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Position *Paper*

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Investment vs. Speculation: *A Current Depiction*

"Investment is most intelligent when it is most businesslike."

- Benjamin Graham: *Security Analysis*, 1934

Today, we believe that speculation has crept into certain corners of the market. There have been many consequences of the fallout from the financial crisis and the resulting period of low interest rates. These low interest rates have driven investors to chase returns whether in high-yield bonds, sub-prime auto loans, or in speculative stocks which have taken off in this "easy money" environment. Investors may be turning a blind eye to the increased risk that accompanies these returns. Areas fostering speculative activity may include biotech, small pharma, social media, cloud computing, and alternative energy.

Signs of Overheating?

Let's take a look at returns for the Russell 2000 Pharma and Biotech indices versus the Russell 2000 Index as a whole:

Total Return	12/31/2012 - 3/31/2014	12/31/2013 - 3/31/2014
Russell 2000 Pharma Index	78.0%	5.8%
Russell 2000 Biotech Index	67.3%	7.9%
Russell 2000 Index	40.4%	1.1%

As you can see Pharma and Biotech returns have greatly outpaced those of the broader index over the last five quarters. Following typical herd-like behavior, inflows have dramatically increased into the top-three biotech ETFs in the first quarter of 2014. Furthermore, the 26 biotech IPOs in the first quarter of 2014 were a quarterly record – this matched the entire year of 2000 when speculation was rampant!

Also, according to IPO investment firm Renaissance Capital, from the beginning of 2014 through March 31:

- "The first quarter's IPOs were more speculative with 70% recording LTM net losses, a function of the large mix of biotechs and money-losing SaaS IPOs. Last year's run-up could also have caused investors to assign overly optimistic valuation multiples to biotechs and tech companies that now seem unjustified."
- "Most of the Software IPOs were unprofitable and commanded high revenue multiples as investors continued to pay up for growth."

Risky Business

What effect have these speculative, money-losing stocks had on the broader market? As they have become a larger part of the index they have skewed valuations. The often quoted P/E ratio of the Russell 2000 Index stood at 21.2X at 3/31/2014. This measure of P/E excludes the results of companies that have negative earnings, which just so happen to be the most speculative securities. If we include these money-losing companies, the P/E skyrockets to 61.3X!

Why does this matter? Well, to many passive investors it may matter more than they realize. This inflated valuation is what a passive investor gets when they buy an ETF or index fund tied to the Russell 2000. It is imperative that people know their investments and yet many may not know of the risks that lurk in their portfolios.

While we acknowledge that some of these speculative securities will be the next great businesses, many more will not have the wherewithal to survive. Fenimore is not willing to take risky bets with our investors' hard-earned savings. We actively avoid areas that we think are overvalued and where speculative activity is occurring.

Fenimore believes that investing in quality, financially durable, well-run businesses at the right price is the key to building real wealth over the long term. Our team conducts in-depth, independent research and analyzes the companies behind the stocks to gain unique insights. We use this firsthand knowledge and our time-tested process to help mitigate risk and achieve our investors' financial goals.

The intimate understanding we have about each of our investments is readily available and transparent to our investors. Additionally, Fenimore's investors understand our consistent process and four core investment criteria:

1) Quality Business 2) Financially Durable

3) Proven Management 4) Margin of Safety

For four decades, Fenimore has held an independent "stand apart from the herd" mentality with our own research and analysis. Our time-tested process and team have staying power through multiple economic and financial market cycles. Fenimore's investment approach culminates with the careful selection of undervalued securities and the construction of concentrated portfolios on behalf of our investors.