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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2014

Global stock markets regained their momentum in the June quarter, with most developed markets in Europe and Asia reporting low-to-mid single-digit percentage gains. Valuations climbed higher yet again, as governments and central banks continue to prop up asset prices with experimental fiscal and monetary policies. The FMI International strategy kept pace in the period, adding approximately 3.9%, despite proceeding with caution and maintaining an elevated level of cash. This compares with the MSCI EAFE Index, which grew by 3.41% in local currency and 4.09% in US Dollars (USD). For the International portfolio, the Consumer Non-Durables, Industrial Services, and Finance sectors performed well on a relative basis, as Process Industries, and Distribution Services lagged the group. Strong individual returns were generated by Amorepacific, Schlumberger, and Fairfax Financial, while Akzo Nobel and Electrocomponents underperformed.

There were a number of portfolio changes in the quarter as we sold our Willis Group and Covidien holdings, and initiated new positions in Smiths Group, Jardine Strategic and Admiral Group. Willis Group's valuation had crept up, despite an inability to control expenses and strong indications that management was looking to pursue growth by acquisition. Medtronic agreed to buy Covidien at a healthy premium to our estimate of fair value, so we monetized the position. Due to lackluster organic sales growth in the Medical and Detection businesses, Smiths Group had lagged equity markets over the past two years, which provided us with an opportunity to invest in a relatively defensive global industrial company, with a solid balance sheet, at an attractive valuation. Smiths Group owns a collection of valuable franchises, including John Crane and Smiths Medical. CEO Phil Bowman came onboard in 2007 and has taken a number of difficult actions to enhance shareholder value. Jardine Strategic is an undervalued Pan-Asian conglomerate with a fantastic long-term track record, a number of high-quality assets which are very difficult to replicate, has attractive growth prospects, and a conservative management team with significant skin in the game. Admiral Group has lost favor with investors due to continued angst over the direction of pricing in the UK personal auto market. This short-term view overlooks the inherent franchise value embedded within the company's efficient and capital-light direct-to-consumer business model. Admiral's underwriting track record, and superior go-to-market strategy, position the company well for future market share expansion. Management holds a meaningful amount of stock, and has a steady practice of returning over 90% of earnings to shareholders as dividends.

As we reflect on the current global environment, it becomes clear that people are increasingly looking to governments and central banks to solve their problems, both economic and social. These governing bodies believe they have the tools to do so, and have taken unprecedented measures to answer the call. However, when these flawed policies don't work, their answer is to try even more of the same. The long-term impact of quantitative easing, negative real interest rates, profligate stimulus, currency devaluation, and the ensuing asset bubbles that may have formed as a result, is unknown. A few possible consequences may include runaway inflation, misallocation of resources, proliferation of zombie companies, investment in share repurchases instead of underlying businesses, leveraging of company balance sheets with excess debt (which eventually leads to bad debt), sovereign debt defaults, a foreign exchange race to the bottom, and another global financial crisis. The risk, in our view, is clearly to the downside, as we go deeper into a continuous cycle of market manipulation and further away from a free market system. We fear that it may take another economic crisis for leaders to wake up and change their ways, as the global groupthink that printing money is a viable economic solution will ultimately need to be broken.

Despite our growing concerns, we remain confident that the portfolio is well positioned for the long run, as we continue to own high-quality, well-run businesses at below-average valuations. Additionally, we keep an active "wish list" of great companies that we would love to own at lower prices. When we finally get a meaningful pullback in global stock markets, we will be well-equipped to seize the opportunity.

Europe: Too Far, Too Fast

European Central Bank (ECB) President Mario Draghi has grabbed headlines once again, becoming the first major central banker to introduce negative deposit rates (i.e. banks pay a 0.1% fee to keep money at the ECB), in an effort to "fight deflation" and spur economic growth. The ECB cut its main refinancing rate to 0.15% (from 0.25%), and announced a €400 cheap loan package for banks to lend to small businesses. Draghi also left the door open for quantitative easing, and may eventually follow the Federal Reserve and Bank of Japan (BOJ) down this path. Meanwhile, the ECB cut its eurozone growth forecast to 1% in 2014, which remains lethargic. In the first quarter, eurozone gross domestic product (GDP) grew at 0.8%, but would have contracted if Germany's 3.3% growth was excluded. Additionally, eurozone unemployment remains stubbornly high at 11.6%, already elevated government debt levels continue to rise, and the financial health of the banking sector remains in question. Europe, from our vantage point, still has a long way to go.[1]

To see the ECB's manipulation of asset prices, look no further than European stock and bond prices (yields) over the past few years. European stocks are up over 155.85% from the lows of 2009, despite subpar business fundamentals and significant macro concerns. Price-to-earnings ratios have risen from less than 12 times in the third quarter of 2008 to 21.2 times today.[2] Sovereign bond yields (inverse relationship to bond prices) tell a similar story. As reported by the *Financial Times*, "French 10-year yields have not been lower since at least the War of the Austrian succession in the 1740s, according to Deutsche Bank; Spain's not since 1789."[3] During the quarter, Spain's yields fell below that of the US. Is Spain really a safer place to invest, with anemic economic growth, 94% debt-to-GDP, unemployment of 25.9% and youth unemployment of 54.0%? Clearly this does not pass the common sense test and may be irrational. Sovereign bond yields across Europe imply a risk-free path to economic prosperity, with virtually no margin of safety. Not to worry, though – Spain, Italy and Britain now plan to include prostitution and the sale of illegal drugs in calculating GDP. That ought to do the trick!

Valuations On The Rise

In addition to Europe, stock valuations across developed markets (which include Japan, Australia, Hong Kong and others) are also increasing. The following charts show the historical price-to-earnings and price-to-cash flow metrics for developed markets, excluding the US, over the past 40+ years:

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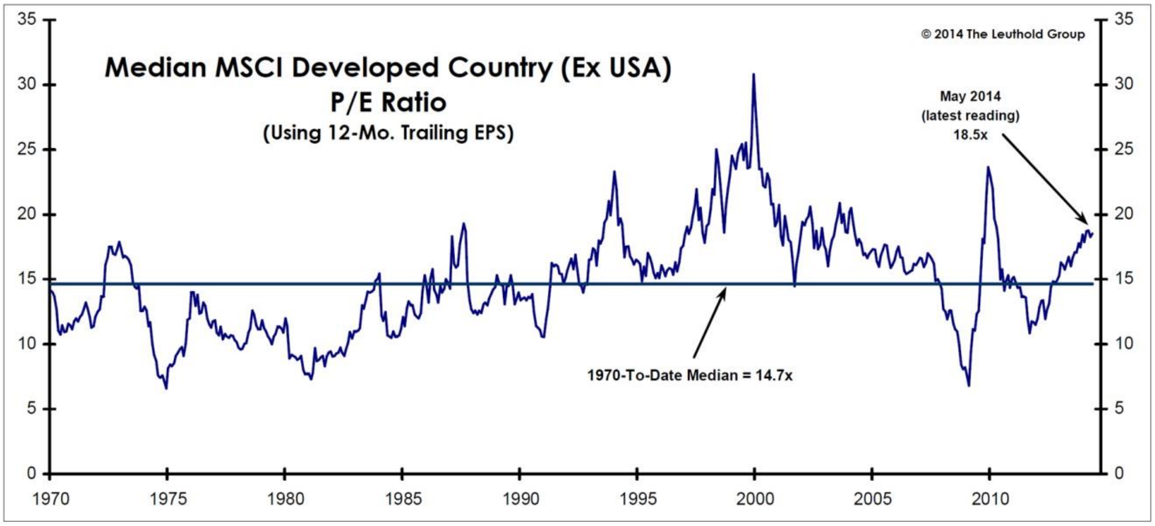
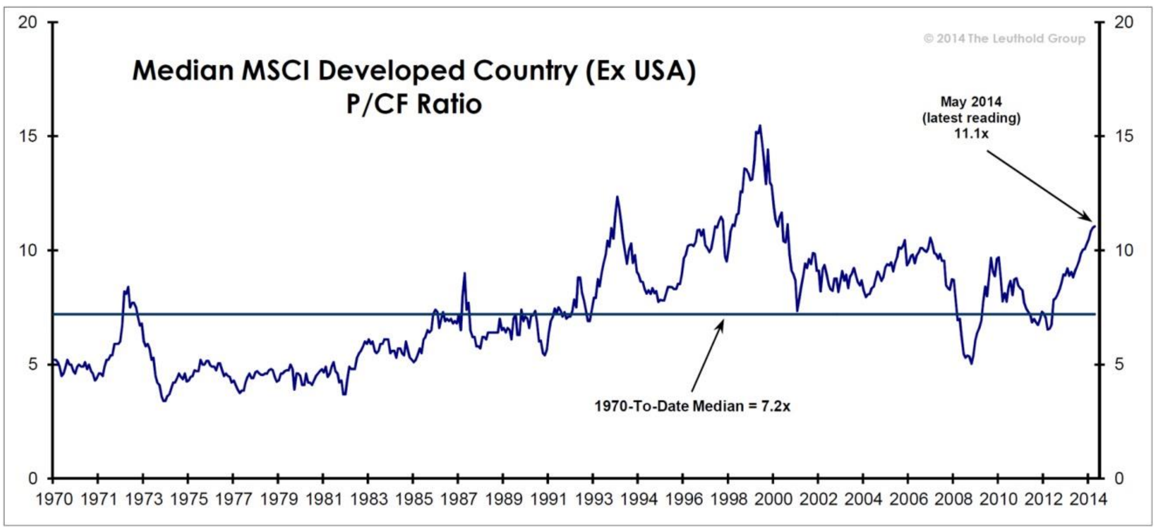
[1] Jones, Claire. Draghi in historic rate cut to stave off Eurozone deflation. *Financial Times*, June 5, 2014

[2] MSCI Europe x UK index and valuations are being referenced. Price-to-earnings reflects the last twelve months of earnings. Source: Bloomberg.

[3] Atkins, Ralph. Grouchy eurozone bonds tell a depressing story. *Financial Times*, June 12, 2014.





While we have not hit all-time highs (just yet), current valuations are well above historical medians, and are quickly approaching levels seen during some of the most expensive markets on record. In our view, global stock prices are discounting financial growth that appears to be overly optimistic.

Japan: Be Careful What You Wish For

Like the Federal Reserve, the BOJ has fully embraced quantitative easing since introducing the program in April of 2013, with an initial objective of doubling the money supply and driving inflation to approximately 2%. The BOJ has been purchasing between ¥6 trillion (approximately $59 billion) and ¥8 trillion ($78 billion) of Japan's government debt per month, and now owns around ¥201 trillion ($1.97 trillion)[4], becoming the largest holder of Japan's debt (20.1% of the total) for the first time ever. To put this into perspective, the BOJ is now purchasing almost 70% of all new government issuance.[5] That is a lot of money printing! It's hard to imagine this pace is sustainable. Juxtapose this backdrop with ultra-low 10-year government bond yields of

[4] As of March, 2014.
[5] Ito, Tatsuo. BOJ is top holder of debt issued by Japan. *The Wall Street Journal*, Thursday, June 19, 2014.

approximately 0.566%, debt-to-GDP of 226%, and secular demographic challenges, and Japan could be setting itself up for failure. The Japanese government sells almost all of its debt to Japanese citizens, which helps keep interest rates artificially low compared with the rest of the world. With an aging population that might need to sell government bonds for retirement, and the BOJ inevitably having to slow their pace of bond purchases or sell bonds back into the market, interest rates could rise toward more normalized levels, making it nearly impossible to service the debt without printing more money and further devaluing the yen (¥). If Japan were forced to start borrowing from the rest of the world it would compound the problem. Risk of default or hyperinflation could quickly become a reality.

Even as Japan's radical policies (including $110 billion of stimulus spending last year) have devalued the yen and driven stock prices higher (+102.15% from the 2009 trough[6]), economic growth continues to be elusive, with the World Bank recently cutting Japan's 2014 GDP growth forecast to 1.3% (from 1.4%). A weaker yen is not benefiting exporters as originally planned, and rising energy costs continue to pressure import costs. In May, Japan's exports (total value) declined for the first time in 15 months, falling 2.7% year-over-year. Export volumes have been weak for the last three years, after peaking in 2008. Put together all the pieces, and Japan has now registered a trade deficit for the 23rd consecutive month.

While Prime Minister Abe's heralded "third arrow" does have a few business-friendly initiatives, we are skeptical that they will be enough to move the needle. Reducing the corporate tax rate to below 30% over the next few years (from approximately 35.6%) should be a positive, but the impact may be more muted than expected. The *Financial Times* writes that despite having the second highest tax rate in the OECD[7], "the unprofitable nature of many businesses, combined with a range of loopholes, exemptions and credits, means in practice that a majority of companies pay no income tax at all."[8] Abe's talk of boosting immigration is also encouraging on the surface, but will be difficult to execute, as the general public is unwilling to open Japan's borders and risk losing domestic jobs or altering their culture. Ultimately, current immigration estimates are too low to mitigate the shrinking labor market.[9] Like Europe, Japan has its hands full.

China: Further Signs Of Vulnerability

China, as many expected, is not sitting idle as many of its real estate markets come unglued. Local and central governments are ramping up stimulus, increasing the year-over-year spending by 25.0% in May, from 9.6% in January-April. They are increasing funding on infrastructure (same old story) and gradually loosening monetary policy, all in the face of weaker fiscal revenues (7.2% growth in May vs. 9.2% in April) and the slowest quarterly GDP growth (+7.4%) since the third quarter of 2012.[10] Housing sales in terms of total value fell by 10.2% in the January-May period, while construction starts fell 18.6%.[11] Prices fell month-over-month for the first time in two years, and Standard & Poor's is now estimating home prices will fall by 5% this year. We believe the ultimate downside could be far worse. Reports have surfaced that developers are offering discounts, more time to pay the "required" 30% down payment, or waving the down payment entirely. "Smart Money" in China is reportedly pulling money out of the housing market.[12] At the same time, China's central bank is pushing lenders to accelerate the granting of mortgages to qualified buyers, as Chinese banks reported the 10th consecutive quarterly increase in defaults, and the biggest quarterly increase in non-performing loans since

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6 Japan TOPIX Index.

7 Organization for Economic Co-operation and Development.

8 Soble, Jonathan. Japan's Abe sets target for corporate tax below 30%. *Financial Times*, June 13, 2014.

9 "Japan tries a new strategy for growth. *Financial Times*, June 19, 2014.

10 Anderlini, Jamil. China raises spending to spur growth. *Financial Times*, June 12, 2014.

11 Magnier, Mark. China Housing Still Clouds Economy. *The Wall Street Journal*, June 13, 2014.

12 Fung, Esther. Smart Money in China Cuts Back on Property. *The Wall Street Journal*, April 23, 2014.

2005.[13] *The Wall Street Journal* writes that "Property accounts for approximately 12% of China's GDP, but Moody's Analytics estimates it to be 23% if construction and house renovation are included."[14] That is a big number! In our March letter we described China's credit crisis, which goes hand in hand with the real estate market, and poses further risk. The cracks in China's armor appear to be growing by the day. Only time will tell if their self-induced bubble can be contained.

It's worth noting an interesting anomaly – investors in Chinese stocks seem to have sniffed out the situation better than elsewhere in the world (or have become wise to the notoriously corrupt Chinese equity markets), with the Shanghai Composite Index up only 24.33% from its 2009 trough. Perhaps investors that are brave enough to venture into mainland China can already see the writing on the wall.

While the US, Europe, Japan and China carry significant weight in global stock markets, we would be remiss not to mention the turmoil in Ukraine, Iraq, and Syria, each of which could be very disruptive in and of itself. A military engagement involving Russia, or further extremism/instability in the Middle East could have meaningful ripple effects, with an oil shock as a potential example. All bets are off if the US or Europe gets roped into another military conflict. In the midst of heightened caution, we will continue to keep our heads down with a goal of identifying great businesses at attractive valuations. We remind our investors that some of the best buying opportunities come when the going gets tough, and we suspect it may.

Thank you for your confidence in Fiduciary Management, Inc.

[13] Chinese Bad Loans Rise Most Since 2005 as Economy Slows. *Bloomberg News*, May 15, 2014.
[14] Fung, Esther. China Housing Slows, Ripples Follow. *The Wall Street Journal*, June 19, 2014.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 03/31/2014

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			
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%
Q1 2014	2.08	1.89	-0.28	1	0.00	10.01	12.36	$ 206.0	$ 19,764.3	1.04%

*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 - 03/31/2014. 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 12/31/2010-03/31/2014. The verification 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 $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 25-35) 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.