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UNCOVER HIDDEN VALUE — LONG-TERM STOCK PICKING

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

Highlights Include:

- Active investors typically determine company valuations using models that rely on three- to five-year time horizons to make investment decisions.
- This mainstream practice can cause investors to overlook companies' potential long-term financial strength and, as a result, misprice them.
- Fenimore Asset Management seeks to take advantage of this market blind spot to generate alpha in portfolios by incorporating a long-term view into its modeling.

This white paper explains a flaw in the efficient market hypothesis and explores how it can be exploited to potentially achieve excess return.

Introduction

Most investment firms determine the value of companies by using models that project earnings over three- to five-year time horizons; investors who determine companies' present value by looking more than a few years ahead are rare. While this typical approach may suffice in determining shorter-term valuations, it may be less effective in assigning valuations for companies with financial strength that are sustainable over longer periods and through various market cycles. At Fenimore Asset Management, our process and philosophy position us to identify such companies and potentially take advantage of short-sighted valuations to generate superior long-term performance.

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The Blind Spot in Most Managers' Valuation Methods

The majority of investment analysts use valuation models to determine the worth of companies and their shares. Common models include the discounted cash flow model, the multiples model, and the economic value-added model. Each of these models seeks to project earnings and other elements of a business's financial performance over a relatively short period — usually three years and five at the most. This short time horizon can prevent investors from identifying, and fully valuing, companies that can sustain strong financial performance over many years.

Consider an example of how managers can overlook long-term value using a hypothetical "Company B." Suppose it is late 2006 and investors are evaluating Company B, the shares of which trade at $200. Company B has earnings per share (EPS) of $10, and therefore a price-to-earnings (P/E) ratio of 20x. Assume that the average investor uses a multiples model to value the business.

Investors in the aggregate — the market, in other words — reach a consensus that the company will likely grow EPS at 15% a year over the next three years, resulting in EPS of about $15 in 2009. However, they also conclude that this type of growth cannot be sustained indefinitely. A P/E ratio of 20x might be appropriate today, given growth expectations for the next three years, but it might not be appropriate at the end of three years. To reflect this viewpoint, investors assign a lower P/E ratio, 17x, to 2009 earnings. With estimates for both EPS and the P/E ratio, we can calculate Company B's expected stock price in 2009.

	2006	3 YEAR ESTIMATE →	2009
EPS	$10.00	15% YEARLY GROWTH →	$15.21
X	X		X
P/E RATIO	20X	EXPECTED MULTIPLE →	17X
=	=		=
STOCK PRICE	$200	EXPECTED STOCK PRICE →	$259

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With EPS of $15 and a P/E ratio of 17x, the expected stock price in 2009 works out to $259. In our example, the stock currently trades at $200; thus we can also calculate the implied return.

	2006	3 YEAR ESTIMATE →	2009
EPS	$10.00	15% YEARLY GROWTH →	$15.21
X	X		X
P/E RATIO	20X	EXPECTED MULTIPLE →	17X
=	=		=
STOCK PRICE	$200	EXPECTED STOCK PRICE →	$259

9% YEARLY RETURN

Company B stock has an implied annual return of 9% (a respectable return in most environments). The matching rates of return suggest that the efficient market hypothesis — that share prices reflect all available information and beating the broad market is impossible — is playing out perfectly.

What if we consider what happens the following year? At the end of 2007, the business has grown EPS 15% over the past 12 months, increasing that metric to $11.50 from $10, as investors had forecast. With a year in the books, investors now need to look one more year out, to 2010, to maintain their three-year model. After the requisite research, the consensus conclusion is the same as it was the previous year: Company B will likely grow EPS at 15% over the next three years and should trade at a P/E ratio of 17x at the end of that period. Once again, a current P/E ratio of 20x is appropriate given three-year growth expectations.

	2007	3 YEAR ESTIMATE →	2010
EPS	$11.50	15% YEARLY GROWTH →	$17.49
X	X		X
P/E RATIO	20X	EXPECTED MULTIPLE →	17X
=	=		=
STOCK PRICE	$230	EXPECTED STOCK PRICE →	$297

9% YEARLY RETURN

At first glance, the implied return remains unchanged at 9% and the market continues to appear efficient. But a closer look raises questions. At the end of 2006, Company B traded at $200. A year later it trades at $230. That is a 15% return — well above the original implied return, and predicated on the consensus that the company's earnings will remain strong beyond the original three-year window. This is where the efficient market hypothesis begins to seem shaky. What happens after another year passes and investors forecast out to 2011?

	2008	3 YEAR ESTIMATE →	2011
EPS	$13.23	15% YEARLY GROWTH →	$20.11
X	X		X
P/E RATIO	20X	EXPECTED MULTIPLE →	17X
=	=		=
STOCK PRICE	$265	EXPECTED STOCK PRICE →	$342

9% YEARLY RETURN

The stock price has now risen from $230 to $265 — another 15% return. This underscores a pattern and a problem with how the market, on average, values companies. Even in a world with perfect information, the market can still be inefficient if the average investor's model does not forecast far enough into the future.

Each year the market rolls forward its 15% EPS growth estimate, the intrinsic value of the stock goes up 15%. In other words, the market struggles with assessing a company's ability to continue generating strong numbers over long periods of time.

	2006	2007	2008	→	2021
INTRINSIC VALUE	$200	$230	$265	→	$1,627

15% RETURN (2006 → 2007) · 15% RETURN (2007 → 2008) · 15% COMPOUND (2008 → 2021)

Had an investor looked at Company B through just a three-year lens, they would have concluded that it was accurately priced and that there was no opportunity to earn alpha. However, a longer-term view would have revealed that there was in fact opportunity to earn alpha that the market had overlooked. Investors could benefit from earnings beyond the three-year projection, at essentially no extra cost.

Why the Market Does Not Create Long-Term Forecasts

So why do investors, in the aggregate, rely chiefly on short-term forecasts to value stocks? Institutionalized educational practices are a big factor: At universities around the country, finance students are typically trained to build three-year valuation models. When they land jobs with investment firms, they find their senior colleagues following the same practice. Further reinforcing this custom, corporations typically issue earnings guidance in three- to five-year windows.

Given the prevailing norms, to promote a longer-term outlook is not easy. An analyst attempting to persuade a portfolio manager to invest in a company based on a 15-year EPS outlook would be met with heavy skepticism. To be fair, that is largely understandable because much can change over the course of 15 years.

Within the investment establishment, to make a longer-term forecast is to go out on a limb. Consider a 15-year model using Company B. All of the original inputs are the same as in the shorter-term models. The only difference is the length of the forecast.

	2006	15 YEAR ESTIMATE →	2021
EPS	$10.00	15% YEARLY GROWTH →	$81.37
X	X		X
P/E RATIO	20X	EXPECTED MULTIPLE →	17X
=	=		=
STOCK PRICE	$200	EXPECTED STOCK PRICE →	$1,383

14% YEARLY RETURN

The implied return is 14%, just about equal to yearly EPS growth (it is slightly lower due to the lower P/E ratio of 17x). Nevertheless, it is highly unlikely that stock analysts would be willing to publicly publish estimates that call for a company's EPS to grow eightfold across any timeframe, let alone 15 years. If sell-side analysts publicly published those estimates, their research would likely lose credibility within the industry.

How Fenimore Seeks to Exploit Market Oversights

While it is more difficult to accurately project companies' financial strength over longer time horizons, we believe that a more robust research discipline can help shed light on their potential. In constructing longer-term models, Fenimore analysts and portfolio managers apply a qualitative overlay onto our quantitative analysis. In other words, we carefully study non-financial factors that, taken together, can provide insight into the sustainability of firms' financial strength. Those factors include companies' scale, competitive moats, growth runways, and brand loyalty.

> "Our qualitative research can help us form opinions about companies' ability to sustain strong financial results. In general, we build 5- to 10-year forecasts for the businesses we analyze."

We also evaluate the quality of their leadership. Executives' records of financial success, along with their reputation for honesty and integrity, can be instructive. Face-to-face meetings help us gauge executives' subjective qualities such as knowledge, critical thinking ability, focus, and passion. Our qualitative research can help us form opinions about companies' ability to sustain strong financial results. In general, we build 5- to 10-year forecasts for the businesses we analyze. Fenimore's reasoning: Three years often fails to capture the full value of durable high performers, while making accurate projections becomes increasingly difficult beyond the decade mark.

Finally, we exercise a conservative buy discipline. We do not purchase stocks at price multiples that exceed the market consensus. But if we feel strongly that a quality business can generate strong earnings beyond the market's short-term modeling window, we will seriously consider initiating or adding to a position.

Conclusion

The stock market uses all available information about companies to create valuations. But those valuations are almost always predicated on three- to five-year outlooks. As a result, investors may misprice companies with the ability to sustain strong earnings over longer time periods. Fenimore Asset Management seeks to take advantage of this market inefficiency through active management by evaluating businesses based on longer time horizons. Seeking what amounts to overlooked opportunity is one of the ways that we endeavor to deliver excess returns for our investors.

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