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

INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

December 31, 2017

The FMI All Cap portfolios gained approximately 5.7% in the quarter ending December 31, compared to the benchmark Russell 3000 Index return of 6.34%. Health Technology, Process Industries, Consumer Services and Health Services all helped in the quarter, while Distribution Services, Communications, Consumer Non-Durables and higher-than-normal cash all detracted. MEDNAX, Twenty-First Century Fox and UnitedHealth Group aided relative performance. Cerner, CenturyLink and Anixter detracted from results. For the calendar year 2017, the All Cap portfolios advanced roughly 18.6%, while the Russell 3000 had a total return of 21.13%. These results were about what we expected, given our more conservative posture versus the market.

> **Only one thing is more important than learning from experience, and that is not learning from experience.**
>
> \- Sir John Templeton -

When one is value-oriented and markets take stocks far beyond anything that resembles value, everyday life becomes a strange dichotomous existence. You're supposed to be happy because everyone has made a lot of money; markets have more than tripled off the bottom and this bull cycle has been one of the strongest since records have been kept. Back-slappers at parties say, "The market was up again today. You must be loving this!" With a weak smile you mumble something; after all, it's the holiday season, and nobody likes a Grinch. The sober part of your brain, however -- the side that is experienced and logical and that has some recollection of history -- senses something far from pleasure. You are, in a word, fearful. You know that the parabolic rise in Bitcoin and other crypto currencies could only take place in an investment environment that had become unhinged from economic reality and common sense. Recently in Europe, we see an upside-down world with negative short-term government yields and junk bonds trading inline with U.S. Treasury yields. In the United States, a review of a relatively stable long-term valuation measure such as enterprise value-to-sales shows most stocks trading not at one standard deviation above their long-term mean, but two or three. On many valuation metrics, particularly those based on median data, the markets have blown through the peak of the 1999-2000 tech bubble, a period that used to be called the most overvalued in history. Goldman Sachs, not a firm that typically raises yellow flags, recently said today's market is the richest since 1900. Margin debt has exploded and growth stocks are beating value stocks for the longest stretch in history. Experience is a ball and chain in this market… at least for the time being.

Bitcoin and companies trying to cash in on this mania come closest to what prevailed on the edges of the 1999 speculative bubble. The FANG stocks (Facebook, Amazon, Netflix and Google [now Alphabet]), as well as numerous technology issues or "sexy" stocks like NVIDIA or Tesla, are reminiscent of the hot stocks of that era. It takes a suspension of reason, and certain amount of raw greed, to get a market that resembles 1999, but investors have managed it. To wit, Crypto Company, a penny stock three months ago, became an $18 stock on December 1st... and a $642 supernova six trading days later. At this price, despite having essentially no revenue and $50 million in losses, it had a $13.3 billion market cap, more than Manpower, Papa John's and Herman Miller combined. LongFin Corporation surged 2,600%, or over $7 billion, in just a few trading days in mid-December, soon after it bought Ziddu.com, "a blockchain-empowered global micro-lending solutions provider," which also just happened to be owned by the CEO of LongFin itself, a company with no reported sales or earnings on FactSet or Bloomberg. Many of these types of crazy stocks in 1999 were initial public offerings (IPOs). We store boxes of prospectuses from this era to give young analysts a history lesson; now we just tell them to turn on their computers. In some respects, the form

is a bit different -- public IPOs in that era versus private billion dollar "unicorns" today -- but the phenomenon is the same.

The FMI All Cap strategy began on 12/31/07, but our sister strategy in the small cap arena dates to 1981. Looking back to the FMI Common Stock Fund's December 31, 1999 letter, we quoted and wholeheartedly concurred with a well-known market commentator, Barton Biggs, who said:

> ***"The technology, internet and telecom craze has gone parabolic in what is one of the great, if not the greatest manias of all times. We understand the net, and its implications for this economy, we just don't understand the valuations. The history of investing in "paradigm-changing industries" such as today's internet, has almost always been profoundly based on revolutionary developments that eventually do change the world. However, without exception, the bubble stage of the craze ends with a massive destruction of wealth."***

Of course, we all know what happened shortly thereafter -- a colossal bear market -- but what people forget is that most stocks were going sideways-to-down for many months prior to the peak of that market. Again, quoting from that letter, "In 1999, over half of the stock in the Nasdaq and Russell 2000 indices were down, as were 61% of those securities on the New York Stock Exchange."

Figure 1

12/31/1999	FMI Common Stock Fund
P/E on trailing earnings	15.1
Price/Sales ratio	1.4*
Enterprise Value/EBITDA	7.7

** The EV/Sales ratio was 1.4. We did not calculate the straight price/sales ratio at that time but we estimate that it would have been approximately 1.1.*

Figure 2*

12/31/2017	S&P 500	Russell 2000
P/E on trailing earnings	25.5	35.1
Price/Sales ratio	2.6	2.2
Enterprise Value/EBITDA	13.0	14.8

** Estimated valuations are calculated using iShares data. Financial companies are excluded from the EV/EBITDA calculation. Valuations have been modified if necessary based on criteria identified by FMI.*

In 1999, a wide swath of the market was reasonably priced and it was not difficult to construct a diversified portfolio of value-oriented stocks, provided one avoided the egregiously overvalued technology issues. The FMI Common Stock Fund appreciated significantly over the next three years while the benchmarks were clobbered. We pulled the valuation data in the accompanying table (Figure 1) for the FMI Common Stock Fund as of 12/31/99 (based on medians). Contrast these figures with the 12/31/2017 data (Figure 2) for the S&P 500 and Russell 2000 (based on medians).

While there are many similarities today versus 1999, in one important way these markets are vastly different: there are few absolute values today. It is difficult, if not impossible, to construct a diversified portfolio of inexpensively-valued good businesses. It has become strictly a game of relative value.

Indexing has aided and abetted market distortions. The massive flow into index funds, particularly ones tied to the S&P 500, has resulted in lights-out performance, and to the believers, confirmation of the brilliance of passive investing. As of 11/30/17, we utilized Morningstar's Advisor Workstation and screened all actively managed funds (oldest share class) with more than $100 million in assets with at least a 5-year track record. Of the 4,573 funds passing this screen, only 6.3% outperformed the S&P 500 over the last half-decade. Index investing is a very crowded trade. *We think the greatest investment mistake of the next few years will be the belief that this will continue.* As we have discussed in previous letters, the further this rally extends, the more it is driven by growth and momentum stocks. Index funds are the ultimate growth and momentum play because they are driven by fund flows rather than fundamentals. The magnitude of this cycle's growth stock outperformance has destroyed long-held relationships that have prevailed since the Ben Graham days (that value outperforms growth over long stretches of time). We anticipate reprinting this table (Figure 3) in five years with the expectation that all negative numbers will be positive.

Lately some have questioned whether we are just wrong about stocks, and wrong about the market. The paradigm has shifted, or so the new theory goes: Stocks will continue to go higher because rates will remain one to two standard deviations below average, and earnings will advance at a higher-than-normal growth rate. Multiples will stay high as there just isn't anything on the horizon poised to upset the perfect balance. Magically, despite underinvestment in capital expenditures and research & development, productivity will pick up, driving noninflationary growth. The nine million men of prime working age that aren't working will somehow make their way to the time clock, keeping wages in check. Government debt, which has grown dramatically despite an economic expansion, will not become a problem. Corporate debt, which has also expanded significantly (mostly to repurchase stock and do deals) will not come back to haunt borrowers. The massive expansion of worldwide central bank balance sheets will have no negative ramifications. No political or geopolitical crises will spoil the party. Nirvana.

Figure 3

Annualized Total Returns Through 12/29/17

	1 yr.	3 yr.	5 yr.	10 yr.
MSCI World Value Index	18.0%	8.6%	11.3%	4.8%
MSCI World Growth Index	28.5%	11.2%	13.2%	6.5%
Value performance	*-10.5%*	*-2.6%*	*-1.9%*	*-1.7%*
Russell 1000 Value Index	13.6%	8.6%	14.0%	7.1%
Russell 1000 Growth Index	30.2%	13.8%	17.3%	10.0%
Value performance	*-16.6%*	*-5.2%*	*-3.3%*	*-2.9%*
Russell 2000 Value Index	7.8%	9.5%	13.0%	8.1%
Russell 2000 Growth Index	22.1%	10.3%	15.2%	9.2%
Value performance	*-14.3%*	*-0.8%*	*-2.2%*	*-1.1%*
MSCI EAFE Value Index	22.2%	7.1%	7.7%	1.9%
MSCI EAFE Growth Index	29.3%	9.6%	9.2%	3.1%
Value performance	*-7.1%*	*-2.5%*	*-1.5%*	*-1.2%*
MSCI EAFE Europe Value Index	8.9%	6.1%	9.2%	2.4%
MSCI EAFE Europe Growth Index	12.8%	8.8%	10.6%	5.4%
Value performance	*-3.9%*	*-2.7%*	*-1.4%*	*-3.0%*
MSCI Emerging Markets Value Index	28.1%	6.2%	1.8%	0.9%
MSCI Emerging Market Growth Index	46.8%	11.9%	6.9%	2.4%
Value performance	*-18.7%*	*-5.7%*	*-5.1%*	*-1.5%*

Source: Bloomberg

Perhaps we have underestimated the positives that come from a regulatory rollback. We've acknowledged this effort and recognize that part of the most recent rally is related to it. Maybe it will be even better for company earnings than we think. There is certainly more business optimism, if surveys are to be believed... but what people say and what they do are often different. We need to see a significant pick-up in organic investment spending. In recent years savings rates have been falling and organic investment has been choppy, so this needs to improve; that may change with a new tax structure. While the market seems to already have discounted the potential impacts from tax reform, perhaps the ramifications are more positive than we anticipate.

One of the more optimistic estimates of the tax plan's effects comes from The Tax Foundation. They see a 0.44% increase in 2018 real GDP growth, from 2.01% to 2.45%, and a cumulative real GDP impact of 1.7%. Further positives are illuminated in the nearby table (Figure 4). They believe an additional $600 billion in federal revenues will be generated by the tax plan's permanent provisions, helping to offset the ultimate cost (estimated by the Congressional Budget Office to be about $1.47 trillion). Of course, the pundits all undershot the positive impacts from lowering tax rates in the 1960s and 1980s. Maybe it will spark faster business activity. We are also hopeful that repatriated funds will be invested in projects and people, rather than buybacks and acquisitions. It's important to keep in mind, however, that we think it will reduce price-to-earnings ratios by less than 10%, leaving them still very elevated by historical standards.

Figure 4

Change in long-run GDP	**1.7%**
Change in long-run capital stock	**4.8%**
Change in long-run wage rate	**1.5%**
Change in long-run full-time equivalent jobs (thousands)	**339,000**

Source: The Tax Foundation

The odd thing about the tax program is that even the optimists have it costing a significant amount of money. With our debt already at dangerous levels, this is concerning. The whole idea in the first place was to simplify tax collection and filing, and to implement a plan that would create more efficiency and incentive to produce, thereby raising economic growth above the cost. Once the sausage making started, this goal quickly broke down and today we are

left, yet again, with an enormously complex and inefficient tax system that many project will cost more than the old one. We hope to be surprised by the ultimate outcome of the tax bill, but remain disappointed that there has been precious little discussion about the bigger and seemingly more intractable problem: too much spending.

This tax reform effort, bearing little resemblance to what was envisioned two years ago by candidates and congressional sponsors, would, under the scenario depicted on the prior page, deliver a cumulative 1.7% GDP growth. Due to increased total debt leverage ratios over the past decade, however, a one percentage point increase in interest rates would cut GDP by 2.5%, according to economist David Rosenberg,[1] completely wiping out the projected positive GDP growth from tax reform. Nearby is a table (Figure 5) depicting how levered world economies have become over the past decade.

Figure 5

G-20: NONFINANCIAL DEBT TO GDP (RATIO)

	4Q 2007	Now
Canada	220.7	295.5
U.S.	228.4	250.8
China	144.9	257.8
Germany	180.9	180.1
Japan	307.5	372.6
G20	212.2	240.0

Source: Bank for International Settlements, Gluskin Sheff

With respect to debt, one theme has been consistent over long time spans, hence the irony in the main title of Reinhart and Rogoff's 2009 book, *<u>This Time is Different</u>: Eight Centuries of Financial Folly* -- and that is, after economies have become highly levered, taking on additional debt results in slower growth -- or worse. It is hard to know exactly what defines highly-levered, but looking at recent relative growth rates juxtaposed against debt leverage, it begs the question of whether we've reached it in some countries.

It's possible that valuations no longer matter, although that defies logic. It is interesting to observe the comments and actions of some other value investors in today's environment. In an October letter written by noted value investor David Einhorn, he said, "After years of running into the wind, we are left with no sense stronger than 'it will turn when it turns.' Perhaps there really is a new paradigm for valuing equities and the joke is on us. Time will tell." Bill Miller, another icon of active value investing (we've never thought of him as a value investor, but that's beside the point), revealed in a December interview that 50% of his fund was in Bitcoin. Other value managers have capitulated and bought stocks like Amazon and Netflix. We remember in early 2000, waiting in an anteroom poised to explain our recent underperformance and defense of value stocks to an investment committee, when we overheard in the main board room another value manager extolling the virtues of their investment in Cisco Systems. The stock was approximately $60 (on its way to a peak of $80) and traded for roughly 70 times earnings. Some value! Today, eighteen years later, it is roughly half of that peak.

Strangely, or perhaps not, the more frequently we see absurd phenomena like crypto currencies or noted investors capitulating or asking existential questions about value investing, the stronger our conviction becomes. As Mr. Einhorn said, time will tell, but we have little doubt that in the long run, and over a full cycle, value will win. Of course, there are no guarantees in the equity business, but we are equally confident in our team and our ability to deliver.

Thank you for your confidence in Fiduciary Management, Inc.

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[1] *"Consider this -- a one percentage point rise in average interest rates would siphon 2.5% out of the U.S. economy (from baseline forecasts) into debt servicing costs." Gluskin Sheff economist David Rosenberg (October 20, 2017).*

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2007 - 09/30/2017

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%
Q2 2017	3.05	2.86	3.02	38	0.08	9.90%	10.48%	$ 268.1	$ 24,881.5	1.08%
Q3 2017	3.55	3.38	4.57	36	0.10	9.66%	10.09%	$ 251.0	$ 25,072.9	1.00%

*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 - 09/30/2017. 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 - 09/30/2017. 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 $25.1 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.