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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

March 31, 2014

The global macro picture was mixed in the March quarter. It featured a slowdown in growth in Japan, positive momentum in Europe, the first corporate debt default in China, economic turmoil across a number of emerging markets (Argentina, Turkey, Brazil, and South Africa to name a few), and Russia's emboldened annexation of Crimea. Stock markets were volatile, with Japan taking a bit of a breather, declining by 6.84% after generating a 54.40% return in 2013. European stock markets bounced around, with the UK market posting a slight decline, while Germany, France, Italy and Spain returned varying gains.[1] FMI International portfolios held up reasonably well with a gain of approximately 2.1% in the quarter, while the MSCI EAFE Index fell by 0.28% in local currency and rose by 0.66% in U.S. Dollars (USD). Portfolio sector outperformance was driven by Process Industries, Consumer Non-Durables, and Finance, while Commercial Services, Producer Manufacturing, and Consumer Services failed to keep pace. Top individual returns were generated by Amorepacific Corporation, Sociedad Quimica y Minera de Chile, and Potash Corp, helping to offset declines by Rolls-Royce, Pirelli and WPP. While we did not add any new names to the portfolio, we did trim and boost a number of our holdings over the course of the period.

Despite a few initial ripples through developed stock markets, great complacency still remains. The notion that central banks will continue to support (manipulate) asset prices and drive markets higher seems to be the prevailing view. We are often asked "how happy we must be" that stocks have been on a tear, with a belief that it "shows quantitative easing is working." In our view, this cannot be further from the truth. Valuations are stretched, and there appears to be a wide disconnect between stock prices and business fundamentals. With interest rates near record lows, investors continue to stretch for yield and chase returns. Following the herd and playing the momentum game can work in the short run when greed is plentiful, but when fear creeps in, it's a race for the exits. Company-wide, we are holding more cash now than has been typical over the firm's history. This is a result of a lack of viable investment candidates that meet our core criteria: a good business, strong management, and attractive valuation. We don't expect everything to be perfect – we just want valuations on our side. If valuations were lower, we would be able to look through the abundance of geopolitical and economic risks across the globe. In our opinion, we are not being adequately compensated for the current risk/reward equation. We believe that at some point stock markets will overly discount, just as they are overpricing today. We will be ready to act.

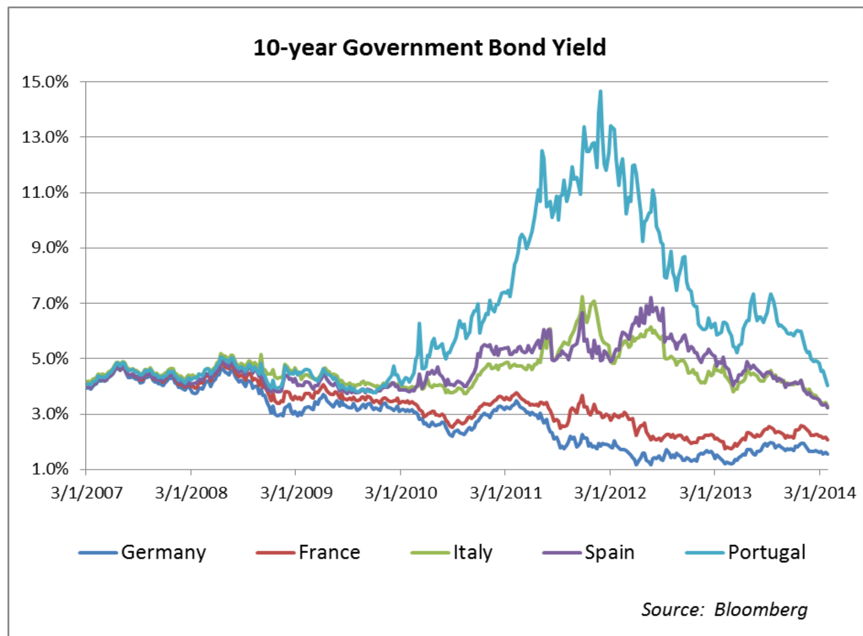
Europe: All Clear On The Western Front?

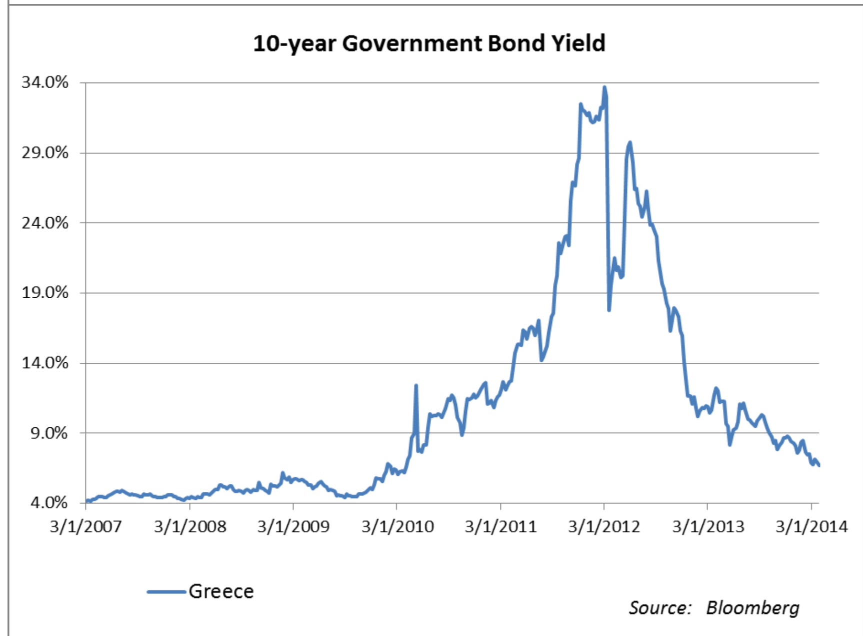
The eurozone continues to show some positive signs, stringing together three consecutive quarters of positive GDP growth (1.1% in the fourth quarter). The European Central Bank (ECB) is expecting growth of 1.2%, 1.5%, and 1.8% in 2014, 2015, and 2016, respectively, after a 0.4% decline in 2013. Manufacturing activity has expanded for nine straight months, and consumer confidence continues to improve. While these trends are certainly encouraging, the elephant in the room is that this level of growth will not be sufficient for the eurozone to "grow its way out" of the mess it has created, which includes an unemployment rate near record levels (11.9%), and debt burdens that are still dangerously high, far in excess of pre-crisis levels. Despite ECB President Mario Draghi's headline-grabbing claims that he will "do whatever it takes" and that the ECB is "ready and willing to act," it's naive to believe that the eurozone is the "island of stability" that he proclaims. Just because European bonds are now priced near or below pre-crisis levels (see charts on the following page), and the ECB and IMF talking heads say the worst of the crisis is behind us, it doesn't mean that we are

[1] Japan TOPIX: 6.84%; FTSE All-Share (UK): -0.29%; Germany DAX: 0.04%; France CAC: 2.88%; Italy FTSE MIB: 14.38%; Spain IBEX: 5.42%.

out of the woods. As a reminder, for quite some time Ben Bernanke said he didn't believe that there was a housing bubble in the U.S. and we all know that story ended badly. Wordsmiths can't change reality.

The reality, from our perspective, is that it's hard to make a case that European banks and sovereigns are structurally better today than they were before the crisis. The European banking system is still precarious. For example, Italy's largest bank, Unicredit SpA, recently posted a record €15 billion ($20.8 billion) loss in the fourth quarter after having to set aside money for bad loans and writing down goodwill. In France, the national auditor recently described France's debt level (which is set to top 95% of GDP this year) to be in a "danger zone," with the country's financial credibility facing a "serious blow" if it misses its deficit reduction target. In addition, German Chancellor Angela Merkel likes to highlight the fact that Europe accounts for 7% of the world's population, 25% of its GDP, and 50% of its social spending. Europe has done little to address this imbalance, and like the U.S., continues to make social promises that are unlikely to be kept.





While European economies are showing some signs of life, unfortunately Europe's publicly traded companies are recovering from the recession at the slowest pace during any business cycle since 1970, according to the *Financial Times*. They write that, "Not only is the recovery in earnings unusually lengthy, but the gap between Europe and the U.S. coming out of the recession is more than three times bigger than it has averaged at this stage in previous cycles. U.S. earnings are now 20% above their peak in 2007, while European earnings are 26% below."[2] At this rate, it may be 2017 (10 years) before European companies return to peak earnings. Despite Draghi's best marketing efforts, it's hard to buy into the notion that all is clear on the western (European) front.

<u>Japan: Plight of "Abenomics"</u>

After 4.5% and 4.1% annualized GDP growth in the first and second quarters of 2013, respectively, the "Abenomics" monetary experiment was quickly hailed as a great success. Japan was growing faster than both the U.S. and Europe, and the future suddenly looked bright again. Sentiment was improving, and Japan's problems seemed to be magically

[2] Gordon, Sarah. "European groups on slow path to profits." *Financial Times,* February 24, 2014.

disappearing. Fast forward just six short months, and as we expected, things are no longer as rosy as they once appeared. After 0.9% growth in the third quarter and 0.7% in the fourth quarter, expectations (and the Japanese stock market) have started to come back down to earth. The World Bank is forecasting just 1.4% and 1.2% growth in 2014 and 2015, respectively. As we have expressed in prior letters, printing money does not solve deep structural problems, and may lead to bigger issues down the road. Japan is no exception.

Despite more than a 35% depreciation of the yen, exports continue to be a drag. As described by the *Financial Times*, Japan "is the only major economic zone where the volume of exports is much lower than the pre-crisis peak."[3] While a weaker yen has done little to boost export volume growth, it has led to significantly higher energy import costs, especially with nuclear power plants shuttered. As a result, February's trade accounts showed a trade deficit for the twentieth straight month, with January's deficit being the largest on record. Trade is no longer the engine of growth that it once was; Japan is becoming increasingly dependent upon domestic consumption – a consumer who will soon be hit with a 3% sales tax hike (to 8%) in April. Demographics are also not on their side, as a shrinking and aging population would make the case for less, not more domestic consumption. Wage growth, which is a key ingredient to Prime Minister Abe's master plan, has been virtually non-existent. January's 0.1% base wage increase (excluding bonuses and overtime) was the first increase in 22 months. However, total pay still fell by 0.2%. While multinational companies such as Toyota, Honda, and Toshiba have announced relatively minor base wage increases, small and medium sized businesses, which employ most of the workers in Japan, are reluctant to raise salaries.[4] This is not a recipe for success. If Abe eventually gets his elusive 2% inflation (or even more), and wages don't follow suit, he will have an even bigger mess on his hands, with rising costs and falling real income.

<u>China: Credit Crunch Fears</u>

For the last several quarters, we have been ringing the bell on China, with concerns that a credit and/or housing bubble could derail the world's second largest economy. It appears China's excess is starting to come home to roost, with visible signs of weakness in early 2014. According to "official" government data, January/February industrial output grew at the slowest pace (8.6%) since 2009, retail sales posted the weakest growth (11.8%) since February 2011, residential and commercial property sales fell by 3.7%, and exports declined by 1.6%. The HSBC Manufacturing Purchasing Managers' Index (PMI) posted three consecutive readings below 50,[5] which also implies contraction. We have long believed that China's GDP growth rates were meaningfully lower than reported by the government, so we are not surprised to see more people starting to question the country's ability to meet its official 2014 growth target of 7.5%, especially after a weak start to the year.

China is in the midst of an unprecedented period of debt-fueled fixed investment, as credit has grown at an annual rate of 20% over the last five years, more than twice that of GDP. During this time, $14-15 trillion of credit was extended, promoting investments in real estate, infrastructure, and manufacturing capacity.[6] A significant amount of these investments are not economic. Ruchir Sharma, Morgan Stanley Investment Management's head of emerging markets, writes: "The key to foretelling credit trouble is not the size but the pace of growth in debt, because during rapid credit booms more and more loans go to wasteful endeavors. That is China today. Five years ago it took just $1 of debt to generate $1 of economic growth in China. In 2013 it took nearly $4 – and one-third of the new debt goes to pay off the old debt." He estimates China's total debt to GDP is now 230%, up from 125% in 2008.[7] Fitch Ratings predicts that at the current rate of credit growth, debt to GDP will exceed 270% by 2017, at which time China's interest payments will account for 20% of GDP.[6] As we have discussed in the past, we do not believe China's growth model is sustainable.

To make matters worse, historically China has had a policy of bailing out companies with bad debt instead of allowing them to fail. This has created a moral hazard and helped facilitate a plethora of "zombie" companies, empty real estate buildings, roads and bridges to nowhere, manufacturing overcapacity, and potentially disastrous bank balance sheets. Importantly, this bailout mentality may be starting to change, at least to some degree, which could have important

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[3] McLannahan, Ben. "Japanese manufacturers fail to reap benefit of weaker yen." *Financial Times,* January 14, 2014.
[4] Soble, Jonathan. "Pay rises likely to rev up Abenomics." *Financial Times*, March 12, 2014.
[5] January reading of 49.5; February reading of 48.5; March reading of 48.0.
[6] Pei, Minxin. "China admits its ills but faces an unpalatable cure." *Financial Times*, March 18, 2014.
[7] Sharma, Ruchir. "China's deb-fuelled boom is in danger of turning to bust." *Financial Times*, January 27, 2014.

ramifications over time. At his annual news conference on March 13, Chinese Premier Li Keqiang commented that in the case of bonds and other financial products, "isolated cases of default will be unavoidable." In fact, on March 6 the domestic Chinese bond market experienced its first public bond default since the central bank started regulating the market in 1997. Shanghai Chaori Solar Energy Science & Technology Co., a maker of solar cells, defaulted after failing to make a ¥89.8 million ($14.7 million) interest payment. Less than two weeks later, news surfaced of another pending default, as closely-held Zhejiang Xingrun Real Estate Co., a Chinese real estate developer with ¥3.5 billion ($566.6 million) of debt, was reported to have collapsed. The company was said not to have enough cash to repay creditors that included more than fifteen banks, with its largest shareholder being detained.[8] If the credit rug continues to be pulled out from under businesses, they may die quickly. However, we suspect China will try to wade in slowly, allowing a select group of companies to default while continuing to bail out a number of others. Li Kequiang commented that the government would take steps to ensure that failures did not pose a threat to the financial system.[9] Good luck with that! As recent history has shown (i.e. Lehman), a credit crisis can spin out of control in the blink of an eye.

This is a time to be cautious yet poised to move as conditions can change quickly. The international equity portfolio has the preponderance of its exposure in powerful, financially strong global franchises such as Accenture, Danone, Henkel and Unilever. We've supplemented these holdings with some special situations, such as the two highlighted below:

Amorepacific Corp Pfd shs (090435-KS)
(Analyst: Jonathan Bloom)

Description

Amorepacific Corp. is South Korea's leading cosmetics company, with a domestic market share of approximately 34%. The company generates 82% of sales domestically and 18% overseas with a presence in China (11% of sales), France (3%), Asia (3%), and the U.S. (1%). Approximately 85% of group sales are cosmetics, with 15% coming from household products and green tea. The company focuses on the high- and mid-end of the market, with 60% of domestic cosmetics sales in the "Luxury" category and 26% in the more reasonably priced "Premium" category. Domestic cosmetics sales channels include door-to-door (27% of segment sales), specialty store (18%), travel retail (17%), department store (14%), digital (13%), discount store (9%), direct sales (1%) and others (1%). Top selling domestic brands include Sulwhasoo, Iope, Hera, and Laneige.

Good Business

- Amorepacific's ROIC (return on invested capital) has averaged over 16% during the last five years, which exceeds the company's cost of capital, creating economic value.
- As South Korea's number one domestic cosmetics company, Amorepacific benefits from economies of scale.
- Amorepacific's brands are perceived to be among the highest quality in South Korea, with strong customer loyalty and brand equity.
- The company has mid-to-high single-digit top line growth prospects, and potential for margin expansion overseas.
- The business is easy to understand.
- The company has a robust balance sheet with net cash.

Valuation

- The preferred shares (090435-KS) trade at an implied enterprise value-to-sales multiple of 1.1 times, which compares favorably with low-to-mid-double-digit operating margins.

[8] Yang, Steven. "Chinese Developer With $567 million debt said to collapse." *Bloomberg News*, March 17, 2014.
[9] Hornby, Lucy & Anderlini, Jamil. "China warning on defaults sparks fears over growth. " *Financial Times,* March 14, 2014.

- The preferred shares (090435-KS) trade at a forward earnings per share multiple of 10.5 times. Global cosmetics peers typically trade at over 20 times.
- The preferred shares trade at a 58% discount to the Amorepacific common shares (090430-KS), which is not economically justified. The preferred shares have the same economic interest, but lack voting rights. The preferred shares also pay a 1% higher dividend (non-cumulative) than the common shares. Voting rights are of little significance, so the discount is attributed to liquidity.
- The valuation implies a deep discount to intrinsic value, offering a wide margin of safety.

Management

- President & CEO, Mr. Kyung-bae Suh, received his MBA from Cornell University. Over $1.6 billion of his wealth is directly tied to the Amorepacific common shares, so he has significant skin in the game.
- The founding Suh family collectively controls approximately 49.5% of voting rights via the common shares.
- Management is known to be conservative, with a preference for organic growth vs. acquisitions.
- Foreign ownership of the preferred shares is approximately 70%, helping to protect minority shareholder interests.
- There is room for improvement with regard to returning cash to shareholders. The current dividend yield is only 1.2%.

Investment Thesis

This is a rare opportunity to buy a growing, high-quality luxury cosmetics business at a deep discount to intrinsic value. The 58% preferred share discount is well above levels found in other developed stock markets. Potential catalysts for share price appreciation include earnings growth, multiple expansion, returning more cash to shareholders via the dividend or a highly accretive share buyback, and incremental interest from like-minded international investors. In a world of expensive stocks, we feel this opportunity is particularly compelling.

Electrocomponents plc (ECM-LN)

(Analyst: Andy Ramer)

Description

Electrocomponents is a high service level distributor of tech products for design and maintenance engineers in Continental Europe (35% of sales), UK (29%), North America (23%), and Asia Pacific (13%). Product categories include electronics, automation & control, test & measurement, and electrical.

Good Business

- Electrocomponents' service accuracy, product range and availability, partnerships with leading global suppliers, global customer reach, eCommerce capabilities, and multi-channel approach are competitive advantages. The company is gaining market share.
- The average order size is only £150 ($250). Maintenance products account for 60% of sales. The business proved relatively resilient in the 2008 to 2009 downturn.
- Return on invested capital was 12% in fiscal 2013 and has averaged 13% over the last five and ten years, respectively. ROIC troughed at 10% in fiscal 2010. Return on tangible capital was 18% in fiscal 2013.
- This business is easy to understand.
- The leverage ratio is 1.1 and interest expense is covered by approximately 22 times. Distribution businesses tend to become more cash generative in weaker times as receivables are collected and inventories are drawn down.

Valuation

- Electrocomponents trades for 15.5 times the forward 12-month earnings per share estimate.
- The enterprise value to last 12-month sales multiple is 1.05 times and compares to a trailing operating margin of 8.5%, a 5-year average margin of 9.5%, and a target range of 9% to 11%.

- Price/book of 3.3 times is in the lower half of the 5-year average range of 2.8 to 4.4 times.
- The dividend yield is 4.4%.

Management

- Ian Mason has been CEO since 2001. Simon Boddie joined as Finance Director in 2005. They know the company and industry well.
- Management is focused on organic growth given their belief that there are significant opportunities to reinvest for growth at attractive returns. Excess capital is returned to shareholders via the dividend.
- Executive compensation is modest. The Chairman and CEO roles are split, and directors stand for reelection annually.

Investment Thesis

We feel Electrocomponents is poised to benefit from the secular growth in electronics, without having to take inventor's risk. Moreover, structural trends favor larger, global distributors, thus enabling the company to continue taking share from smaller distributors who are unable to match Electrocomponents' advantages. Systems are critical to success. The eCommerce channel represents 57% of sales and continues to move towards the medium-term target of 70%, and SAP has been implemented in over 90% of the business.

Thank you for your support of Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 12/31/2013

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	Three Year Ex-Post Standard Deviation *Benchmark	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2011	-0.78	-1.52	-12.15	1	0.00	n/a	n/a	$ 16.7	$ 12,273.6	0.14%
2012	19.35	18.46	17.31	1	0.00	n/a	n/a	$ 76.3	$ 15,253.5	0.50%
2013	25.89	24.95	26.93	1	0.00	9.78	12.22	$ 165.8	$ 19,705.3	0.84%

*MSCI EAFE Net Local 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 - 12/31/2013. 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 International Equity Composite has been examined for the periods 12/31/2010-12/31/2013. The verification reports are available upon request.

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 $19.7 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 International Equity Composite was created on December 31, 2010. This composite invests mainly in a limited number (usually between 15-25) of large capitalization (namely, companies with more than $5 billion market capitalization) foreign companies.

The International Equity Composite reflects time-weighted and asset-weighted returns for all discretionary accounts. 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, gross of custodial fees, gross of withholding taxes 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®. This information is not available for the International Equity Composite.

Currently, the advisory fee structure for the International Equity Composite portfolios is as follows:
All assets at 1.00% -- Current Expense Ratio. This includes a management fee of 0.75%.

The firm generally requires a minimum of $25 million in assets to establish a discretionary account. 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 MSCI EAFE Net Local Index® is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Net Local Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. It is reported in local US Dollar currency and net of hedges. The International Equity composite uses the MSCI EAFE Net Local Index® as its primary index comparison.