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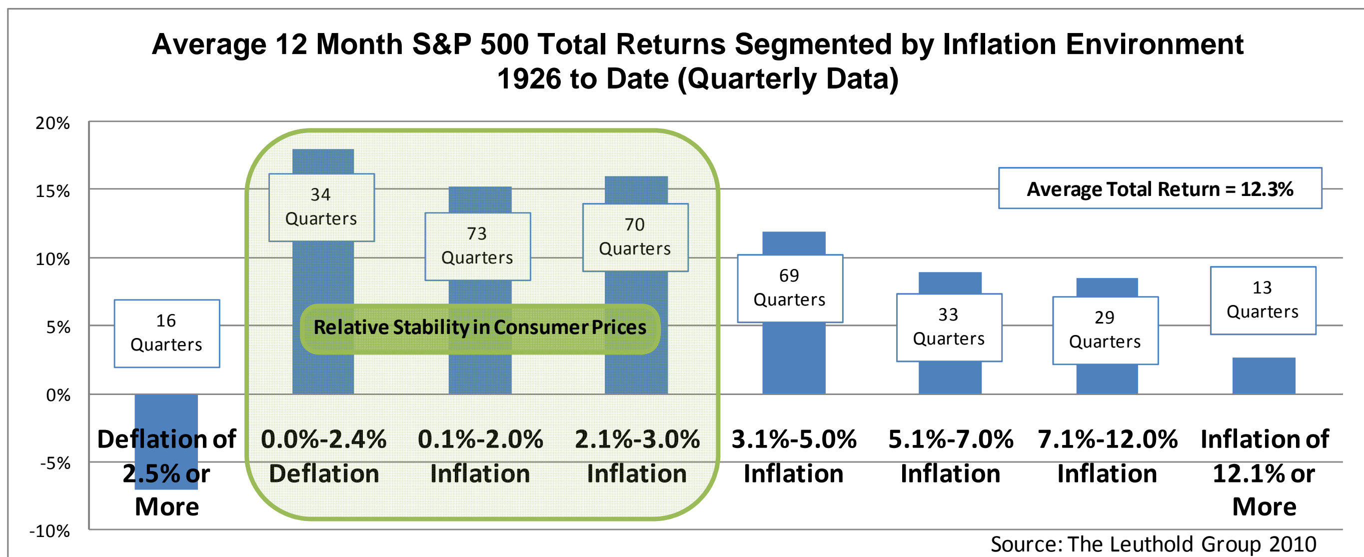
INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

June 30, 2010

FMI All Cap Equity portfolios lost approximately 9.8% compared to a loss of 11.3% for the benchmark Russell 3000 Index in the June quarter. Finance, Producer Manufacturing, Technology Services and the Consumer Non-durables sectors all helped relative performance, while Energy, Commercial Services and Health Technology detracted. BP (sold June 1) was the biggest decliner, while AmerisourceBergen advanced nicely in the quarter. Approximately 80% of the Russell 3000 stocks lost ground in the quarter.

Volatility and worry returned to the market in the second quarter. Seventy percent of the trading days in May experienced moves of 1% or more, while 20% of the days had 3% or greater volatility. Gold ($1,243/oz.) continues to hit new highs, yet somewhat strangely, the 10-year U.S. Treasury yield (2.94%) is in the lowest decile since 1957. Are investors worried about inflation or deflation? Yes, as the old joke goes. In a moment we'll discuss these and other issues we feel are causing increased investor angst. But first, the conclusion, self-serving as it might seem: equities stand the best chance of not only growing wealth, but protecting its purchasing power over the long run.

In the near term, the case for deflation may be every bit as strong as the case for inflation. The U.S. continues to struggle with deflationary debt loads and weak labor markets. Housing statistics remain grim, with foreclosure rates showing no sign of abating and home prices flat to down on a sequential basis. As many as seven million homes are empty and eight million more are in various stages of distress. Capacity utilization bounced off the bottom but remains well below average. Consumer balance sheets are still unhealthy. Talk of a "double dip" permeates the airwaves. Absent the replenishment of inventories, the economy appears to be weaker than one would expect at this point in the cycle. Recent data shows consumer prices dipping slightly. History shows, however, that mild to moderate deflationary environments have been quite good for stocks.



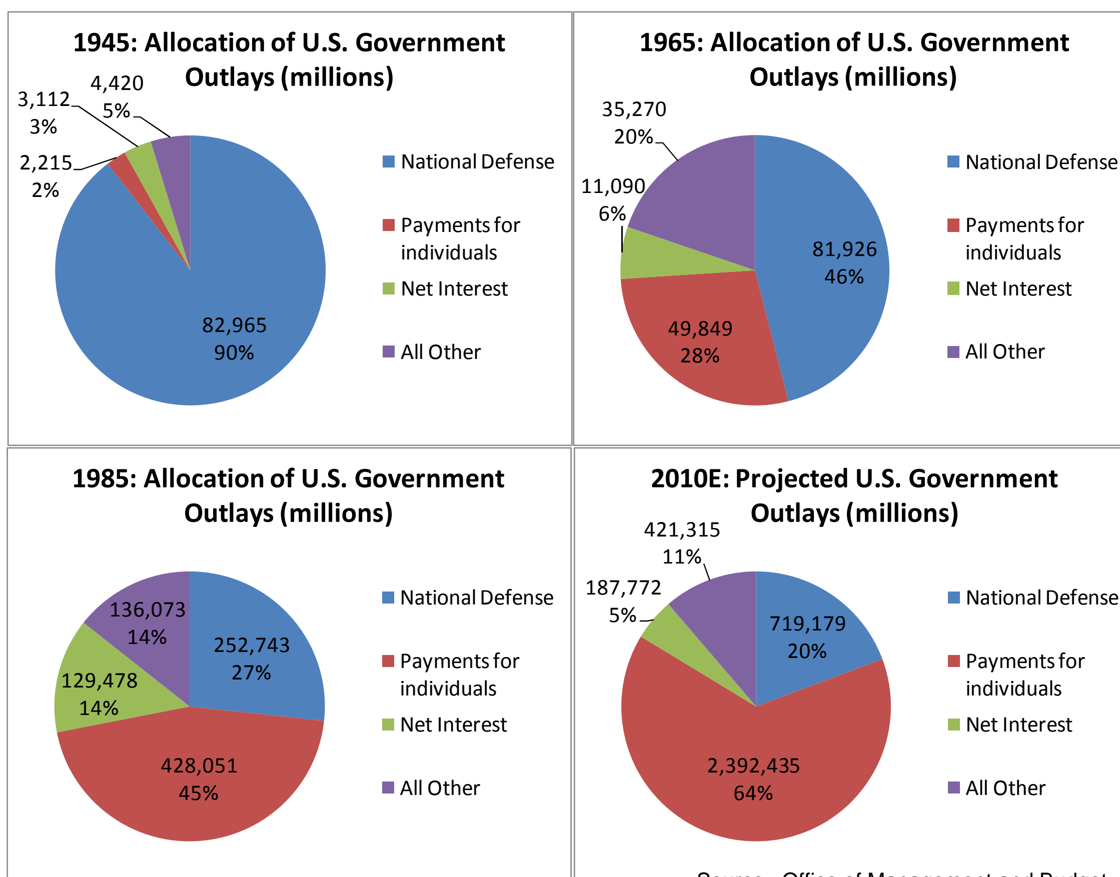
Conversely, if the Fed's policies take their natural course and Washington elects not to default, both will get what they want: inflation. Of course, they want the kind that won't hurt; the one that will ease the burden of paying back debt as well as give a little top-line bump to the economy, not the one that makes interest rates soar and wages and prices spiral higher. Of course, time will tell on the subject of inflation, but history shows that

moderately rising prices are also good for stocks. Even if inflation eventually becomes a more virulent variety, we still like the case for stocks, although at that point it is a relative argument. Equities represent a call on businesses that can adjust to inflation. Durable franchises selling necessary goods can change cost structures, pricing policies and end markets. Bonds, cash, precious metals and commodities can't do this.

Debt, Deficits

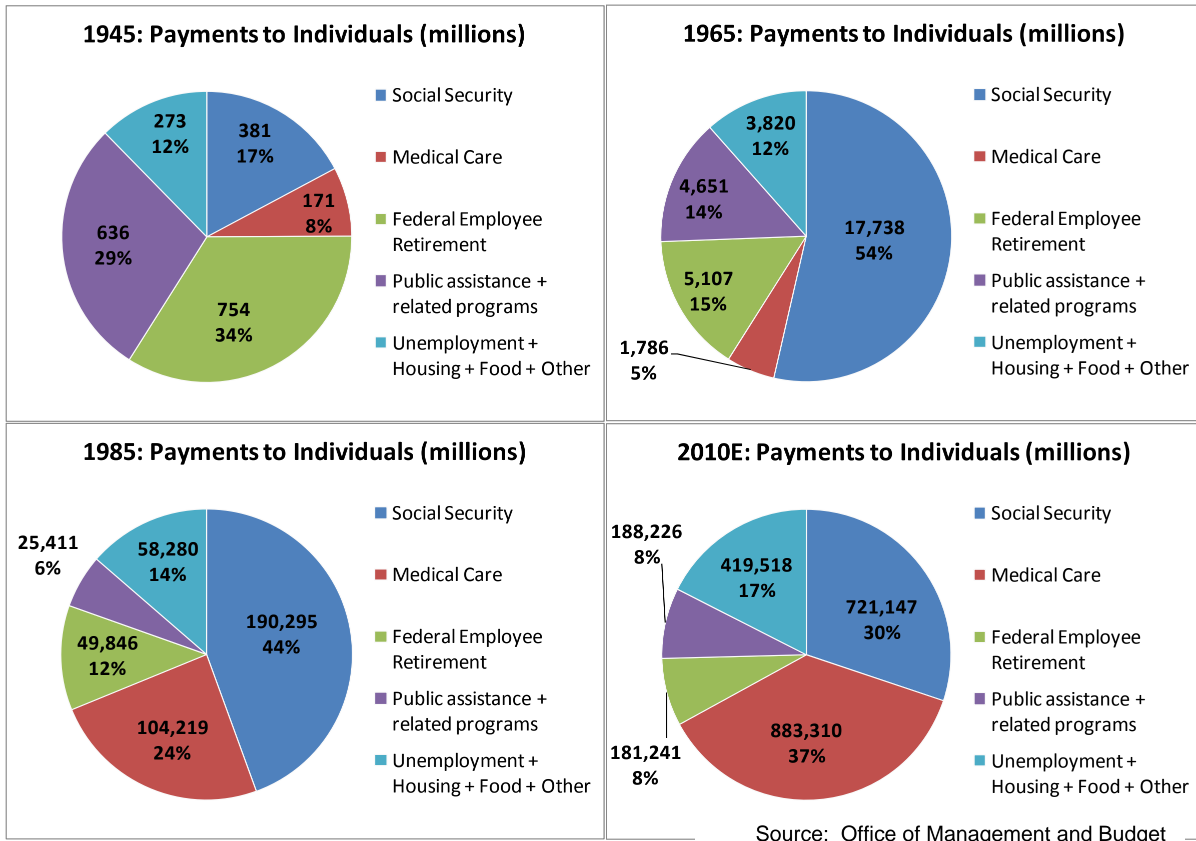
Over the last several years we have repeatedly raised the red flag with respect to debt, deficits and unfunded liabilities (primarily Social Security and healthcare). These liabilities are so extreme that they could threaten our democracy, although presumably leaders will eventually recognize this and take strong remedial action. The U.S. Government is currently running a budget deficit of $1.5 trillion, or approximately 10% of GDP. Total debt outstanding is around $13 trillion or roughly 89% of GDP. These are remarkably high figures by historical standards. The 2010 budget is approximately $3.7 trillion, so we are borrowing about 40% of our annual outlays.

The last time America ran deficits as high as today was in 1945. Recall in the September 2009 letter we published the 1945 federal government spending chart, which is reproduced below. Ninety percent of 1945 expenditures were for National Defense and just 2% went to Payments for Individuals, which included Social Security, Medical Care, Public Assistance, Federal Employee Retirement, Unemployment and Other. Similar charts for 1965, 1985, and 2010 are also shown. Lyndon Johnson gave his "Great Society" speech in 1964. In 1965, the Defense portion was 46% and Payments for Individuals was 28%. In 1985, the Defense portion was 27% and Payments for Individuals was 45%. By 2010 (projected), 20% will go to National Defense and 64% will be Payments for Individuals.



Source: Office of Management and Budget

We have also created the following additional charts showing the major constituents within the Payments for Individuals section for the same four periods:



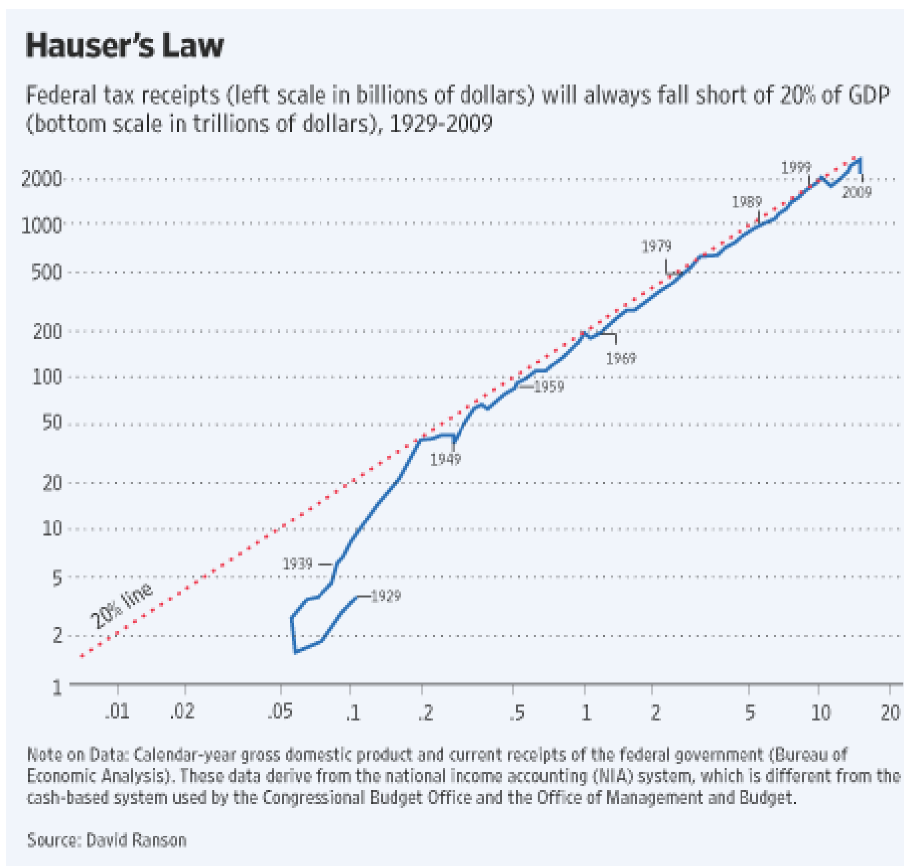
While all spending categories have grown significantly, Social Security and Medical Care growth are noteworthy. The following table shows the compound annual growth rates from both 1965 and 1985 for these constituents, compared to Inflation and Population growth. Population and Inflation have grown at compound rates of 1.4% and 4.5%, and 1.2% and 2.9%, respectively, for the periods beginning in 1965 and 1985. Social Security has grown at an 8.2% clip over the past 45 years, while Medical Care has raced ahead at a 14.1% pace, and we haven't yet even begun paying for the recent expansion in coverage. Public Assistance and Federal Employee Retirement are also compounding at high rates. According to the Bureau of Economic Analysis, average annual compensation (including benefits), for federal civilian workers is $119,982, compared to $59,909 for private industry. Decades ago, government workers made less than private sector workers; now they make twice as much. Every category of social spending has increased far more rapidly than our ability to pay. The National Defense spending growth rates of 6.1% and 4.1%, respectively, in the two periods shown have advanced more slowly than any of the social categories, but are still at unsustainable rates.

	Annualized Growth from 1965-2009	**Annualized Growth from 1985-2009**
Inflation	4.5%	2.9%
Population	1.4%	1.2%
Social Security	8.2%	5.5%
Medical Care	14.1%	8.9%
Federal Employee Retirement	7.9%	5.0%
Public Assistance and Related Programs	8.3%	7.9%
Unemployment, Housing, Food & Other Public Assistance	10.6%	6.8%
Total Payments for Individuals	**9.6%**	**6.8%**
National Defense Spending	6.1%	4.1%

The Keynesians tell us that the government can and should step in to prop up the economy to make up for a dearth in private sector spending. The equations all say it should work. We're a trillion dollar increase into the latest iteration of this philosophy that won't die. Where is the multiplier effect? Where are the private sector employment gains? Where is the GDP growth? Perhaps our leaders might consider that the long arm of the government may be hindering rather than helping. Our conversations with business people and entrepreneurs indicate a high level of caution about employing both labor and capital, with the primary factors being concern about America's long-term fiscal health and onerous mandates.

Taxes

Some will argue that we will just have to raise taxes in order to close the deficit. While it is a virtual certainty that taxes will be raised, it isn't clear at all whether tax receipts will rise. In a recent *Wall Street Journal* piece, David Ranson, head of research at W.C. Wainwright & Co. Economics, illustrated and expanded on work first introduced in the early 1990s by a Hoover Institute economist, Kurt Hauser. This data spans eight decades and shows that federal tax receipts always fall short of 20% of GDP, despite big changes in marginal tax rates in both directions. This has become known as Hauser's Law (see chart). The budgets Washington has projected assume gains from higher taxes that history has demonstrated time and time again will not materialize. Mr. Ranson points out that large tax increases reduce GDP, and therefore, revenues too. Quite simply, there is really no way out of our predicament except to lower spending. This reality has recently been brought home to Greece, Spain and other Western European countries that face fiscal crises. Significant reductions in public sector programs and benefits will become reality in these nations, as they will elsewhere.



Employment

Unofficially, we are 12 months into the economic recovery, yet the U.S. labor force still isn't growing. After some signs of life in March and April, the May labor report showed just 41,000 private sector jobs created. The headline unemployment rate of 9.7% dropped, but if the labor force had held constant, the unemployment rate would have been 9.9%. Forty-six percent of unemployed workers in America have been out of work for six months or more. Heretofore, it has been politically easy to extend unemployment benefits (now a record 99 weeks), but recently the extension has been allowed to expire. Perhaps this reflects acknowledgement that there is some connection between the most generous unemployment benefits of all time and stubbornly high unemployment.

While industry often tangles with government, there seems to be an unusual level of frustration recently with what is perceived to be Washington's anti-business attitude. The *Wall Street Journal* reported recently that in a study released in June, The Business Roundtable group detailed hundreds of separate actions and decisions

that stifle manufacturing, innovation and job growth. Ivan Seidenberg, the CEO of Verizon and the current head of the group, reiterated a point we've made several times in these letters, calling our corporate tax structure "a major impediment to international competitiveness," citing the administration efforts to raise taxes on foreign earnings and slowing movement on a proposed overhaul of the U.S. corporate tax code (note that the U.S. has the second highest corporate tax rate of all but one of the OECD countries). While abusive executive compensation schemes and high profile financial shenanigans have resulted in a backlash against corporations (and rightly so) we are concerned that new legislative initiatives and regulations may hurt the prospect for a genuine recovery in employment.

This is not to suggest that there aren't some good ideas embedded in the recent financial regulation overhaul bill (not signed as of this writing). The so-called Volcker Rule and more oversight over derivatives appear to be good ideas, but overall it is another huge piece of legislation that increases the scope and power of the government. Regulators have always had the authority to check Wall Street and the banks (market share concentration, capital requirements, off-balance sheet lending, etc.). Congressional policy toward Fannie Mae and Freddie Mac was at the heart of the financial crisis, yet, ironically, these entities are not even addressed in the legislation and continue to cost taxpayers hundreds of billions of dollars. So, regulators and Congress not performing up to par gives cover to create yet more regulation and more legislation?

The only certainty coming out of the Washington whirling dervish is a raft of new agencies and increased government payrolls. It appears that the health care legislation alone creates 159 government programs, offices or agencies. Growing public sector jobs is not the path to recovery; it is a path to ruin. Recently the *USA Today* reported that paychecks from private businesses shrank to their smallest share of personal income in U.S. history.

The Economy

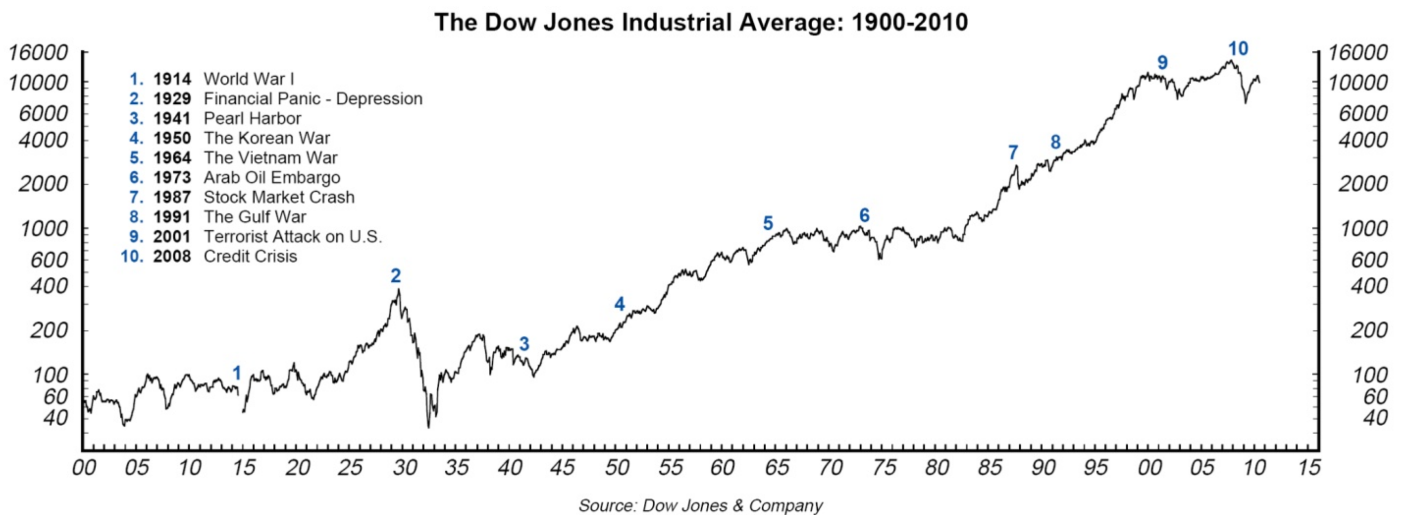
It is remarkable that despite a hostile business and regulatory climate, the economy continues to claw its way forward. Some think the mountains of stimulus money are masking weakness that would otherwise manifest itself. We actually believe the opposite. It seems to us that businesses have been overly cautious because the government has been so active. Out of necessity, these conditions will reverse over time, which should result in more sustainable, private sector-driven economic growth.

Most of the pundits continue to be fixated on the housing market as a key to the economy. We don't agree. It may be years before the housing market is healthy, but that doesn't necessarily condemn the macro picture. Other sectors are gaining ground, including technology, bioscience, specialty chemicals, certain industrials and consumer staples. Most of the companies we track regularly are telling us that conditions in the U.S. are either stable or improving. [They aren't hiring, but they are growing earnings.] Despite a currency and fiscal crisis, Europe appears to be flat to up modestly. We raised the caution flag on China in the last quarter because we saw many signs of excess. The Shanghai Index has dropped about 20% recently, due perhaps to a multitude of issues, but certainly the Chinese government's attempt to cool the property market has been a factor. The overall longer- term outlook for China, India and most of Asia remains positive.

The Stock Market

Contrarians generally do better than trend followers in the stock market. By the time trends are recognized and embraced, forces have already started working in the other direction. The capital cycle brings money into popular areas, damaging the profitability of the incumbents. Capital vacating industries with excess capacity sets the stage for an eventual turnaround in these sectors. Psychology and politics work in similar fashion. Debt and deficit fear-mongering, which we are most definitely guilty of, serves a great purpose to both the stock market and society. Problems that aren't generally recognized are usually what upend the market. For example, the vast majority of people didn't recognize the tech or real estate bubbles, not to mention derivatives or off-balance sheet financing. The realization of these problems was a big negative surprise, which hurt the stock market. With a rising level of scrutiny and attention focused on fiscal policy today, there is not only a better chance that forces will be employed to fix it, but it may also assure this won't become the source of a future stock market surprise.

We reiterate the earlier statement that stocks have the best chance to protect and enhance real wealth over the long term. Very few assets besides stocks can adjust to a changing environment. The graph below shows stocks seemingly inexorable rise, despite many challenges over time. We believe this will continue going forward.



Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2007- 06/30/2010

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2008	-26.65	-27.18	-37.31	12	0.60	$ 56.9	$ 4,062.5	1.40%
2009	30.19	29.35	28.34	18	0.23	$ 86.9	$ 7,008.9	1.24%
Q1 2010	8.05	7.86	5.95	19	0.06	$ 95.3	$ 7,953.9	1.20%
Q2 2010**	-9.77	-9.92	-11.32	19	0.06	$ 85.7	$ 7,486.0	1.14%

*Benchmark: Russell 3000 Index®
** Subject to reconciliation and verification.

Returns reflect the reinvestment of dividends and other earnings.
The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss.

Fiduciary Management, Incorporated (FMI) has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

FMI has received a firm-wide GIPS verification for the period 12/31/1993 – 03/31/10. In addition, the FMI All Cap Equity Composite has received a performance examination for the period 12/31/2007 – 03/31/10.

FMI was founded in 1980 and is an independent investment-counseling firm registered with the SEC and the State of Wisconsin. The firm manages approximately $7.5 billion in assets of pension and profit sharing trusts, mutual funds, Taft-Hartley funds, insurance company portfolios, endowments and personal trusts. The firm includes both institutional and mutual fund business. Although the firm has participated in wrap programs, it is a separate and distinct business, and is excluded from firm-wide assets.

The FMI All Cap Equity Composite was created in December 2007. These accounts primarily invest in small, medium and large capitalization US equities.

The FMI All Cap Equity Composite reflects time-weighted and asset-weighted returns for all discretionary accounts. From December 31, 2007 all accounts were managed for at least one month. All returns are calculated using United States Dollars and are based on monthly valuations using trade date accounting. All accounts in this composite are fee paying. Gross of fees returns are calculated gross of management fees and custodial fees and net of transaction costs. Net of fees returns are calculated net of management fees and transaction costs and gross of custodial fees. Dispersion is calculated using the standard deviation of all accounts in the composite for the entire period.

Currently, the advisory fee structure for the FMI All Cap Equity Composite portfolios is as follows:

Up to $25,000,000	0.75%
$25,000,001-$50,000,000	0.65%
$50,000,001-$100,000,000	0.60%
$100,000,001 and above	0.55%

The firm generally requires a minimum of $3 million in assets to establish a discretionary account. High Net Worth individuals may establish an account with a minimum of $1,000,000, however, the firm reserves the right to charge a minimum dollar fee for High Net Worth individuals depending on the client servicing involved. The minimum account sizes do not apply to new accounts for which there is a corporate, family, or other substantial relationship to existing accounts. In addition, the firm reserves the right to waive the minimum account size and minimum annual fee under certain circumstances. A complete list and description of all firm composites is available upon request.

Additional information regarding policies for calculating and reporting returns is also available upon request.

The Russell 3000 Index® is an unmanaged index generally representative of the U.S. market for stocks. FMI uses the Russell 3000 Index® as its primary index comparison.