FENIMORE ASSET MANAGEMENT

Your Trusted Investment Partner

ACTIVE MANAGEMENT

A DIFFERENT PERSPECTIVE

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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:

- Fenimore's active management strategy is focused on active research and high-conviction investments in quality businesses.
- How Fenimore's active management strategy has been market-tested for 50 years.
- The correlation between active research and high-quality, concentrated portfolios with lower turnover, higher ROIC, and attractive returns.

Fenimore Asset Management, manager of the FAM Funds, is dedicated to protecting and growing capital over the long term. To accomplish this, we focus on independent, in-depth research; it's this due diligence that we believe makes an effective active management strategy—one focused on active company research rather than trading activity.

An often cited statistic relevant to active management strategies is Active Share. Although our Funds do possess high Active Share, in this paper, we discuss Fenimore's active investment management process, its key features (beyond Active Share), and how it compares to other styles of active management.

For the purpose of this paper, we benchmark against our peers with actively managed, long-only, no-load mid-cap funds.[1] However, we apply this active management strategy to all our portfolio strategies.

FENIMORE'S STYLE OF ACTIVE MANAGEMENT

On the surface, our portfolios may not seem "active," certainly when judged by trading activity. However, it's quite the contrary. Our research team is very active when judged by the activities that we believe matter most– the diligence that helps us build conviction and grow wealth for our investors over the long term.

At the most basic level, active investment management can be defined as a strategy where portfolio managers actively make decisions to buy or sell securities. This is opposed to passive investment management, where investment decisions are made automatically or quantitatively with the aim of tracking an Index or Benchmark. When it comes to active management, there are many styles. We find that oftentimes investors equate active management with high portfolio activity– that is, trading activity and high turnover of portfolio holdings. At Fenimore, we take a different approach.

While our level of portfolio activity, as measured by trading and turnover, will ebb and flow, the activity that drives our investment research process and ultimately portfolio decisions, remains in constant motion. Our active management strategy is focused on a philosophy and process dedicated to conducting extensive due diligence on any business in which we may invest.

The goal of this independent, in-depth activity is to build concentrated, focused portfolios that create real wealth over the long term, without taking undue risk. Real wealth, in our view, is created by generating absolute returns that outpace the rate of inflation.

CHANGING TIMES. UNCHANGING PRINCIPLES.

As we arrive at our 50th Anniversary in 2024, we remain deeply rooted in the same investment philosophy we set out with back in 1974—independent in-depth research, quality insights, and a value focus. We are proud of this consistency which has historically delivered market-tested results for a half-century.

Our investment philosophy is guided by our four core investment criteria. This set of criteria, established by our founder and current Executive Chairman Tom Putnam, has been refined and market-tested for 50 years:

1
QUALITY BUSINESS
Understandable business models, growing cash profitability, and defensible competitive advantages.

2
STRONG FINANCIALS
Strong financials including significant free cash flow generation and low leverage.

3
PROVEN MANAGEMENT
Proven and ethical management who focuses on creating value and astute capital allocation.

4
MARGIN OF SAFETY
A margin of safety, including balance sheet strength, long-term sustainable growth potential, and a discounted price based on our estimate of their intrinsic value.

[1] *Screened for actively managed, long-only, mid-cap funds with no load using Morningstar Direct. The peer group consists of 245 funds.*

Implementation of our investment philosophy starts with our in-house investment research team. Each portfolio holding goes through a rigorous review by our ten-person team of analysts and portfolio managers. This process includes, but is not limited to:

- Meetings with management
- Document review
- Attendance of trade shows and conferences
- Interviews with former employees, customers, and suppliers
- Financial analysis

Meeting with Management

The number of conversations we have with management is one of the most critical activities that drives our investment team, and a measure we track closely. When we buy a stock, we are buying partial ownership in a business. As partial owners of businesses, we entrust management to steward the businesses and capital they are in trust of. Therefore, interviewing management and understanding how they think about running the operations, strategy, capital allocation, etc., is a must. Furthermore, we put the utmost emphasis on meeting with management face-to-face or in-person, especially meetings that take place at company headquarters or at a company facility.

One of the hardest elements of a business to gauge, an element a purely quantitative investment strategy (i.e., algorithmic trading) would have trouble assessing, is the human element or said another way—corporate culture.

In business and the stock market, a good versus bad corporate culture can make the difference between a winning versus a losing organization. By walking a corporation's halls, its factory floors and by engaging with key employees, we feel that we are better able to assess the business, its management, and the odds of success—helping to guide our decisions.

In the end, this process and activity is aimed at improving our ability to identify a select group of high-quality businesses that constitute our portfolio. As a natural outcome of our process, our portfolios tend to exhibit certain defining characteristics that are differentiated from our peers—these natural outcomes include business quality, concentration, and low turnover.

> "Our activity in 2023 included more than 140 in-person meetings and facility tours with leaders of our holdings and prospective holdings."

Guided by Quality

Given our first investment criteria—Quality Business—it may be unsurprising that a portfolio of high-quality businesses has historically been a natural outcome of our process. There is no uniform definition of what constitutes a high-quality business. To us, some of the features of a quality business include having an understandable business model and a defensible competitive advantage, in addition to measurable data points.

A key metric that we believe manifests from having a quality business shows up in the financials—this measure is return on invested capital (ROIC). ROIC measures the return that a business generates for each dollar of capital that is invested.

A business with a sensible economic business model will generate a high ROIC that is sufficiently above the firm's cost of capital. If we invert, the logic behind this becomes even clearer—a firm that generates a low ROIC that does not cover the true cost of that firm's capital, by definition, cannot sustain its existence in that position forever—eventually, the business will run out of money, all else equal. At Fenimore, we seek businesses that generate high returns and are self-sustaining in the long run.

See how the ROIC for Fenimore's portfolios stack up compared to our mid-cap peer group:

FAMEX	15.67%
FAMVX (INVESTOR CLASS)	17.19%
PEER GROUP (MEDIAN)	10.05%

Morningstar Direct as of 12/31/2023

Concentration & Conviction

Another outcome of our process is a concentrated portfolio. This stands in contrast to other active managers who tout the benefits of wide diversification. While we do find a certain degree of diversification to be appropriate, academic studies[2] going back to when Fenimore was founded 50 years ago have shown that most company-specific risk is diversified away once a portfolio reaches ~20 securities. With a limited number of high-quality businesses passing through our intensive research process and stringent hurdles, we prefer to focus our time getting to know this select number of businesses intimately, rather than knowing only a little about a large number of holdings.

Widely diversified active managers with a large number of holdings can lead themselves to be overdiversified, diluting the impact of the best portfolio holdings. Oftentimes, we find that the addition of another name to our portfolios undermines the strength of the portfolios, rather than improving it—or in the words of the great Peter Lynch, "diworsification." A portfolio with a large number of holdings would undoubtedly risk owning numerous low-quality, financially risky businesses. At Fenimore, we seek businesses that generate high returns and are self-sustaining in the long run.

A look at Fenimore's concentration compared to our peer group:

	# OF HOLDINGS	% TOP TEN
FAMEX	29	53.53%
FAMVX (INVESTOR CLASS)	31	51.62%
PEER GROUP (MEDIAN)	62	28.94%

Morningstar Direct as of 12/31/2023

As you can see, with 50% fewer holdings compared to the average peer group, our focus on active management to deliver a concentrated portfolio of high-quality business correlates to a much higher percentage of top ten holdings. It is our approach and intensive research process that affords us the ability to avoid over-diversifying and provides the conviction to manage a portfolio with substantial weightings in what we deem to be our best ideas.

[2] Modigliani, Franco and Pogue, Gerald. "An Introduction to Risk and Return: How Diversification Reduces Risk." The Financial Analyst Journal March – April 1974

Low Turnover

The final outcome of our investment philosophy and process that we will discuss is our portfolio's low turnover. Once we find a concentrated number of high-quality businesses, we aspire to stick with them for the long-term.

Part of our assessment of business quality includes understanding the durability of the business's competitive advantages. If we deem a business to have a durable competitive advantage that can last for an extended period, as partial owners of that business, to capture the high rates of return such a business can generate, our ownership will usually be long-term. We want to find the right businesses and then benefit from those businesses' ability to compound capital. In certain instances, we've benefitted from ownership periods measured in decades!

An alternative, which high turnover active managers may employ, is to jump in and out of these businesses frequently, trying to time the short-term peaks and troughs as the market oscillates. We find this short-term trading not only extremely difficult to execute, leading investors to miss out on long-term compounding, but this hyper-activity can leave investors with both a higher tax bill and transaction costs, whereas our low turnover approach is designed to minimize these costs.

Fenimore holding turnover compared to our peer group:

FAMEX	4.00%
FAMVX (INVESTOR CLASS)	9.00%
PEER GROUP (MEDIAN)	33.00%

Morningstar Direct as of 12/31/2023

THE POTENTIAL BENEFITS OF FENIMORE'S ACTIVE MANAGEMENT STRATEGY

Now that we have walked through our investment approach, process, and the natural outcomes on the portfolio—high-quality, concentration, and low turnover, let's take a look at the potential benefits of employing our active management strategy.

Fenimore returns compared to our mid-cap peer group[1]:

RETURNS	1-YEAR TR	5-YEAR TR	10-YEAR TR
FAMEX	19.70%	14.32%	11.10%
FAMVX (INVESTOR CLASS)	16.09%	11.76%	9.45%
PEER GROUP (MEDIAN)	16.88%	12.48%	8.70%
INFLATION	3.35%	4.07%	2.79%

[1] Screened for actively managed, long-only, mid-cap funds with no load using Morningstar Direct. The peer group consists of 245 funds. FactSet as of 12/31/2023. Performance data quoted above is historical. Past performance is not indicative of future results, current performance may be higher or lower than the performance data quoted. Investment returns may fluctuate; the value of your investment upon redemption may be more or less than the initial amount invested. All returns are net of expenses. To obtain performance data that is current to the most recent month-end for each fund as well as other information on the FAM Funds, please go to fenimoreasset.com or call (800) 932-3271. https://fred.stlouisfed.org/series/CPIAUCNS

Over the past 10 years, the FAM Dividend Focus Fund and the FAM Value Fund returned 11.10% and 9.45%, respectively. This level of absolute return achieved our goal of building wealth for our long-term investors, as both Funds outpaced the 2.79% rate of inflation over the period. In addition, our style of active management outperformed on a relative basis, with both Funds also outpacing the median return of our Peer Group.

CONCLUSION

Our achievement of these returns, we believe, is a direct result of Fenimore's style of active management. That is, a process that favors active research and due diligence over trading activity. This due diligence results in an intimate understanding of each holding and provides the conviction needed to manage a concentrated, high-quality portfolio that potentially benefits from low turnover and attractive returns.

If you would like to discuss how we apply a differentiated active management strategy to our portfolios, please contact us.

Visit **fenimoreasset.com/active** or **call 800-721-5391.**

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> **—Marc Roberts,**
> Portfolio Manager, FAM Value Fund

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To obtain a prospectus or summary prospectus and for performance data that is current to the most recent month-end for each fund as well as other information on the FAM Value Fund, FAM Dividend Focus Fund, and FAM Small Cap Fund, please go to fenimoreasset.com or call (800) 932-3271.

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50 YEARS