FAM FUNDS

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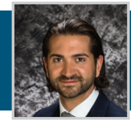
# BEYOND THE STYLE BOX:

*FAM'S case-by-case application of value investing principles*



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## Executive Summary

This white paper examines the application of the Morningstar style classification system to the FAM Funds mutual fund family.

**Topics Covered Include:**

- The concept of value investing
- Morningstar's classification methodology
- FAM's application of value investing principles
- Industry-specific considerations in value investing
- How FAM's quality overlay and long-term focus may impact apparent "style drift"

*The assertions in this white paper are based on Fenimore Asset Management's opinion. Fenimore Asset Management is the investment advisor to FAM Funds.*



## Overview

Fenimore Asset Management consistently adheres to a disciplined, value-based investment process in making purchases for our three mutual funds: FAM Value Fund, FAM Equity-Income Fund, and FAM Small Cap Fund. Nonetheless, our funds will, at times, drift out of the Morningstar value style boxes. We recognize that this may result in client questions for the advisors that utilize our funds, and this paper reviews our investment process with reference to the Morningstar classification system. Specifically, we seek to outline how our industry- and company-specific application of value investing principles, along with our focus on quality and a long-term investment horizon, will inevitably lead to variances with the value lens applied by Morningstar.

Across all of our strategies and portfolios, Fenimore Asset Management employs a **value investing** philosophy with a focus on **quality** companies. While the focus of this whitepaper is principally on what constitutes a "value stock" in our eyes, let us first look at what FAM means by "quality."

## Quality Defined

As value investors, a focus on quality businesses is designed to help avoid those stocks that are "cheap for a reason." In seeking to identify quality companies, we first screen for **superior business models** accompanied by **conservative debt levels**.

The metrics we use to analyze the economics of an enterprise include:

- Return on Invested Capital — profitability for all providers of capital to a business
- Return on Equity — profitability per dollar of shareholder equity
- Net Profit Margin — percentage of sales translated into profits

With respect to all three measures, quality companies display higher ratios versus their competition and/or increasing ratios over time.

In looking at a company's level of debt, the debt/total capital ratio (debt as a percentage of all sources of capital) provides a starting point for analysis. In general, quality businesses display lower debt/total capital ratios relative to the competition and/or decreasing ratios over time.

Finally, quality companies, in our view, must feature **outstanding leadership** and a demonstrated commitment to **capital allocation practices** that are in the best interest of shareholders.

Quality Companies:

- Superior Business Model
- Conservative Debt Level
- Outstanding Leadership
- Shareholder-Focused Capital Allocation

## Value Investing Defined

The concept of "value investing" was most famously set forth by legendary investor Benjamin Graham and refers to the effort to identify securities trading at prices below the true or intrinsic value of the underlying businesses. This process can take a variety of forms, but generally involves evaluating a range of **valuation multiples**.

A valuation multiple relates the price of a security to a key statistic which drives the value of a business. Some examples include:

- Price-to-Earnings Ratio
- Price-to-Sales Ratio
- Price-to-Book Ratio
- Dividend Yield
- Price-to-Cash Flow

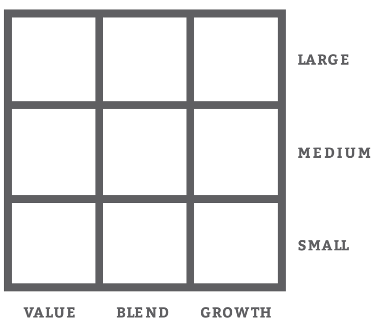
A business carrying lower valuation multiples relative to its peers and/or the firm's typical valuation range may present an opportunity to buy shares at a discount to the company's true worth.

## Morningstar's Style Box

In 1992, Morningstar introduced a framework designed to help investors classify the investment style of a mutual fund in a simple and efficient manner. The framework was dubbed the "Morningstar Style Box," and to say that it was widely adopted as a tool by investors and advisors would be an understatement.

The style box system classifies mutual funds by a) the market capitalization of the businesses held by a fund and b) the degree to which the fund utilizes a value-oriented or growth-oriented investment approach. Each fund tracked by Morningstar is classified into one of nine categories as displayed below:

Morningstar Style Box™




Determining the current market capitalization of any given company held by a fund is a straightforward matter. By contrast, classifying a stock as either value or growth requires making some decisions about how to factor in various financial ratios.

Within each market capitalization bucket (large, medium, small) **Morningstar assesses the value profile of a stock based on these multiples** (weighting in parentheses):

- Price-to-Projected Earnings (50.0%)
- Price-to-Book (12.5%)
- Price-to-Sales (12.5%)
- Price-to-Cash Flow (12.5%)
- Dividend Yield (12.5%)

Similarly, **Morningstar assesses the growth profile of a stock based on these multiples**:

- Long-Term Projected Earnings Growth (50.0%)
- Historical Earnings Growth (12.5%)
- Sales Growth (12.5%)
- Cash Flow Growth (12.5%)
- Book Value Growth (12.5%)

If a stock receives relatively similar scores for growth and value, it is considered "core."

Importantly, Morningstar reclassifies stocks as growth or value on a monthly basis.

## FAM's Value Analysis

Let us look at why our funds do not always fit neatly into the value style box within Morningstar's classification system.

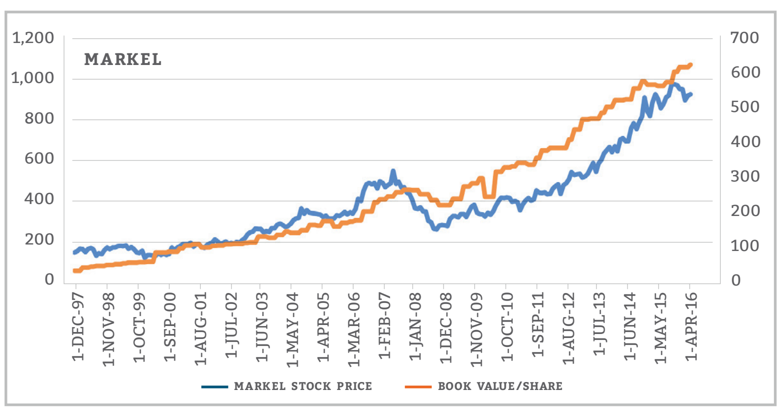
In assessing the value profile of a stock, FAM will look at many of the same financial measures as Morningstar. And, as under the Morningstar analysis, we do not assign equal weight to each of these measures.

Importantly, as a value specialist engaged in managing high-conviction portfolios, we have the luxury of making judgments on a **stock-by-stock basis** as to the appropriate weighting to assign each multiple.

These decisions with respect to valuation measures are at the core of our process. We believe it is essential because the relative importance of each multiple varies depending on the type of business in which the company is engaged. In fact, some multiples have very little utility in assessing certain types of businesses.

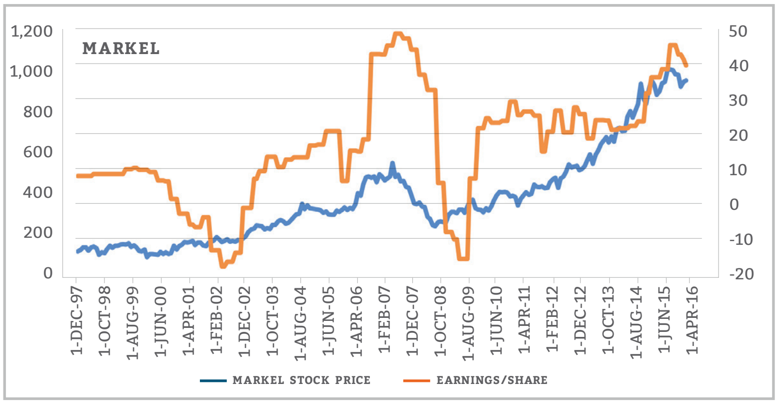
For example, when assessing the valuation profile of an insurance company, the price-to-book ratio is generally far more useful than the price-to-earnings ratio. Why? Insurer earnings are more unpredictable on annual basis than for the broader market, largely due to the random nature of catastrophic events. Furthermore, insurance companies invest a substantial portion of the premiums they receive into stocks and bonds, which are captured on the balance sheet. Thus, to value an insurance firm principally on its annual earnings would be to ignore a major source of value for the business — its investment operations.

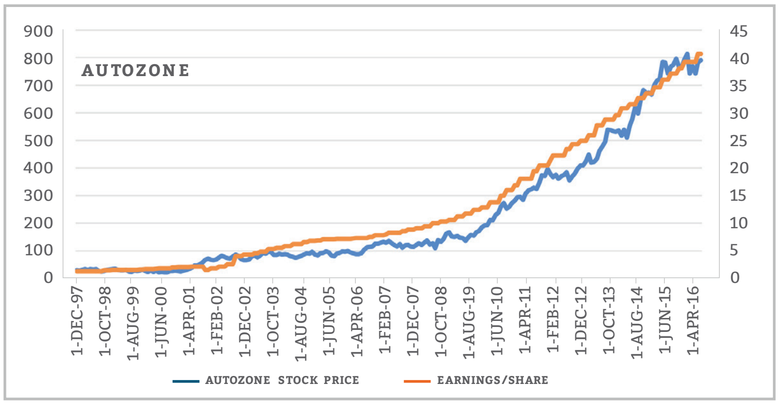
To illustrate, Markel Corporation remains a core holding for Fenimore as of this writing. Markel engages in insurance underwriting. Below we can see how the growth in book value per share has tracked the stock price over 20 years:

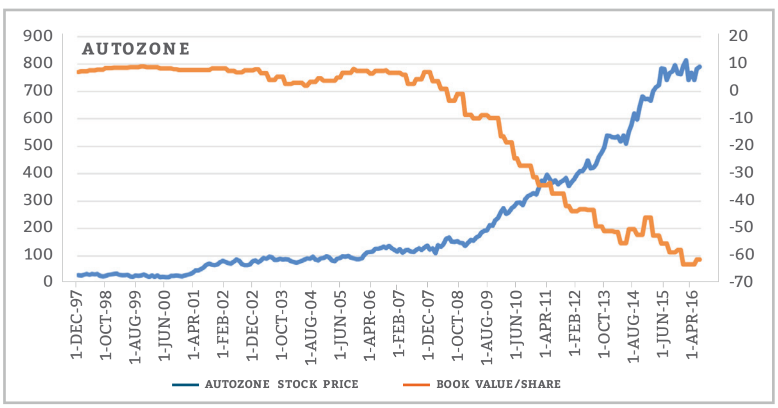



*Past performance does not indicate future results.*

Using earnings per share, we see a completely different story.




*Past performance does not indicate future results.*

Let us look at the reverse scenario, AutoZone. This company is a retailer of auto parts and is a core holding in the FAM Value Fund at the time of this writing. Here we see a different story, where earnings are far more relevant than book value. The reason is that for retailers, business results are largely driven by the ability to operate profitable stores and invest those profits into opening new stores. Simply put, the more profitable stores AutoZone has, the more valuable the enterprise. The chart on the left shows how earnings-per-share has historically tracked the stock price for AutoZone.

By contrast, if we look at book value per share, we see no real correlation (please refer to the third chart on the left). This is because in addition to opening profitable stores, AutoZone's management has engaged in significant share repurchases in order to return cash to shareholders. Due to accounting conventions, the book value of AutoZone's equity is negative, but this clearly has no bearing on the market value of the stock.

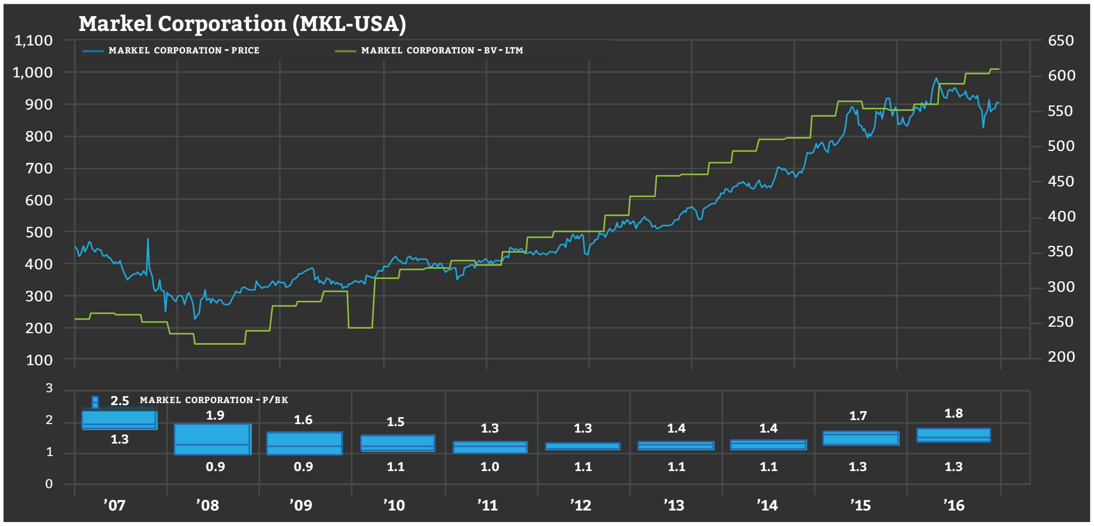
## Focus on Holding Quality Stocks for the Long Term

If we are successful as managers, a stock purchased on the basis of value will ultimately experience price appreciation that takes it out of the value stock category as gauged by one or more multiples. However, this does not mean that we automatically sell the stock. Our intent with each stock we purchase is to hold it as a quality, long-term investment. This approach also contributes to our funds sometimes drifting out of the "value" boxes under Morningstar's classification system, despite the consistent application of valuation-based analysis in deciding which stocks to purchase. In contrast to Morningstar's classification system, as managers of high-conviction portfolios we do not view our holdings through a monthly lens.

Turning again to Markel, an investor purchasing shares in 2008 would have done so when book value growth was negative and the price to book multiple had fallen. At this point in time, most investors and analysts likely would have classified Markel as a "value stock." By 2016, book value growth had rebounded and the price-to-book multiple correspondingly rose. While arguably taking Markel out of the value category, we maintained the position based on our assessment of the corporation's quality profile. Markel has diversified earnings sources, excellent execution, and shareholder-friendly management.

"Quality" is an integral element of "value" under FAM's framework of analysis. It is possible that a great business, like Markel, can trade at above-average multiples and still provide an ample margin of safety because a growing quality business should become more valuable over time.

For example, Markel's P/B multiple expanded from .9x to 1.5x between 2008 and 2010 which means the stock became more expensive. However, given the quality of Markel's business and its management team, it was clear that there was still plenty of value to be realized over time and the stock performed quite well after 2010.




*Past performance does not indicate future results.*

This does not mean we will hold the stock indefinitely, just that we continue to view it favorably relative to other investment opportunities based on the total view of its quality and value.

## Conclusion

In summary, FAM Funds' three portfolios adhere to a consistent, value-based selection process. However, they may experience "style drift" under Morningstar's classification system due to:

- FAM's industry- and company-specific application of value investing principles
- FAM's focus on holding quality businesses for the long term

The Morningstar classification system has served as a useful starting point for many investors since 1992. At Fenimore Asset Management, the investment advisor to FAM Funds, we have applied the same rigorous approach to valuing stocks since 1974 and will continue to execute on our steadfast process.

### FAM Value Fund Top 10 Holdings

*As of 9/30/17*

| Name | Portfolio Weighting % |
|---|---|
| IDEX Corp. | 5.8% |
| Markel Corp. | 4.8% |
| CDW Corp. | 4.7% |
| Ross Stores | 4.4% |
| Illinois Tool Works | 4.2% |
| CarMax | 3.9% |
| Brown & Brown | 3.9% |
| Brookfield Asset Management | 3.8% |
| Berkshire Hathaway | 3.7% |
| AutoZone | 3.2% |

*The portfolio is actively managed and current holdings may be different. The past performance of the related stock is not indicative of past or future performance of the Fund.*

*Fenimore Asset Management is an independent, research-based, bottom-up investment advisor and the manager of FAM Funds: FAM Value Fund, FAM Equity-Income Fund, FAM Small Cap Fund. FAM Funds' key portfolio characteristics are: high-quality equities, low-turnover, and concentrated. The value-oriented funds are managed toward the preservation and long-term appreciation of capital.*

*To obtain prospectuses or summary prospectuses and performance data that is current to the most recent month-end for each fund, please go to famfunds.com or call (800) 932-3271.*

*Please consider a fund's investment objectives, risks, charges and expenses carefully before investing. The FAM Funds prospectus or summary prospectuses contains this and other important information and should be read carefully before you invest or send money. The principal risks of investing in the fund 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).*