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White Paper

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Executive Summary

This paper details why the value of high-quality equities still has not been fully realized in the stock market since the 2008 Financial Crisis.

Topics include:

- **Interest Rates** – the Federal Reserve's unprecedented reaction to stress on the financial system including a historical look dating back to 1973.
- **Definition of Quality** – four financial ratios used to measure quality.
- **Performance Analysis** – high- versus low-quality stocks since late 2007.
- **Investment Outlook** – investors may want to consider what types of businesses will outperform under more normal conditions.

The assertions in this white paper are based on Fenimore Asset Management's opinion.

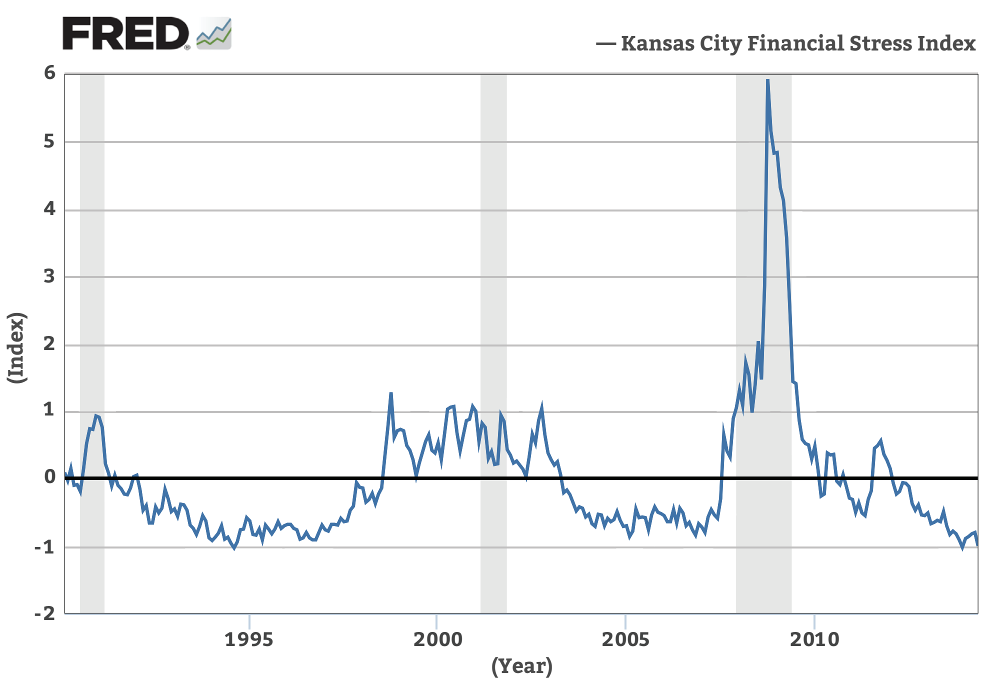
QUALITY MATTERS

The 2007 to 2014 period in stock market history is unique due to the credit expansion and an accommodative monetary policy in 2007, and then the ensuing acute credit contraction from 2008 to 2009. Given the severity of the economic environment, the Federal Reserve reduced interest rates to unprecedented levels, below 1%, and has maintained them for a record-setting time. Meanwhile, as of June 30, 2014 the U.S. stock market, as measured by the S&P 500 Index, had increased for more than five consecutive years since its March 2009 trough— a rise from 676 to 1,960. This combination of events has led to a salient performance contrast between high- and low-quality companies.

Severe Economic Environment

This graph illustrates the extreme financial pressure on the U.S. economy in 2008 — an unparalleled time since the Great Depression. The measurement of economic stress includes: bond spreads, credit losses in banks, and the amount of liquidity. The index typically ranges from -1, which means that there are loose conditions, no credit losses, and cash is available, to +1, which usually indicates a recession, credit losses, and less liquidity.

The index hit a +1 in the recessions of 1990 to 1991 and 2000 to 2001. The 2008 Financial Crisis created six times more stress than earlier recessions. It was a time when weak companies, that were highly leveraged, needed to raise money. The government responded in an extraordinary way.



Shaded areas indicate U.S. recessions: 2014 research.stlouisfed.org

Source: Federal Reserve Bank of Kansas City

"The Kansas City Financial Stress Index (KCFSI) is a monthly measure of stress in the U.S. financial system based on 11 financial market variables. A positive value indicates that financial stress is above the long-run average, while a negative value signifies that financial stress is below the long-run average."[1]

The Federal Reserve's Unprecedented Response

Due to the extreme stress on the system the Federal Reserve countered with a reaction never seen before, as the table below demonstrates, reducing interest rates to their lowest levels. Additionally, it has maintained these rates for the longest time frame in 40 years.

Bear Markets & Short-Term Interest Rates

For purposes of these calculations, a Bear Market is defined as a period during which stock prices dropped at least 20% from their peak in the Standard & Poor's 500 Index. The quarters for each S&P 500 peak and trough are denoted in the table. For example: "Q1 1973" and "Q4 1974," respectively. The interest rate is listed next to each quarter as well as in the "One Year Later" and "Five Years Later" columns.

S&P 500 Index		1-Year CM T-Bill	
Peak	Trough	One Year Later	Five Years Later
Q1 1973 = 6.9%	**Q4 1974** = 7.3%	6.60%	11.98%
Q4 1980 = 14.9%	**Q3 1982** = 10.9%	9.81%	7.67%
Q3 1987 = 7.7%	**Q4 1987** = 7.2%	8.99%	3.61%
Q3 1990 = 7.8%	**Q4 1990** = 7.1%	4.38%	5.31%
Q1 2000 = 6.2%	**Q3 2002** = 1.7%	1.24%	4.14%
Q3 2007 = 4.1%	**Q1 2009** = 0.6%	0.40%	0.13%

- *Interest rate shown is one-year constant maturity Treasury.*
- *Data from FRED database, St. Louis Federal Reserve.*

Our conclusion is that low and falling interest rates have been maintained with the Federal Reserve's quantitative easing policies since 2008. As we will see, such low interest rates since early 2009 have created a platform for low-quality, levered companies to outperform in the stock market by a large measure.

Quality Defined

For this study, quality is measured using the following four financial ratios:

1.	Return on Equity (ROE) →	Higher = Better
2.	Total Debt as % of Equity →	Lower = Better
3.	EBITDA Margin →	Higher = Better
4.	Cash from Operations/Cap X →	Higher = Better

We define high-quality businesses as those with high profitability (high ROE and profit margins), low debt, and the ability to generate free cash flow.

Conversely, low-quality companies have low profitability, much debt, and little cash generation.

[1]Federal Reserve Bank of Kansas City Website

These quality criteria were applied to three ETFs measuring small-, mid-, and large-cap stocks: the Russell 2000 Index, Russell Midcap Index, and S&P 500 Index, respectively. In all cases, financial stocks were excluded as these equities have different metrics from operating businesses.

The results show the following:

- During the Bear Market phase of late 2007 through the first quarter of 2009, the highest quality equities outperformed in all three ETFs.
- During the current Bull Market measured from March 2009 through June 2014, the lowest quality stocks have outperformed, by a large measure, in all three ETFs.

Performance Study of High-Quality vs. Low-Quality Stocks

	ROE	Debt to Equity	EBITDA Margin	Cash Generation*	Bear Market Sept. '07 – Mar. '09	Bull Market Mar. '09 – June '14
Russell 2000 Index ETF						
High-Quality	15.8%	5.5%	19.6%	8.3x	-31%	248%
Low-Quality	-12.9%	133.2%	8%	1.3x	-56%	330%
Russell Midcap Index ETF						
High-Quality	19.5%	15.2%	25.2%	7.6x	-31%	215%
Low-Quality	-5.1%	174.9%	17%	2.4x	-56%	334%
S&P 500 Index ETF						
High-Quality	20.6%	19.7%	26.6%	7.4x	-33%	196%
Low-Quality	-2%	158.3%	15.2%	2.4x	-51%	278%

**Cash Generation = cash from operations divided by capital expenditures. As the number increases, so does the amount of cash that the company generates beyond what it needs. This excess money can be used to increase shareholder value through stock buybacks, dividend increases, acquisitions, and investing in the business.*

Low-Quality Equities Continue To Outperform

During the stock market's initial rebound, a large number of the riskier stocks that performed the worst during the Bear Market did the best — this is typical. Even though the survival of many corporations was questioned due to precarious financial footings, their stocks boomeranged as fears abated.

We needed to look no further than the healthcare sector to find two good examples that demonstrate this contrast between low- and high-quality stocks since the financial crisis. We analyzed one business in the lowest quartile and another in the highest.

Company A, in the lowest quartile, was losing money on a GAAP basis in 2008. It was highly levered with $4B net debt and $100MM of equity, and was paying $400MM of interest expense per year. This business' stock price in 2007 was in the mid $20s, it then dropped to $4 during the Bear Market and trades at $63 today — roughly 16x from the low.

Company B, in the highest quartile, had a 22% ROE, 7% debt to equity, and after capital expenditures still generated $400MM of free cash flow. This business' stock dropped less than 10% in the Bear Market and came back almost 100% from the bottom. This is a solid absolute return, but it is well below low-quality companies, overall, and less than the market's performance.

> *Today, well after the initial run-up, low-quality stocks have continued to outperform.*

Although unusual, this scenario makes sense for two reasons:

1. The extended "easy-money" environment has allowed flatlining companies to succeed because the cost of borrowing is reduced when they refinance — this makes bankruptcy a remote possibility. Consequently, investors "re-rate" the equity and it begins to trade without the stigma of bankruptcy. This means that low-quality loses its "Scarlet Letter."
2. Sustained low interest rates have driven numerous investors to chase returns in areas such as high-yield bonds, sub-prime auto loans, and speculative stocks in hopes of producing income. This "search for yield" has made investors more forgiving of borrowers and provided needed liquidity to many fragile businesses that have issued debt at rates that were unthinkable 10 years ago.

What's Next?

> *The question for investors going forward is, "What types of businesses may outperform in the future under more normal conditions?"*

Both high- and low-quality stocks have benefitted from the post-fiscal crisis environment, but low-quality equities have certainly had the advantage over the past several years. However, at some point in the future we do know that interest rates will rise, borrowing will become more expensive, and there will be less liquidity in the system.

As a result, the winners and losers in the market should change. Companies that don't need financing, are generating cash, and maintain a reasonable balance sheet should do well when there's less liquidity. With modestly higher interest rates, financial companies (what we call "balance sheet financials" — like insurance companies, banks, and brokerage firms) should earn more money and generate a higher ROE. This should lead to higher valuations which could help their stock prices.

During times when the value of a high-quality enterprise is not reflected in its stock price, our patience can be tested. Nonetheless, Fenimore's confidence is tethered to compelling historical data that reinforces our conviction that buying undervalued equities of superior companies succeeds in the long run. We invest in top-notch companies because it's our experience that these enterprises can perform well in growing, stagnating, and declining conditions.

Fenimore Asset Management is an independent investment advisory firm located in Cobleskill, NY since 1974. Fenimore's affiliates are the Fenimore Private Client Group & FAM Funds – offering separately managed accounts and mutual funds. In-depth research. Insightful investing.