# FAM DIVIDEND FOCUS FUND

Annual Shareholder Letter 2020

December 31, 2020

Dear Fellow Dividend Focus Fund Shareholder,

What if we told you at the beginning of 2020 that, amidst a global pandemic, the U.S. would see unemployment touch 14%, full-year GDP (gross domestic product) would be estimated to shrink 3.5%, and corporate profits (measured by S&P 500 earnings) would be down 15%, yet the U.S. equity market would be up double-digits and finish the year near all-time highs?[1]

You, like us, would probably be skeptical of such a prediction, yet 2020 provided the clearest reminder in recent memory that the stock market and economy are not the same thing and that the two can diverge — sometimes significantly.

While the economy took a massive blow due to widespread lockdowns, people and businesses propped up by significant government stimulus, lower interest rates, and lending programs. This massive liquidity and stimulus, along with an influx of retail traders, created an ideal backdrop for equities to have an exceptional year in our view. The FAM Dividend Focus Fund (the "Fund") delivered a +12.3% return for the year, an outcome that would have been hard to grasp in late March when the Fund's performance was down more than -35.0%.

The Fund's performance lagged the Russell Midcap Index benchmark which was up 16.9%, but a deeper look at returns throughout the year shows two distinct periods.[2] For roughly the first three quarters of the year, the Fund outperformed its benchmark. During that time, when uncertainty was high, investors favored companies that had minimal or no COVID-related disruptions, quality balance sheets, or benefited from the developing work-from-home trend.

However, as the year progressed and clarity grew on the timing of vaccine approval and distribution and the economy inched toward reopening, investors shifted toward more speculative and cyclical investments. This was very evident in the fourth quarter.

Signs of this speculative shift included a record year for IPO (initial public offering) activity, particularly early-stage biotechs and high-growth, yet unprofitable tech companies. 2020 also saw the mainstream emergence of SPACs (special purpose

[1] *FactSet as of 12/31/2020*
[2] *Bloomberg as of 12/31/2020*


Securities offered through Fenimore Securities, Inc. Member FINRA/SIPC, and advisory services offered through Fenimore Asset Management, Inc.

acquisition companies). These investment vehicles are essentially blank checks for management teams to make an acquisition and are an avenue for businesses to go public without traditional investor scrutiny. Additional areas that investors frenzied for included work-from-home beneficiaries, anything electric vehicle related, and bitcoin.

Some of these investments may live up to the early investor hype, in our opinion, but history tells us that most probably will not. Many of these businesses are nascent and unproven and their financial profile usually falls well short of our investment criteria. Importantly, it would be rare for any of these stocks to have a sound dividend growth policy given their growth and early stage. On the other hand, the majority of the Fund's holdings demonstrated their financial excellence by growing or sustaining their dividend in 2020.

During the year, 21 of the Fund's 28 holdings measured at year-end grew their dividend by an average growth rate of 9%.[3] An additional five companies maintained their dividend.[4] Ross Stores was the only company that suspended their dividend, ending a payout streak of 25 years. Despite being hit hard by COVID-related lockdowns as a brick-and-mortar retailer, we believe Ross Stores remains well positioned for growth as we move past the virus and is committed to paying a dividend in the long run.

## Portfolio Activity

We had significantly higher-than-usual portfolio activity in 2020 with the market experiencing its strongest decline since the Great Financial Crisis when it fell by more than -30% in March.[5] We took the opportunity to upgrade the Fund's portfolio by purchasing stock in what we believe are several quality businesses that we have long followed but waited on for attractive entry prices. While most of this activity was in the first half of the year, we were able to add three new names and sell another four in the second half. That brought full-year activity to eight new names and 13 sales.

**Purchases**
Here are the new holdings:

- **Cintas (CTAS)** is the largest provider of uniform rentals, first aid, and safety products in the U.S. and Canada. Cintas utilizes its scale advantage to enable them to acquire and serve customers at a lower cost than their competitors. We also like Cintas' high rates of recurring revenue and historical customer retention rates. The company has also paid a dividend every year since it went public in 1983.
- **Jack Henry & Associates (JKHY)** provides critical core processing software to financial institutions which creates high recurring revenue and profitability. The firm continues to grow through increased tech spending by banks and credit unions. Management has a track record of capital allocation and runs the business with a clean balance sheet, typically net cash. It has grown its dividend for 26 straight fiscal years.
- **Paychex (PAYX)** provides HR, payroll, and benefits and insurance services for small- and medium-sized businesses. They serve approximately 670,000 clients and more than 12 million employees. Paychex benefits from increased regulations, which drive more outsourcing of payroll and HR solutions. The stock often trades around employment numbers, which enabled us to build our position in the stock.
- **Republic Services (RSG)** is the second largest solid waste collection and recycling provider in North America. Trash collection is a highly durable business with

[3] *FactSet as of 12/31/2020*
[4] *Not included is Trane Technologies, which, as described later in the letter, was spun out of Ingersoll Rand in March*
[5] *Bloomberg as of 12/31/2020*

predictable cash generation that supports M&A (mergers and acquisitions) and a shareholder friendly capital allocation policy. RSG has returned nearly $5 billion in cash to shareholders (approximately 18% of its current market cap) over the last five years in dividends and stock buybacks.

- **STERIS (STE)** provides sterilization equipment and services to healthcare providers like hospitals, surgical centers, and outpatient GI procedure centers as well as medical device and pharma manufacturers. STERIS benefits from growth in medical procedures and more than 75% of its revenue is recurring. Additionally, the medical industry is highly regulated, which makes their products and methods very sticky with customers. The business has paid a growing dividend every year since 2005.
- **HEICO (HEI)** is a market leader in aftermarket parts and repair services for commercial aircraft. They also provide a broad list of electronic components to a variety of end markets (e.g., defense, space, and medical). Their aircraft replacement products, which need FAA approval, are typically priced 30% to 50% below OEMs (original equipment manufacturers) and provide cost savings for airlines. While flight segment demand was decimated during the pandemic, we believe the value proposition HEICO offers should lead to market share gains during the recovery.
- **First Hawaiian Bank (FHB)** was repurchased in November after a sale earlier in the year. At the time of the initial sale, we had significant concerns about the impact of lower interest rates, rising credit costs, and Hawaii's dependence on tourism. With a conservative credit culture, the bank's balance sheet held up nicely throughout the year. Once we received some clarity on the impact to FHB's financials and the distribution of a vaccine, we repurchased shares and believe the stock should benefit from an economic reopening.
- A position in **Graco (GGG)** was initiated. This diversified industrial company is best known for their paint sprayers and we expect them to benefit from economic expansion. Graco also has a track record of growing their dividend and buying back shares.

**Sales**

- **Essential Utilities (WTRG)** was formerly known as Aqua America until its purchase of a natural gas utility in late 2018 (transaction closed in March 2020). We thought this acquisition was outside their core competency and believed they paid a more than full price at 15 times EBITDA (earnings before interest, taxes, depreciation, and amortization). Our team was initially attracted to WTRG due to the economics of water utilities and this transaction complicated that thesis, so we decided to fully exit our position.
- **Ingersoll Rand (IR)** was sold after its separation from **Trane Technologies (TT)**. In the first half of 2020, Ingersoll Rand split its HVAC business off into a separate company (Trane Technologies). The remaining industrial compressor, vacuum, and blower business merged with competitor Gardner Denver and kept the Ingersoll Rand name and stock ticker. We are happy to continue to own the durable HVAC business in a pure-play format, but sold IR which is more cyclical and doesn't pay a dividend.
- **Marriott International (MAR)** was sold as their business suffered greatly from the virus outbreak. Liquidity concerns forced Marriott to complete several debt raises and suspend their dividend "until further notice." We believe there is too much uncertainty in its immediate future and, with increased balance sheet risk, decided to move on.
- We sold our stakes in **Monro (MNRO)** and **South State Bank (SSB)** not because anything was wrong with the businesses or our investment theses, but rather to use the proceeds to fund other purchases in enterprises that we hope should be even better compounders.
- A small stake was purchased in **Penske Auto Group (PAG)** as we looked to put cash to work at attractive valuations in a fully valued market. This was subsequently sold after they suspended their dividend.

- **National Instruments (NATI)** was sold as we believe results have been subpar despite a decent operating environment over the last few years. The company also recently completed an entire corporate reorganization and last year surprisingly announced a CEO transition after only three years.
- **Snap-on (SNA)** was another business that we sold as growth issues have persisted for several years. The operation's stagnation increased our concerns about inventory levels and operating margins along with their ability to continue to create value for shareholders.
- **US Ecology's (ECOL)** $900 million acquisition of NRC Group Holdings Corp. (NRCG) in 2019 was an example, we believe, of a company completing M&A too far away from its core competency. The transaction created much execution risk, in our view, and we exited our remaining position.
- **Watsco (WSO)** was sold at the beginning of the year after running up 30% in 2019. Recent results have been below our expectations as their technology spending has weighed on margins and the sustainable level of growth has come into question. Additionally, its dividend payout ratio (dividends/free cash flow) has run in excess of 86% over the last two years, which could put it at risk for a cut.
- **ResMed (RMD)** was sold after a brief stint in the Fund. ResMed is a leading provider of air flow medical devices for the treatment of sleep apnea. They also have a growing respiratory care (i.e., ventilators) and software business. We started buying the stock during the market selloff in March, but the price ran up before we could build a full position as its ventilator business saw astronomical demand due to the coronavirus. With uncertainty over reopening rates of sleep clinics and a looming CMS (Centers for Medicare & Medicaid Services) reimbursement ruling, we decided to sell. It represented less than 1% of the Fund's assets at the time of sale.
- We sold our position in **Xilinx (XLNX)** in late October shortly after the firm announced it was being acquired by Advanced Micro Devices (AMD) in an all-stock transaction. Xilinx, a semiconductor company, had been a Fund holding since 2009. We decided to sell and lock in gains since we would not be keeping AMD shares, which has a greater than $100B market cap and is well outside our mid-cap focus. Additionally, we thought it was prudent to raise cash amid broader market volatility.
- We exited **EOG Resources (EOG)** in September. Their business was greatly impacted by the declines in oil prices and spent much of the year down more than 30%. EOG is a well-run, low-cost producer in our view, but this attribute is weakened by the inability to control the price at which they can sell their oil. While EOG would have cyclical tailwinds during an economic reopening, we believe secular headwinds will continue to grow.

## Closing Thoughts

With the multitude of hardships that 2020 brought, many people are looking forward to turning the calendar to 2021. As we look forward to next year, the FAM Dividend Focus Fund will be celebrating an important milestone — its **25th Anniversary**.

This is a long time in the industry, and much has changed — even the Fund's name. But what hasn't changed is the investment process that has enabled the longevity and success of the Fund.

Over the decades, we have learned from our mistakes and continually work to improve our research process while maintaining the core principles our Founder, Tom Putnam, established on day one. Our team is committed to investing in what we deem to be quality businesses with sustainable competitive advantages, financially sound balance sheets, and strong management teams at attractive prices relative to fundamentals. And once we invest in these companies, we continue to monitor them closely and visit (or Zoom) with the management teams annually.

Since our launch in 1996, our investment process has been tested by a variety of market environments like the tech boom in the late '90s and the Great Financial Crisis, but our ability to take a long-term view has helped us stay focused and enabled the Fund to endure.

Over the next 25 years, our success should be predicated on doing more of the same — adhering to our investment process and maintaining a long-term view. If we do this, we are very optimistic about the Fund's future.

## TOP 5 CONTRIBUTORS AND DETRACTORS*

### 12/31/2019 TO 12/31/2020

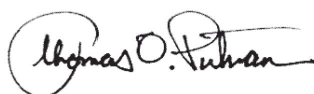
| TOP 5 CONTRIBUTORS | | |
|---|---|---|
| NAME | AVERAGE WEIGHT (%) | CONTRIBUTION (%) |
| Entegris | 5.36% | 2.56% |
| Pool Corp | 3.94% | 1.84% |
| Microchip Technology | 6.12% | 1.48% |
| Arthur J. Gallagher & Co. | 5.82% | 1.34% |
| Broadridge Financial Solutions | 4.79% | 1.03% |

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

| TOP 5 DETRACTORS | | |
|---|---|---|
| NAME | AVERAGE WEIGHT (%) | CONTRIBUTION (%) |
| Marriott International | Sold | -1.85% |
| Monro | Sold | -1.15% |
| EOG Resources | Sold | -1.07% |
| US Ecology | Sold | -0.60% |
| South State Bank | Sold | -0.60% |

*Past performance does not indicate future results.*

**Paul Hogan, CFA**
Portfolio Manager



**Thomas O. Putnam**
Portfolio Manager

**William W. Preston**
Portfolio Manager

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**Reflects top contributors and top detractors to the fund's performance based on each holding's contribution to the overall fund's return for the period shown. The information provided does not reflect all positions purchased, sold or recommended for advisory clients during the period shown. It should not be assumed that future*

*investments will be profitable or will equal the performance of the security examples discussed. Past performance is no guarantee, nor is it indicative, of future results. For more detailed information on the calculation and methodology as well as a complete list of every holding's contribution to the overall fund's performance during the time period shown, please call (800) 932-3271 or visit the fund's website at famfunds.com. Portfolio composition will change due to ongoing management of the fund. References to individual securities are for informational purposes only and should not be construed as an offer or a recommendation, by the fund, the portfolio managers, or the fund's distributor, to purchase or sell any security or other financial instrument. The summary is not advice, a recommendation or an offer to enter into any transaction with Fenimore or any of its affiliated funds. The portfolio holdings as of the most recent quarter most recent quarter.*

## TOP 10 HOLDINGS — AS OF 12/31/2020

| FAM DIVIDEND FOCUS FUND | % OF PORTFOLIO |
|---|---|
| Microchip Technology | 6.12% |
| Arthur J. Gallagher & Co. | 5.82% |
| Trane Technologies | 5.71% |
| CDW Corp. | 5.61% |
| Ross Stores | 5.51% |
| Air Products & Chemicals | 5.39% |
| Entegris | 5.36% |
| Stryker Corp. | 5.34% |
| Broadridge Financial Solutions | 4.79% |
| Genpact | 4.13% |
| **TOTAL NET ASSETS** | **$509,666,284** |

*The portfolios are actively managed and current holdings may be different.*

## AVERAGE ANNUAL TOTAL RETURNS — AS OF 12/31/2020

| | SINCE INCEPTION | 10 YEAR | 5 YEAR | 3 YEAR | 1 YEAR | TOTAL FUND OPERATING EXPENSES* |
|---|---|---|---|---|---|---|
| FAM DIVIDEND FOCUS FUND (4/1/96) | 9.65% | 12.98% | 15.51% | 14.51% | 13.20% | 1.26%* |

*The performance data quoted represents past performance.*

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*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 each Fund and should be read carefully before you invest or send money. To obtain a prospectus or summary prospectus for each fund as well as other information on the FAM Funds, please go to fenimoreasset.com or call (800) 932-3271.*

*Risk Disclosures: 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).*

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**FAM Dividend Focus Fund Disclosure: The Fund's total annual operating expense ratio as stated in the fee table of the Fund's most recent prospectus is 1.26%. The total operating expense as reported in the FAM Dividend Focus Fund's audited financial statements as of 12/31/19 is 1.24%. The Advisor has contractually agreed, until 5/1/2021, 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 Investor Shares at 1.26%.*