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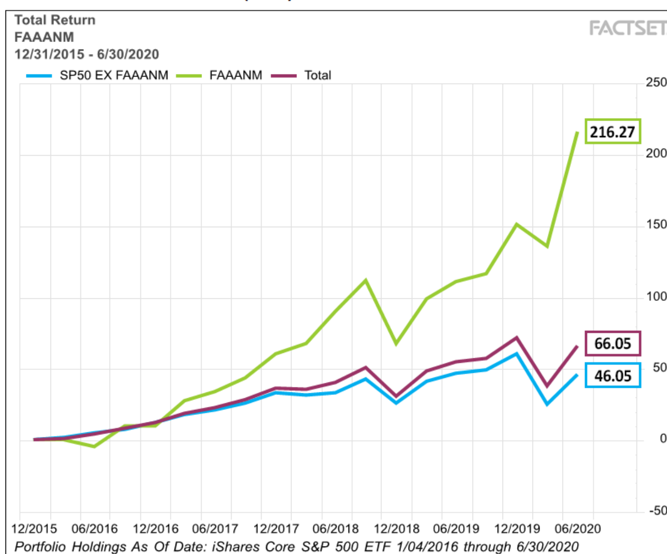
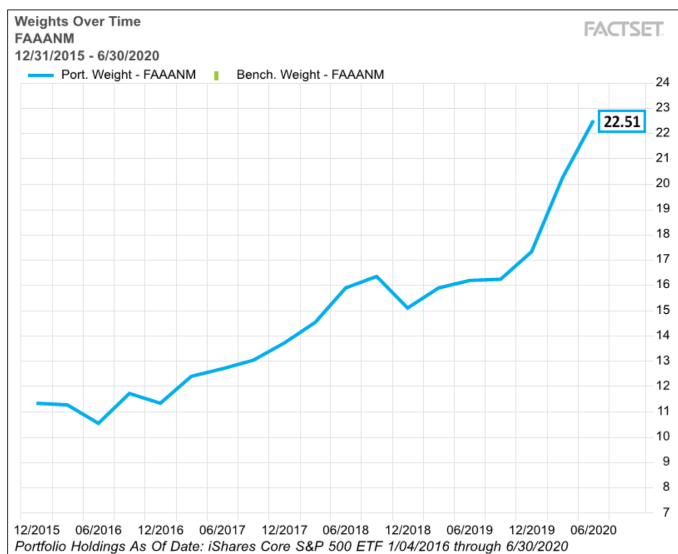
INVESTMENT STRATEGY OUTLOOK – ALL CAP EQUITY

June 30, 2020

The FMI All Cap portfolios returned approximately 15.8% in the June quarter compared to 22.03% for the Russell 3000 Index, and 14.55% for the Russell 3000 Value Index. Health Services, Producer Manufacturing, and lack of exposure to Utilities and Communications added to performance compared to the Russell 3000 in the period. Finance, Electronic Technology, and Technology Services detracted relative to the Russell 3000. Masco Corporation, Quest Diagnostics, and Arrow Electronics aided the results, while Berkshire Hathaway, White Mountains Insurance Group, and Omnicom lagged.

If there was a mercy rule in the game of growth versus value investing this year, the contest would have been called and the kids pulled off the field. Year-to-date, the Russell 3000 Growth Index has outperformed the Russell 3000 Value Index by an astonishing 25.73% (nearly identical to the 27.18% spread of growth over value in 1999). Similar to the Standard & Poor's 500 Index, the preeminence of the FAAANM (Facebook, Amazon, Alphabet "Google," Apple, Netflix, and Microsoft), and to a somewhat lesser degree, a couple of dozen or so other names like them within the Russell 3000, is remarkable. Following are charts showing the performance of the S&P 500 with and without FAAANM, and the percentage of the S&P 500 (22.43%) these names currently represent. While these stocks get a lot of attention and are certainly highly valued, many of the most egregiously overvalued issues are not FAAANM, but rather can be found in SaaS (software-as-a-service), health and biotechnology, and financial technology. For example, Shopify has a market valuation of $113 billion, compared to sales of just $1.7 billion (last twelve months) and negative $132 million in net income. As *Barron's* recently reported, Shopify's market value is approximately six times the projected 2027 size of the entire ecommerce software market.[1] This article also revealed that ten tech stocks greater than $5 billion in market value gained over 130% year-to-date.





Today we have two stock markets. The first market is the popular one, driven by technology, biotechnology, other "growth stocks" (often better-performing if they are money-losers) momentum plays, and coronavirus beneficiaries. This market is abetted by a belief in perpetually-low interest rates ("the Fed has your back"), and a mantra that no amount of fiscal stimulus could possibly be deleterious. The popular market is impervious to disease, social unrest/mayhem, unemployment, socialism, debt, poor GDP growth, trade tensions, and poisonous politics. The second market, the unpopular one, has at its core a lower form of life, a species called "value stocks." In that market, a shrinking band of

[1] *Barron's* 7/2/20 cites Grand View Research projecting 2027 ecommerce software industry size of $20.6 billion.

unenlightened Luddites ply a trade practiced successfully for ages, but one that today is viewed with various degrees of disdain. This market is fearful of record-high valuations, rampant speculation, weak earnings, dangerous balance sheets, rate normalization, difficult economies, and what happens when any person, corporation, or government spends beyond its means. The difference between these two markets is cavernous.

The Russell 3000 has morphed from a broadly diversified core index a decade ago, to one dominated by a handful of companies; it looks and behaves like a growth stock benchmark. FMI has always focused on relatively low-valuation, high-quality companies, and has generally sold at a meaningful discount to the Russell 3000, and a more modest discount to the Russell 3000 Value. Today, the average discount (on the metrics seen in the accompanying table) to the Russell 3000 is exceptionally wide (~47%).

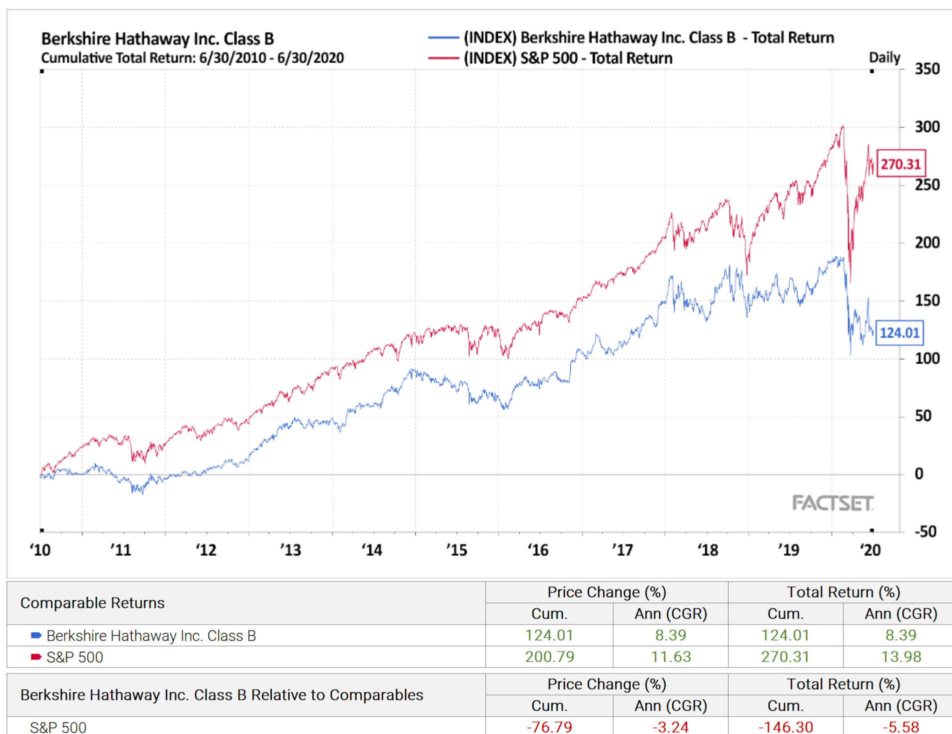
June 30, 2020 Weighted Average	FMI All Cap	iShares Russell 3000	Discount to the Benchmark
P/E (1 Year Trailing)	20.9x	36.1x	42%
FY1 P/E (1 Year Forward)	24.1x	35.2x	32%
P/S	1.9x	5.8x	67%
EV/EBITDA	12.0x	23.3x	48%
Average Valuation Discount			47%

** Estimated valuations for FMI and the iShares are weighted average valuation calculations, not reweighted to exclude cash, and financial companies are excluded from the EV/EBITDA calculation. Valuations for both the portfolio and the ETF are modified based on criteria identified by FMI. For more detailed information regarding these valuations, please contact FMI.*

In recent years, the All Cap portfolio has consistently outperformed the value index, but has not kept pace with the Russell 3000, which benefits not only from the dominant growth stocks previously mentioned, but also the flow of dollars to passive strategies, which we believe will exhaust itself when growth stocks sputter, momentum reverses, rates change, or externalities hit.

Sometimes a picture can truly capture the essence of reality. Below is a price chart and total return table for Berkshire Hathaway compared to the S&P 500 over the past decade. The S&P 500 has beaten this premier value stock by approximately 146% cumulatively. Berkshire's great track record, stable of solid businesses, Fort Knox balance sheet (~$400 billion of very liquid equity value), and cheap valuation apparently mean little today.

Conversely, more investors seem to want stocks like Tesla, which has a market capitalization of $200 billion, has not turned a profit since its founding 17 years ago, consumes prodigious amounts of cash, and competes in a highly competitive car industry, where virtually every automaker and emerging competitor is targeting electric vehicles. Approximately a year ago, Tesla traded for $223 per share, up sevenfold from seven years earlier. As of 6/30/20, it was $1,080. Debt has gone from virtually zero to $14.5 billion over the past ten years. The contrast between Tesla and Berkshire Hathaway is stark. At FMI, we use the mental imagery of a five-year lockbox when evaluating competing ideas. "Which stock would you rather own if you had to lock them both up for five years?" Given today's enormous macro concerns and sky-high valuations for growth stocks, and what could happen if fear struck, it appears to

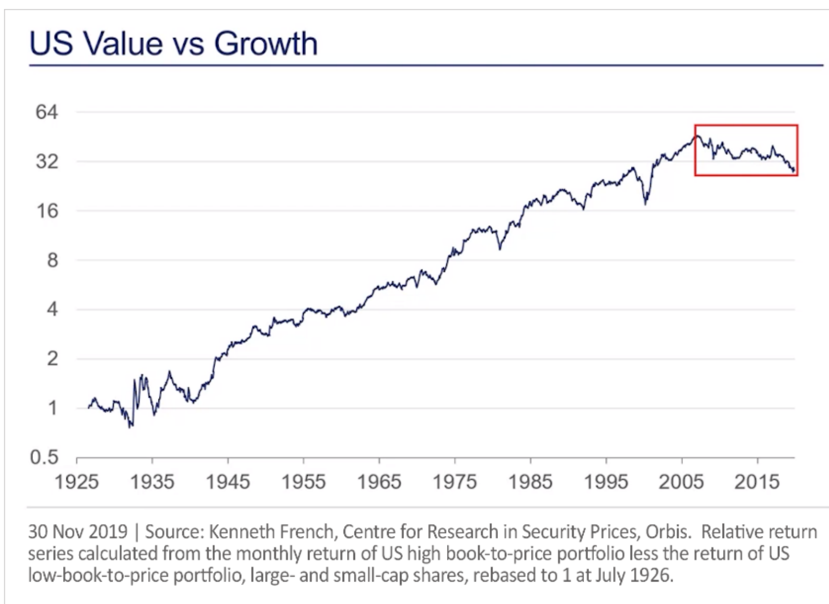


Comparable Returns	Price Change (%) Cum.	Price Change (%) Ann (CGR)	Total Return (%) Cum.	Total Return (%) Ann (CGR)
Berkshire Hathaway Inc. Class B	124.01	8.39	124.01	8.39
S&P 500	200.79	11.63	270.31	13.98

Berkshire Hathaway Inc. Class B Relative to Comparables	Price Change (%) Cum.	Price Change (%) Ann (CGR)	Total Return (%) Cum.	Total Return (%) Ann (CGR)
S&P 500	-76.79	-3.24	-146.30	-5.58

be a proverbial layup to us. Yet our perception is that the large majority of investors today would pick Tesla (or Shopify, Zoom, Datadog, etc.).

We offer explanations but no excuses for underperforming an index that is being driven by stocks we consider to be overvalued. Hindsight will always show that we missed some great growth stocks. It isn't our style or philosophy to chase "winners" in the hope they will keep winning. We buy only when fundamentals and valuation justify it. Amazon, for example, has been a great growth company, but we cannot step up today to a stock trading at over 200 times free cash flow (FCF) when adjusting for finance leases and stock-based compensation, with the implied expectation that FCF will grow in excess of 30% compounded for ten years.[2] Our experience is that a portfolio of relatively out-of-favor stocks that have solid underlying fundamentals tends to outperform the collective group of growth stocks over time. The chart to the right shows the near 100-year superior record of value investing, with the more recent difficult period boxed.



30 Nov 2019 | Source: Kenneth French, Centre for Research in Security Prices, Orbis. Relative return series calculated from the monthly return of US high book-to-price portfolio less the return of US low-book-to-price portfolio, large- and small-cap shares, rebased to 1 at July 1926.

Despite the tough run for value, we are optimistic the tide will turn. Investors today cannot envision FAAANM or similar stocks underperforming, but the history of markets is that vaunted names lose their luster, and herd behavior is not perpetually rewarded. We haven't seen a more universally-held opinion than the one recently reiterated by a hedge fund analyst, as relayed to us by a Wall Street contact: "Selling is for fools. Just buy V (Visa), MA (Mastercard), PYPL (PayPal), FAANG, and all things SaaS (software as a service), and just come back in 5 years to count your money." It's nearly identical to the commentary we heard in 1999 about the great growth stocks of that era. As the old saw goes, *markets make opinions; opinions don't make markets.* People will always craft a message to justify the prevailing investment sentiment. Speculation in money-losing stocks is as widespread as we have ever seen. In June, *The Wall Street Journal* quoted Dave Portnoy, founder of Barstool Sports (and ersatz day trading guru), who told his listeners, "Stocks only go up, this is the easiest game I've been part of!" And, "It took me a while to figure out that the stock market isn't connected to the economy."

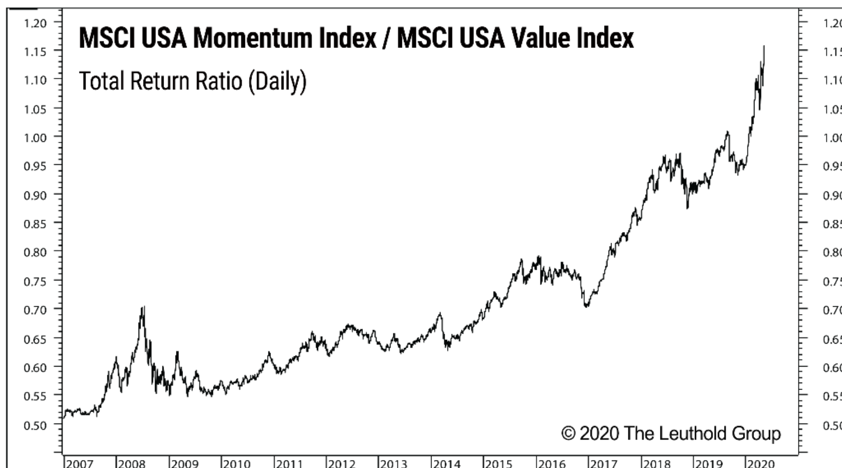
Servpro is a company who cleans up homes and buildings after fires and floods. Its clever advertising jingle is "Like it Never Even Happened!" For growth stocks, it truly is *like it never happened*. The "it" being 2020's unprecedented economic collapse, severe unemployment, rapid increase in debt, and large corporate earnings decline. Yet despite all of this, the year-to-date gains in the NYSE FANG Plus Index, NASDAQ Composite Index, and Russell 3000 Growth Index are 32.33%, 12.74% and 8.98%, respectively. Contrast that with the S&P 500 Energy Sector Index, which is down 35.34%; the S&P 500 Financial Sector Index, down 23.65%; the S&P 500 Industrials Sector Index, down 14.64%; and the Russell 3000 Value, down 16.74%. All of these indices are connected to the same economy, which today is operating close to 40% below (quarter-over-quarter) where it was just a few months ago, according to the Atlanta Federal Reserve. Unemployment is certainly on the mend, but over 19 million people remain out of work, and there is a growing concern that a significant number will not regain employment anytime soon. The action in the stock market suggests a so-called "V-shaped" recovery. It may take a lot longer than most investors expect.

[2] 10-Year expected growth rate equals 37% with a 3% terminal growth rate and an 8% cost of equity.

If the recovery takes longer than most believe, how does value win?

Value investing can reestablish itself in a myriad of ways. If it goes like the last big tech bubble, which peaked in March of 2000, there might not be any readily identifiable catalyst. Growth stocks just got too expensive. Speculation simply ran too hot. Expectations were far too high. When the momentum shifted in 2000, it became a torrent of selling in the popular names. Value strategies were outstanding for a long time after that. Value could win if the cost of capital rises. Although the Fed is pulling out all the stops to suppress interest rates by printing money and monetizing government debt (and even buying corporate debt), that is not a strategy with limitless potential. The amount of money recently conjured with a keystroke ($3 trillion since February, and an expectation that Fed assets will grow to $10 trillion by this fall) is astonishing, and may find its way to inflation after we get through the economic downdraft. Money supply growth has broken modern peacetime records, according to Tim Congdon, chairman of the Institute of International Monetary Research. Inflation will likely beget higher interest rates and an elevated cost of capital. A higher cost of capital can also come from credit concerns (wider spreads) and greater stock market volatility (increased cost of equity). You don't need an inflationary environment to see that; we saw it briefly in February and March before the Fed restarted the printing presses. Investors could also have a thing or two to say about sovereign interest rates as they get wise to the dangerous game the Fed is playing. Who wants to loan a government 10-year money at less than 1% when underlying true inflation is much higher than that?

Value could also win if the economy turns around and grows more rapidly than expected. Cyclical and other depressed companies could shine in that scenario. All the extra reserves in the banking system could crank up the loan market, and this might have an impact on inflation and rates. Most growth stocks depend on ultra-low discount rates over a long time horizon. A small change in the discount rate can result in a huge change in the present value of cash flows. Value can also win simply because of size. The popular benchmarks are dominated by bigger companies, most of which are considered growth stocks; the amount of growth needed to move the needle has become high, and the law of large numbers can make it difficult to meet expectations. The notion that nothing bad can happen to the mega-cap tech companies and their suppliers may be fanciful, especially if the political winds blow differently. Anti-trust and other regulatory actions can put a damper on growth and sentiment.



Value could win if investors refocus on balance sheets and self-funding operations. Many of the best performers in today's environment are dependent on capital markets that can shut down when heavy turbulence hits. A market that turns sour tends to refocus investors' minds on sustainable franchises instead of aggressive possibilities. Value could also win as asset allocators start focusing on risk mitigation and good values. Momentum is driving this market, not fundamentals (see chart). Many investors who are beating the S&P 500 or other growth indices are doing it by owning a higher weighting in the most popular stocks. You can think of it like front-running the flow into passive investment. This will look very different when momentum flips!

These are challenging times to be value oriented. In an effort to keep pace with the indices, we are seeing more and more of our value competitors buying growth stocks. This is exactly what happened in 1999. We will remain steadfast to our disciplines. Stocks can stay disconnected from the fundamentals for only so long. Our team is strong and clear-eyed. We are grateful for the investors who stick with us. We are right there with you. The team continues to increase their ownership in our strategies via the FMI Family of Funds.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
All Cap Equity Composite
12/31/2009 - 12/31/2019

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			
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%
2018	-5.05	-5.70	-5.24	34	0.38	10.08%	11.18%	$ 212.8	$ 19,833.6	1.07%
2019	27.65	26.87	31.02	20	0.83	10.29%	12.21%	$ 208.5	$ 22,609.8	0.92%

*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 - 12/31/2019. 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 - 12/31/2019. 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 $22.6 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	0.65%
$25,000,001-$50,000,000	0.55%
$50,000,001-$100,000,000	0.50%
$100,000,001 and above	0.45%

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.