100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545
www.fiduciarymgt.com

INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

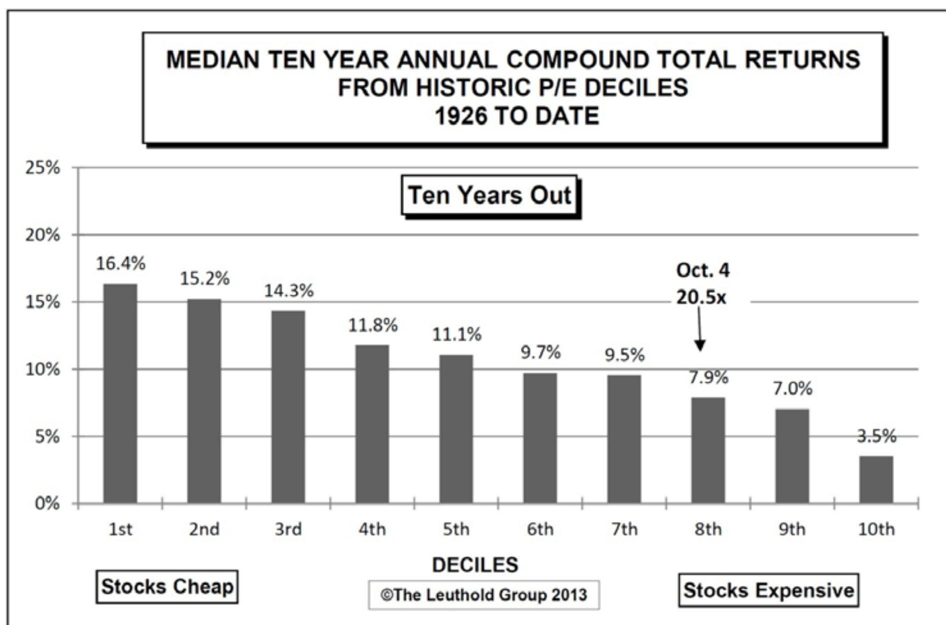
December 31, 2013

FMI All Cap portfolios gained approximately 8% in the December quarter compared to a 10.10% gain in the Russell 3000 Index. For the year, the all cap portfolios were up approximately 29% versus a gain of 33.55% for the Index. Given our more conservative investment style and elevated cash levels, we were not surprised to lag such a strong up market. For the year, sectors contributing to relative performance included Electronic Technology, Producer Manufacturing and Finance. TE Connectivity, 3M and Protective Life were solid contributors in these broad industry sectors. On the flip side, cash, Process Industries, Consumer Non-Durables and Retail Trade all detracted from the relative performance. Potash Corporation, Nestlé, Danone and Family Dollar underperformed. Despite tougher pricing and slower volumes, along with a lot of noise related to industry players in Russia, we feel the long-term outlook for Potash Corporation is bright and we have increased our stake during this tumultuous period. We believe the market has moved way out on the risk curve and "safer" names like Nestlé, Danone and Family Dollar lagged in 2013. We have increased our position sizes in Nestlé and Danone; however, the retail sector has been tough for some time due to a number of issues surrounding online shopping. While this hasn't directly affected our Family Dollar Position, it has been a factor in some of our other retail investments. The future trajectory of this sector depends a lot on Amazon, and whether Wall Street will continue giving Amazon a "free pass" in the sense that they are not requiring the company to make money to any significant degree. The stock was up 58.96% in 2013 and trades in excess of 500 times fiscal 2013 earnings estimates! Amazon is underpricing their services, putting enormous pressure on more traditional players. We sold eleven stocks in 2013, including a spin-off business from Covidien. Most of the sales were related to stocks that had appreciated beyond what we felt was reasonable. Omnicom was sold because we felt strongly that the pending merger with Publicis is a mistake, Sysco Corp. was sold on their announcement to acquire US Foods, and McDermott's inability to bid properly and execute across a number of areas sealed its fate in the portfolio. Although 2013 was a gratifying period from an absolute performance standpoint, we exit the year with trepidation. Froth is prevalent. Valuations are high. Complacency is higher.

The stock market continued to roar ahead in 2013, completely disconnected, or so it seemed, from the underlying fundamentals. The gain and duration of the Russell 3000 run since the March 9, 2009 low reached 213.18% and 57 months, respectively, more than double the median return, and 14 months longer than the average bull market cycle. One of the great mysteries of the past several years is the utter failure of the economy to grow at a rate that would justify this kind of stock market run, much less put our government balance sheet and fiscal budget house in order. Perhaps it is even more ironic that the U.S. economy is finally showing a better tone, and this development is being used as further justification for stocks to go even higher. The stock market seems to be in a no-lose endeavor: stocks go up strongly when the economy is weak and then they go up even more when the economy improves. They go up when the national debt explodes, when the government stops working and when the national health care rollout falters. They go up when an Arab Spring is in the air and they go up when riots, bombings and mayhem permeate the Mideast. They go up when the currency printing presses are running full tilt and even - if a few days in late December are any indication - as the Fed reduces its asset purchases. In our view, this is the anatomy of a market that has suspended fear and is only tangentially connected to reality.

At the risk of sounding simplistic, it is nevertheless interesting to note just how often stocks do not follow the economy in the short run. Clearly the past three years have shown remarkable stock market performance in the face of very slow economic growth. Early in the last decade, tech and telecom stocks dragged the market down even while the economy grew at a reasonable rate. The flipside was true in the late 1990s, as the market indices

gained at a far greater rate than the underlying economy. A noteworthy mismatch occurred in 1987, when the market crashed but the economy continued to grow at a healthy rate. Over really long periods of time stocks tend to appreciate at about the same rate (approximately 6%) as the underlying earnings of the companies that make up the economy. Over the hundred or so years since reliable stock market return data has been collected, equities have delivered about a 9% total return (6% price appreciation and 3% from dividends). Companies in the S&P 500, a good proxy for the U.S. economy, have averaged about 6% earnings growth. Periods when stock returns are significantly different than the underlying earnings growth rate mean that the multiple has either expanded or contracted. And there are small cycles and large cycles related to multiples. For the past thirty years or so we've been in a very large multiple expansion cycle, pockmarked by a few sharp corrections. The early 1980s were characterized by very high interest rates and inflation, and very low multiples. Today we have just the opposite. One was a terrific buying opportunity; we suggest that the other is not. In between there have been cycles when stocks got pretty darn cheap, such as 1990, and reasonably cheap, such as 2002 and late 2008/early 2009. Stock returns generally follow valuations but it isn't always immediate. Today, stocks are back to expensive levels and historically, this has meant substandard long-term returns, as the chart above attests.



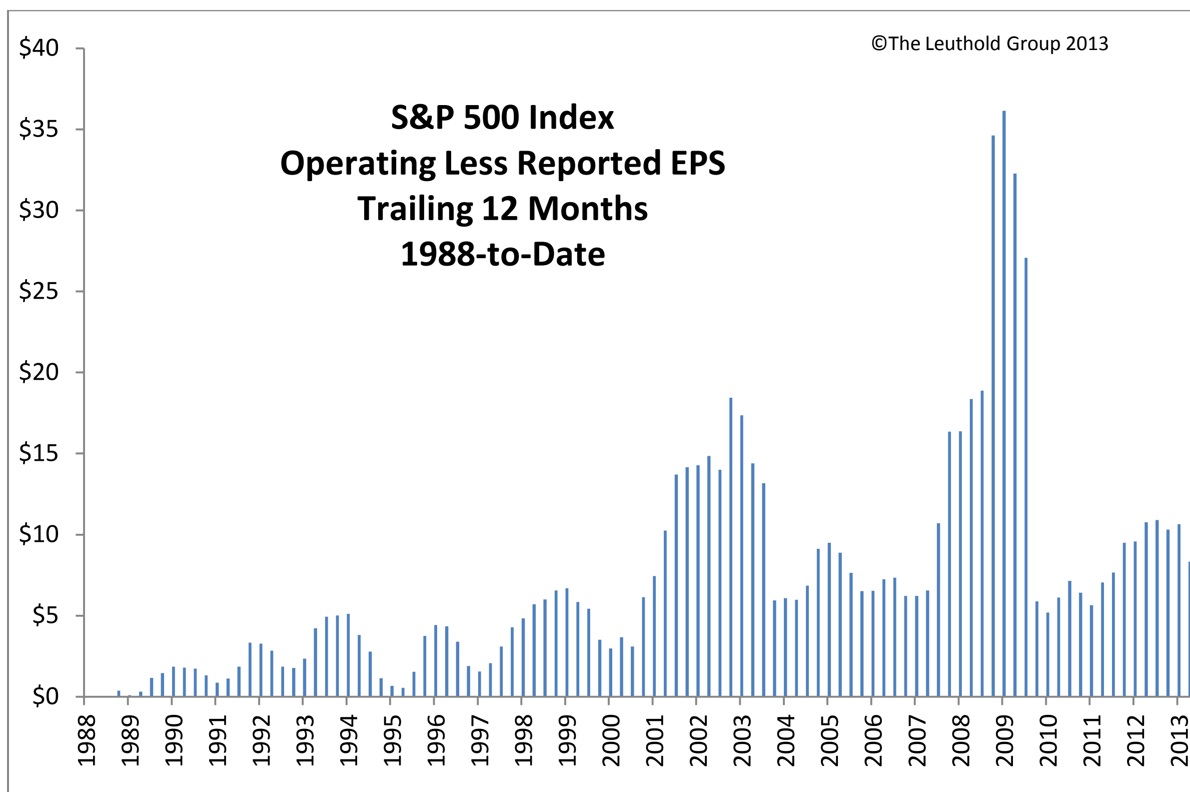
The list of companies trading at what we view as truly frothy valuations grows by the day. While there most certainly will be another Google or Apple that comes along and flourishes both fundamentally as well as from a stock appreciation standpoint, there will also be many disappointments trading at fractions of their current valuations. Visible stock market winners like Tesla Motors, Splunk and Twitter carry outsized market caps and trade at astonishing multiples of revenue (10.3, 27.4, and 67.5 times, respectively), yet to date, all remain unprofitable. To put these revenue multiples in perspective, the S&P Industrials 57-year average is slightly less than 1.0 times. Dozens of biotech companies, left for dead in 2009 with only a handful of them having turned a profit, are enmeshed in nothing short of a speculative frenzy. We screened the investable universe of stocks (over $400 million in market value) and found over 100 biotech stocks that were not making money. This group of stocks was up over 200% over the past 24 months.[1] Imagine what will happen to these stocks if fear makes a comeback, funding dries up and these companies are left to stand on their merits.

What makes this market so unusual and troubling, however, is not these highly speculative stocks, which probably constitute less than 10% of the investable equities; it is the fact that the vast majority of stocks are also trading at historically high valuations. Our quarterly survey of 48 valuation metrics puts the market in the 8th decile (1 being the cheapest, 10 being the most expensive) and even this might not tell the whole picture, as illuminated below.

The prevailing sentiment of Wall Street is that stocks are reasonably priced and a price-to-earnings (P/E) ratio for the S&P 500 that is in the mid-teens is cited as evidence. Usually the most cited P/E ratios are based on projected rather than actual earnings. Putting this aside for a moment, as well as the fact that companies are experiencing

[1] Data for this paragraph was compiled on December 20, 2013.

record high profit margins and an extraordinary amount of share repurchases (both helping the E part of the P/E), the reality is that P/E ratios have significantly changed over the past 25 years. The earnings figure that analysts use typically excludes stock-based compensation (a real cost), amortization of intangibles and other one-time items. Wall Street often plays a game of sanitizing near-term earnings, only later employing "one-time" write-off maneuvers in hopes that the market ignores it. These so-called adjusted operating earnings have gotten further and further removed from GAAP (generally accepted accounting principles) reported earnings. Prior to the 1990s there was almost no difference between so-called operating earnings and reported earnings. The following chart shows just how much this has changed.



How organizations calculate the P/E ratio for the indices varies, but most use a method that is problematic in determining a true P/E. Taking the S&P 500 for example, most use a calculation that essentially sums the market values for all constituents and then divides this by the total of all the earnings. While this may look proper on the surface, in reality, an index fund buyer is purchasing the weight of each stock multiplied by its corresponding P/E ratio. A simple example will illustrate how the two methods yield far different results. Imagine a three-stock portfolio with prices of $10, $25 and $40 respectively, and assume all have $1 per share in earnings and just 1 share outstanding (so the market value equals the stock price). The S&P method adds the market values ($10 + $25 + $40 = $75), which is divided by $3 in cumulative earnings, giving a P/E ratio of 25. But a holder of this index actually owns one stock with a 10 P/E ratio and a weight of 10/75 or .1333, for a weighted average value of 1.33 (10 x .1333), plus one stock with a 25 P/E ratio and a weight of 25/75 or .3333, yielding a weighted average of 8.33 (25 x .3333), plus one stock with a 40 P/E ratio and a weight of 40/75 or .5333, which computes to a weighted average of 21.33. The sum of these weighted average values equals 31, which is 24% higher than the conventional calculation of 25. The first calculation is certainly easier and if the market doesn't have a lot of unusual valuations the two methods don't vary widely. That isn't the case today, as you can see from the previous discussion, so in our view it makes P/E analysis misleading. In the Russell 2000 Index, for example, there are over 550 companies that are losing money, rendering valuations based on P/E ratios highly unreliable.

There is a large and growing disconnect between valuation analyses using P/E ratios versus other measures, such as those based on revenue, which is much harder to manipulate or massage. Our standard menu of 48 different

valuation measures uses 28 metrics not based on P/Es. These measures show today's market to be in the ninth decile, obviously nowhere near a reasonable valuation level. As we mentioned in last quarter's letter, the median multiple of the stock market today is even higher than the median multiple at the end of the great technology and telecom boom of the late 1990s. High valuations don't mean stocks will fall tomorrow. They do mean that the margin of safety in this market is extremely low. Reiterating an earlier point, it's ironic to think about the conditions that prevailed in the early 1980s that led to one of the greatest bull runs of all time, and how we have almost the opposite conditions today.

Rarely is a viewpoint strictly black or white. While we remain firmly in the camp that monetary and fiscal policies are seriously flawed and ultimately will cause pain that is in no way reflected in today's valuations, we are encouraged that some economic variables appear to have bottomed and a few are improving, such as employment and industrial production. We are hopeful the latest GDP print of 4% is a harbinger of times to come, although the large inventory build embedded in this figure doesn't inspire confidence. We note the higher home values and the better tone to some consumer areas. We acknowledge it is possible that somehow we will grow into these valuations and we would be thrilled to see it. This rosy scenario seems to be the overwhelming consensus of the markets and it shouldn't be surprising that we remain skeptical. The underpinnings of a sustainable strong recovery just do not seem to be prevalent, particularly in the areas of capital investment, new business creation and total labor participation.

Today it is simply difficult to find high-quality businesses that trade at reasonable valuations. That is really the best barometer of the stock market and something to keep in mind as we approach the fifth anniversary of this bull market. Fiduciary Management's long-term track record (34 years in small/mid cap and 13 years in large cap) has revealed an ability to capture much of the up markets while avoiding the full magnitude of down markets. This combination has delivered superior long-term results. We've done this by carefully selecting stocks with an eye toward risk aversion. The all cap portfolios currently trade at a significant discount to the Russell 3000 based on a wide number of valuation parameters. At some point in the future, sentiment will change and when it does, we are optimistic that the relative performance will be favorable.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2007 - 09/30/2013

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation		Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
						Composite	*Benchmark			
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%
Q2 2013	2.36	2.19	2.69	30	0.10	13.37%	14.00%	$ 175.2	$ 18,032.6	0.97%
Q3 2013	5.68	5.48	6.35	31	0.11	12.05%	12.85%	$ 189.5	$ 19,063.5	0.99%

*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 - 09/30/2013. 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 - 09/30/2013. 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 $19.0 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.