FAM FUNDS

FAM Small Cap Fund

Annual Shareholder Letter 2018

December 31, 2018

Dear Fellow Small Cap Fund Shareholder,

Clearly, the past few months have been volatile with concern about a slowing economy spreading among many investors. As investors turned from optimism to pessimism, the Russell 2000 Index (the primary index for small, publicly traded U.S. companies) at its August 31 peak was up 14.3% year-to-date before falling to end the year down -11.01%.[1] We are studying various economic and political concerns, especially the setting of new trade rules and tariffs, inflation (both labor and materials), and falling optimism (which potentially creates a self-fulfilling prophecy). Our team is also assessing the risk that the Federal Reserve may accidentally raise interest rates too high, thus stemming growth rates. So far, our conclusion is that while these issues are quite real – we see many companies reporting slower growth and thinner profit margins – it remains unclear if they are severe enough to trigger a recession, as some may fear, or justify the 25.31% drop in small-cap stock prices.[2]

The impact of these issues differs at every business our team follows. At one extreme, a firm might rely on a Chinese-centered supply chain now facing tariffs, suffer through higher trucking costs, and face a step up in government mandated minimum wage rates while having little ability to raise prices. At the other extreme, some businesses do not encounter many of these issues. For example, consider enterprises that hire experts and resell their advice, such as in real estate brokerage or accounting services. While they too would be impacted by a recession if it occurs, they do not import goods, use trucks to move anything, or hire many minimum-wage employees. Plus, they have some ability to raise prices to reflect their higher costs. Much of our time is devoted to studying various industries and companies to better ascertain the impact of these new realities.

Meanwhile, there are reasons to be optimistic. Many of the problems facing us will likely be resolved. For instance, the U.S. and China may eventually strike a trade agreement with lower tariffs. Furthermore, the longer this uncertainty goes on, the more firms move sourcing to places such as Mexico, India, or Vietnam to avoid the China tariffs. Additionally, the Federal Reserve may decide that conditions no longer warrant further interest rate increases. It is quite possible that a year from now many of these issues may have passed. Humans certainly have their shortcomings, but they excel at adaptation.

In volatile days such as these, it is worth reiterating what our investment research analysts are striving to accomplish. Most of our shareholders have longer-term goals they wish to achieve – saving for retirement, funding college educations, providing for the care of a disabled child, or the like. However, it is a virtual certainty that while saving for these big goals in life, we will see a tremendous variety of macro environments and swings in investor sentiment. Additionally, the shifts from extremes are essentially unpredictable; however, this is nothing new.

In just the past 20 years, we have seen: the devaluation of several emerging market currencies in 1998 (and a debt default by Russia); a massive bubble in technology stocks in the late 1990s; a recession in 2001; the horrific events of 9/11; a slew of accounting scandals in the early 2000s; a rash of hurricanes including Katrina; a housing bubble; the Great Recession of 2008-2009; unemployment touching 10% in October 2009 and frustratingly slow growth in the years after; struggles in Greece (and Portugal, Spain, Italy, etc.) so severe the European Union almost unwound; and a collection of various epidemics and government shutdowns – and this is only a partial list.[3] Despite all these events, the Russell 2000 Index compounded at 7.40% per annum in the past 20 years as of

[1] Bloomberg, 12/31/18

[2] Bloomberg, 12/31/18: from the intra-day high on 8/31/18 to the 12/31/18 close

[3] Wikipedia, 12/31/18 (our predecessors faced the same reality with 24 recessions in the 19th century)

December 31, 2018. What this means is that $100 invested 20 years ago is now worth approximately $417 (this assumes all dividends and capital gains were reinvested).[4]

Our goal for your capital and ours, as we too are investors in the Fund, is to find about 25 to 30 of what we deem to be the best businesses possible. Enterprises that have some advantage over competitors which, when combined with strong management, should allow them to be much larger in 5 to 10 years. This may involve grinding through challenging economic or political climates along the way.

Not only that, we wish to buy our shares "on the cheap" – at a discount to what a rational competitor or private equity firm would pay for the entire company. This is where the swings in investor sentiment pay off. When investors are overly optimistic, seeing nothing but opportunity on the horizon, prices tend to be so expensive as to make future returns unimpressive. However, good times are difficult to sustain. Eventually, conditions change and anxiety typically returns. When most investors are fearful, this is the time for value investors such as us to scoop up bargains. Sooner or later, the skies clear and optimism reappears – and the never-ending cycle continues. While our team tends to benefit from knowing companies well, our true advantage is the ability to be less emotional than the average investor.

In the short term, stock prices are unquestionably driven by emotions, but over the long term they are typically more rational and driven primarily by earnings growth. Specifically, in our small-cap universe, if a profitable, growing enterprise is ignored by investors for too long, then a larger competitor or private investor often buys the entire operation. This is one of the underpinnings of our long-term enthusiasm for investing in smaller companies.

We have successfully assembled a collection of high-quality businesses from our viewpoint. Each seems to have the potential and necessary leadership to grow profits considerably over time under our most reasonable assumptions. Perhaps more importantly, after several years of struggle to find attractively priced opportunities, today's bargains are more prevalent. In our opinion, many of the Fund's holdings trade at a considerable discount to the price a knowledgeable, private, cash buyer would offer for the whole company.

<u>Portfolio Activity</u>
Earlier this year, we struggled to find interesting investment opportunities, but as prices declined our team put quite a bit of capital to work. This is demonstrated in our cash balances, which are essentially a residual of our efforts to find interesting opportunities. The Fund entered the year with only 5.3% in cash, but as prices rose bargains were difficult to find. Cash reached 11.5% by September 30. However, with the recent price declines, we found additional attractive investments. The cash balance declined to 2.4% by year-end. During 2018, we initiated four new positions and exited six.

Three of our purchases and sales were really "swaps" where, in our opinion, our team sold admirable, well-run companies only because we found an even more attractive opportunity in a similar business. In the first case, we sold our shares in **Evolution Petroleum (EPM)** after concluding that **Matador Resources (MTDR)** was an even better investment opportunity. Similarly, we sold real estate owner **Consolidated-Tomoka Land Co. (CTO)** and invested in real estate service provider/broker **Colliers International Group (CIGI)**. Finally, we sold our shares in value manager **Westwood Holdings Group (WHG)** while adding to our existing position in **Diamond Hill Investment Group (DHIL)**.

Purchases
Matador Resources (MTDR) is a domestic energy firm, primarily focused on finding oil in southeast New Mexico and West Texas. Two things separate Matador from the dozens of other small-cap energy businesses, in our opinion. Firstly, they are good operators, routinely drilling good wells at solid economics. Secondly, although harder to define but definitely important, their culture is excellent in our view. This shows up several ways, but is best highlighted by their contrarian approach to capital allocation. Management has a long history of smart moves such as buying reserves when prices are low, selling most of their natural gas operations when prices were near a peak, and leveraging their own oil assets to develop a valuable pipeline serving themselves and neighboring competitors.

[4] Cumulative performance of a hypothetical $100 investment in the Russell 2000 Index. The returns do not reflect the payment of any brokerage commissions or brokerage costs incurred as a result of buying or selling Russell 2000 Index fund shares or trading shares on an exchange and do not reflect the deduction of taxes to which an investor would be subject as a result of owning or selling shares of a fund. If they did, the returns would be lower than those shown.

Colliers International Group (CIGI) is a global real estate services company offering everything from building management and lease negotiations to valuation services and brokering the sales of buildings. While the business could undoubtedly remain cyclical, it is a growing, profitable corporation in a prosperous industry where all the major players tend to do well. What makes Colliers particularly interesting, from our viewpoint, is its sharp leadership that allows for both organic growth and smart bolt-on acquisitions of smaller peers at attractive returns on capital.

Natus Medical (BABY) was added to the portfolio in the second quarter. Natus is a medical instrument/device firm with impressive franchises in newborn care (e.g., newborn hearing), neurology (e.g., sleep diagnostics), and audiology (e.g., hearing aid tuning). However, Natus stumbled recently, the largest factor being unexpected difficulty integrating an acquisition. We believe these challenges should abate, leading to a rebound in profitability. Some of our best purchases have come from a good business faltering temporarily and we believe Natus falls into this category.

In the fourth quarter, we began buying shares in **Frontdoor (FTDR)**, the leading U.S. home warranty provider, recently spun off from its former parent company (ServiceMaster). We believe Frontdoor was already attractively priced after the spinoff. Investors in ServiceMaster received shares, but most had little interest in holding a small company such as Frontdoor and thus sold quickly. Unfortunately, the stock fell even further after they disappointed investors with a poor third quarter report. Our team continued to add to the position at these lower prices. Our assessment is that Frontdoor is already a good business with a history of impressive growth, the best profit margins in the industry, and strong free cash flow while trading at what we estimate to be a cheap price. That alone can lead us to a nice outcome. However, Frontdoor has the potential to be much larger if new CEO Rex Tibbens (formerly Chief Operating Officer at Lyft) can successfully lead them into the "on-demand" side of home repair. It is an imaginable future where consumers simply use a phone to order a home repair from one of Frontdoor's 45,000 independent technicians.

Sales

As mentioned, we sold our shares in **Evolution Petroleum (EPM)**, **Consolidated-Tomoka Land Co. (CTO)**, and **Westwood Holdings Group (WHG)**.

We exited our position in **Lindsay Corp. (LNN)** after a nice gain. Lindsay's primary business is selling agricultural irrigation equipment under the Zimmatic brand name. Despite virtually no change in commodity prices or demand from farmers, Lindsay's share price rose approximately 50% over the two years the stock was held. As a result, our team decided that the smart move was to sell, but we remain fans and, at the right price, could reestablish a position.

Mistras Group (MG) was sold early in the year. Mistras provides testing and related services to a few industries – particularly refineries and petrochemical plants. Those customers reduced their demand for services when oil prices began falling in late 2014 and Mistras' share price fell as well. After years of watching Mistras and its competitor (Team, Inc.), we thought there was finally an opportunity. We started buying shares shortly thereafter with the theory that this was a good enterprise facing a difficult environment that could revert to normal in time. Yet, as oil prices began to rebound off their early 2016 bottom, demand for Mistras' services improved only modestly. Clearly, something seems to have changed in the industry dynamic and, despite our best efforts, we were unable to fully comprehend the changes. Our team decided to exit the position, but happily generated a small positive return.

In September, **Sonic Corp. (SONC)** announced their sale to Inspire Brands (the private owner of chains such as Arby's and Buffalo Wild Wings) for $43.50 per share in cash. This capped off a wonderful investment for us. We initially purchased shares in early 2017 after Sonic and most of their peers struggled, primarily due to an increase in competitive intensity. Believing that the condition was temporary, we purchased shares at a nice discount to what we thought Sonic was truly worth. Thankfully, results improved and Inspire was kind enough to prove us right on the valuation.

In addition to new ideas and outright sales, we often expand and trim existing positions as warranted. Our largest moves were additions to two of our bank holdings – **Pinnacle Financial Partners (PNFP)** and **South State Corp. (SSB)** – late in the year as bank stocks sold off. We also made a sizable reduction in **US Ecology (ECOL)**, a hazardous waste disposal operation.

Closing Thoughts

As mentioned earlier, after a solid start to the year, stock prices declined in the final four months. It was certainly disappointing to be down in 2018, but we were pleased to outperform the Russell 2000 Index. Within this environment, “growth” investors dramatically outperformed us “value” investors in both 2017 and 2018. Much of this was driven by the healthcare sector, which includes many unprofitable businesses with big dreams that we consider to be much too speculative. A few may succeed, but many could fail.

As the saying goes, the only constant is change. The economic and political backdrop in which we invest is always shifting. While the specific events of the day might be surprising, we are never surprised to find conditions changing. It is because of this that FAM Funds favors enterprises that we estimate can do well and grow in a wide variety of scenarios. We believe that we have a nice collection of solid companies within the portfolio and that they could achieve healthy, long-term returns from current, reasonably attractive valuation levels.

As always, we are grateful for the trust you have put in us. It is an honor we do not take lightly.

Best & Worst Performers for 2018

Best Performers		Worst Performers	
Sonic Corp.	2.57%	Multi-Color Corp.	-3.00%
CBIZ	1.35%	Carriage Services	-2.07%
US Ecology	1.11%	Hostess Brands	-1.44%
Monro	1.11%	Frontdoor	-1.38%
AngioDynamics	0.83%	Matador Resources	-1.38%

This reflects the FAM Value Fund’s best and worst performers, in descending order, based on individual stock performance and portfolio weighting. Past performance does not indicate future results.

Performance (as of 12/31/18)

	YTD	1-Year	3-Year	5-Year	Since Inception 3/1/2012
FAM Small Cap Fund Investor Shares	-9.37%	-9.37%	5.58%	3.70%	9.49%
Russell 2000 Index	-11.01%	-11.01%	7.36%	4.41%	9.14%
S&P 500 Index	-4.38%	-4.38%	9.26%	8.49%	11.50%

Past performance does not indicate future results.

Andrew F. Boord
Co-Manager

Thomas O. Putnam
Co-Manager

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Performance data quoted above is historical. Past performance is no guarantee of future results. Current performance may be higher or lower than the performance data quoted. The principal value and investment return of an investment will fluctuate so that your shares, when redeemed, may be worth more or less than their original cost.

FAM SMALL CAP FUND TOP 10 HOLDINGS

As of 12/31/18

Name	% of Total Net Assets
Hostess Brands, Inc.	5.4%
Frontdoor, Inc.	5.0%
National Commerce Corp.	4.9%
CBIZ, Inc.	4.9%
ExlService Holdings, Inc.	4.8%
Choice Hotels International, Inc.	4.7%
Monro	4.7%
Natus Medical, Inc.	4.6%
Diamond Hill Investment Group	4.2%
Pinnacle Financial Partners	4.1%
TOTAL NET ASSETS	$147,820,716

AVERAGE ANNUAL TOTAL RETURNS AS OF DECEMBER 31, 2018
The performance data quoted represents past performance.

	SINCE INCEPTION	10 YEAR	5 YEAR	3 YEAR	1 YEAR	TOTAL FUND OPERATING EXPENSES*
FAM SMALL CAP FUND *Investor Class* (3/1/12)	9.49%	N/A	3.70%	5.58%	-9.37%	1.34%*
Institutional Class (1/1/16)	5.71%	N/A	N/A	5.71%	-9.29%	1.21%*

** Disclosure: The Fund's total annual operating expense ratio as stated in the fee table of the Fund's most recent prospectus is 1.34% for the Investor Class. The Fund's total annual operating expense ratio as stated in the fee table of the Fund's most recent prospectus is 1.21% after fee waivers of (0.02)% for the Institutional Class. When excluding Acquired Funds Fees and Expenses, which are not direct costs paid by the Fund's shareholders and fee waivers, the total annual operating expense as reported in the FAM Small Cap Fund's audited financial statements as of 12/31/17 Investor Class is 1.30% and Institutional Class is 1.20% as of 12/31/17. The Advisor has contractually agreed, until May 1, 2019, to waive fees and/or reimburse the Fund certain expenses (excluding interest, taxes, brokerage costs, Acquired Fund Fees and Expenses, dividend expense and extraordinary expenses) to the extent necessary to maintain Net Fund Operating Expenses for Institutional Shares at 1.20%.*

Past performance is not indicative of future results, current performance may be lower or higher 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 Small Cap Fund and should be read carefully before you invest or send money. The principal risks of investing in the 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 Small Cap, please go to famfunds.com or call (800) 932-3271.

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