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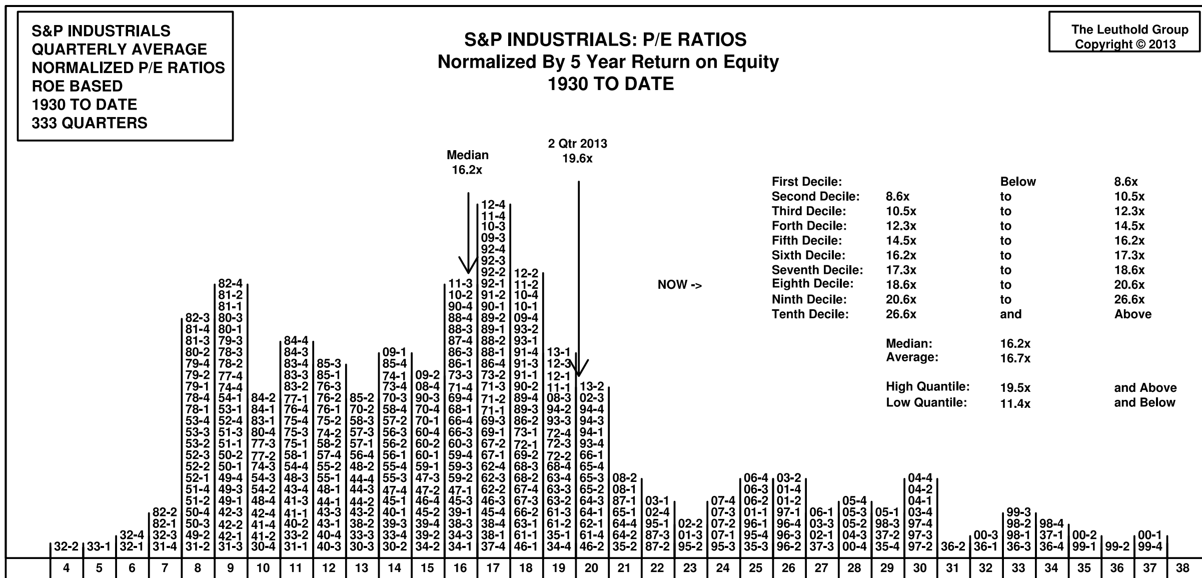
INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY
June 30, 2013

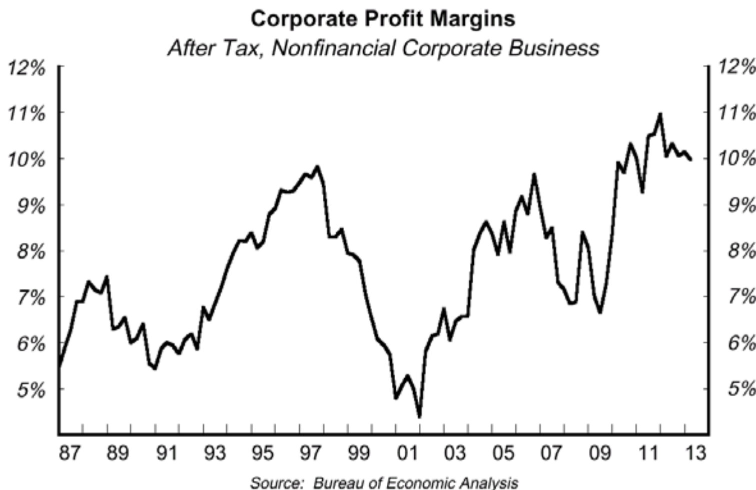
FMI All Cap portfolios returned approximately 2.4% in the quarter ended June 30, 2013. This compares to the 2.69% return for the Russell 3000 Index. Sectors that aided relative performance in the quarter included Producer Manufacturing, Technology Services, and Commercial Services. Illinois Tool Works, Microsoft and Dun & Bradstreet all gained nicely in the quarter. On the downside, Cash, Industrial Services and Health Technology all hurt relative performance. Several stocks declined in the period, including McDermott, Accenture, and Nestlé. Markets have rallied nearly nonstop for over four years and the gains seem out of step with fundamentals that are, at best, plodding along in slow growth mode. In our opinion, the portfolio is structured more conservatively than the market, so a further strong up move in the Russell 3000 (without a commensurate improvement in the fundamentals) will likely result in underperformance. While we can almost always find interesting and appropriate investments, it has been especially difficult to do so lately, in spite of intense efforts.

It is interesting that although our everyday existence at FMI involves numbers, white papers, interviews, spirited debates about business quality, industry trends, management competency and so forth, some of our best insights come from anecdotal data. These are the observations of life: the magazine covers, what's happening in the mall or on the web, the prevailing "wisdom" dispensed by Cramer (a CNBC celebrity stock commentator), the comments and questions we get from the general public and so forth. In the mid 1990s, stock valuations reached high levels. Wall Street showed all the classic signs of excess (speculative offerings, aggressive accounting, alternative ways to value stocks, e.g. "eyeballs," etc). Yet it was the guy on the street who told you it could get a lot crazier. It was the optometrist who first bragged about his Webvan or Inktomi stock, only to then trade in his eye charts for stock charts as he took up day-trading full time. It was the long-time conservative client who fired his value manager to buy the Janus Twenty Fund (which at the time was completely dominated by high-multiple technology stocks), or worse, to play the IPO game. Indeed, it got a lot crazier, and by 1999 valuations for the technology and telecom stocks reached ridiculous levels, and of course we all know what subsequently happened. Yet it was but a few years later that another speculative bubble began to develop in the housing and financial services markets. "Home prices never fall" was the battle cry from the bankers and Wall Street. We saw the relaxation and even elimination of down payments, credit scores, appraisals and so forth, along with sloppy securitizations of subprime mortgages, and thought it was getting out of hand. But it was the former used car salesman from Las Vegas who was buying his twelfth home, and the birthday clown (comedy club comedian) who got a $350,000 mortgage from Washington Mutual that told you it could get even wackier. This Fed assisted run-up and eventual crash turned out to be even more damaging than the internet/telecom defenestration, given how it compromised the banking system and negatively impacted a much wider audience (home owners versus tech stock holders). Sadly, the "public" can indeed be counted on to be spectacularly wrong at the inflexion points. Typically they are late to recognize trends and then wholeheartedly adopt them just about the time that underlying conditions are changing, and in the end, are often left holding the proverbial bag. It's why stock markets have compounded at approximately 9% over the long run while the public has achieved something closer to 3%.

Today's market may be equally divorced from underlying fundamentals and common sense. The relentless money printing by the Fed, a.k.a. Quantitative Easing (QE), has induced something akin to a Pavlovian response by investors, sending stocks to levels that, to us, simply don't appear to reflect underlying fundamentals or a realistic expectation of future growth. Readers are well familiar with the valuation work the Leuthold Group does. Today (Q1 2013), the 48 long-term valuation measures that they produce and we monitor show the market to be in the 8th decile (10th being the most expensive). Following is a chart of one of those 48 data series, a normalized S&P Industrials price-to-earnings (P/E) ratio.

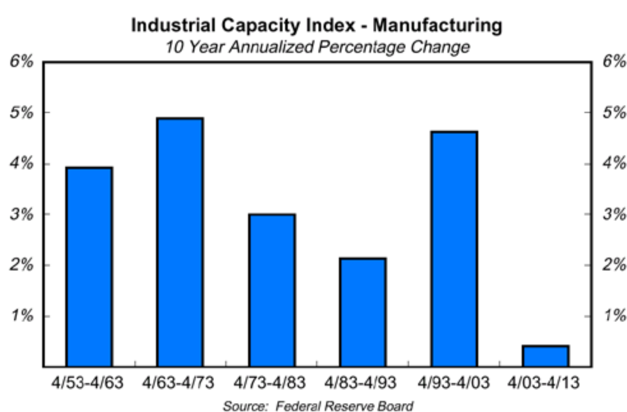


It's disturbing that unlike most periods, when there are usually a handful of very expensive sectors that are driving overall valuations, today the overvaluation is widespread. There are almost no sectors that are unequivocally cheap. Moreover, unlike many of the upper-decile periods of the past when growth was fairly strong and interest rates were falling, today underlying growth appears to be weakening and interest rates are ticking higher. Two years ago the broad market indices showed double-digit sales and earnings growth. Growth slowed steadily in 2012, and in the first quarter of 2013 the S&P 500 sales and earnings growth rates were both around 2%. We are unlikely to get help from margins; corporate profit margins, as depicted in the chart below, are very high by historical standards and have started to slip.



Based on what we are hearing from companies, growth is not expected to accelerate meaningfully in the near future. While interest rates remain very low, we think the probability of higher rates is greater than that of lower ones over the next 3-5 years. Bernanke and the other central bankers have been plying their grand experiments for years without success. We think these policies have already caused a lot of damage by sending the wrong pricing signals to the marketplace. Money printing rewards lower quality companies, borrowers and

speculators while channeling credit to the government instead of job creators. It penalizes savers, risk-averse investors and better companies by keeping poorer ones alive. Ultimately, if history is any guide, these policies will end in high inflation. What we are left with are economies buried in debt and simply not growing very fast. Businesspeople remain cautious, delaying investment in both capital and people as they struggle with new health care mandates, higher taxes and a fear that policies are permanently damaging the "system." Recent industrial production figures show flat-to-up activity but nothing strong enough to drive respectable gross domestic product (GDP) growth. Following is a chart showing capital formation by decade and it shows little net new growth in manufacturing capacity over the past decade. A recent Philadelphia Fed survey, however, showed intentions for capital spending have moved higher, but it hasn't yet translated into spending. Beside that is a chart of the labor force participation rate, which is near a record low. These two charts do not paint a pretty picture.

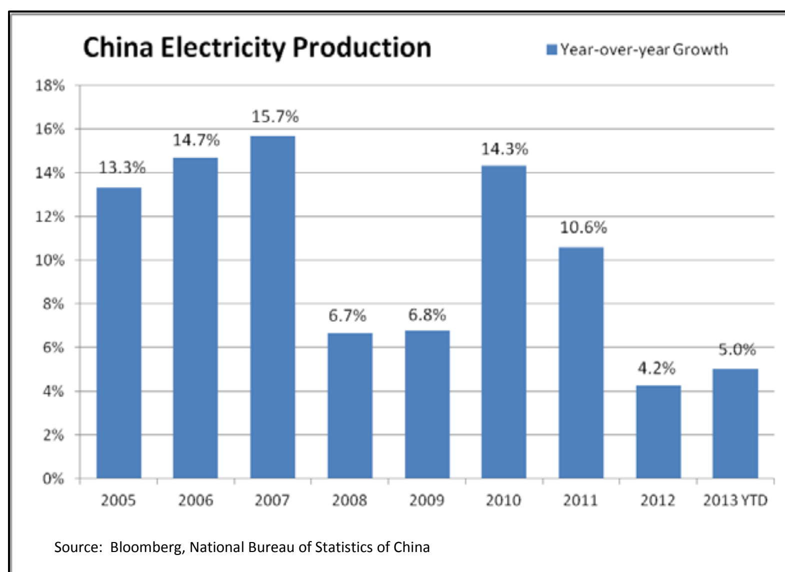


Yet with all of this, what is the anecdotal data saying? Newspaper headlines extol the virtues of Keynesian policies and central bankers' acumen. The housing recovery is heralded, without mentioning that 90% of new mortgages are being backed by the government and new purchases appear to be driven by short sales, investors and institutions (assisted by the Fed), rather than owner-occupied units. Acquaintances say things like, "I feel a lot better about things right now and I think it is time to wade back into the market." Spouses' coworkers ask about hot stocks and whether we'll get another QE. Friends at the gym are back bragging about the performance of their high yield (a relative term!) stocks and bonds. A popular set of advertisements being run by John Hancock has various couples meeting with their financial advisors saying things like, "We felt better holding on to our money… but waiting? We just can't wait any more. It's time to invest again." They waited over four years and 160% on the S&P 500? The median duration of the 15 bull markets since 1929 is 43 months and the median return is 83%. Seeing the public behave this way is not the kind of soft data that warms the heart; it's the kind that tickles the contrarian's antennae.

Economic fundamentals worldwide, with some exceptions, appear to be weakening. The consensus estimated Chinese GDP growth rate has been reduced to 7.7%, but is widely regarded to be lower. The chart on the following page illustrates Chinese electricity consumption that may be a better proxy of recent growth.

China appears to be suffering from overcapacity in a large number of manufacturing and commodity end markets, a banking system that is fraught with bad loans and cronyism, and a long effort ahead of them to move from a production-driven to a consumption-driven economy. Europe remains sick. The Eurozone is in recession and has shrunk for six straight quarters (likely seven when the June numbers are released). European auto sales are at a 20-year low. Sovereign debt loads continue to build as austerity proves unpopular. Many European banks remain in deep trouble. Not to worry, however, as French President Hollande recently told Japanese business leaders: "What you need to understand here in Japan is that the

crisis in Europe is over." What's over is any reasonable prospect of France meeting their growth or spending targets. With respect to Japan, the ultimate ramifications of massive monetary easing and fiscal pixie dust from Shinzo Abe remain to be seen. Initially it ignited the predictable euphoria from investors but recently it has given way to a sharp correction. Brazil and other emerging markets are feeling the pain as well. Brazil's real GDP growth rate plummeted to less than 1% last year and 2013 estimates have been cut significantly. Inflation is now running 6.7%. The Brazilian Bovespa is down over 22% year-to-date and popular unrest has moved to the streets. Russia's growth rate estimate has been slashed by nearly a third by the World Bank. In the United States, GDP growth estimates remain mired in the 2% range. The World Bank recently cut their overall worldwide 2013 growth rate estimate to just 2.2%.



Source: Bloomberg, National Bureau of Statistics of China

Ironically, we really are not in the camp that expects another deep recession, although anything is possible. We believe growth will accelerate at some point. It just won't be enough to justify prevailing stock market expectations. Once investors grasp that all of these grand monetary and fiscal policies won't generate the kind of growth needed to drive significant employment improvement and good GDP growth, the disappointment will set in. If we get inflation as collateral damage from these policies, it will be an additional hit to valuations. Future interest rates are always a wild card, but our bet would not be on lower rates over the next several years. If we see tax reform, spending reform and policies that private sector business owners and risk-takers can embrace (those that generate economic rewards and tax revenue) we'll sing a different tune. Until then, or perhaps more importantly, until more value surfaces in the stock market, we'll remain cautious.

Today it is very difficult to find stocks that have defendable business franchises and strong balance sheets, and that trade at attractive valuations. In the late 1990s, even though stock market valuations were at an extreme, most of the excess was confined to a few sectors. It was not difficult to build a diversified portfolio of high-quality businesses at reasonable prices. Similarly, in the middle of the last decade, it was relatively easy to avoid housing-related stocks or complex financial enterprises that were heavily involved in derivative alchemy. Today, this is not the case. There is widespread overvaluation. Many more stocks are overvalued today than in the late 1990s; it's just that the mathematics of market weighted indices doesn't show this. In the late 1990s, highly-valued mega market cap names like AOL, Dell and Cisco made the markets look more expensive than the median multiple would indicate. Today, the median multiple is higher than what it was in 1999, a period that is widely regarded as the most expensive ever. The FMI portfolios are carrying more cash than normal, as we sold a few stocks that reached full value and have not been able to find attractive replacements. So-called defensive stocks are also very expensive, closing off that investment avenue. The companies we do own are financially sound and strong, and in our opinion, are relatively more attractive than the market, but they are not cheap in an absolute sense.

Thank you for your support of Fiduciary Management, Inc.

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2007 - 03/31/2013

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	Three Year Ex-Post Standard Deviation *Benchmark	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	n/a	n/a	$ 56.9	$ 4,062.5	1.40%
2009	30.19	29.35	28.34	18	0.23	n/a	n/a	$ 86.9	$ 7,008.9	1.24%
2010	18.20	17.41	16.93	18	0.26	n/a	n/a	$ 103.3	$ 9,816.0	1.05%
2011	3.85	3.14	1.03	23	0.41	19.57%	19.35%	$ 127.4	$ 12,273.6	1.04%
2012	16.06	15.34	16.42	30	0.27	14.87%	15.73%	$ 168.5	$ 15,253.5	1.10%
Q1 2013	10.76	10.57	11.07	30	0.42	14.78%	15.44%	$ 176.1	$ 16,957.4	1.04%

*Benchmark: Russell 3000 Index®

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) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 03/31/2013. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The All Cap Equity composite has been examined for the periods 12/31/2007 - 03/31/2013. The verification and performance examination reports are available upon request.

FMI was founded in 1980 and is an independent investment counseling firm registered with the SEC and the State of Wisconsin. The firm manages over $16.9 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 actual management fees and transaction costs and gross of custodial fees and withholding taxes.
Dispersion is calculated using the equal weighted standard deviation of all accounts in the composite for the entire period. As of 12/31/2011, the trailing three year annualized ex-post standard deviation for the Composite and Benchmark are required to be stated per GIPS®.

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.
Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The Russell 3000 Index® measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The All Cap Equity composite uses the Russell 3000 Index® as its primary index comparison.