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INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

September 30, 2017

The FMI All Cap portfolios returned approximately 3.6% and 12.1% for the three and nine months ending September 30, respectively. This compares to 4.6% and 13.9% in the corresponding periods for the Russell 3000 Index. In the quarter, sectors on the plus side included Retail Trade, Producer Manufacturing and Process Industries. Stocks with a positive relative impact were Dollar General, Woodward and Potash Corp. On the flip side, economic sectors Electronic Technology, Communications and Commercial Services detracted, as did cash. Individual securities that hurt performance included Level 3 Communications, Interpublic Group, AmerisourceBergen Corp. and Omnicom.

The character and tone of most stock markets around the world remains bullish. While economic and corporate performance has improved in 2017, stocks have continued to vastly outpace fundamentals, as they have for quite some time. The average stock, and certainly almost any benchmark, appears to be significantly overvalued. Investor sentiment remains high, and while this has historically been a good contrarian indicator, it hasn't proven to be in recent years. A powerful move from active into passive investment strategies, and perhaps an unjustified but enduring belief in the Federal Reserve, may be preventing the normal ebb and flow of the market. As of this writing, it has been over 450 days since there has been even a 5% correction -- the longest stretch in over 20 years. The current 8 ½ year bull market in the S&P 500 is the second longest on record, and has gained over 340% from the trough in 2009. Most companies, particularly the types of businesses we like to own, are trading between one and three standard deviations above their long-term historical valuation ranges. The market is valued between the ninth and tenth deciles, using an exhaustive array of approximately 50 valuation measures compiled by The Leuthold Group. Valuation has become an afterthought in today's growth and momentum-driven market. This phenomenon has been in place far longer than we ever thought possible. While the confidence of the growth, momentum and passive investor (gradually all becoming one and the same) reaches a crescendo, we take comfort in the knowledge that human nature rarely changes. People who were scared stiff in 2008-09 -- and dumping stocks -- are now rolling the dice. The fear of missing out has overwhelmed value principles and risk mitigation.

A common refrain we hear is: "Stocks may be a bit elevated, but earnings are good, the Fed is a steadying hand, inflation is under control, political risks are being managed, and there just doesn't seem to be anything that will derail the market." It's important to understand that this statement generally comes from four sources, all of whom have built-in biases or blind spots. First, the media perpetuates this sentiment... because a bull market is good for business. This is easy to understand when looking at the advertisements on the financial programs, and in the press. It's similar for the second constituency: brokerages and investment banks; they are not going to throw a wet blanket on a bull market, particularly when M&A (mergers and acquisitions) activity is rocking. The third source for this narrative is the money managers; they don't want investors to pull their money, so they sugarcoat reality. Finally, it's the investors themselves, who want to avoid cognitive dissonance, or the state of having inconsistent thoughts or beliefs: "I'm smart and I'm fully invested, therefore it must be the smart thing to do." When people see things the same way and act accordingly, eventually a point is reached where there aren't enough people left to convince, and the situation reverses; this is the essence of contrarian thought. Today, market participants either ignore, or don't want to entertain a narrative that conflicts with a bull market. Following is a table of items where the left side is labeled "prevailing beliefs" and the right side is "alternative beliefs." We aren't suggesting that every alternative belief will trump the more popular counterpart. It's just that in our decades of investment experience, we find that many popular beliefs end up not being true in the end; something that nearly everyone views as a pillar of faith crumbles. The prevailing belief in the 1990s was that the technology train was leaving the station and you had to be on it. In the middle of the last decade it was that home prices would never fall, and that derivative mortgage products were

safe investments. No one knows which “infallible” belief will fall, but there is a good chance it will come from something on the left side of this table:

Prevailing beliefs	Alternative beliefs
The economy is sound and is getting better.	The economy has chronically underperformed, and is trapped in a low-growth mode, despite massive fiscal stimulus. Organic growth stimulants are still missing.
Stocks will continue to rise because interest rates will remain low.	Stocks have already risen at approximately double their normal rate for 8 ½ years, partly due to low interest rates. Eventually, risk will be reflected in the price of money.
Inflation will not be a problem.	Services, over double the weighting of goods in the economy, have inflated 2.4-3.2% in recent years. Governments almost always engineer inflation to ease debt repayment.
Valuations are reasonable.	Valuations are extremely high. On many valuation measures the median stock is significantly higher-valued than in the peak of 1999-2000.
The Federal Reserve has managed through tough times, and has “investor’s backs,” so to speak.	The Fed has crushed savers, and caused a massive misallocation of resources. Inflating assets to spur wealth-effect spending hasn’t worked in nearly nine years.
Quantitative Easing (QE) has worked well and can be unwound gracefully.	If QE was good for stocks, how can the unwinding of the Fed’s balance sheet also be good?
Passive indexing is an economical and low-risk investment approach.	Indexing has become a momentum trade. Herd behavior never ends well. What a smart person does in the beginning, a fool does in the end.
FAANG stocks (Facebook, Apple, Amazon, Netflix, and Alphabet’s Google), tech, and biotech are unique opportunities that shouldn’t be measured by traditional valuation metrics.	Almost all stocks have their reckoning at some point, and eventually trade within a justifiable bound of conventional valuation.
Budget deficits matter little.	Increased government debt robs private sector investment and crimps growth. It burdens future generations. World debt levels are increasing, and exceed those of 2007.
The unemployment rate is low, which is a sign of health.	Tens of millions of people have dropped out of the workforce, skewing the unemployment rate measure. The total number of full-time workers is just 5 million higher than it was 10 ½ years ago.
Low volatility is a sign of negligible risk.	Abnormally low volatility indicates a dangerous level of complacency.
Investor confidence is high, indicating good times for the economy and the stock market.	For most of history, high confidence was a precursor for low future returns; it is a contrary indicator.
Wall Street earnings are growing nicely.	Most companies now use adjusted earnings, which ignore full costs. Adjusted earnings per share vs. GAAP (generally accepted accounting principles) earnings exceeds 30%. True underlying earnings growth doesn’t vary much from nominal GDP over the long run.
Politicians and poisonous political differences won’t halt stocks or the economy.	Anything is possible out of Washington; the environment is unusually volatile. Political dysfunction hasn’t hurt yet, but if investors become sour, it will weigh on multiples.

Prevailing beliefs	Alternative beliefs
Geopolitical risks, i.e., North Korea, Iran, Russia, China and Latin America, won't derail stocks.	Any one of these could break the wrong way. The Chinese credit bubble is particularly risky.
Demographics are not a concern.	Rich countries are not replacing their populations. Retirement benefits and budgets are imperiled by upside-down demographics.
Housing and autos are healthy. Lending is healthy.	Four of the past five months, mortgage applications have fallen. Autos appear to be rolling over. Credit growth metrics are falling.
Companies will buy back shares to keep earnings per share growing.	Buying back shares does little for the economy. Doing it with borrowed money at extreme valuations is a low-return, high-risk endeavor.
Crypto currencies like Bitcoin will revolutionize money and payment systems.	The dramatic rise in these currencies smacks of rank speculation. Only in a runaway bull market could you see anything like this.
The S&P 500 is at an all-time high, which indicates strength, and is also a low-risk way to invest.	The market is narrow, and is unnaturally benefitting from indexing. Any asset class, including an index fund, can become overvalued.
M&A is a positive, as it boosts growth rates.	Many studies show that on balance, M&A destroys value for the acquiring entity. Managements and analysts want people to ignore recurring write-offs and poor returns on invested capital. Today deal valuations are extreme.
There is a pile of cash on the sidelines poised to enter the market.	Money market funds have been in a range of approximately \$2.6-2.8 trillion since 2010. Overseas cash faces heavy taxes.

In a study done ten years ago, two Stanford researchers, Peter DeMarzo and Ilan Kremer, along with Ron Kaniel of Duke University, showed that “what investors fear the most is not the risk of loss per se, but the risk that they may do poorly relative to their peers.” The study revealed that investors knowingly bought risky securities and tended to “choose portfolios that look a lot like others in their community or professional cohorts.” DeMarzo said, “Such herding around certain investments allows you to combat the fear that everyone else might be betting on the winner and you’re not.” It is difficult to try to convince people to fight their impulses, because investors seem to be inherently programmed to follow the hot hand -- either that, or they throw up their hands and index (“If I can’t beat them, I’ll join them”). Investors simply cannot fathom that both strategies are fraught with risk today. The hot hand is likely to be trafficking in risky growth stocks, and indexing suffers from a nonfundamental buy/sell algorithm (money flow) that today is buying despite extreme valuations.

Yes, we are going to have a bear market; all bull markets are followed by the opposite and it will probably unfold when sentiment is high and the outlook, at least from the CNBC pundits, is positive. One can avoid losses by going to cash. Going to all cash is not an easy strategy as it implies having to make a second decision to return to the market. Over the decades, our observation is that many who make the decision to go to cash usually do so after getting clobbered, and if they do return, it is typically well after the next bull market is underway. Thus, it is rarely successful. Still, in theory, if you could stomach listening to your friends talk about how much money (on paper) they were making in the most popular stocks or index funds, and you had the mettle to redeploy into equities when the markets were in disarray, you might not find a better time than today to do it.

Practically speaking, however, it is usually better to just ride out bear markets if one truly has a long-term investment time horizon. The question then becomes, “What kind of investment approach is best suited to take one through the inevitable down market and up the other side?” We will begin our self-serving answer with a statement that

historically, as a firm we have generally outperformed in difficult markets, and this has overwhelmed the underperformance in bull markets such that full cycle performance is superior. The peak of the current 8 ½ year bull market is unknowable, so this cycle could be different, but it really doesn't change the basic premise. We own strong business franchises that trade at significant discounts to the benchmark, and at a very wide discount to the growth stocks driving the bull market. Our companies are likely to earn a return in excess of their cost of capital over a cycle, and they have solid balance sheets. We also have a deep list of stocks in our bullpen into which we can move aggressively when volatility emerges. We have the constitution to make difficult swaps amid a bear market (selling a stock that holds up relatively well, and redeploying the proceeds into a stock that has been unfairly punished, and that has significantly higher upside). Conversely, investors can choose to stick with the recent big winners and hope that they do not turn out like the 1990s vintage, many of which today still trade at fractions of their former value, or are no longer in business. Investors can opt to hang on to their index funds, which appear extraordinarily overvalued, much as they did in the late 1990s to early 2000s. The price of the S&P 500 in March of 2013 was 1,527 -- the same price it was thirteen years earlier, the last time the S&P 500 was as inflated as it is now. Even though nearly everyone is making money, today's investment landscape is by far the most difficult we have experienced, in terms of finding solid businesses at reasonable prices. We are, however, confident in our team and in the belief that over the long term, we will produce superior risk-adjusted results.

As is customary in the September letter, we highlight a couple of investments:

TJX Companies, Inc. (TJX)

Analyst: Ben Karek

Description

TJX Companies is the world's largest off-price apparel and home fashion retailer. The company operates 3,862 stores through four business segments: Marmaxx (T.J. Maxx and Marshalls chains -- 64% of sales, and 70% of profit), HomeGoods (13%, and 14%), TJX Canada (10%, and 10%), and TJX International (13%, and 6%). Geographic exposure includes the following: U.S. (77% of sales), Europe (14%), Canada (9%) and Australia (<1%). Merchandise mix consists of clothing, including footwear (55%), jewelry and accessories (15%), and home fashions (30%). TJX operates self-service, low-cost store formats that are typically 25-30,000 square feet in size, and located in suburban shopping centers. They feature department store brands at a 20-60% discount, creating a strong value proposition and "treasure hunt" experience. Fast-turning inventory is purchased opportunistically via order cancellations, manufacturer overruns, closeouts, special direct production, etc. The company has a world-class buying organization, with more than 1,000 buyers in 11 countries, and over 18,000 vendors in more than 100 countries. The company runs 14 million square feet of distribution centers across six countries.

Good Business

- The company's 5-year average return on invested capital is greater than 30%, generating economic value for shareholders.
- TJX Companies (with 43% market share) and Ross Stores (with 25%) dominate the U.S. off-price retail channel, leading to economies of scale. Benefits include buying power, sourcing, distribution, IT, marketing, brand equity, etc. Smaller chains have struggled, as evidenced by several bankruptcies (e.g., Filene's Basement and Loehmann's).
- Expanding market share demonstrates relative advantage over traditional retailers. From 2008-2014, off-price retailers grew at an 8.4% compound annual growth rate, while U.S. apparel/footwear/accessories sales averaged 2.9%. Off-price retail accounts for only 15% of an approximately \$300 billion market.
- Resilient same store sales growth has averaged around 4% over the last 10 years, and TJX has had positive same store sales for 20 straight years, including the 2008-2009 recession.

- There is significant opportunity for new store growth. TJX has a target of 5,600 stores in *existing* markets (mid-single-digit annual square footage growth). We believe HomeSense, Sierra Trading Post and yet-unpenetrated geographies offer upside to the long-term total store count.
- TJX offers low prices, with the average item around \$14, and an average ticket of roughly \$30-\$40. This discount pricing, combined with an ever-changing, treasure hunt shopping experience, helps to mitigate the online threat.
- TJX is very conservatively financed, with net cash of \$723 million.

Valuation

- TJX trades at 11.3 times enterprise value-to-earnings before interest and taxes (EV/EBIT) on 2018 estimates. This represents a discount to the S&P 500 of 37% on trailing 1-year EBIT, and 28% on forward 1-year EBIT. TJX is a better-than-average business trading at a material discount to the market.
- TJX trades at 18.4 times price-to-earnings (adjusted for net cash), near its 10-year average, and one standard deviation below its 5-year average.
- Total shareholder return will be driven by 1-2% same store sales, 4-5% square footage growth, 0-2% margin improvement, 1.7% dividend and 3-4% share buybacks.

Management

- There is a strong track record of value creation. Chief Executive Officer Ernie Herrman has been with company since 1989.
- TJX actively returns cash to shareholders while continuing to invest organically in the business.
- The company's top five insiders own approximately \$86 million of stock, so they have skin in the game and their interests appear aligned.

Investment Thesis

Off-price retail continues to take market share from malls and department stores, and has carved out an attractive, high-return retail niche. We expect the channel to further consolidate, and for TJX to be a key beneficiary. The company's value proposition is defensive in nature (positive comparable store sales in the last six recessions), appealing to those who "want" and "need" a bargain. The business also performs well in good times, as shoppers still seek a deal. TJX has an attractive runway of growth domestically and overseas, and generates a blended return on invested capital well above its cost of capital. Transitory headwinds including foreign exchange, wage pressure (minimum wage increases), and infrastructure investments have weighed heavily on near-term results, creating an opportunity to own the stock.

JPMorgan Chase & Co. (JPM)

Analyst: Matthew Goetzinger

Description

JPMorgan Chase is one of the largest and most diversified financial services providers, with total assets of \$2.5 trillion. The company's activities encompass asset-based lending, credit cards, capital markets, advisory, custody, processing and asset management. In aggregate, roughly two thirds of JPM's earnings are from commercial businesses, with consumer-focused lending accounting for the remaining third of the business.

Good Business

- JPM controls leading market shares across each of its four main businesses, with operating margins that exceed most pure-play comparables. In contrast to most global bank competitors, JPM's strategy has been remarkably consistent with a steadfast approach of reinvestment for long-term growth.
- Total non-interest fee-based income accounts for just over 50% of total revenues.
- JPM has had one of the most stable earnings streams among large banks over the past decade.

- In the last ten years, JPM has grown tangible book value per share at an 11% compound annual growth rate, with book value expanding during the most recent recession.
- The stability of the company's earnings and returns has earned JPM the reputation of a good risk manager. JPM targets a return on tangible capital of 15%.
- A salient and enduring characteristic is the bank's fortress balance sheet. The bank carries substantial excess capital at a 12.5% common equity Basel III Tier 1 ratio.

Valuation

- JPM's 10-year average price-to-tangible book value multiple is 1.7 times, ranging from a low of 0.3 times to a high of 3.4 times, and the stock is presently valued at its 10-year average multiple.
- Over the past 20 years, large cap banks have traded at an average relative forward earnings multiple of 0.8 times the S&P 500; this suggests an industry multiple of 16 compared to JPM's price-to-earnings ratio of 12.
- Continued loan growth, modest margin expansion, and significant share repurchase result in earnings power greater than \$8.50 per share. Valued at a 16 multiple, JPM's fair value is 40% higher.

Management

- Most of JPM's management team has grown up with the company, helping preserve its strong culture and strategic vision. Chief Executive Officer Jamie Dimon has been with the bank since the completion of the Bank One merger in 2004.
- JPM's senior bankers have an average tenure of 15 years with the bank.
- Over the past several years the company's incentive compensation has shifted to performance-based return on tangible capital.

Investment Thesis

JPM's business embodies a balanced mix of offensive and defensive attributes. With leading market shares across a number of economically vital end markets, the company has succeeded in building a vast array of important lending, advisory and asset servicing businesses under one brand. Enabled by a strong defensive balance sheet, efficient operations, and continuous reinvestment, JPM is positioned to gain further market share. Viewed on a total return basis, the shares are attractively valued. JPM will also likely prove to be a beneficiary of a flight to quality in a tougher market environment.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2007 - 03/31/2017

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%
2013	29.61	28.70	33.55	35	0.69	11.72%	12.53%	\$ 211.6	\$ 19,705.3	1.07%
2014	12.65	11.91	12.56	41	0.31	8.43%	9.29%	\$ 268.0	\$ 21,001.1	1.28%
2015	-0.14	-0.82	0.48	42	0.45	9.70%	10.58%	\$ 263.7	\$ 21,042.9	1.25%
2016	16.71	15.90	12.74	39	0.37	10.50%	10.88%	\$ 275.9	\$ 22,636.7	1.22%
Q1 2017	5.07	4.90	5.74	39	0.08	10.06%	10.56%	\$ 278.9	\$ 24,541.9	1.14%

*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 - 03/31/2017. 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 - 03/31/2017. The verification and performance examination reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

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 \$24.5 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 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.