FENIMORE
ASSET MANAGEMENT

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THE QUEST FOR QUALITY SMALL-CAP STOCKS

QUANTITATIVE ANALYSIS & QUALITATIVE INVESTIGATION

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The assertions in this paper are based on Fenimore Asset Management's opinion. Fenimore Asset Management is the manager of the FAM Funds.

Highlights Include:

- Fenimore's quantitative analysis and qualitative investigation.
- Our proprietary, in-depth, quality and margin-of-safety screens.
- The Small Cap Strategy's investable universe.
- Fenimore's actively managed approach to constructing concentrated portfolios.

Small-cap investors scour a large universe of approximately 2,000 companies in the U.S. in search of opportunity. However, Fenimore, with a strong focus on what we believe are the highest quality businesses, eliminates the vast majority of the 2,000 and studies a much smaller group of impressive companies.

In our May 2015 white paper, "Small-Cap Stocks – Potential Resources of Positive Relative Return," we highlighted an interesting academic paper, "Size Matters, If You Control Your Junk."[1] The researchers found that higher quality, small-cap stocks outperformed over a long period of time in almost every developed country's stock market.

More recently, in September 2020, our colleague Marc Roberts followed up with another white paper, "Margin of Safety – A Multi-Dimensional Investment Principle." This paper explains well Fenimore's focus on a more holistic version of "margin of safety" that goes beyond merely buying stocks at a discount to an estimated intrinsic value. It includes often forgotten sources of risk such as overly indebted balance sheets, unsustainable growth, and weak competitive positions.

Our goal with this paper is to demonstrate how we apply these margin-of-safety factors to sourcing what we deem to be the best investment opportunities for our Small Cap Strategy in order to mitigate risk and construct concentrated portfolios.

Small-Cap Universe

The small-cap universe, defined primarily by the Russell 2000 Index, gives us about 2,000 businesses to choose from with market capitalizations between $95 million and $4.4 billion (the range when the index was last reset in May 2020). From this group, our team wants to build portfolios of the highest quality companies.

Quality Small-Cap Businesses

From Fenimore's vantage point, these businesses are:

A — **Already highly profitable with the potential to grow earnings nicely for many years.**

B — **Operated with no or modest debt relative to the company's characteristics.**

C — **Run by leaders with both uncommon talent and strong ethics.**

D — **Available at a discount to our estimate of intrinsic value.**

In our experience, these criteria necessitate an approach that combines both quantitative financial statement analysis and qualitative investigation. A successful quality investor combines the spreadsheet skills of an accountant with the investigative approach of a journalist. The first step, however, is often a quantitative screen to identify companies that are likely to meet our first requirement of being highly profitable.

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[1] *Authored by Clifford Asness, Andrea Frazzini, and Ronen Israel of AQR Capital, Tobias Moskowitz of Yale School of Management, and Lasse Pedersen of Copenhagen Business School.*

Screen #1: Quality

A recent "screen" that Fenimore's analysts ran demonstrates this well. Of the companies in the Russell 2000, we identified approximately **495 businesses** with market capitalizations between $200 million and $4.4 billion and some combination of what we think is impressive return on equity, return on tangible equity, return on invested capital, and return on tangible assets. This establishes a solid starting point from which to do more research.

While new names appear on the list regularly, after running similar screens for years and spending countless hours searching for hidden gems, this is a group of companies we know relatively well. Over the years, we have studied most of these businesses including reading earnings releases, phoning management with questions, visiting headquarters, and speaking with experts, customers, suppliers, and competitors.

Screen #2: Managing Risk

As Marc Roberts explained in Fenimore's "Margin of Safety" white paper, there are many ways other than overpaying for investments to suffer a significant, permanent loss of capital. So much of our effort on this list of 495 highly profitable companies is to weed out the riskiest situations. A quick scan of the list, based on years of focusing on small-cap equities, reveals numerous firms to avoid due to several factors such as:

VALUES–BASED	
We avoid businesses focused on alcohol, pornography, gambling, tobacco, and weapons.	
UNSUSTAINABLE	
Many enterprises appear very profitable today, but we estimate they are unlikely to remain profitable long enough for long-term investors to do well. The potential obstacles include:	
DISRUPTION	For instance, old media and retailers can still generate high profit metrics, but many are doomed to a slow deterioration as dynamic challengers and larger social forces erode their current standing.
ONE–TIME GAIN	As an example, an otherwise unprofitable biotech company receiving a one-time payment from a partner for hitting a development target is not sustainable.
CYCLICALITY	Many industries are unavoidably cyclical, so at the strongest points in the cycle a cyclical company can be highly profitable, but earnings are bound to retreat when the cycle swings. This does not make it a bad business, but this is clearly key to a proper assessment in our view.
FADS	Over the years, we have seen firms benefit from crazes in the short term – including rollerblades, Beanie Babies, and karaoke – but perform poorly over the long term. More subtle examples include restaurant chains that start strongly, but then their popularity fades over time.
EXCESS FINANCIAL RISK	
Many companies are dependent on financial markets functioning smoothly which, as history tells us, is never guaranteed. For example, heavily indebted operations depend on lenders extending additional loans, many investment banks need the derivatives market to operate properly, and most non-bank lenders cannot survive unless they can securitize their receivables. These markets usually run well, but when they do not it can trigger a disaster.	
REGULATORY TARGETS	
A few industries, like for-profit education and consumer lending, are routinely the subject of government regulation. This can eventually lead to a significant reduction in profitability.	
DIFFICULT TO UNDERSTAND	
Occasionally, we find a business that is highly profitable today, but the competitive advantage that leads to these higher profits is hard to fully grasp, perhaps built upon arcane science or "manufacturing know-how." Without a comprehensive understanding, it is virtually impossible to predict the sustainability of high profit margins. These types of ideas go on our "too hard pile."	
LACK OF GROWTH	
Many good firms generate substantial free cash flow, but struggle to grow earnings. For example, they may already hold a leading position and have little growth left to accomplish. Our ideal is a business that is already quite successful and profitable, but still has avenues for growth – either organic expansion or smart accretive acquisitions of smaller competitors.	
ETHICS	
Frankly, we may be concerned about the management because something just does not smell right. The accounting may look suspect, the sales practices uncomfortably aggressive, and/or the leadership seems too promotional. In such situations, the surprises are never positive in our experience.	

Distinctive Focus

These various layers of risk-conscious filtration remove about 300 to 400 names from our list of 495 solidly profitable companies. This leaves us with our much more limited area of opportunities. We already own shares in many of these remaining firms while others we would buy today if the price were right. Meanwhile, some are superfluous (e.g. the third impressive enterprise in an industry where we already own the top two) and in several situations we are still trying to nail down a few more facts. *Ultimately, our investable universe is approximately **100 to 200 quality businesses**.*

Concentrated Portfolios

With our Small Cap Strategy's investable universe, we aim to build concentrated portfolios (typically 20 to 30 holdings) of our best ideas. For example, to reinforce how we differ from the index, our FAM Small Cap Fund's active share versus the Russell 2000 is 98.33%.[2] Fenimore's analysts want each holding to potentially have a meaningful impact on performance. As a result, our team will not speculate with our investors' hard-earned assets – or ours – but instead demands a collection of select, quality, profitable, durable, and well-run businesses.

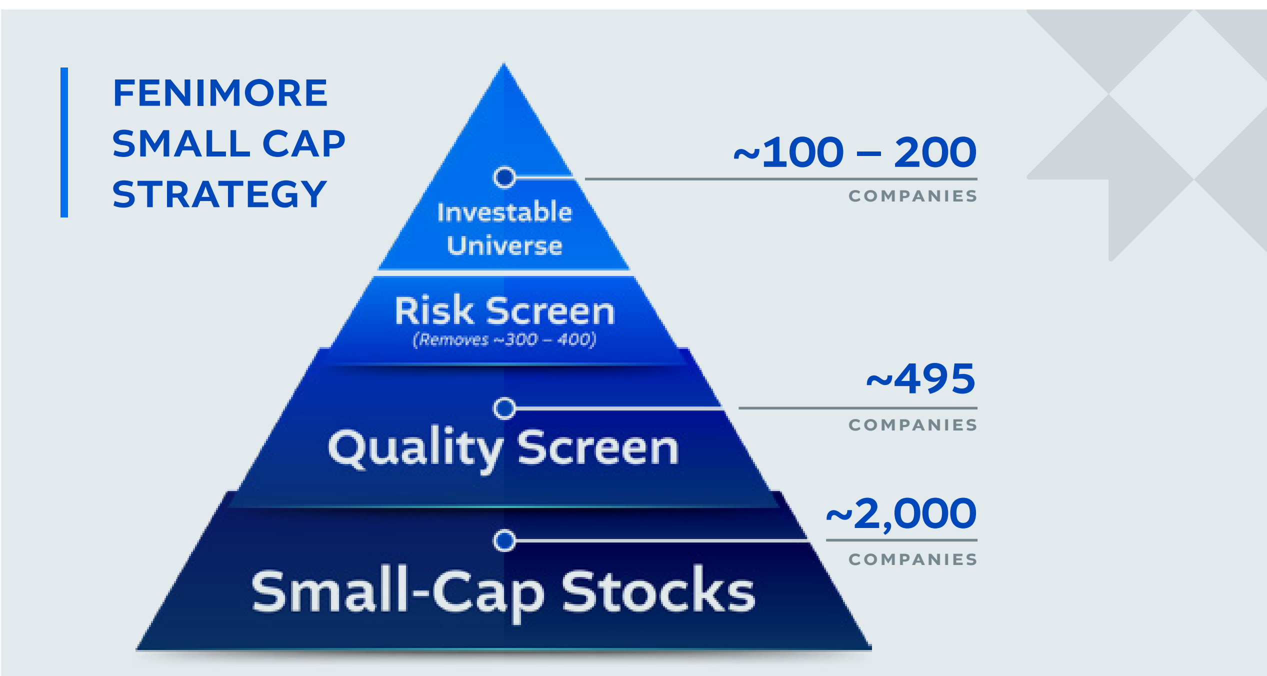
Actively Managed

Short-term performance is unpredictable and subject more to the emotions of investors, but we strongly believe that, ultimately, long-term investment performance tracks the quality of the underlying companies. We feel very comfortable with positions that have better profit margins and less debt than the overall Russell 2000. Just one of Fenimore's internal metrics that we monitor for quality is return on tangible assets (ROTA). ROTA is essentially how efficiently a business uses its assets and how much cash it can generate per dollar of assets. For instance, the FAM Small Cap Fund – run against the Russell 2000 Index ETF IWM – shows 44% ROTA versus 26%.[3]

What this means is that, on average, for every $100 invested in tangible assets, our holdings produce $44 in cash versus $26 for the average Russell 2000 company. Put another way, our holdings produce about 70% more in cash per dollar of tangible assets than the average Russell 2000 business.

Conclusion

Fenimore's relentless "Quest for Quality Small-Cap Stocks" began in 1974 and continues today. We describe our investment approach as "contrarian" (seeking companies under a rock or under a cloud). In our experience, few active managers make the intense effort to discover what we would call the cream of the crop – the select number of quality businesses that successfully pass our screens and extensive margin-of-safety requirements. We believe that our proprietary metrics and distinctive investment research process should continue to enable our Small Cap Strategy to fare well over time.



[2]*FactSet, active share is as of 12/31/2020.*

[3]*FactSet, as of 1/31/2021. ROTA is calculated by taking EBITDA and dividing it by a company's tangible assets. EBITDA (earnings before interest, taxes, depreciation, and amortization) serves as a proxy for cash flow. Total tangible assets (total assets less cash, goodwill, and intangible assets) represents assets that the company actively deploys to generate earnings. Dividing one by the other shows how much cash a company generates per dollar of tangible assets deployed.*

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