Overview
The historical outperformance of small-cap stocks versus their large-cap peers over the very long term has been common knowledge for years. Less well-recognized are the significant caveats to this performance story. Moreover, largely overlooked is the role of additional sources of positive relative return potential within the small-cap universe related to market capitalization, valuation, and quality traits. This paper will seek to outline these sources of return and put the FAM Small Cap Fund strategy into perspective relative to these factors.

Long-Term Outperformance of Small-Cap Stocks
It is true that, viewed over the broad sweep of time, small caps have outperformed the principal alternatives. The chart below displays cumulative long-term performance for various asset classes alongside inflation. As it indicates, small-cap equities have historically proven to be a superior generator of wealth, outperforming not only such alternatives as long-term government bonds and Treasury bills, but also their large-cap equity peers. The long-term outperformance of small caps has been widely attributed to their reduced liquidity and greater volatility versus other asset classes. In other words, the thinking goes, investors require higher potential returns from small caps as a result of their higher inherent risk.

Value vs. Growth
— demonstrates that value has outperformed growth in the small-cap space.

Controlling for Junk
— recaps an academic study emphasizing that small, high-quality companies offer more robust size premiums.

Overview
May 2015 | Topics Covered Include:

Long-Term Outperformance
— shows the history of small caps outperforming other asset classes.

Small End of Small Caps
— highlights the corollary between smaller market capitalization and higher average annual returns.

This paper examines the key potential sources of positive relative return for small-cap stocks.

The assertions in this white paper are based on Fenimore Asset Management’s opinion. Fenimore Asset Management is the investment advisor to FAM Funds.

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Stocks, Bonds, Bills, and Inflation 1926-2014

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Small End of the Small-Cap Space Has Been Even Better

Interestingly, the “small-cap effect” applies within the small-cap universe. As shown in the next chart, when small-cap companies are segmented by size, the smaller the market capitalization the higher average annual returns achieved.

What is the explanation for these higher returns over time the farther down the capitalization spectrum one goes? One explanatory factor may be the illiquidity premium. There is inherently more risk in assets that are less liquid. In turn, investors require a premium to invest in these securities. This lack of liquidity also creates constraints under which most of Wall Street operates. Due to the lower dollar volume of available shares, small-cap stocks begin with a strike against them when it comes to large asset management firms with multi-billion dollar portfolios. Such investors find it difficult to “move the needle” in terms of impact on their portfolios by investing in this space, and this is especially true with the smallest of the small-cap stocks.

This has resulted in notably reduced coverage by Wall Street and institutional analysts, less competition to invest in attractive companies, and increased pricing inefficiencies with respect to the smaller stocks within the small-cap space. In our view, the lower level of institutional attention directed toward very small-cap stocks means expanded opportunities to find value and higher potential returns.

With reference to the above chart, stocks held under the FAM Small Cap strategy generally fall within the second and third market cap deciles. One might ask: Why not have all of the strategy’s assets invested in the first decile given its performance over time?

There are two principal reasons why not, related to the strategy’s investment criteria and risk management process. The first reason relates to the illiquidity premium referenced earlier: the smallest decile companies tend be less liquid due to their size and trading volumes. While there may be a long-term performance premium associated with these stocks, the risk of not being able to readily exit a significant position in response to a change in overall business conditions or company fundamentals must be weighed even more carefully than with the rest of the small-cap universe. Second, these businesses generally do not meet the strategy’s quality criteria with respect to strength of earnings, balance sheets, and management teams. While we seek attractive long-term returns, this goal is balanced by a reasonable concern for preserving capital along the way. The best way we know how to do this is to focus our investments in high-quality businesses.

On Risk Management

It’s true that small-cap stocks are more volatile than their large-cap counterparts. However, we define risk as permanent loss of capital — not stock price volatility. We see market fluctuations as providing opportunities to invest in quality businesses at bargain prices during declines. These are often temporarily out-of-favor enterprises that mainstream investors overlook, but we seek to unearth.

Managing risk is crucial to an effective long-term approach. Many may seem adept at managing money when the market is rising, but fail to have a solid game plan for withstanding and ultimately taking advantage of downturns. Our research efforts enable us to intimately know the businesses behind the stocks we hold, and give us the confidence to maintain, and even increase, our shares in these enduring corporations when the market drops. Furthering this confidence is our process of building relationships and understanding the thought processes of our portfolio companies’ management teams.

We don’t make macroeconomic predictions or time the market. Our strength is our systematic, disciplined approach to identifying high-quality businesses with strong balance sheets that are positioned to increase their intrinsic value, and then purchase shares in them at attractive prices. It’s our observation that, over time, stock prices should follow the earnings growth of businesses, regardless of inevitable short-term market fluctuations.
Valuation and Historical Performance

Fenimore Asset Management, the investment advisor to FAM Funds, was founded on and remains true to a value-oriented investment approach focused on individual companies. This value investing philosophy is applied by the firm in all environments and regardless of market cycle stages. As seen in the following chart, there is a strong foundation for this approach as value styles have significantly outperformed growth over the long term.

![Average Annual Return by Style (1927–2014)](source: Kenneth French Data Library)

Notably, the highest average annual returns have been experienced within the small value category. This gives us confidence that applying our traditional focus on valuation to the small-cap equity universe is a worthwhile endeavor. Of course, the concept of “value” does not exist in a vacuum: some stocks are “cheap for a reason.” The quality profile of a company is integral to our assessment of overall valuation.

Quality: A Timely Concern with Enduring Advantages

Fenimore Asset Management defines high-quality businesses as those with high profitability, low debt, and the ability to generate strong free cash flow. Conversely, low-quality companies have low profitability, high debt, and low cash generation.

Low-quality equities have clearly been supported in recent years by easy financing and low interest expenses. However, at some point interest rates will rise, borrowing will become more expensive, and there will be less liquidity in the system. As a result, companies that are less dependent on financing, are able to generate cash, and are capable of maintaining a reasonable balance sheet should be positioned for stronger relative performance. Our analysis suggests that a focus on quality is prudent and timely for those seeking to maintain equity exposure, regardless of market capitalization.

Additionally, a focus on quality is not only timely, but a matter of enduring concern. Five independent stock-market experts, including three hedge-fund managers and two business-school professors, recently published the first draft of a research paper with important implications for ordinary investors. “Size Matters, If You Control Your Junk” was authored by: Cliff Asness, Andrea Frazzini and Ronen Israel of AQR Capital, a hedge fund company based in Greenwich, Connecticut; Tobias Moskowitz, a professor at the University of Chicago’s Booth School of Business; and Lasse Pedersen at the Copenhagen School of Business in Denmark.

The authors looked at more than 50 years of U.S. stock market data, and over 30 years of data for overseas stock markets. As the study outlines, the truth concerning small-cap performance is complex. Most of the historic outperformance came in the 1960s and 1970s. In addition, the bulk of small-cap outperformance has occurred during the month of January. Finally, when you take into account the higher costs typically involved in running small-cap funds and the greater volatility, the actual benefits from focusing on small-caps were quite modest.

However, the authors’ most significant finding is startling in its simplicity: the subset of companies that were both small and “high quality” (as measured by fundamentals like balance sheet strength, profitability, stability and growth) has consistently outperformed the broader market by notable margins. As the paper details, the advantage of “small-cap, high quality” seems to have persisted over a long period of time, and in almost every developed country’s stock market.
Put another way, the work of Asness and company demonstrates that by “controlling for junk” within small caps, investors can benefit from a much stronger and more reliable size premium. The study concludes that – once low-quality stocks have been filtered out – this size premium is robust across time, including periods where the size effect seems small when one does not control for junk.¹

**Summary and Conclusion**

There are a number of important caveats to the story of small-cap outperformance, and it is necessary to drill down on the asset class to find enduring sources of positive relative return. In particular, a focus on the small end of the small-cap market may result in the identification of under-recognized opportunities. In addition, a focus within small caps on value and quality factors, which we view as intertwined in most cases, appears to hold significant promise from a performance perspective.

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1. **Concentrated Portfolio:**
   Our view is that very concentrated portfolios of 20 to 30 names have a better chance of outperforming the broader market over the long run than highly diversified portfolios. This approach permits us to focus on our best ideas and allows each stock’s performance to potentially have a meaningful impact on returns.

2. **Small End of the Spectrum:**
   The Fund invests in the small end of the small-cap space. By doing so, we believe there are enhanced opportunities to find companies selling below their intrinsic value due to a lack of competition from mainstream analysts and pricing inefficiencies. Currently, our average market cap is approximately $600 million.

3. **Quality:**
   The Fund favors highly profitable, financially sound niche companies with proven managements that have been in operation for a number of years. We typically do not invest in start-up businesses as these are not capable of meeting our rigorous investment criteria. The Fund seeks to mitigate risk and protect capital through in-depth research and active management.

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Fenimore Asset Management is an independent, research-based, bottom-up investment advisor and the manager of FAM Funds: FAM Value Fund, FAM Dividend Focus Fund, FAM Small Cap Fund. FAM Funds’ key portfolio characteristics are: high-quality equities, low-turnover, and concentrated. The value-oriented funds are managed toward the preservation and long-term appreciation of capital.

To obtain additional prospectuses or summary prospectuses and performance data that are current to the most recent month-end for each fund, please go to famfunds.com or call (800) 932-3271.

Please consider a fund’s investment objectives, risks, charges and expenses carefully before investing. The FAM Funds prospectus or summary prospectuses contains this and other important information and should be read carefully before you invest or send money. 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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