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DIVIDEND GROWTH

FOR THE LONG TERM

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Executive Summary

September 2016 | Topics Covered Include:

- Historically, dividends have been about one-third of total return.
- Dividend growers have offered higher returns along with a lower risk profile.
- Growth in dividends is key to outpacing cost of living increases.
- Dividend growth companies have performed well in both declining and rising interest rate environments.

This white paper examines the primary benefits of businesses that grow their dividend over time.

Dividends are not guaranteed and a company's future ability to pay dividends may be limited.

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

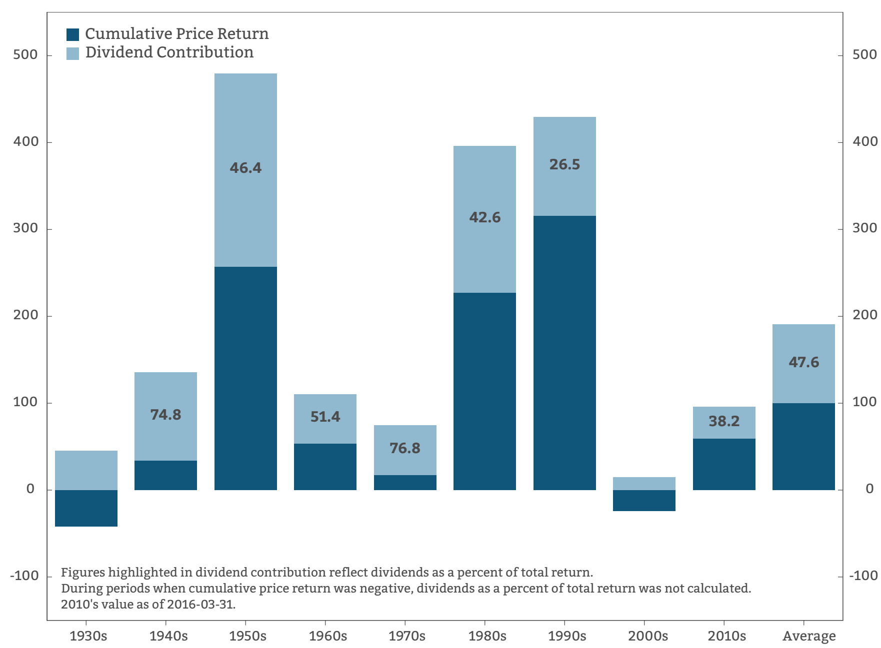
If an investor is looking for investment income, they often consider adding dividend-paying stocks to their portfolio. The natural inclination is to look for dividend payers with high dividend yields; however, dividend growth is a key metric to examine as well — especially as it relates to performance. Not only do dividends give investors a head start on their investment returns, research plainly shows that there are benefits to dividend growth such as: offering higher returns and lower risk; outpacing inflation; and performing better in both rising and declining interest rate environments.

Contribution of Dividends to Investor Returns

S&P Indices "Research Insights" indicates that, since 1926, dividend payments to shareholders have represented about one-third of total return. A central reason for their substantial contribution to total return is that once a dividend is paid, it is a permanent gain because it is not subject to market fluctuations as with the price of a stock. To illustrate, in the exhibit below, the light blue portion of the bars represents the percentage that dividends contributed to the S&P 500 Index[1] total return for the last nine decades.

During the 1950s, 1980s, and 1990s, investors realized tremendous appreciation in the equity market — yet dividends still contributed nicely to boosting returns. More importantly, during the decades when appreciation was not as robust, dividends made up more than half of investor returns. Even more notable, when stock appreciation was negative for a decade, it was dividends that tipped total return into positive territory. In short, it is during less-than-stellar periods in the market when dividend payments matter the most.

S&P 500 Dividend Contribution to Total Return



[1] *The S&P 500 did not actually have 500 stocks prior to 1957, and was known as the S&P Composite Index. However, for simplicity's sake we use the term "S&P 500" throughout this paper.*

Dividend Growers Have Performed Better and Have Been Less Volatile Than Non-Dividend Payers

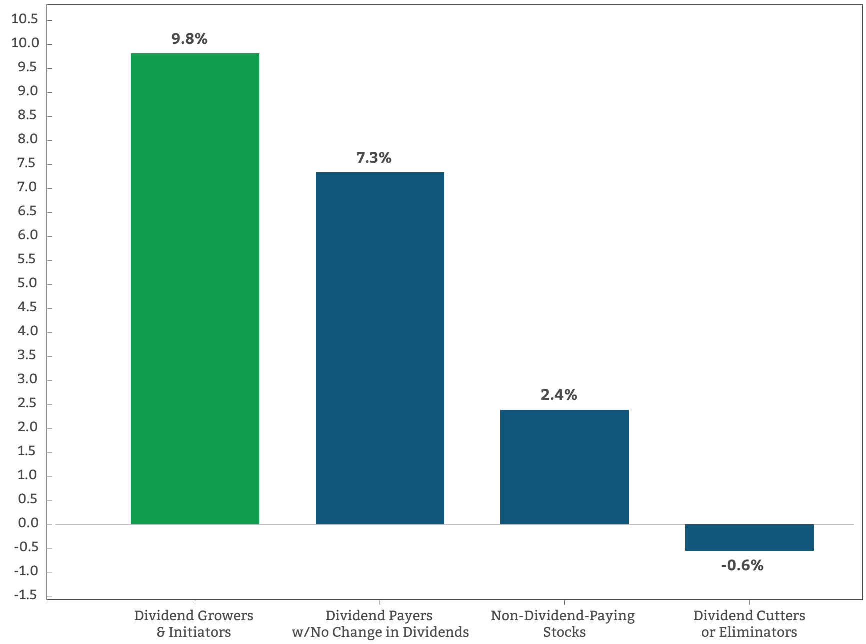
The universe of dividend-paying companies can be segmented by their growth profile, ranging from businesses that pay a static dividend to companies that pay a higher dividend every year. The data shows that, since 1972, corporations that grow their dividend, or initiate a dividend, post higher returns than those that do not raise their dividend. Historically, dividend increases have signaled management's confidence in the prospects of their business. In fact, the "Dividend Discount Model" was developed to value companies based on how rapidly their dividend was expected to grow over time.

As a group, these dividend growers and initiators outperformed non-dividend-paying businesses over the period with an annualized return of +9.8%. In order to increase dividends consistently over the long term, companies require growing cash flow. The typical profile of this type of business is one that expands both their sales and earnings, thereby generating more cash than is needed to reinvest back into their operations. It also demonstrates management and the board's commitment to returning cash to shareholders.

At the opposite end of the spectrum are the dividend cutters or eliminators. We observe that this worst-performing subset had a negative impact on annualized returns of -0.6%. These S&P 500 corporations are usually forced to reduce or stop paying their dividend because their financial condition is deteriorating, they are unable to expand, or they need to redirect their cash flow toward reinvestment. It makes perfect sense that this group had the poorest performance.

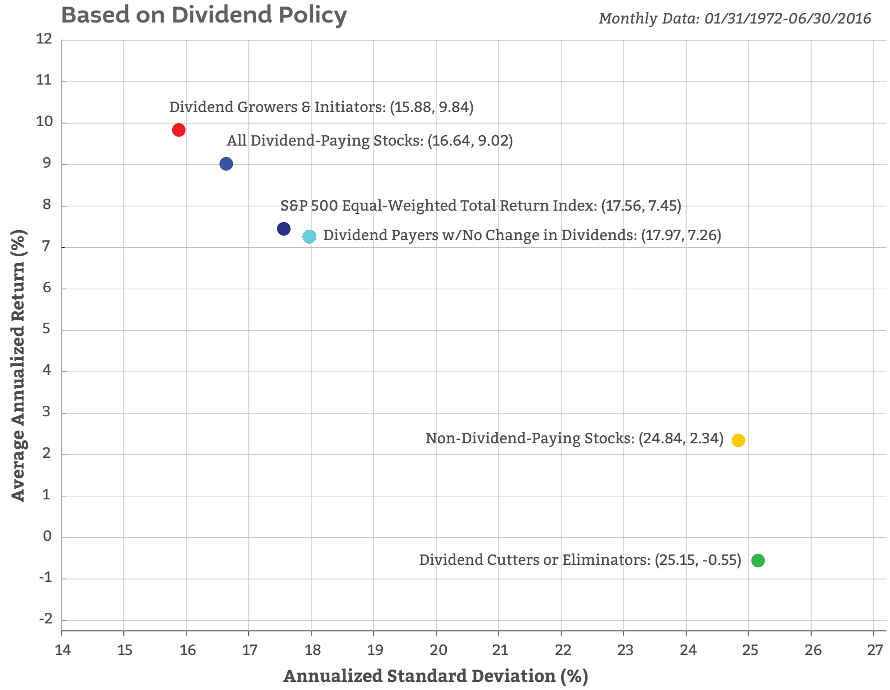
In addition to higher total stock returns, the dividend growers and initiators exhibited a lower risk profile than the other three groups (companies that: did not increase their dividend, did not pay any dividend, or cut/eliminated their dividend) as measured by standard deviation. The explanation for lower risk in the dividend growth group can be attributed to their superior financial stability by virtue of strong balance sheets and increasing cash flows. The dividend yield also tends to put a floor on their valuation during turbulent markets.

Returns of S&P 500 Dividend-Paying Stocks Have Significantly Outperformed Those of Non-Dividend-Paying Stocks (01/31/1972 - 04/30/2016)



S&P 500 Index: Risk vs. Return Based on Dividend Policy

Monthly Data: 01/31/1972-06/30/2016

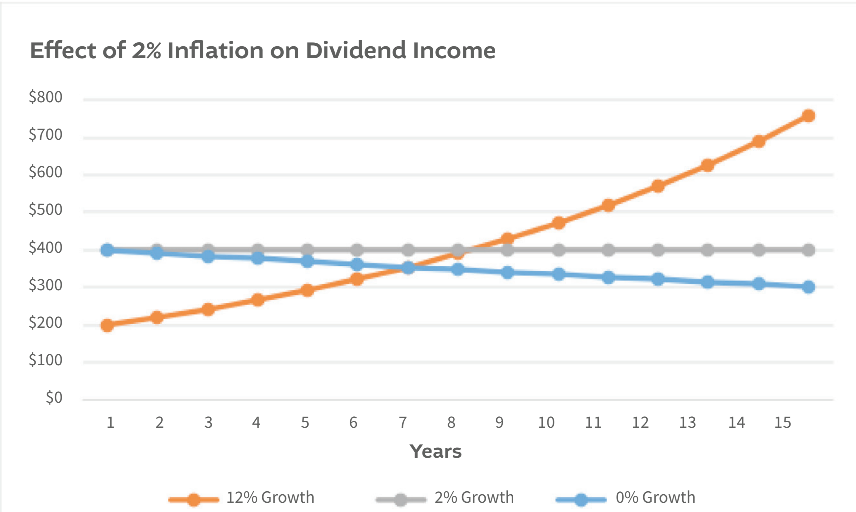


Note (as of 6/30/2016): "Dividend Growers and Initiators" include stocks that increased their dividend anytime in the last 12 months. "Dividend Cutters and Eliminators" are companies that have lowered or eliminated their dividend anytime in the last 12 months.

Dividend Growth Can Help Outpace Cost of Living Increases

Another benefit of a growing dividend is that it can help sustain purchasing power. Over time, the cost of living goes up with inflation so dividend income must be adjusted accordingly. If we assume inflation will average 2% over the long term, which is the Federal Reserve's target inflation rate, dividends must increase at that same rate just to maintain their purchasing power. It is understandable that investors searching for yield may be attracted to high current dividend yields while ignoring the pace at which a company is growing its dividend. However, in order to outpace inflation, it is very important to look at long-term dividend growth as well because a dividend that grows will generate dividend income for an investor at an increasing rate.

The chart below illustrates three hypothetical $10,000 investments in dividend-paying stocks. Company A, the business represented by the gray line, has an initial dividend yield of 4% and raises its dividend 2% each year. After adjusting for 2% inflation,[2] the dividend income from the investment stays the same year after year (2%-2%=0%). The investor receives $400 annually in dividend income.



Company	Initial Investment	Dividend Yield	Dividend Growth	Inflation Adjusted Growth	Dividend in Year 1	Dividend in Year 15
A	$10,000	4%	2%[2]	0%	$400	$400
B	$10,000	4%	0%	-2%	$400	$301
C	$10,000	2%	12%[3]	10%	$200	$759

Dividend-paying companies have performed better than non-dividend-paying companies in both rising and declining interest rate environments.

Company B, the investment represented by the blue line, also yields 4%, but does not grow. After adjusting for 2% inflation, the dividend income actually declines 2% each year (0%-2%=-2%). For this investment the dividend income starts out at $400 in year one, but declines to roughly $300 in real terms by year 15.

Company C, the investment represented by the orange line, has a dividend yield of only 2% initially — half the dividend yield of the other two investments — but it grows 12%[3] each year before inflation. After adjusting for inflation, the growth rate is 10% (12%-2%=10%) and dividend income increases from $200 in the first year to nearly $760 in year 15.

In short: it is critical for long-term investors to take into account a company's dividend growth rate, in addition to the level of its current dividend, because this can provide better protection of purchasing power against inflation.

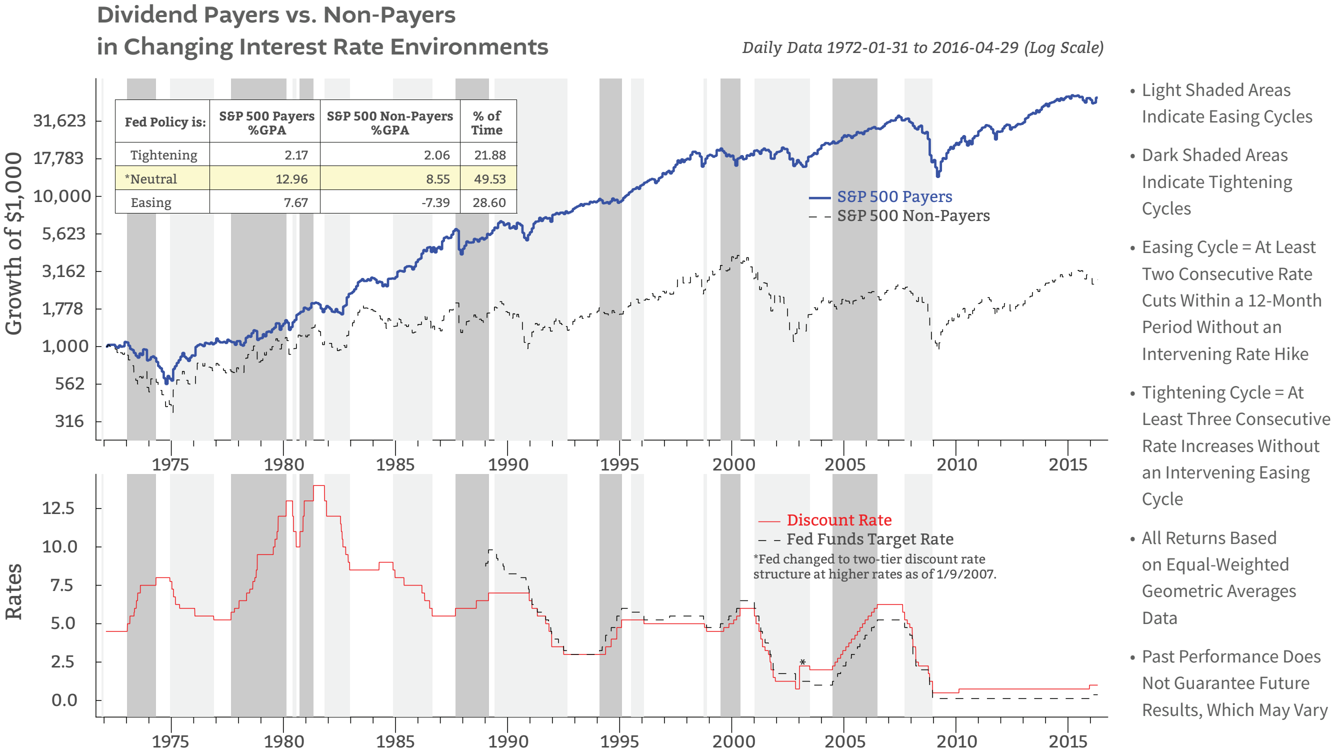
Dividend Growth Has Historically Performed Well in Rising Rate Environments

Interest rates have been on a downward trend for the last 36 years and are now at historic lows. At some point, interest rates are likely to rise. Investors may be concerned that dividend-paying stocks will trade more like bonds during a period of rising rates and lose value. In fact, the opposite is true. Dividend-paying companies have performed better than non-dividend-paying companies in both rising and declining interest rate environments.

[2] The Federal Reserve's target inflation rate is 2%.

[3] The 12% number is based on S&P 500 companies. These companies, on an equal-weighted basis, have increased their dividends by a 12.4% compounded annualized growth rate (CAGR) over the past five years (as of 6/30/16).

This chart illustrates that during periods when the Federal Reserve tightened monetary policy, the return of dividend payers was a positive 2.17% — slightly ahead of the non-payers.



Fed Policy is:	S&P 500 Payers %GPA	S&P 500 Non-Payers %GPA	% of Time
Tightening	2.17	2.06	21.88
*Neutral	12.96	8.55	49.53
Easing	7.67	-7.39	28.60

Conclusion

Investing in dividend-paying stocks has benefited investors by giving them a head start on their investment returns. This strategy has historically performed better than investing in an equally-weighted S&P 500 Index portfolio and significantly better than investing in non-dividend-paying companies. Additionally, businesses that increase their dividend over time have traditionally exhibited superior performance as a group relative to those that either maintain a static dividend or cut their dividend. Not only do dividend growers perform better over time, but the group has experienced less short-term volatility. Even in periods of Federal Reserve tightening, dividend-paying stocks outperformed non-payers.

In summary, the data suggests that a portfolio of dividend-paying companies— that increase their dividend faster than the market — holds the clear potential to benefit investors over the long term.

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 prospectuses or summary prospectuses and performance data that is 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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