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# INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

September 30, 2014

The third quarter of 2014 yielded mixed results for global equity markets, with stock indices in Japan and France advancing by 5.71% and 0.04%, respectively, while German and the U.K. stocks fell by -3.65% and -0.90%, respectively,[1] as weak economic data (including a -0.2% decline in Germany's second quarter GDP[2]) weighed on investor sentiment. The FMI International strategy fell by approximately 1.1% in the period, which compares with an MSCI EAFE Index gain of 0.93% in local currency and a decline of 5.88% in U.S. Dollars (USD). The relative performance of the portfolio was aided by the Consumer Non-Durables, Retail Trade, and Energy Minerals sectors, while Electronic Technology, Health Technology and Finance sectors were a drag on results. Amorepacific Corporation, LG Household & Healthcare, and Taiwan Secom generated strong individual returns, while Electrocomponents, Admiral Group, and Adecco each fell in value. The USD strengthened by over 5% against the Japanese Yen, Euro and British Pound. As a reminder, we have chosen to hedge currency risk so that the portfolio's performance is predominantly driven by stock selection, not movements in foreign exchange rates.

To avoid sounding like a broken record, we will spare our readers the reiteration of our view that stock markets are expensive, growth is weak, macro risks abound, and fiscal and monetary policies are misguided and reckless (see our previous shareholder letters for reference). We thought a little change of pace might be refreshing, so instead we will share a few takeaways from our recent research trip to Asia, where two of our analysts visited Japan, South Korea, and Hong Kong. FMI met with over 60 companies, a handful of industry analysts, a Chinese economist, and a member of the Ministry of Finance in Japan. There were a number of interesting observations from the trip:

**Japan: Perceptions & Reality**

Consistent with our prior meetings in Japan, it remains clear that a vast majority of companies do not have a grasp of return on invested capital (ROIC). It's all too common for businesses in Japan to fail to earn their cost of capital. During our recent travels, we often came across businesses with long-term (beyond 2020) aspirational targets for return on equity (ROE) that were at or below 10%… far from inspiring. Sometimes this can be a result of an inefficient balance sheet (i.e. hoarding cash and investments), and at other times, an outcome of a low-quality business, poor management, or a lack of focus on profitability (i.e. margins well below global peers). Some companies are slowly starting to talk more about returning additional cash to shareholders, with an increase in dividends and buybacks appearing to be a more realistic consideration. In terms of management quality, we do not expect this to improve overnight, as it will take a long time to change the business culture in Japan. In the meantime, we strive to find the exceptions to the rule, which we believe we have found in our existing Japanese holdings: SMC Corporation, Secom, and Shin-Etsu

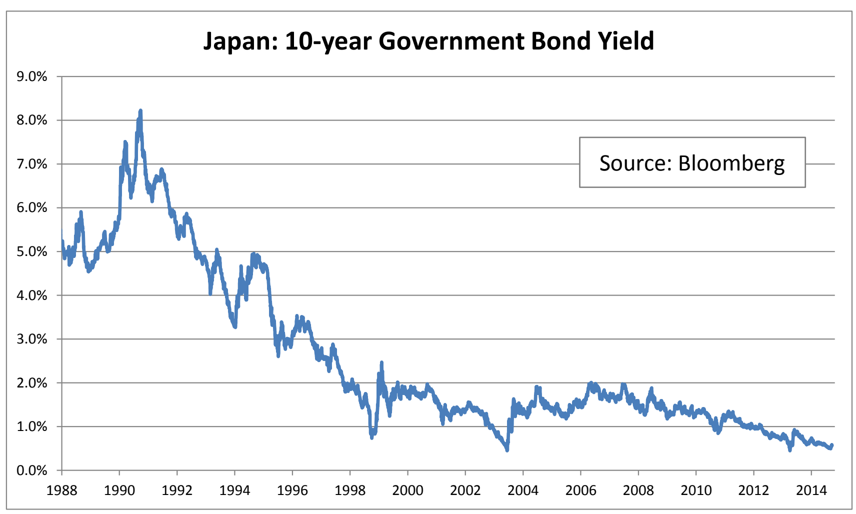
[1] The following market indexes are being referred to above: Japan TOPIX, U.K. FTSE All-Share, France CAC-40, and Germany DAX.

[2] Germany's GDP (gross domestic product) declined 0.2% in the second quarter of 2014, on a quarter-over-quarter basis.

Chemical. Each is a high-quality, dominant business with strong profitability and significant barriers to entry. Their balance sheet efficiency (flush with cash), on the other hand, still has room for improvement.

While we do not believe "Abenomics" will ultimately be successful in rescuing Japan from its mountain of debt, demographic headwinds, and weak economic growth, the policy does appear to be making some initial progress on the inflation front (we would note, however, that printing money is a dangerous game, as modest inflation can quickly turn into hyperinflation). After over fifteen years of deflation, Japan's inflation rate is now over 1% (with a 2% target), and consumers and companies alike appear to be embracing the reality that prices can actually go up. Companies have long tried to creatively "raise prices" by offering new services and/or technologies, innovative new products, new packaging, reduced product count at the same price, etc. If inflation sticks, companies might actually look to change prices the old fashioned way – simply raise them. This could have a profound impact on a company such as Secom, which provides electronic security services to commercial and residential buildings (think ADT in the U.S., but with its own nationwide security force). Due to low penetration rates in Japan, Secom's volume growth has been strong for many years, but pricing pressure has held back topline growth. Pricing has started to stabilize in recent years, and our discussions with the company suggest there may be an opportunity to start increasing prices down the road. This could change the company's growth profile dramatically, and potentially lead to a re-rating of the stock. Inflation in Japan was never baked into our original investment assumptions, but could end up being a positive catalyst nonetheless.

During our time in Japan, we also sat in on a presentation and Q&A session presented by the Ministry of Finance's new investor relations (IR) department for Japanese Government Bonds (JGBs). The IR people will have their work cut out for them trying to drum up support for JGBs; why any rational international investor would be interested in buying 10-year bonds from the most indebted (not to mention economically-challenged) developed country in the world at a paltry yield of 0.53% is beyond our comprehension. As it stands today, Japan's national debt service accounts for 24% of the 2014 annual budget and 46% of the tax revenues, despite unsustainably low financing costs. To calm investor fears that a rise in interest rates would cripple the country, IR presented a sensitivity table assuming interest rates could go as high as 4.4% by 2017 (our worst-case would be far higher). Under this scenario, debt service would increase to ¥37.5 trillion from ¥23.3 trillion today (+61%), held down by the duration of the existing portfolio. The further you go out, however, the worse the interest burden will become. According to the speaker, as long as their economic recovery continues (they assume 3% nominal growth), "everything will be okay." When asked what would happen if rates rose but the economy went into a recession, there was basically no response. It appears there is a blind trust that the government will know just what to do. To our amazement, a comment was made that interest rates "never" really go up above 2%.[3] The chart above (with a slightly longer memory) might beg to differ.




3 "The Japanese Economy and Debt Management," presentation published by Financial Bureau, Ministry of Finance, Japan, September 2014.

**South Korea: Opportunities & Pitfalls**

South Korea remains intriguing, as valuations are among the lowest in the developed world (we do not consider it an emerging market[4]), and a number of inefficiencies still remain, creating attractive investment opportunities. We were pleasantly surprised by a handful of our company meetings. While English filings and language skills can be limited in some cases, financial statements are often available in far more detail than is provided elsewhere in the world. A prime example of the inefficiencies in Korea is the discount placed on the preferred share class, a mispricing that is not economically justified. In Korea, preferred shares typically have the same economic interest as the common shares and pay a *higher* dividend, but are less liquid and do not have voting rights. As many of the companies are family-controlled, voting rights are of less significance, so the discount is mainly attributed to liquidity. As recently as last year, preferred shares traded at discounts as wide as 60% to 80% versus the common shares, an anomaly that simply did not make sense. We have been able to exploit this opportunity through our investments in Amorepacific Corp. and LG Household & Health Care Ltd. (LG H&H), which were purchased at single-digit multiples of earnings -- a significant margin of safety for the L'Oreal and Procter & Gamble equivalents of Korea. Over time, we had expected the discount to narrow, to be more in line with what we see in Europe where similar preferred shares trade much closer to par. This has started to play out, as AmorePacific and LG H&H's preferred shares now trade at a 52% and 46% discount, respectively, from 67% and 70% at the time of purchase. Both stocks remain attractive from an absolute valuation perspective, which we view as far more important than the nominal spread.

The two biggest takeaways from our trip to Korea were the major pitfalls we need to avoid: government involvement and poor corporate governance. While we were already aware from prior research that the government can influence certain industries with a heavy hand, we were surprised to hear from as many companies as we did that they were being adversely affected. The government is a champion for the consumer, so industries that provide basic necessities appear to be the most at risk. The government's influence is not always through official policy, and in some cases may be through direct communication with an industry and an expectation of compliance. For example, one of the country's leading instant noodle makers had not been able to raise prices for years, as they were not permitted to by the government. One of the leading discount hypermarket chains was forced to close two days per month so that small- and medium-size enterprises would have a better chance at success. Wireless telecom providers are told one day to cut tariffs, and to cap subsidies another. The list goes on. When a company cannot control its own destiny, we will simply pass and move on to the next.

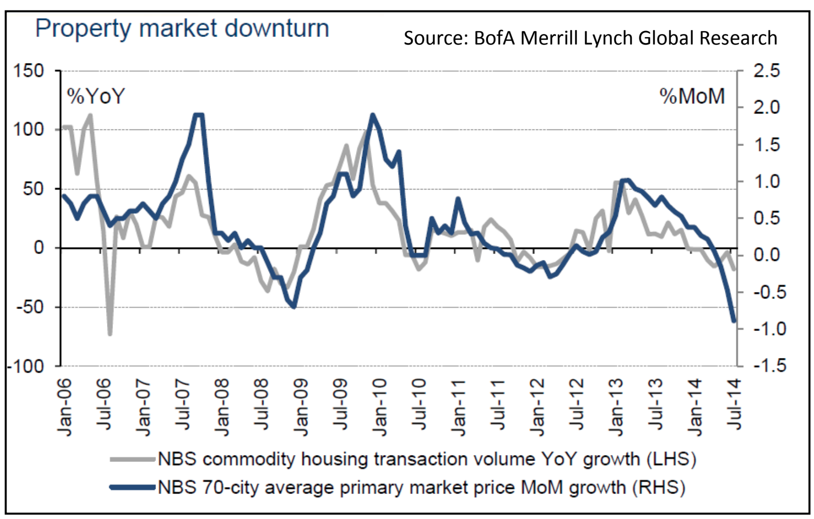
While corporate governance in Korea is slowly improving, we also witnessed a few examples that suggest that there is still a long way to go. Chaebol conglomerates with multiple cross-holdings of affiliated operating companies must be watched closely. We saw cash-rich operating companies making expensive non-core acquisitions on behalf of their holding companies, less attractive assets being shifted from one operating company to another, and inefficient balance sheets due to equity investments at the operating company level. Before making investments in Korea, we are careful to analyze the corporate structures, aligning ourselves with the controlling family's direct ownership interests. Being aligned with those who have skin in the game is paramount, and should help to mitigate the risk of being caught on the wrong side of the value equation.

[4] Please see Investment Strategy Outlook letter from March 31, 2013 for an in-depth discussion.

**Hong Kong: Further Insights Into China**

As most people are aware, the rule of law is much stronger in Hong Kong than it is in China and contracts are viewed similarly to those in the United States. Additionally, the taxes are low and there is a free flow of money, with companies able to transfer billions of dollars in and out of Hong Kong with ease. Hong Kong also has an excellent proximity to China, with Beijing two hours away and Shanghai, just three. International businesses have relocated to Hong Kong because they are close to the action in China and Southeast Asia, but have the aforementioned advantages of being based in Hong Kong. Though Hong Kong's future political situation is becoming increasingly uncertain as tensions have recently risen with China, historically, it has served these companies quite well. The ongoing political developments will be closely monitored going forward.

Key to success is a company's ability to build a deep knowledge base in the region, and longstanding contacts and relationships in the countries in which they operate, as is the case with our investment in Jardine Strategic Holdings. A case in point: it has become abundantly clear that China is interested in building local champions, and has, in many cases, made it extremely difficult for multinational players to succeed (just ask retailers Wal-Mart, Tesco, and Kingfisher). One of Korea's leading hypermarket retailers told us of their failed efforts to enter China. They blamed the Chinese government for refusing to grant them access to prime real estate while local players were given these rights, as well as other subsidies. In discussing Jardine's recent investment in Zhongsheng Group, an automobile dealership group in China, management described a multi-year due diligence process where they were able to meet with all of the top thirty local Chinese dealers at least once or twice, in order to narrow down the list to a few companies with which they felt comfortable working. Before reaching a final decision, they spoke with top executives at both Toyota and Daimler who communicated that Zhongsheng was the best dealership group in China, especially when it came to integrity and quality. Jardine chose a careful entry point, investing when the stock came under pressure in both equity and convertible debt, to help protect their downside. By partnering with Jardine Strategic, we have the ability to participate in growth in Greater China and Southeast Asia, thanks to the family-owned investment holding company's 175+ years of experience and impressive long-term track record of creating shareholder value.




Finally, during our travels we were also surprised to hear a local economist and a number of companies in Hong Kong downplay the risks associated with a potential real estate bubble and credit crisis in China. There was a positive spin for every negative data point we presented. It is clear a lot of people are still "drinking the Kool-Aid." From our perspective, the facts are overwhelmingly negative, and as a result we are going to err on the side of caution. We would rather be wrong and miss out on some of the upside, than try to play a speculative game. While the long-term secular outlook in China may be positive, the near-term risk is substantial, as we have articulated in a number of prior letters. With the real estate market starting to turn down, it might not be long before we find out who is right.

**Europe: More of the Same**

Unfortunately, not much has changed in Europe, as economic growth continues to languish. The Organisation for Economic Cooperation and Development (OECD) is now forecasting 0.8% growth in the eurozone in 2014 and 1.1% in 2015, a considerable downgrade from earlier expectations in May of 1.2% and 1.7%, respectively.[5] Capital investment remains low and unemployment high, a debilitating recipe which is likely to continue to impede economic growth. European Central Bank (ECB) President Mario Draghi is trying to pull out (almost) all the stops, unexpectedly cutting all three major interest rates by an additional 10 basis points to new record lows (the deposit rate is now -0.2%), and signaling that approximately €700 billion of fresh stimulus will be on the way through an asset-buying program of covered bank bonds and asset-backed securities. While coming up short of the full-blown quantitative easing programs championed by the U.S., U.K. and Japan, the ECB is targeting to expand its balance sheet from €2 trillion today to €2.7 trillion, the same level it achieved at the beginning of 2012.[6,7] As outlined in prior letters, we have argued that printing money is not a viable economic solution, and our view has not changed.

While this remains a particularly challenging environment to navigate -- with high stock valuations, weak business and economic fundamentals, and macro concerns across the globe -- listed below are two recent additions to the portfolio that meet our eye with regard to quality and long-term value:

**Jardine Strategic Holdings Ltd. (JS-SP)**
(Analyst: Jonathan Bloom)

**Description**
Jardine Strategic Holdings is a family-controlled investment holding company with a focus on Greater China and Southeast Asia. Key assets include controlling positions in Dairy Farm International (DFI-SP), Hongkong Land Holdings (HKL-SP), Astra International (ASII-IJ), and a cross-holding in Jardine Matheson (JM-SP). Key industry exposures include retail store operation (supermarket, convenience store, drug store, home furnishings), restaurant management, real estate investment and development, motor vehicle sales, manufacturing and financing activities, mining, agribusiness, luxury hotel management, engineering, and construction, among others. In 2013, underlying profits by geography were as follows: Southeast Asia (55%), Greater China (40%), U.K. (2%), and Rest of the World (3%).

**Good Business**
- Dairy Farm International, Astra International and Hongkong Land Holdings all generate a return in excess of their cost of capital, creating economic value.
- Jardine's history dates back to the 1830s, as it has established a proven long-term track record in its allocation of capital. Part of the company's competitive advantage lies in its very deep knowledge base of the region, and long-standing contacts and relationships in the countries in which it operates.
- Jardine Strategic's holdings include several businesses and assets with local incumbent advantages and market share positions that would be very difficult and costly to replicate.
- The company generates various sources of recurring revenue including rent from prominent Hong Kong commercial buildings (Hongkong Land Holdings), automobile service and components (Astra

[5] Thomas, Leigh. "OECD slashes growth forecasts, urges aggressive ECB action." *Reuters*, September 15, 2014.
[6] Riecher, Stefan. "ECB unexpectedly cuts interest rates as outlook darkens." *Bloomberg*, September 4, 2014.
[7] Black, Jeff and Bosley, Catherine. "ECB readying asset-backed purchases after rate cut, Draghi says." *Bloomberg*, September 4, 2014.

International), and the purchase of consumer staples at various retail formats (Dairy Farm International).
- Commercial real estate leasing, automobile dealerships, supermarket and drug store operation, and hotel operation are all easy to understand.
- The company has a solid balance sheet; net debt (excluding net debt of financial services companies) to equity is 5.4%. Interest coverage exclusive of financial services companies is strong at approximately 34 times.

**Valuation**
- The company trades at fiscal year 1 and 2 price-to-earnings (P/E) ratios of 12.6 and 11.5 times, respectively. This is roughly in line with 5-year averages of 12.5 and 11.4 times, respectively.
- Jardine Strategic is trading at an approximately 39% discount to its sum of the parts (SOTP) valuation, which is based on the public market values of its listed investment holdings. This compares with a 10-year average discount of approximately 35%.
- Applying the Jardine Strategic conglomerate discount allows us to purchase its underlying holdings in Astra International, Hongkong Land Holdings, and Dairy Farm International at implied fiscal year 1 P/E ratios of 8.2, 11.0 and 15.8 times, respectively.
- The company's current dividend yield is 0.7%. This compares with a 5- and 10-year average of 0.8% and 1.1%, respectively.

**Management**
- The Keswick family has successfully navigated Southeast Asia and Greater China for over 175 years.
- Management has a proven track record of creating value for themselves and shareholders (significant 10- and 20-year outperformance vs. the MSCI EAFE Index), a long-term investment horizon, and conservative financial management.
- Management possesses a contrarian mentality; Jardine invested in Astra International in 2000 when others were heading for the exits after the 1997 Asian financial crisis. They had followed the company for 15+ years and seized the opportunity.

**Investment Thesis**

Owning Jardine Strategic will allow FMI to participate in geographic areas (Indonesia, Malaysia, Greater China) where we might otherwise struggle to navigate, while creating diversification across several industries. It is an opportunity to invest alongside a family-run organization that has navigated the region for over 175 years, while creating significant shareholder value through a conservative, long-term approach to capital allocation. At an approximately 39% discount to net asset value, Jardine Strategic offers us a sizeable margin of safety and an attractive investment opportunity.

## Smiths Group PLC (SMIN-LN)

(Analyst: Karl Poehls)

**Description**

Smiths Group is an industrial conglomerate based in the U.K. and has five separate operating businesses, including John Crane (39% of 2013 EBITA), Smiths Medical (32%), Smiths Detection (10%), Smiths Interconnect (12%), and Flex-Tek (7%). In total, the company provides products and services to a diverse range of end markets: transportation and security; oil, gas, and petrochemicals; hospitals and pharmaceuticals; telecommunications; construction; as well as manufacturers in a variety of sectors globally.

**Good Business**

- A number of products within Smiths Group's portfolio hold market leading positions. For example, John Crane is the global leader in mechanical seals with 30% market share, and the Medical unit's Medfusion brand occupies the leading position in neonatal drug delivery.
- The company estimates that 48% of its revenues can be considered recurring in nature. Approximately two-thirds of John Crane's sales are generated from the aftermarket and nearly 85% of Smiths Medical's sales are single-use consumables.
- Smiths Group has a strong balance sheet with net debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) and interest coverage ratios of 1.3 and 9.3, respectively.
- Over the past five years, the company's return on invested capital (ROIC) has averaged 13%, which exceeds its cost of capital. We estimate Smiths Group's ROIC could approach 16-18% over the next few years.

**Valuation**

- Smiths Group's common stock price has underperformed the MSCI EAFE Index over the trailing 1-year and 2-year periods by approximately 5%.
- Over the past four to five years, sell-side analysts have become increasingly frustrated with the company's organic growth rate, and roughly half of them assign the shares a Sell or Underweight rating. This suggests there is quite a bit of pessimism built into the current valuation.
- The company's trailing P/E multiple is 14.5 times. Over the past ten years, Smiths Group's stock has traded for an average P/E of 16.3 times.
- Based on comparable peer takeout and trading multiples, our sum-of-the-parts analysis suggests a fair market value of £17-£18 per share, which is approximately 20-25% above the current market price. We believe this is a valid approach to valuing the company given the odds of future portfolio divestitures.

**Management**

- In 2007, Philip Bowman became CEO of Smiths Group. Since this time, he has made a number of positive strategic decisions (e.g., several enterprise resource planning [ERP]) implementations, executive leadership changes, and increased research and development investments) to improve the underlying franchise value of the company's core operating units.
- Under Mr. Bowman's leadership, Smiths Group's earnings before interest taxes and amortization (EBITA) margin improved from 15.3% in 2008 to 18.0% in 2013.
- Prior to joining Smiths Group, Mr. Bowman was involved in the sale of Allied Domecq in 2005 as well as the sale of Scottish Power in 2007; he has a strong track record of maximizing value for shareholders.

**Investment Thesis**

Smiths Group owns a collection of valuable franchises, and Phil Bowman has taken a number of difficult actions to improve their cost positions as well as their executive talent over the past six years. Due to lackluster organic sales growth in the Medical and Detection businesses, the stock has lagged the equity markets over the past two years. This has provided us with an opportunity to invest in a relatively defensive global industrial company with a solid balance sheet, at an attractive valuation.

Thank you for your confidence in Fiduciary Management, Inc.

**Fiduciary Management Inc.**
**International Equity Composite**
**12/31/2010 - 06/30/2014**

| 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% |
| Q1 2014 | 2.08 | 1.89 | -0.28 | 1 | 0.00 | 10.01 | 12.36 | $ 206.0 | $ 19,764.3 | 1.04% |
| Q2 2014 | 3.93 | 3.74 | 3.41 | 1 | 0.00 | 9.75 | 12.41 | $ 330.3 | $ 20,679.0 | 1.60% |

*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 - 06/30/2014. 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 - 06/30/2014. 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 $20.6 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 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®. For the periods 2011-2012, the 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.