the portfolio. We wouldn't say the 10-year Treasury is going to be 3% in a year, and as a result we should buy Charles Schwab and Federated and other things that benefit from higher rates, and we should sell anything related to real estate that might be hurt. We don't know what the 10-year Treasury is going to do.

But you do need to have a clear sense of how your portfolio would be impacted by changes in important macro factors, which for us today are interest rates, oil prices, exchange rates and the credit cycle. With interest rates, for example, on balance we're tilted more to benefit if rates go up. With energy, we own some, but are still underweight the sector. Our currency exposure, given our mix of global and domestic companies, I'd say is balanced. Finally, with respect to credit, we own banks, but we have little exposure to consumer finance, subprime or other areas tied to riskier lending.

You own a fair number of money managers, including big (T. Rowe Price [TROW] and Franklin Resources [BEN]) and small (Diamond Hill [DHIL] and Westwood Holdings [WHG]). At the risk of being a bit cheeky, is this still a good business?

JF: The competitive environment has obviously changed with the advent of passive investment alternatives that charge lower fees. That makes it more difficult to grow than it was ten years ago and puts increased pressure on profitability. But valuations have come down quite a bit and in some cases we believe too far. T. Rowe Price, for example, has been a strong performer for a long time, its fees are reasonable, it has a very solid retirement-fund franchise and it is now working to build greater distribution outside the U.S. The company is still very profitable and generates a lot of cash, giving them flexibility around capital allocation for shareholders' benefit. We don't think a business like that should trade at a discount to the market. In the case of a Westwood Holdings or a Diamond Hill, like smaller companies in any industry, we believe they have strong franchises and, by adding products and improving distribution, incremental growth opportunities that the market isn't recognizing.

There will always be a cyclical element to money management and performance will always attract assets. The S&P 500 has performed very well on a relative basis since the financial crisis, which has created a lot of interest for passive. But it will still go the other way as well. When the S&P 500 went down 50% over three years after the Internet bubble popped, there was a huge influx of money to active managers, including us.

If we're as good as we should be in arriving at what companies are worth, active managers should be able to take advantage of money just blindly moving prices around based on nothing other than an algorithm. We're cognizant of the fact that we may need to trade more in order to take better advantage of that.

One big issue is educating clients so that even if you go through a one- or two- or three-year period of underperformance, they stay with you. It may not be any harder to outperform than it ever was, but it may be harder to keep your investors engaged with you through the ups and downs. When we did the quality study I mentioned earlier, we asked people to think about the fact that we'd had this dramatic rebound off the bottom, credit was being reintroduced into the system and interest rates were unbelievably low. Is what had been working really going to win next? VII

Average Annual Returns: 3/31/16

Fund & Inception Date	1 Year	3 Year	5 Year	10 Year	Inception	Total Annual Fund Operating Expenses**
FAM Value Fund **FAMVX Investor Class (1/2/87)**	-0.54%	11.19%	10.20%	5.86%	10.35%	1.18%**
FAM Equity-Income Fund **FAMEX Investor Class (4/1/96)**	3.12%	9.12%	10.72%	5.41%	8.42%	1.27%**
FAM Small Cap Fund **FAMFX Investor Class (3/1/12)** **FAMDX Institutional Class* (1/1/16)**	1.46%	11.17%	–	–	13.58%	1.36%**

DISCLOSURE

Fund selection was determined by the subjective criteria of the author. No objective criteria for selection (e.g.; performance returns, manager tenure, expense ratio, etc.) were evaluated for identification of these funds. Consequently, other mutual funds not identified in the article or considered by the author may have similar characteristics.

Past performance is not indicative of future results, current performance may be higher or lower than the performance date quoted. Investment returns may fluctuate; the value of your investment upon redemption may be more or less than the initial amount invested. Please consider a fund's investment objectives, risks, charges and expenses carefully before investing. The FAM Funds prospectus or summary prospectus contains this and other important information about the FAM Value Fund, FAM Equity-Income Fund, and FAM Small Cap Fund and should be read carefully before you invest or send money.

The principal risks of investing in the FAM Funds are: stock market risk (stocks fluctuate in response to the activities of individual companies and to general stock market and economic conditions), stock selection risk (Fenimore utilizes a value approach to stock selection and there is risk that the stocks selected may not realize their intrinsic value, or their price may go down over time), and small-cap risk (prices of small-cap companies can fluctuate more than the stocks of larger companies and may not correspond to changes in the stock market in general).

To obtain a prospectus or summary prospectus and performance data that is current to the most recent month-end for each fund as well as other information on the FAM Value Fund, FAM Equity-Income Fund, and FAM Small Cap Fund please call (800) 932-3271.

**Institutional Class shares became available for sale on January 1, 2016. For performance prior to that date, this table includes the actual performance of the Fund's Investor Class (and use the actual expenses of the Fund's Investor Class), without adjustment. The Institutional Shares of the Fund are a newly established share class and therefore do not yet have their own performance history. The performance results shown on this page and the next page for the periods prior to January 1, 2016, the date of commencement of operations for Institutional Shares, are for the class of shares of the Investor Shares, which are subject to higher fees as a result of differences in the shareholder administrative services fees and certain other fees paid by each class. Institutional Shares and Investor Shares would have substantially similar performance results because the shares of each* *class are invested in the same portfolio securities of the Fund. Because of the difference in the level of fees paid by Investor Shares, the returns for the Investor Shares will be lower than the returns of the Institutional Shares.*

***Expenses are from the most recent prospectus. When excluding Acquired Funds Fees and Expenses, which are not direct costs paid by the Fund's shareholders, the total operating expense as reported in the FAM Value Fund's audited financial statements as of 12/31/15 is 1.18%. When excluding Acquired Funds Fees and Expenses, which are not direct costs paid by the Fund's shareholders, the total operating expense as reported in the FAM Equity-Income Fund's audited financial statements as of 12/31/15 is 1.27%. When excluding Acquired Funds Fees and Expenses, which are not direct costs paid by the Fund's shareholders, the total operating expense as reported in the FAM Small Cap Fund's audited financial statements as of 12/31/15 is 1.36%.*

FAM Value Fund Top Ten Holdings As of 3/31/16	
Markel Corporation	4.8%
IDEX Corporation	4.8%
Ross Stores, Inc.	4.7%
Brown & Brown, Inc.	4.4%
Brookfield Asset Management, Inc.	3.9%
White Mountains Insurance Group, Ltd.	3.8%
CDW Corporation	3.6%
Illinois Tool Works, Inc.	3.5%
Berkshire Hathaway Inc.	3.5%
AutoZone, Inc.	3.3%

FAM Small Cap Fund Top Ten Holdings As of 3/31/16	
Echo Global Logistics, Inc.	5.7%
Fabrinet	5.6%
PC Connection, Inc.	5.3%
National Commerce Corporation	4.9%
Mistras Group, Inc.	4.8%
ScanSource, Inc.	4.8%
Westwood Holdings Group, Inc.	4.7%
FRP Holdings, Inc.	4.6%
US Ecology, Inc.	4.6%
Franklin Electric Co., Inc.	4.5%

FAM Equity-Income Fund Top Ten Holdings As of 3/31/16	
Stryker Corporation	6.3%
CDW Corporation	5.6%
Flowers Foods, Inc.	5.1%
US Ecology, Inc.	5.1%
Airgas, Inc.	5.0%
Ross Stores, Inc.	4.6%
Xilinx, Inc.	4.6%
DSW Inc.	4.3%
Aqua America, Inc.	3.9%
Digital Realty Trust, Inc.	3.9%

FAM FUNDS