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Fenimore Private Client Group & FAM Funds
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White Paper

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July 2013

Executive Summary

This paper details why Fenimore believes that investing in quality businesses, at a discount to their intrinsic value, is key to building real wealth over the long term.

Topics include:

- **Defining & Measuring Inflation** – including an everyday example.
- **Real vs. Nominal Returns** – a look at the impact on an investor's purchasing power.
- **Equities Help Protect Wealth** – our research shows that, since 1900, five-year compound returns exceeded inflation and provided positive real returns 74% of the time.
- **Discounted Equities** – we found that when stocks were selling for a bargain during the same time period, they yielded an average annual real return 6.87% greater than when stocks were expensive.

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

Value Investing Builds Real Wealth

Sir John Templeton's first rule in his "16 Rules for Investment Success" is to "Invest for maximum total real return." In other words, an investor's goal should be to maximize their invested dollars after taxes and inflation. We frequently discuss taxes of all kinds, but inflation tends to be ignored. To build real wealth, an investor must earn returns that outpace inflation and we believe that investing in quality businesses at a discount to their intrinsic value is vital to accomplishing this objective.

Defining & Measuring Inflation

When considering how inflation impacts investment returns we must define inflation, as well as how one measures inflation. Inflation is simply the increase in prices one pays for goods and services over time. Keeping track of the price changes of all goods and services over time would be an arduous undertaking. Thankfully, the U.S. Bureau of Labor Statistics publishes the Consumer Price Index (CPI) which tracks the price changes in a basket of more than 200 goods and services over time. Examples of some of the products and services included in the CPI are food and beverages, apparel costs, housing-related expenses, and education costs. Although imperfect, the changes in CPI over time serve as a useful proxy for getting a general sense of how inflation has trended. Since the turn of the 20th Century, inflation has averaged between two to three percent per annum, however there have been periods when inflation was much higher and lower than this average.

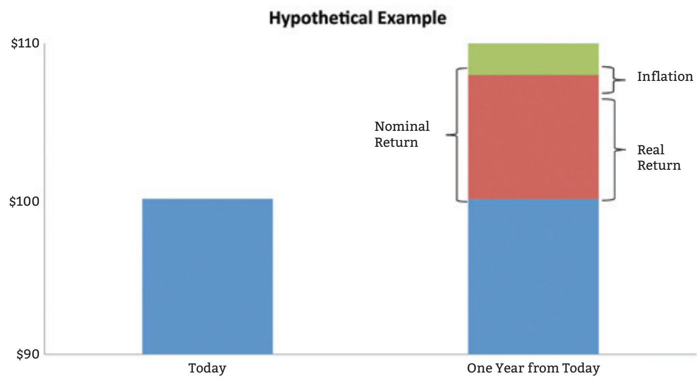
Although the CPI is a useful tool to understand the big picture for changes in prices, it is often easier to think about just one product or service versus a whole basket in order to understand inflation – especially products or services that have endured and maintained their primary use. For example, in 1986 a Big Mac from a U.S.-based McDonald's was, on average, $1.60 and at the start of 2013 it was $4.37. This is an average annual increase of 3.7%.

Stated another way, we could say that the "inflation rate" for a McDonald's Big Mac was 3.7% over the past 26 years.

Real versus Nominal Returns

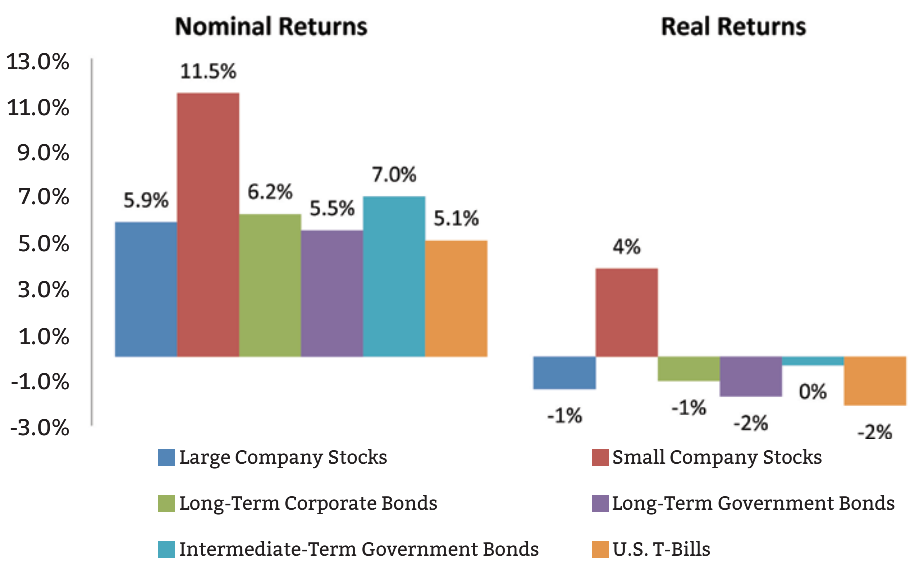
With an understanding of inflation, we can now differentiate between real and nominal returns. Inflation has serious implications for investment returns and it is imperative to know the difference between nominal and real returns. Nominal returns are investment performance without considering inflation. Comparatively, real returns factor inflation into the equation and indicate how much your purchasing power has actually changed.

This can be illustrated with a hypothetical example. If an investor buys a stock at $100 and at the end of the year it rises to $110 and inflation is 2%, the investor's nominal return is 10% and real return equals 8% (10% minus 2%).[1] In terms of purchasing power, if at the start of the same year a soda costs $1.00, at year-end it will increase to $1.02 with inflation. As a result, although our hypothetical investor has 10 more dollars, he/she cannot buy 10 more sodas. Consequently, our investor's purchasing power grew slower than their investment account. <u>This is why inflation matters.</u>



Since one day you hope to spend what you have invested, real returns are the more important measure.

Moving from the hypothetical to the historical there have been periods in history of higher-than-average inflation. Inflation in the U.S. was a major drag in the 1970s. Although investors in long-term corporate bonds averaged nominal returns of 6.2%, inflation was at very high levels averaging 7.4%. At first glance 6.2% per year seems like a satisfactory return on bonds; however, when inflation is factored in investors' purchasing power was actually weaker at the end of the decade compared to the beginning.



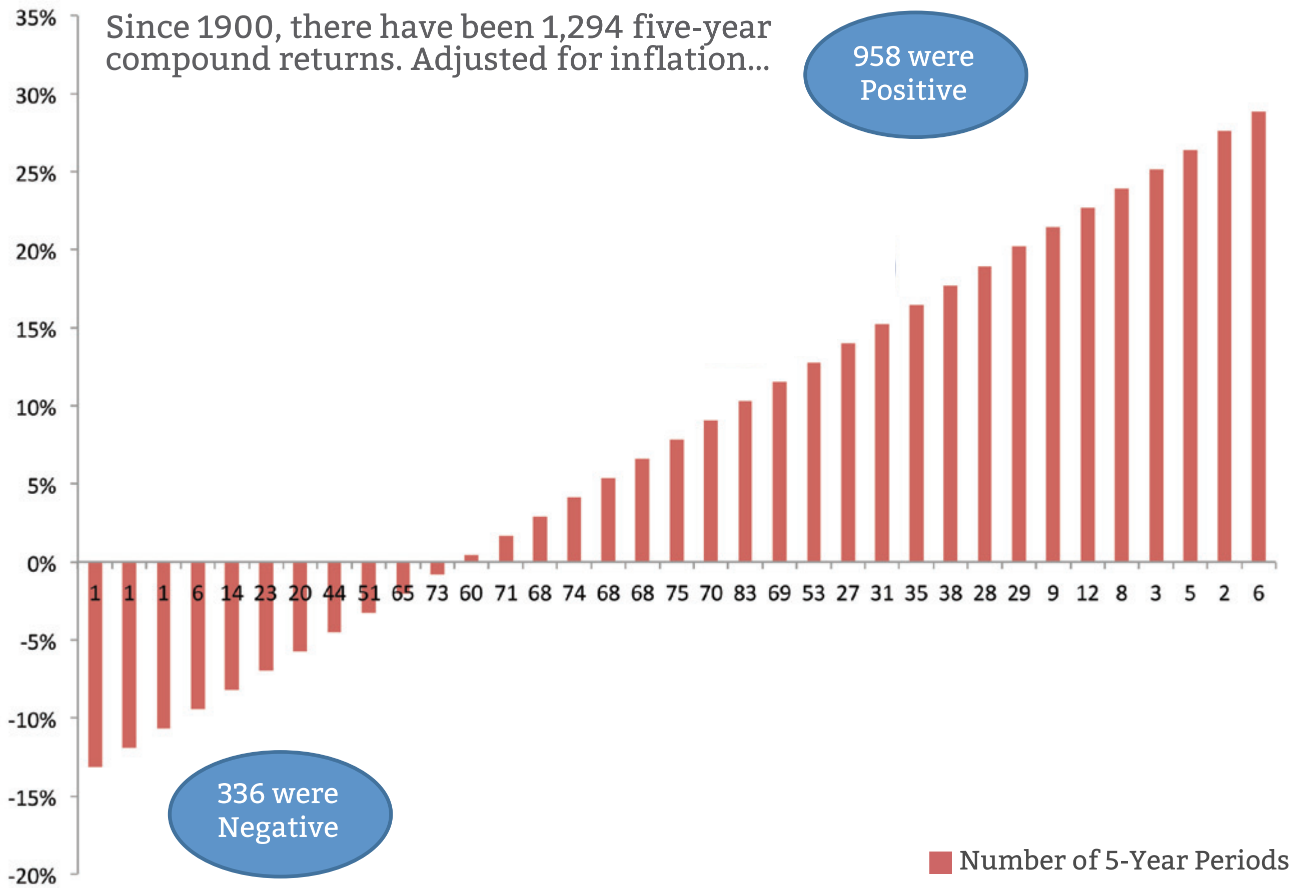
The chart above summarizes both the nominal and real performance of several types of investments and shows an extreme example of the detrimental effects that inflation can have on preserving and building wealth.

[1] The calculation used is for illustrative purposes. The formula is technically (1.1/1.02)-1.

Equities Help Protect Wealth

It is clear that investors need a strategy to protect their wealth from the impact of inflation. The simplest solution is to make investments over time that will outpace the rate of inflation. Although there are a multitude of investment options that could outpace inflation, we believe that investing in companies that can grow faster than inflation is the best way to preserve purchasing power and grow wealth over the long term. To test this theory, we analyzed five-year rolling returns[2] of selected equities since 1900.[3] In fact, the five-year compound returns exceeded inflation and provided positive real returns 74% of the time.

The research supported our thesis that equities have definitely been useful in building real wealth.

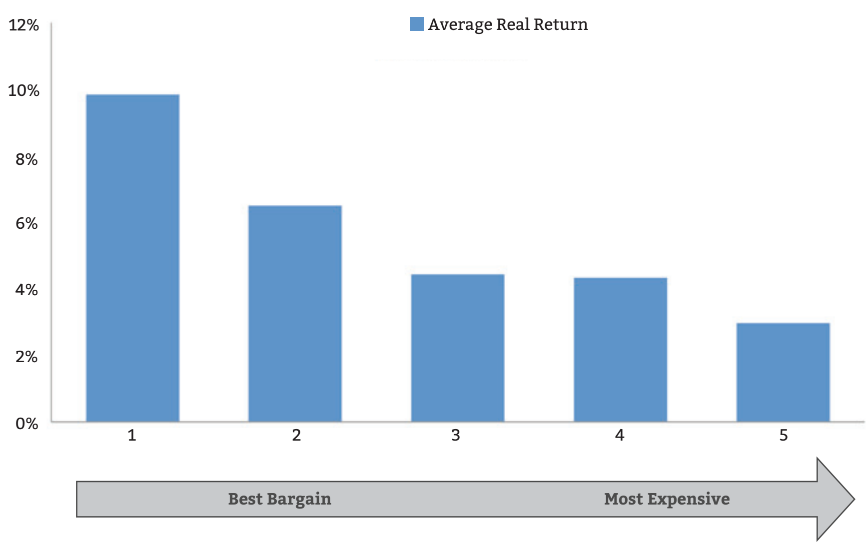


[2] Rolling returns are the average annual percentage returns for a fixed time period, in this case five years.
[3] Data from: Shiller, Robert J. Irrational Exuberance. Princeton University Press, 2000; second edition, 2005.

Discounted Equities – Patience Pays

In addition to analyzing equities as a means to protect and grow real wealth, we also tested our conviction that investing in equities at bargain prices would yield even better real returns. Over this same time period, we analyzed the impact of purchasing stocks when they were cheapest as judged by the price-to-earnings ratio. To do this we took our same set of five-year rolling returns and sorted them into five equal-sized groups from cheapest to most expensive. The chart below summarizes the average return within each group. We found that when stocks were selling for a bargain they yielded an average annual real return 6.87% greater than when stocks were expensive. In the context of total returns, this means that patient investors who waited for discounts would have had about 40% more real wealth than investors who purchased equities when they were most expensive at the end of five years.

We found that when stocks were selling for a bargain they yielded an average annual real return 6.87% greater than when stocks were expensive.



There is no doubt that inflation can erode the purchasing power of accumulated wealth. Although we can observe historical trends of inflation, it is simply impossible to correctly forecast how this trend will continue into the future with any certainty. Thus, it is our opinion that a conservative and thoughtful investment strategy that can consistently outpace inflation is the best way to invest. Our research has shown that purchasing equities at bargain prices has proven to be an effective strategy for accomplishing this objective. At Fenimore Asset Management, our goal is to invest in small- to mid-sized companies at a discount to our estimate of their intrinsic value in order to protect and increase our investors' real wealth.

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.