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

INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

March 31, 2018

The FMI All Cap portfolios returned approximately -0.4% in the March quarter compared to -0.64% for the Russell 3000 Index. Finance, Commercial Services and Energy Minerals were three notable positive sector contributors, while Producer Manufacturing, Electronic Technology and Technology Services all detracted. Stocks that helped during the period included Progressive Corp., Interpublic Group, and TJX Companies. On the flipside, Comcast Corp., Cerner Corp., Oracle Corp. and ManpowerGroup, Inc. all hurt.

There were a few new elements to contend with in the investment world this quarter that we haven't seen in a while. An almost complete lack of volatility over recent years was interrupted for twenty trading days, beginning January 27th. Over nine sessions, the S&P 500 dropped 10.10%, followed immediately by a gain of 7.84% during eleven trading days, leaving it down just 3.05% for this period. Interestingly, the average of the FAANG stocks actually outperformed in the down-and-up part of this mini-cycle, reinforcing both the "buy-the-dip" and the "value doesn't matter" notions. It is going to take more than a few bad days to shake people's faith in these exceedingly expensive stocks. Amazon and Netflix were up 23.8% and 53.9%, respectively, *in the quarter*, and trade at multiples that would make the big cap tech darlings of 1999 blush. Amazon and Netflix both have trailing GAAP (Generally Accepted Accounting Principles) price-to-earnings ratios north of 180. Facebook, a phenomenal stock over the past five years, did wobble a bit in March, marking this as an unusual occurrence. Stocks suffered a rare few bad days near the end of the quarter, with most pundits tying this to tariff concerns. The last few sessions also saw more volatility in the FAANG group, Tesla and a few other tech high fliers. Perhaps change is on the horizon. Additional wrinkles from the quarter include the 3-month Libor (London Interbank Offered Rate, a key number tied to $200 trillion in financial contracts) gaining roughly 60 basis points to 2.3% -- a level not seen since 2008 -- and an inflation rate hitting 2.2% in February, which, if it holds for the year, would be the highest annual figure since 2011. For the first time in years, companies were talking about higher raw material and transportation costs pinching margins. Oddly, given the widespread view that lower taxes were expected to propel the economy into overdrive, real GDP forecasts for the first quarter from the Atlanta Fed (GDPNow) have dropped from 5% in early February to 2.4% at the end of March. We find corporate revenue growth to be a more reliable indicator and it still appears solid, but the precipitous drop in GDPNow is noteworthy. One more significant change in today's investment landscape was the defenestration of the price of Bitcoin, as foreshadowed in our last letter. It was down 52.7% in the quarter and is off 72.4% from its peak on December 18th of 2017.

Bull Markets In The DJIA, 1900 To Date

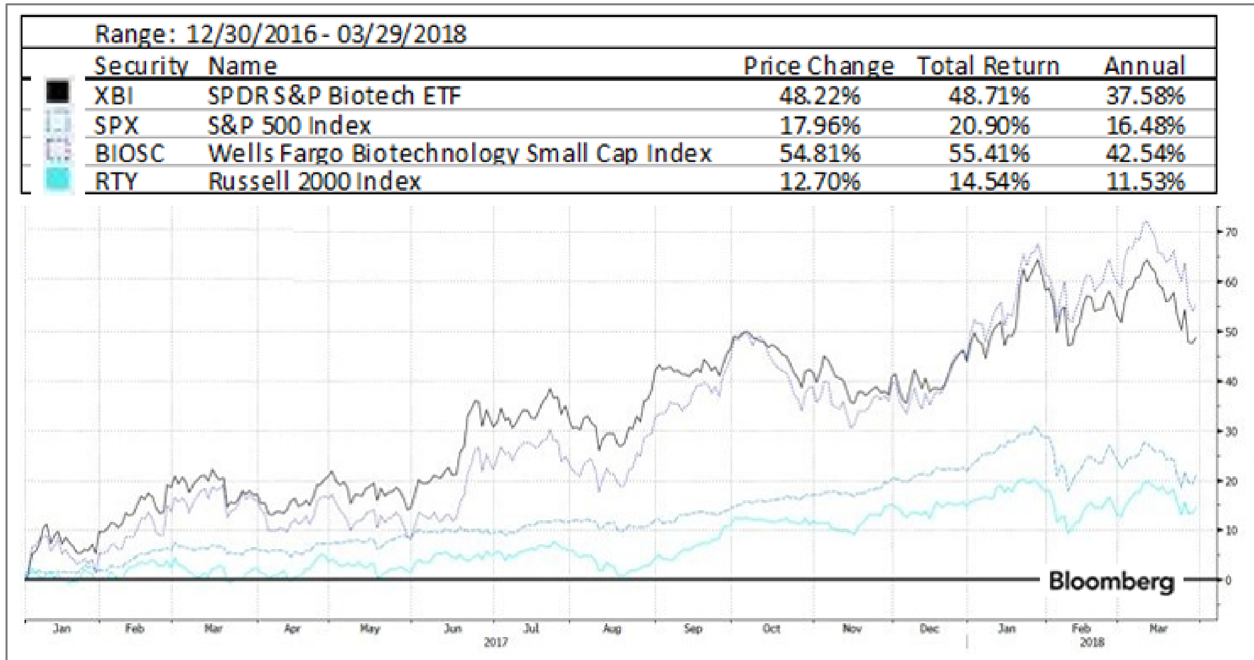
Dates	Gain (%)	Duration (Mos.)
August 24, 1921 - August 30, 1929	495.2 %	96
July 8, 1932 - March 10, 1937	371.6	56
→ **March 9, 2009 - January 26, 2018**	**306.5** ←	**107**
October 11, 1990 - July 17, 1998	294.8	93
August 12, 1982 - August 25, 1987	250.4	60
June 13, 1949 - April 6, 1956	222.4	82
November 9, 1903 - January 19, 1906	144.3	26
April 28, 1942 - May 29, 1946	128.7	49
July 30, 1914 - November 21, 1916	110.5	28
October 9, 2002 - October 9, 2007	94.4	60
November 15, 1907 - November 19, 1909	89.6	24
June 26, 1962 - February 9, 1966	85.7	44
December 19, 1917 - November 3, 1919	81.4	22
December 6, 1974 - September 21, 1976	75.7	21
October 22, 1957 - December 13, 1961	75.1	52
October 19, 1987 - July 16, 1990	72.5	33
May 26, 1970 - January 11, 1973	66.6	32
March 31, 1938 - November 12, 1938	60.1	7
August 31, 1998 - January 14, 2000	55.5	16
September 24, 1900 - June 17, 1901	47.8	9
February 28, 1978 - April 27, 1981	38.0	38
October 7, 1966 - December 3, 1968	32.4	26
September 25, 1911 - September 30, 1912	29.1	12
AVERAGE	**140.4 %**	**43**
MEDIAN	**85.7 %**	**33**

© 2018 The Leuthold Group

Most things about this market, however, haven't changed much over the past several years. March 9th marked the ninth year without a bear market in the large cap indices, making this the longest bull market (using the Dow Jones Industrial Average) in measured history and the third most powerful (see table).

We aren't going to conduct a lengthy rehash of what we have been articulating for some time. Despite a slightly improved valuation environment from the December quarter, stocks, on a median basis, remain near the most expensive we have ever experienced or studied. Many stock indices have become quite narrow again, reflecting a strong funneling effect from passive flows to the most popular names. Eight of the ten largest companies in the S&P 500 outperformed the index in 2017. The median stock once more underperformed the S&P

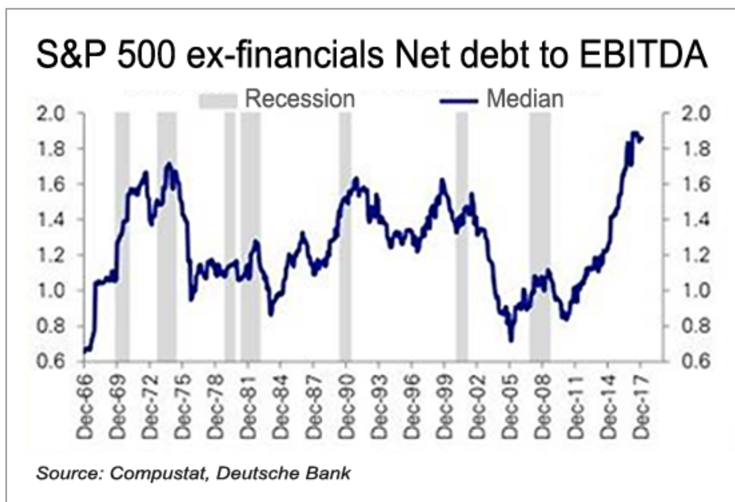
500 Index in the March quarter. Speculative biotech stocks have again been on a roll, as seen in the chart below showing performance compared to the benchmarks since the beginning of last year. Like some of the popular tech names, however, they also had a few tough days right at the end of March.



Range: 12/30/2016 - 03/29/2018

Security	Name	Price Change	Total Return	Annual
XBI	SPDR S&P Biotech ETF	48.22%	48.71%	37.58%
SPX	S&P 500 Index	17.96%	20.90%	16.48%
BIOSC	Wells Fargo Biotechnology Small Cap Index	54.81%	55.41%	42.54%
RTY	Russell 2000 Index	12.70%	14.54%	11.53%

Investor confidence, which was near record-high territory three months ago, has started to fall. Still, there appears to be widespread belief that the S&P 500 is a safe investment over any time horizon. The losses that S&P 500 Index investors sustained in the past two bear markets (47.4% in 2000-2002 and 55.3% in 2007-2009) apparently are forgotten. People have been conditioned not to fear, yet ironically, risk elements are on the rise. Debt continues to pile up, as we have noted numerous times previously. The S&P 500's debt-to-earnings before interest, taxes, depreciation and amortization (EBITDA) is at a 50-year high. (see chart below).



Total Returns 12/30/16 - 3/31/18

MSCI World Value Index	13.3%
MSCI World Growth Index	28.7%
Value performance	***-15.4%***
Russell 1000 Value Index	10.4%
Russell 1000 Growth Index	32.1%
Value performance	***-21.7%***
Russell 2000 Value Index	5.0%
Russell 2000 Growth Index	25.0%
Value performance	***-20.0%***

Source: Bloomberg

Growth stocks have bested value stocks over the last ten years, causing investors to question the premise that value beats growth over long time frames. More recently, since the beginning of 2017, growth stocks have seemingly gone into overdrive, as shown in the table above.

Despite the great outperformance of growth compared to value during most of the past decade, over longer periods, value has still significantly outperformed growth. Using the Russell 3000 growth and value indices as far back as the Bloomberg data goes (12/31/1979-12/31/2017), value has outperformed growth (7,450% versus 4,983% -- or 12.0% versus 10.9% compounded annually). We are confident value will win in the long run because it takes advantage of human nature and behavior. People tend to be overly optimistic in bull markets, paying up for projected growth. When reality strikes and stocks fall, some panic. In a true bear market, many lose faith, become overly pessimistic, and sometimes even vacate the market completely. These investors typically do not come back until "the situation stabilizes," which is usually well into the next up cycle. Since 1994, DALBAR, Inc. has published studies of the "Quantitative Analysis of Investor Behavior," where they attempt to measure the "effects of investor decisions to buy, sell and switch into and out of mutual funds over short and long-term timeframes." Not surprisingly, "The results consistently show that the average investor earns less – in many cases, much less – than mutual fund performance reports would suggest."[1] For example, in their 2016 study, over the last 30 years, DALBAR estimates that the average equity investor generated an annual return of 3.98% versus the S&P 500 at 10.16%.[2] Buying near the top and selling near the bottom are all too common. Similarly, in Spencer Jakab's book, *Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor*, he examines the track record of Fidelity Magellan's renowned portfolio manager Peter Lynch: "During his tenure Lynch trounced the market overall and beat it in most years, racking up a 29 percent annualized return. But Lynch himself pointed out a fly in the ointment. He calculated that the average investor in his fund made only around 7 percent during the same period. When he would have a setback, for example, the money would flow out of the fund through redemptions. Then when he got back on track it would flow back in, having missed the recovery."[3]

In our view, human nature will never change. Emotion, fear, and greed will continue to play a role in investor behavior. In its simplest form, value investing looks to appraise the value of a business, invest when the business is undervalued by the market (out of favor), and sell when the discount has narrowed. It is inherently contrarian in nature – buying when the masses are running for the exits, and selling during periods of irrational exuberance. Conversely, growth, momentum, and technical investing are far more speculative in nature. A disciplined value-oriented approach is well-positioned to outperform over the long run, as it is rooted in fundamental analysis with valuation as its guidepost. We firmly believe that value investing's recent lull is the exception, not the rule. A confluence of factors -- including large-scale central bank asset purchases, suppressed interest rates (i.e., negative yields), a lack of volatility, a disconnect from valuation, and a massive shift from active to passive investing -- have obscured markets since the great financial crisis of 2008-09. Today, high-quality, well-run businesses often trade at one or two standard deviations above their historical averages. It's likely just a matter of time before history repeats itself, fear rears its head, and value investing returns to the top.

Below we highlight a couple of investments:

Omnicom Group (OMC)

(Analyst: Rob Helf)

Description

Omnicom Group is a strategic holding company comprised of advertising, marketing and corporate communication service firms. The company's agency networks include: BBDO, DDB and Omnicom Media Group. In 2017, 57% of overall revenue was generated in North America, 9% in the UK, 18% in Europe, 11% in Asia Pacific, 3% in Latin America and 2% in the Middle East/Africa. Omnicom's global branded networks provide a comprehensive range of services in four disciplines: advertising (including creative and media planning/buying), which makes up 54% of revenue; customer relationship management, 31%; public relations, 9%; and healthcare, 6%.

---

[1] "DALBAR's 22nd Annual Quantitative Analysis of Investor Behavior: Period Ended 12/31/15." www.dalbar.com.

[2] "DALBAR 2017: Investors Suck At Investing & Tips For Advisors," by Lance Roberts. Realinvestmentadvice.com. September 25, 2017. Performance period ending December 30, 2016.

[3] Spencer Jakab. "Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor." July 12, 2016.

Good Business

- Omnicom is one of the world's largest advertising and marketing services companies.
- The company offers a comprehensive roster of fee-based services to a diverse mix of clients.
- Omnicom should be able to grow as fast as general advertising. The company has significant exposure to developing markets and higher growth marketing services.
- The company's largest client represents less than 4% of overall revenues.
- The integrated relationship between client and agency results in high switching costs.
- Over the past decade, Omnicom has generated a return on invested capital (ROIC) greater than its cost of capital. On average, its ROIC has been approximately 13%.
- The company's balance sheet is in excellent shape, with net debt less than EBITDA.
- Omnicom pays a $2.36 per share annual dividend to yield 3.2%. The dividend has grown at over 13% per annum over the past five years.
- Over the past ten years, the company has repurchased an average of over $750 million worth of its equity per year.

Valuation

- Omnicom trades at approximately 1.2 times enterprise value (EV)-to-sales, 8 times EBITDA and 13 times forward earnings per share (EPS) estimates. The business generates a 13.5% operating margin.
- Over the past fifteen years, the stock has traded, on average, at 1.5 times EV/sales, 10 times EBITDA and 17 times EPS.
- Currently, we estimate that Omnicom trades at a 40-50% discount to the S&P 500 on many statistical measures vs. a conventional discount of 10-20%.

Management

- John Wren, 65, has been President and CEO since 1997. He has been in advertising since 1984, joined Omnicom in 1986, and owns over $100 million worth of OMC shares.
- Phil Angelastro, 53, has been CFO and Executive VP since 2014, and has been with Omnicom over 20 years in various accounting and finance executive positions.

Investment Thesis

Omnicom fell short of expectations in 2017. Revenues and profits have been impacted by fee compression and lower spending by the advertising-heavy consumer goods, retail and auto sectors as a residual of softer top-line, zero-based budgeting and activist shareholders. There are some near-term challenges for the industry, however, we believe that these pressures are more cyclical than secular in nature and will ease in the medium term. Importantly, Omnicom is one of the leaders in the advertising and marketing service industry, which has historically been able to adapt with changes in technology and media. The business continues to offer an outsourced solution to clients, has demonstrated a flexible cost structure, and is managed by entrepreneurial individuals. Additionally, the business provides an important function in helping clients establish brands and grow revenues. At just over 9 times EBIT and 13 times EPS, shares of Omnicom are attractive on an absolute and relative basis.

Quest Diagnostics (DGX)

(Analyst: Matthew Goetzinger)

Description

Quest Diagnostics is the largest independent clinical laboratory testing company, with 24% market share. The company's Diagnostic Information Services (DIS) business (96% of total company revenues) provides clinical laboratory testing, focusing on routine tests (66% of DIS revenues), esoteric tests (25% of DIS revenues), and anatomic pathology tests (9% of DIS revenues). The Diagnostic Solutions business (4% of total company revenues) focuses on risk assessment services for life insurance customers. Quest's clinical trials business is now included within the Q^2 Solutions joint venture with Quintiles (IQV), of which the company owns 40%. Q^2 is the industry's second largest central lab.

Good Business

- Quest Diagnostics is the market leader in the clinical lab sector, controlling roughly a quarter of the $27 billion independent U.S. lab industry.
- The scale and scope of Quest's lab network result in the company consistently operating as the industry's low-cost provider.
- The company's testing revenues are reasonably predictable and recurring in nature.
- The broader lab industry is a $79 billion market accounting for only 2% of total healthcare spending, and yet influencing over 70% of medical decisions. Quest's value-add is further supported by a very modest average cost per requisition of approximately $46.
- The company's established network business model requires minimal incremental capital, with the stock earning a 30% return on tangible capital over the past five years.
- The stock is currently levered at 2.3 times net debt-to-EBITDA. In 2017, Quest generated $1.2 billion of operating cash flow.

Valuation

- Over the past five years, the stock has traded at an average price-to-free cash flow multiple of 16 times. This valuation metric is a slight premium to the company's 5-year average price-to-earnings (P/E) ratio. Presently, the stock trades at 15 times free cash flow.
- With conservative growth, margin, and capital allocation assumptions, the company's earnings power exceeds $8.50 per share.
- The stock presently trades at a modest discount to other healthcare service companies, despite maintaining a stronger fundamental outlook.

Management

- Steve Rusckowski has been President and CEO since May 2012, and Chairman of the Board since January 1, 2017.
- Since the beginning of CEO Rusckowski's tenure, the company has used ROIC as a key long-term performance metric.
- Over the past five years, 75% of free cash flow generation has been returned to shareholders through share repurchases.

Investment Thesis:

As the largest independent clinical lab testing company, Quest operates the industry's most expansive and lowest cost network. Over the past five years management has been building upon a focused strategy to improve the organic growth rate of the business, and harvest additional cost efficiencies. The company's strategy to address each facet of the hospital testing market is beginning to yield growing market share. Government pricing pressures from PAMA (Protecting Access to Medicare Act) are manageable and contained to a small subset of their business. Presently, Quest shares represent a reasonable value and an opportunity to invest in a business with the enduring value-add of providing quantifiable data used to guide treatment protocols at a small fractional expense.

Thank you for your confidence in Fiduciary Management, Inc.

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

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%
2017	18.56	17.75	21.13	35	0.35	9.66%	10.09%	$ 258.8	$ 25,322.0	1.02%

*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 - 12/31/2017. 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 - 12/31/2017. 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 $25.3 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.