FIDUCIARY MANAGEMENT, INC.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

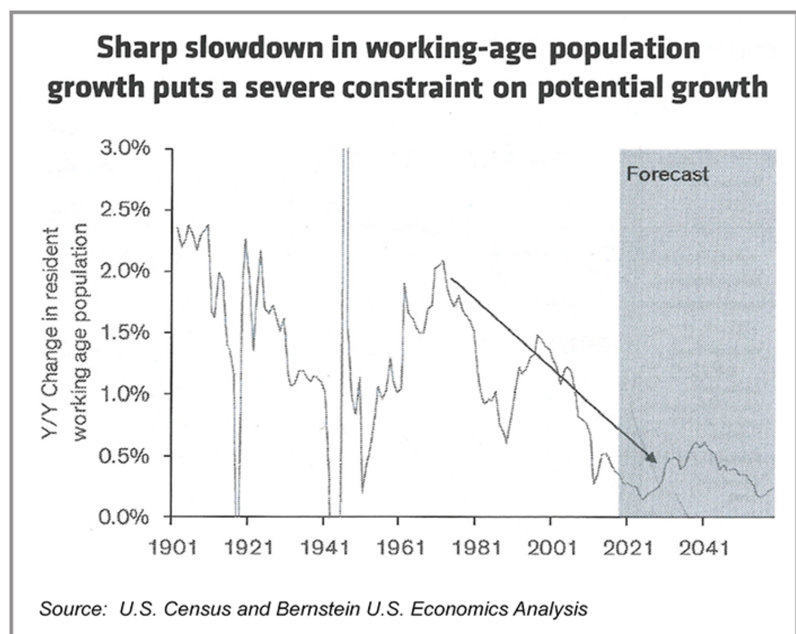
September 30, 2018

The FMI All Cap portfolios returned approximately 2.9% in the September quarter compared to 7.12% for the Russell 3000 Index. Growth stocks continued to outperform value stocks, leaving us in the proverbial penalty box. Sectors that contributed positively to results included Finance, Consumer Durables and Producer Manufacturing. On the negative side of the sector ledger were Consumer Services, Health Technology and Electronic Technology. Cash was an additional drag. Positive performers included Berkshire Hathaway, Honeywell and TJX Companies. On the flip side, eBay, ViaSat and Twenty-First Century Fox underperformed. We eliminated Progressive and MEDNAX from the portfolio and added Hain Celestial Group, Dollar Tree, Chubb and Franklin Resources.

> ***The seeds of any bust are inherent in the boom that outstrips the pace of whatever solid factors gave it its impetus in the first place. There are no safeguards that can protect the emotional investor from himself.***
> ***– J. Paul Getty***

The bull market stretched into uncharted territory in the third calendar quarter, reaching its longest duration and one of its strongest up-cycle performances on record. Investors continued to focus on the good news--the U.S. economy, Wall Street's version of earnings and rising stock prices…while ignoring danger signals--overconfidence (as reflected in valuations), rising rates and inflation, unbridled debt accumulation, a burgeoning trade war and perhaps some signs of fatigue in the economy. Faith in index funds and exchange-traded funds (ETFs) continued unabated, despite the "crowded trade" nature of many of these products. High confidence in technology shares harkens back to the 1990s, with exceptionally optimistic valuations for both established and startup companies. Private equity transactions, in all but a small minority of cases, are taking place at record-high valuations and debt leverage. So-called “covenant-lite” conditions have returned to the high yield arena. Across the board there appears to be little regard for safety and downside protection.

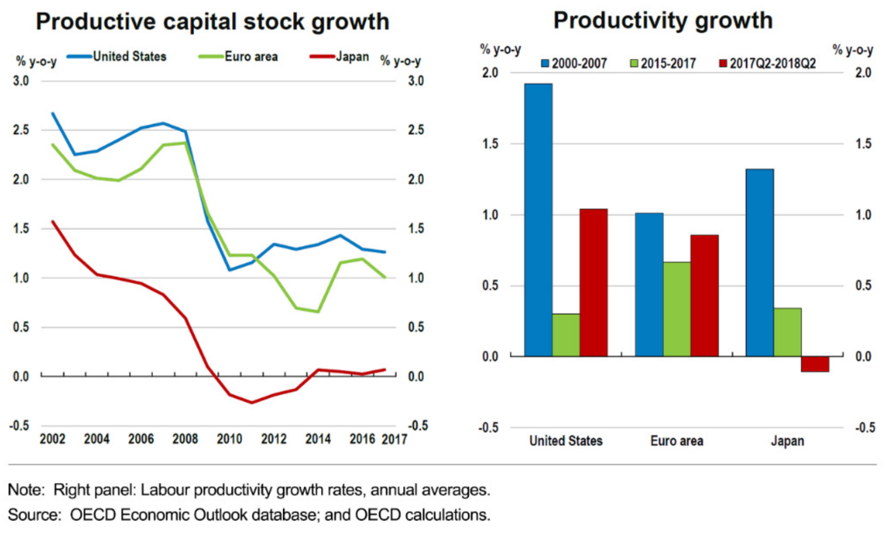
According to Bloomberg’s weekly survey, U.S. real GDP grew at an estimated rate of 3.0% in Q3 and is predicted to grow 2.8% in the December quarter. While the unemployment rate is low, the work force participation rate of 62.7% remained well below its 67% peak, and today, hovers near a 40-year low. Working age population growth continued to be soft (see chart) and unless birth rates or immigration pick up, will be a source of future weakness.



Source: U.S. Census and Bernstein U.S. Economics Analysis

The large number of working-age people who lost jobs in the last recession and were supposed to be returning to the labor force this cycle appear to be mostly idle. The evidence of this is rising wage rates (recently exceeding 3% according to the Atlanta Fed). With wages being the largest cost for most companies, margins may be at risk. Productivity gains, which have

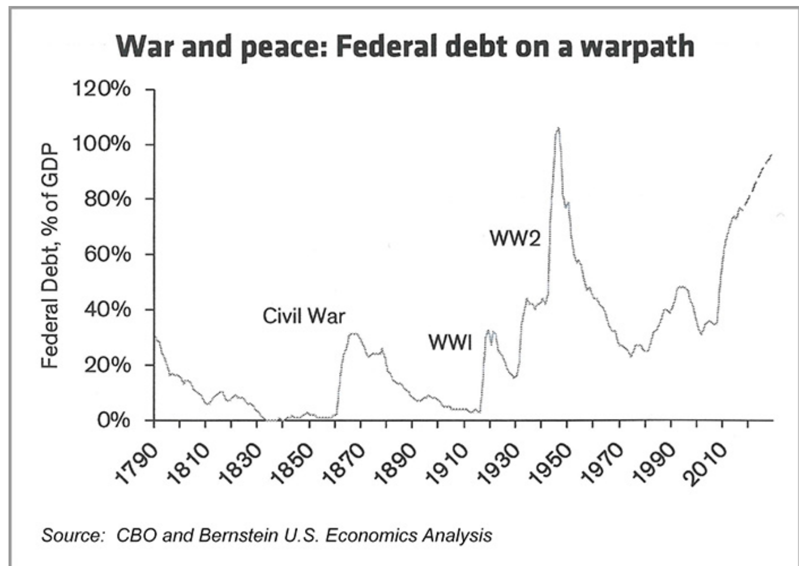
been meaningfully below long-term averages (see charts to the right) may not provide the offset to wage pressures unless there is a sustained increase in business improvement spending.



Note: Right panel: Labour productivity growth rates, annual averages.
Source: OECD Economic Outlook database; and OECD calculations.

The benefit from lower tax rates and fewer regulations is a positive, although the lack of fiscal discipline threatens long-term prosperity. The market seems unconcerned with the potential of an economic downturn. While we are not economists, we do recognize that recessions often come out of the blue. A yield curve that is near inversion doesn't bolster confidence that fair weather is a foregone conclusion. The CRB Metals Index is off over 15% from its recent peak. Pending home sales declined for the eighth straight month in August, down 2.3% from last year. Auto sales, at a recently annualized rate of 16.6 million, are down nearly 1.9 million units from the peak. Many technology companies are seeing inventories grow much faster than sales. Overseas economies, buyers of U.S. products, have softened, particularly in the emerging markets. Currency weakness in many of these countries is of particular concern, given high levels of dollar-denominated debt.

Across the globe, debt levels are rising significantly. The sovereign debt load has approximately doubled, and debt of all kinds is up 75% over the past decade, even though excessive debt was at the root of the last crisis. Worldwide debt-to-GDP is at a record 318%. The U.S. annual budget deficit as a percent of GDP is running at a 4.2% rate…the kind of figure one would normally see in the throes of a recession. Interestingly, it wasn't that long ago that U.S. leaders chastised Eurozone countries for exceeding the 3% deficit-to-GDP mandate. It is highly unusual for debt ratios to be rising at this point in the economic cycle. The U.S. national debt is $21.5 trillion, an astonishing figure relative to our $20.5 trillion economy and unprecedented in non-war times (see accompanying chart from Bernstein). Unfunded welfare benefits are a multiple of our debt obligations.

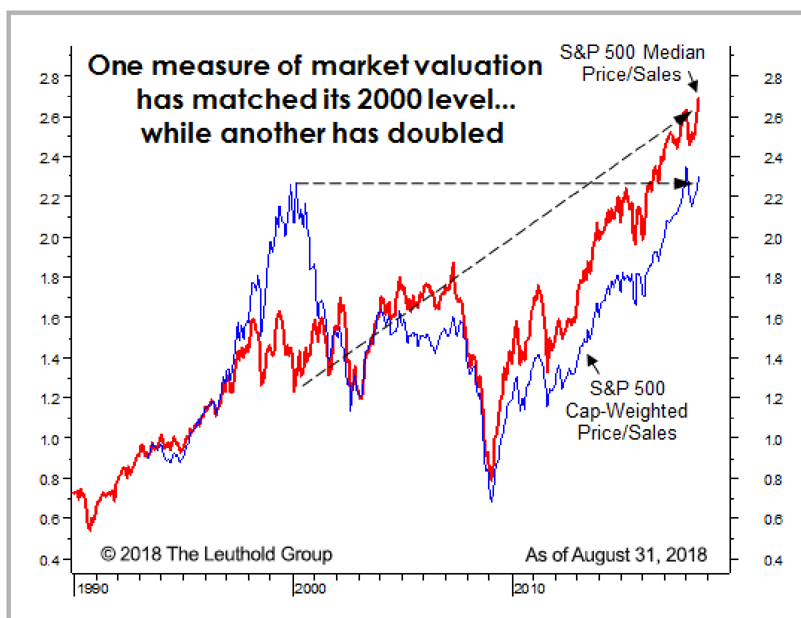


Source: CBO and Bernstein U.S. Economics Analysis

Much has been made of the strong earnings performance in recent quarters. Everyone's skepticism meter ought to be blinking yellow when Wall Street says earnings growth is 20% while the economy is growing 5% nominally and sales growth is in the single digits. We are, of course, experiencing a one-time positive year-over-year benefit from lower corporate tax rates but once those lap, long-term earnings growth rates will likely fall significantly. Wall Street, with an assist from corporate managements, has embraced the concept of "adjusted earnings," as discussed in previous letters. The abuse of this measurement has reached alarming levels. Based partly on our inquiry, the Leuthold Group studied

actual GAAP (generally accepted accounting principles) reported, operating and "adjusted" S&P 500 earnings over a long-term (30-year) time frame. The spread between these figures has become wide. Even excluding the credit crisis quarters, the spread between reported GAAP earnings and Wall Street earnings is 23.6% (Wall Street's version is *always* higher). Proponents of adjusted earnings presentation say that amortization of intangibles, stock compensation and other one-time items justify this measure. Leuthold, among other findings, determined that more than 40% of the amount companies spent on mergers & acquisitions activity ended up in the scrap heap (written off). Additionally, many companies that claim "one-time" charges often have these write-offs with great frequency. Excluding the real cost of stock options seems dubious. There may be some justification for adding back a portion of amortization to GAAP earnings, but it seems managements and Wall Street have overplayed this hand.

Using the long-term, oft-cited valuation data provided by Leuthold, stocks today are in the 9th decile on a median basis (10th being the most expensive). We regularly review 46 different valuation series, including several price-to-earnings (P/E) data sets. It would be odd, to say the least, to have most of these measures registering in the 9th or 10th deciles, while at the same time having Wall Street's version of P/E ratios be "reasonable" or even "attractive," as proponents like to tout. Somebody is wrong. Using a much harder-to-manipulate series, price-to-sales, tells a different story. Leuthold recently called the nearby chart "the scariest chart in the world." Of course, investor sentiment usually reflects the current trajectory of stock prices. "Markets make opinions," as the old bromide goes.



Ten years after the last financial and stock market crisis, the media has engaged in a lengthy rehash and post mortem of what transpired. It's ironic and quite surprising to us at least, given how fresh the crisis still is in our minds, that many of the same mistakes are being repeated by investors today. A decade ago most investors scoffed at the notion that home prices could fall. A house was a surefire investment, and the proof of that was the willingness of banks to loan 95% or more against it. Investors believed in Wall Street's products (credit default options, mortgage-backed securities, collateralized loan obligations, etc.) and high-yield bonds. The economy was seemingly healthy, and the market saw little reason to worry about high valuations. They believed in central bankers. Today, investors have the same lofty confidence in high-flying social media, technology and med-tech shares. Many of the same aforementioned derivative investment vehicles are back in vogue, along with a cornucopia of ETFs and index products. Many mistakenly believe that these products carry not only low fees, but low risk. Do investors in the iShares U.S. Energy ETF, iShares Technology ETF or iShares Telecom ETF, for example, know that far from investing in diversified portfolios, they are putting over half their money behind just five stocks? A little over a year ago we discussed the potential liquidity issues facing many of the most popular ETFs. With turnover in many of these ETFs vastly greater than even the most liquid underlying constituent stocks, trading activity could be very interesting when markets get shaky. Junk bond spreads recently hit 315 basis points over treasuries--half the level of two years ago and a figure not seen since 2007, according to economist David Rosenberg. The faith in central bankers seems unshaken. Finally, just like a decade ago, perception that the economy is strong appears to be overriding any concern about high valuations or other potential troublesome developments.

What we have seen as excessive and unsustainable has persisted far longer than we thought possible. On one level that makes us "wrong," but of course that doesn't change the reality of the aforementioned conditions. We would rather give up some of the upside than to be remorseful in hindsight. Greed usually ends in regret. That means being more cautious with our investments and expectations today. Is there a way around another crisis and lousy stock

market? Anything is possible when it comes to markets and human behavior. Earnings...the good and sustainable kind...could advance at a healthy rate and inflation could stay within earshot of 2%. The big one, interest rates, though significantly higher than two years ago, could stay well below normal for an extended period. Wages and other escalating costs could recede. The political crisis between the left and right could ameliorate. The nascent trade war with China could resolve. Externalities such as terrorism, wars, natural disasters, etc., could be benign. In other words, a lot must go right and not much can go wrong given today's valuations. We continue to hunt for attractive investments but acknowledge the environment is far from ideal. We are working diligently, with a focus on the long term. Additionally, we have our own money invested right alongside yours. Our confidence in achieving good full cycle returns remains high.

Below we highlight a couple of investments:

Dollar Tree, Inc. (DLTR)

(Analyst: Matt Sullivan)

Description

Dollar Tree is a leading discount retailer in the United States and Canada, operating over 15,000 total stores. 6,812 stores, or 45%, are operated under the Dollar Tree and Dollar Tree Canada (225 stores) banners. The other 8,261 stores are operated under the Family Dollar banner, which was acquired in July of 2015. The Dollar Tree brand accounts for 51% of the combined company's revenue, 58% of gross profit, and 67% of EBITDA (earnings before interest, taxes, depreciation, and amortization). The Family Dollar franchise accounts for the remaining 49% of revenue, 42% of gross profit, and 33% of EBITDA.

Good Business

- The Dollar Tree banner has one of the best margin and return profiles in the physical retail industry. Family Dollar's return on invested capital (ROIC) is lower but has ample opportunity to improve. Its closest competitor, Dollar General, earns very high returns on capital. We believe Family Dollar can at least partially close the ROIC gap with Dollar General.
- Dollar Tree has grown its same store sales for 41 consecutive quarters. Family Dollar's comparable same-store sales have been less impressive, particularly recently, yet Dollar General's comps have been positive for 28 straight years. Both the dollar and discount store business models, respectively, have proven to be defensive and should hold up well in a more difficult economic environment.
- The customer profile, low average ticket, and types of products sold protect the business from online competition.
- The Dollar Tree business model is unique within the retail landscape. The $1 price point and constantly changing inventory provides the customer with a differentiated, treasure hunt shopping experience. The ever-changing merchandise in the store also provides management with the ability to control the company's gross margin.
- Both Dollar Tree and Family Dollar are difficult to replicate.
- The balance sheet is in good shape with net debt-to-EBITDA of approximately 1.7 times.
- The business is easy to understand.

Valuation

- Dollar Tree shares are down by more than 20% this year. This compares to the S&P 500, which is up approximately 10% year-to-date.
- Dollar Tree is trading at 1.1 times enterprise value-to-sales, which is about one standard deviation below its 3- and 5-year averages.
- Dollar Tree is trading at 9.5 times enterprise value-to-EBITDA (EV/EBITDA), which is a discount to other high-quality retailers as well as the S&P 500.
- On a sum of the parts basis using 2018 estimates, if we ascribe a 12 times EV/EBITDA multiple to the Dollar Tree banner, we believe we're paying less than 5 times EV/EBITDA for Family Dollar. For reference, Dollar General trades at 12 times EV/EBITDA.
- The stock is trading at approximately 14 times next year's consensus earnings per share estimate.

Management

- Bob Sasser became Executive Chairman of the Board on September 18, 2017. He was previously Chief Executive Officer from 2004 to September 2017. From 1993 to 2003, he was Dollar Tree's Chief Operating Officer.
- Gary Philbin became President and Chief Executive Officer of Dollar Tree and was appointed to the board of directors on September 18, 2017. He was previously Enterprise President of Dollar Tree from December 2016 to September 2017. From July 2015 to December 2016, he served as President and Chief Operating Officer of Family Dollar. From March 2007 to July 2015, he was Chief Operating Officer of Dollar Tree.

Investment Thesis

We believe Dollar Tree is an excellent business with a good operational management team. The Family Dollar business that was acquired in July 2015 is still a work in progress. The turnaround is taking much longer than management or Wall Street originally expected. Some analysts are beginning to lose faith that the business will ever be successfully turned around. This has created a drag on the stock price.

The stock is now much cheaper than other discount retailers as well as the market. While we're not convinced that the Family Dollar turnaround will work, we believe the market is ascribing an excessively low multiple to the asset. This leads us to believe that there are multiple ways to win in the stock, including a potential separation or sale of Family Dollar. A number of sell-side analysts have already started calling for a spin or sale of Family Dollar. This could be an excellent outcome if it happens relatively quickly, as opposed to later, after further struggles. If management does successfully turn Family Dollar around, the stock should do well, considering its relatively modest valuation.

Chubb Ltd. (CB)

(Analyst: Matthew Goetzinger)

Description

Chubb is one of the largest publicly traded property and casualty insurance companies globally. In aggregate, the company has operations in 54 countries and territories. Chubb provides commercial, personal property, casualty, personal accident, and supplemental health insurance to a diverse group of clients. A.M. Best rates the company as an A++ (stable) insurer, and Standard & Poor's carries it at a AA (stable) rating. Approximately 63% of premiums are from the U.S., 13% from Europe/Eurasia & Africa, 11% from Asia, 8% from Latin America, and 5% from Bermuda and Canada.

Good Business

- Chubb is a durable, differentiated multi-line insurer with an attractive small and middle market commercial book of business, as well as a highly attractive high net worth personal lines customer base.
- For medium-to-larger-sized commercial enterprises, casualty insurance is a necessary coverage. This non-discretionary attribute, along with Chubb's emphasis on high service levels, results in strong customer retention and predictable revenues. The company's renewal retention ratio generally ranges between 85 to 90%.
- The company's disciplined risk selection and cycle management have led to consistently conservative initial loss picks, underwriting stability, and a low volatility return on equity (ROE). The company presently generates a 16% return on total capital. Incremental returns on capital are attractive.
- Chubb currently maintains industry-low balance sheet leverage metrics across the three most important indicators of net premiums-to-shareholders' equity (0.67 times), invested assets-to-shareholders' equity (2.4 times), and debt-to-total capital (20%). Approximately 55% of net premiums are from shorter tail lines.

Valuation

- Over the past 25 years, Chubb's price-to-book multiple has averaged approximately 1.5 times, ranging from a low of around 1 times to a high of over 2 times. The stock presently trades at multi-year lows.
- Over the past 13 years, Chubb has grown book value per share at a 10% cumulative annual growth rate.
- Downside margin of safety is supported by the company's current low valuation multiple, excess capital, loss reserve cushion, and significant franchise value.

Management

- Chubb has a diverse and highly-respected management team, led by Evan Greenberg as Chairman and CEO. The top five executives own approximately $400 million of stock.
- Management is compensated based upon key financial metrics (75% overall weight) of tangible book value per share growth, core operating ROE, core operating income, and the property & casualty (P&C) combined ratio. The residual quarter of incentive compensation is determined by operational and strategic goals.
- Mr. Greenberg's management team has been a cohesive group, with backgrounds tying back to legacy ACE and supplemented by key individuals staying on from the Chubb organization.
- Philip Bancroft has been the Chief Financial Officer of Chubb Ltd. since January of 2002.

Investment Thesis

Chubb is a defensive and diversified P&C company serving attractive commercial and personal lines. The franchise is run by one of the industry's most respected management teams, who are expected to continue operating the company with a disciplined focus on underwriting cycle management and maintaining a conservative balance sheet. Gradual deployment of the company's excess capital into organic premium growth, small complimentary tuck-in acquisitions outside the U.S., and repurchases at an attractive discount to intrinsic value should continue the company's 15-year track record of 10% compound annual growth in book value per share. Chubb's current multi-year low valuation provides a unique opportunity to invest in one of the best businesses in property and casualty insurance.

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.