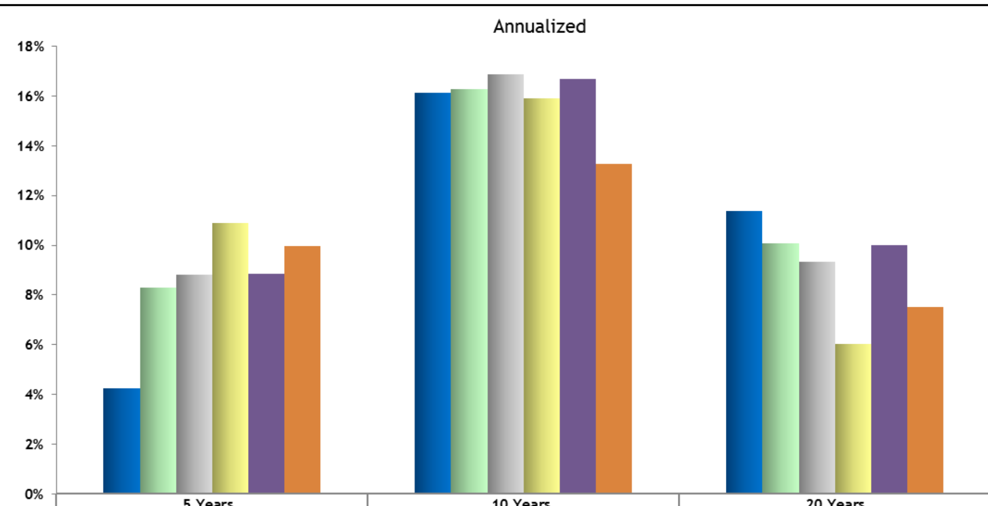
# THE CASE FOR LONG-TERM, ACTIVE MANAGEMENT

*May 22, 2019*

The recent *The New York Times* article titled: "A Quirk of the Calendar Is Messing With Stocks" struck a chord with many of us at Fairpointe. Little did I know that as I was pondering it and sharing it with colleagues, so were portfolio manager Fran Tuite and our founder and CEO, Thyra Zerhusen. Even though I'm relatively new around here, it was clear that this article was tapping into something important at Fairpointe. Its message was that stock market investors should expect, "intermittent heartache, bursts of profit and, if the future is like the past, reasonably high returns. But the long run may need to be much longer than 10 or even 20 years."

We've recently experienced the "intermittent heartache" the article references, and we too can fall into the trap of drawing large conclusions about the market based on a very limited timeframe. When performance is tough, as it was for our mid-cap strategy for 2018, it's easy to grasp for credible explanations for lackluster returns. I was looking for things to cheer us up a bit and noticed the Vanguard Mid-Cap Index Fund referenced in the article. Like Vanguard, we have 20 years of returns and I was pleased to see that we outperformed the fund and the S&P 500[1]. Looks good, right? In fact, as Thyra is fond of saying, our long-term track record is better than Warren Buffett.




| | 5 Years | 10 Years | 20 Years |
|---|---|---|---|
| Fairpointe Mid-Cap Composite * | 4.3% | 16.1% | 11.4% |
| S&P 400 MidCap Index | 8.3% | 16.3% | 10.1% |
| Russell MidCap Index | 8.8% | 16.9% | 9.3% |
| S&P 500 Index | 10.9% | 15.9% | 6.0% |
| Vanguard Mid-Cap Index Fund ** | 8.9% | 16.7% | 10.0% |
| Berkshire Hathaway Cl A ** | 10.0% | 13.3% | 7.5% |

* Net of Fees **Data from Morningstar / CapIQ / eVestment Alliance — Data as of March 31, 2019

Intuitively, I knew this was the case: when you have bad years over a certain time period, that whole time period looks worse. But this article also prompted us to look more closely at the mathematical results of our process. As Jack Bogle, the king of index funds, aptly warned, avoiding big losses is probably more important than reaping those rare, big market gains[2].

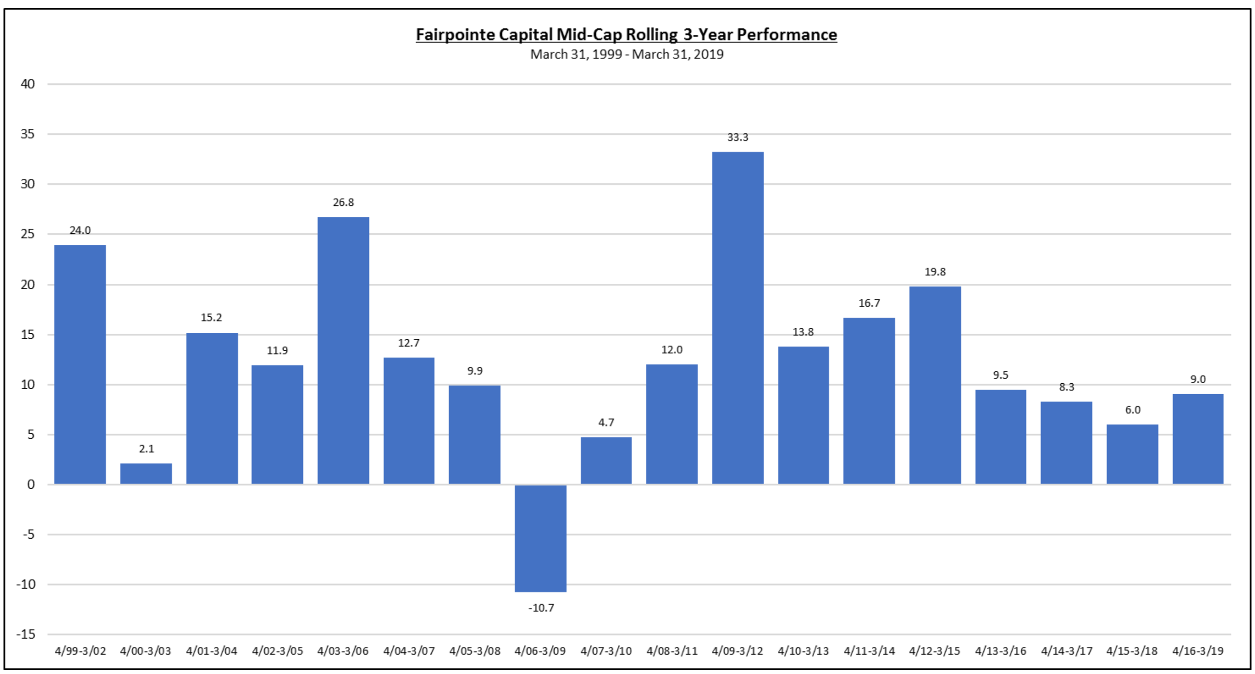
[1] 20 Year track record through April 30, 2019. [2] The New York Times article, "A Quirk of the Calendar Is Messing With Stocks".

Being a bit of a data nerd, I wanted more validation of Fairpointe's approach, which is a long-only, actively managed, value-oriented, mid-cap strategy. These days, all four of those characteristics place us outside the mainstream. The industry has long debated the benefits of active versus passive approaches; long-only just isn't as cool as shorting stuff or using derivatives; value versus growth is always a seesaw; and, finally, many institutional investment consultants will tell you they don't "allocate to mid-cap."

This distaste for mid-cap companies strikes me as especially short-sighted because mid-cap companies have unique qualities that make them great candidates for active investing. Mid-cap management teams love long-term investors like us, which means we are able to talk to management teams frequently and learn what's really going on in a company and an industry. On the other hand, these companies are big enough that we can keep investing in them, as opposed to small cap stocks where there is often less capacity for long-term, sizable investment. They are also more frequent acquisition targets. Indeed, these factors support our view that active stock selection aligns well with mid-cap companies.

But again, I am a data nerd, and I wanted to see how the quantitative information backs up our process. In our pitch deck, we include a chart of our annual returns for each year from 1999 to 2018, and when looking at it one day, I began to notice a pattern. Every three to four years, our returns became either negative or low positive.

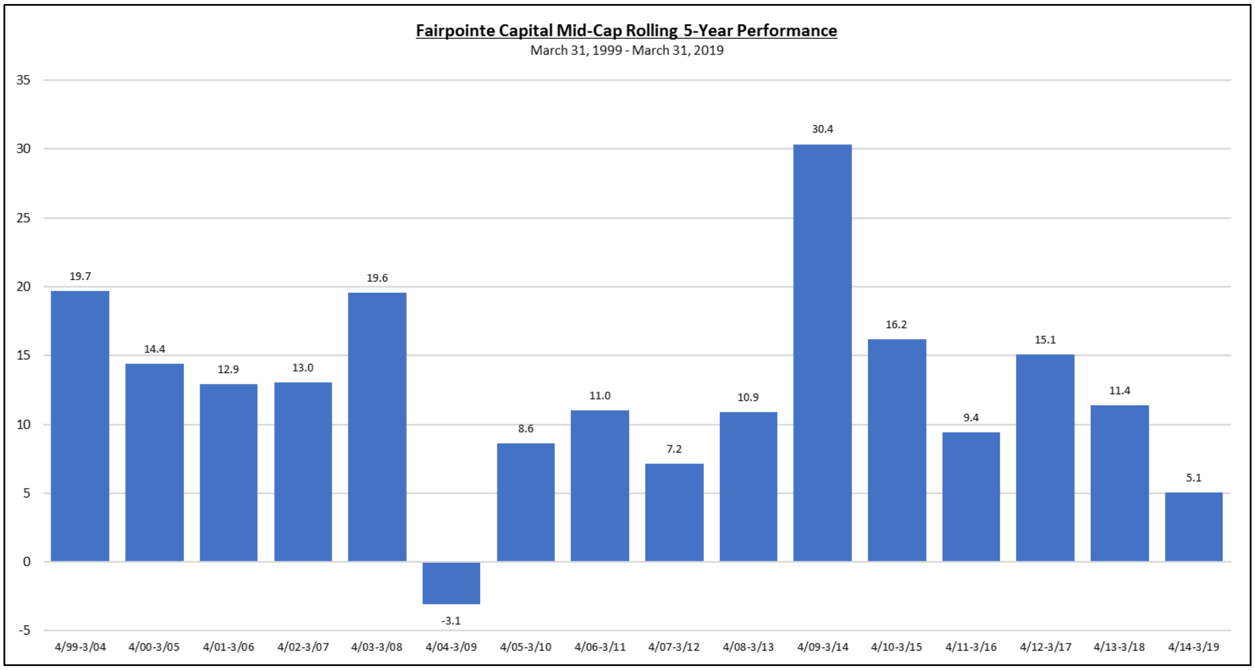
To better understand the data, we put together a chart that showed the rolling average three-year returns, and then the trends became even clearer.



Source: eVestment Alliance

This chart shows how we've avoided the "big losses" that Jack Bogle warned about.

As I was discussing these trends with Jeanine Meola, our head of sales, she mentioned that our average holding period for stocks is over five years. (We are long term investors, indeed!) So, then I decided to run the data on our rolling five-year returns.




Source: eVestment Alliance

When put in this perspective, it became even clearer how long holding periods and patient investing can benefit our clients.

We've only experienced one five-year period when our returns were negative. We believe, as the data suggests, that holding stocks for longer time periods can enable investors to avoid big losses and generate superior returns. Sure, our approach may seem old-fashioned or out of style. It may require some patience. But you can see the value of Fairpointe's approach in the numbers.

*Liz Kirscher, President*
Fairpointe Capital

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Ms. Kirscher serves as President of Fairpointe Capital and is a member of the firm's Executive Team. Her responsibilities include leading the firm's operations.

Ms. Kirscher spent more than 20 years at Morningstar and was a member of the executive team for 12 years. Liz served as President of Morningstar's Data division from 2000 to 2012 and played an important role in preparing Morningstar for its IPO in 2005. During her tenure, Liz's team grew and globalized Morningstar's data licensing business making it Morningstar's largest product. Today, the data is still one of Morningstar's largest contributors to revenue. More recently Kirscher ran key parts or Morningstar's talent and culture team and was proud to be part of the company as it crossed the $1B in revenue in 2018. Liz joined Morningstar Inc. in 1995 as a member of the company's institutional sales team. She holds a Bachelor's degree with honors in History from Vassar College and a Master's degree in Business Administration from the Columbia Business School. She's held a variety of board positions including serving as a director on Morningstar's behalf on the board of Morningstar Japan KK and PitchBook, a business Morningstar has since acquired. She's currently an advisor to Mission Measurement a company that measures social impact.

**DISCLOSURE**

The Mid-Cap Composite contains fully discretionary equity accounts that follow the mid-cap style. The Mid-Cap Composite represents portfolios that seek long-term total return through capital appreciation by investing primarily in mid-cap stocks. For comparison purposes the composite is measured against the S&P MidCap 400 and Russell MidCap indices. The S&P MidCap 400 is a market value weighed total return index that represents the performance of the medium-capitalization sector of the U.S. Securities market. The Russell MidCap is a market value weighed total return index that represents the mid-cap segment which measures the performance of the 800 smallest companies in the Russell 1000 index. Both indices are representative of the types of equity assets invested by Fairpointe Capital. Market indices are unmanaged and do not reflect the deduction of fees. You cannot invest in an Index and the performance of the index does not represent the performance of any specific investment. The minimum account size for this composite is $2.5

million. Prior to May 1, 2011 the account minimum was $5 million. Effective March 31, 2013, the account minimum has gone back to $5 million. The Mid-Cap composite was created January 1, 2005. Performance presented prior to May 1, 2011 occurred while the Portfolio Management Team was affiliated with prior firms and the Team was solely responsible for selecting the securities to buy and sell.

Fairpointe Capital is an independent registered investment adviser.

The firm maintains compliant presentations and a complete list of composite descriptions which are both available upon request. Please send inquiries to mkatauskas@fairpointecapital.com or call 312-477-3300.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. Market, economic, company, and industry specific conditions are considered during the investment selection process. This was a period of generally rising security prices.

The U.S. Dollar is the currency used to express performance. Returns are presented net of management fees and include the reinvestment of all dividends, capital gains, and other earnings. Net of fee performance is calculated using actual fees.

Policies for valuing portfolios, calculating performance, preparing compliant presentations and a list of all holdings since inception of Fairpointe are available upon request.