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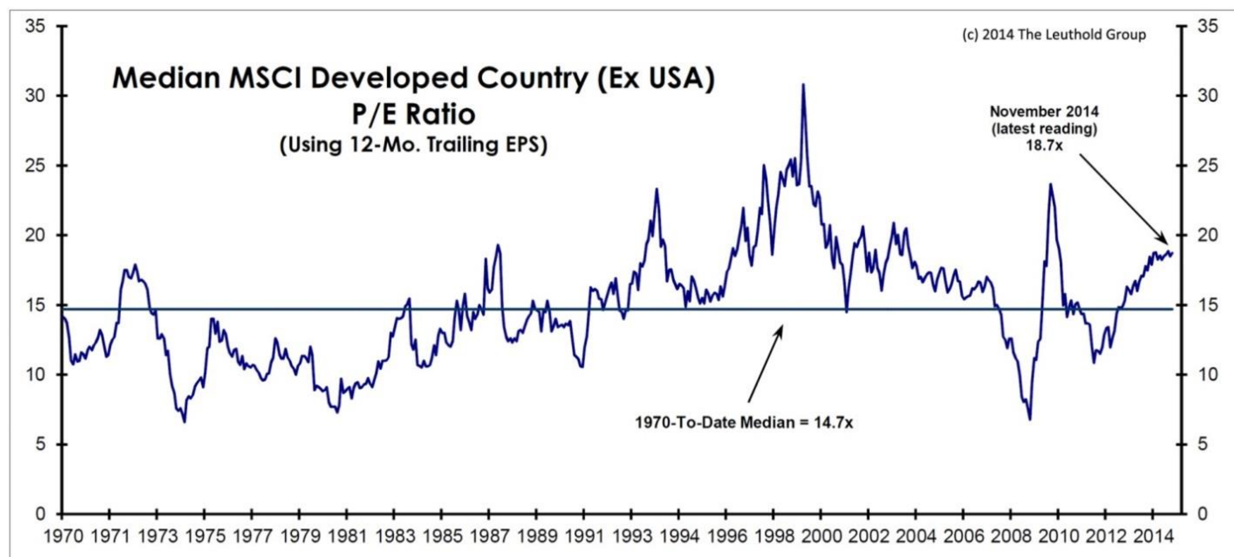
INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

December 31, 2014

Volatility returned in the December quarter, as FMI International portfolios advanced by approximately 0.7% in the period, compared with an MSCI EAFE Index increase of 1.77% in local currency and decline of 3.57% in U.S. Dollars (USD). Performance was driven by the Technology Services, Finance, and Commercial Services sectors, while Retail Trade, Consumer Durables and Producer Manufacturing weighed on results. The strongest individual gains were generated by Fairfax Financial, TE Connectivity and Accenture, as Smiths Group, Schlumberger and Rolls-Royce came up short of expectations. For the full calendar year, the International portfolios advanced by about 5.7%, while the EAFE rose by 5.92% in local currency and fell by 4.90% in USD. In 2014, the USD strengthened by 12.78% against a basket of international currencies, accounting for the spread between the EAFE's local and USD return. As a reminder, FMI has historically hedged currency risk in an effort to have the portfolio performance be representative of stock selection, and not unpredictable movements in foreign exchange markets.

The global macro picture remains complicated, as improving growth in the U.S. is offset by a slowdown in Europe, Japan and emerging markets, including China, Russia, Brazil, and Indonesia. Global debt levels have soared to new heights and now exceed $100 trillion, up 40% over the six years from mid-2007.[1] Money printing is in vogue, government spending is on the rise, and companies are levering up their balance sheets at record-low interest rates. Economies and stock markets alike have become increasingly reliant on central banks to prop them up, and central bankers have willingly obliged. As we have previously said, this is a dangerous game with unintended consequences that will extend many years into the future. Unfortunately, in our opinion stock valuations do not reflect these risks, as they are well above historical levels and continue to rise (see chart below), despite subpar business fundamentals. The macro and valuation environment calls for caution, and our elevated cash levels reflect a less attractive opportunity set. When better investment prospects start to resurface, we will be ready to pounce.



[1] John Glover. "Debt Exceeds $100 Trillion as Governments Binge." *Bloomberg,* March 10, 2014.

Japan: Reckless Abandon

In the wake of last summer's sales tax hike, Japan's growth has come to a screeching halt, with Gross Domestic Product (GDP) falling by 6.7% and 1.9%,[2] respectively, in the second and third quarters. A decline in capital investment and weak private consumption remain key headwinds. Instead of looking in the mirror and questioning the efficacy of unparalleled money printing, Japan's fourth recession in the last six years has further emboldened Prime Minister Shinzo Abe. Abe has called for (and successfully won) a snap election, delayed a second increase in the nation's sales tax, and announced even more radical stimulus measures. "Abenomics" now calls for ¥80 trillion per year (approximately $704 billion) of quantitative easing (QE), an increase of up to 33% from already elevated levels of ¥60 to ¥70 trillion. To put this in perspective, Japan is now inching closer in size to the Fed's record level of QE in 2013 (about $1 trillion), despite being less than one-third the size of the U.S. economy.[3]

The Bank of Japan (BOJ) appears determined to print money for as long as it takes to reach its growth and inflation targets, and now aims to purchase ¥8 to ¥12 trillion of Japanese Government Bonds (JGBs) per month, which would account for virtually ALL of the ¥10 trillion that the Ministry of Finance sells into the market each month.[3] These are not typos. Astonishingly, Koichi Hamada, who is a special advisor to Prime Minister Abe and one of the main architects of "Abenomics," recently admitted that this was a "mild Ponzi game," but that it was "feasible" because of Japan's huge foreign reserves. He was quoted as saying, "In a Ponzi game you exhaust the lenders eventually, and of course Japanese taxpayers may revolt. But otherwise there are always new taxpayers, so this is a feasible Ponzi game, though I'm not saying it's good."[4] No, this is definitely NOT GOOD, and sure has the look and feel of a Ponzi scheme to us. With Japan's shrinking and aging population, assuming there will always be "new taxpayers" willing to play the "game" could be a huge mistake. Eventually taxpayers will realize that money is coming directly out of their own pockets.

In the meantime, Japan's debt level exceeds 240% of GDP,[5] which remains the highest in the developed world. If not for artificially low interest rates (i.e. 10-year JGBs trade at a 0.33% yield), Japan would be in a heap of trouble. According to a 2013 paper by economists Gary Hansen and Selahattin Imrohoroglu, in order to put Japan's debt on a sustainable path, the government would need to increase tax revenue to between 40% and 60% of GDP,[6] which would be unprecedented. While it may take a number of years for the consequences to unfold, runaway inflation, debt restructuring or a sovereign default are all very real risks, and perhaps the most likely outcomes.

With Japanese stocks up 70%+ over the past two years (as the yen has debased by over 38%), valuations are no longer cheap, and we are struggling to find attractive investment opportunities in Japan, with only a few exceptions. With Abe throwing all caution to the wind, we will continue to remain prudent. As we have expressed in prior letters, printing money will not solve Japan's core underlying problems, or anyone else's (i.e. Europe) for that matter. Our underweighting in Japan has hurt our relative performance substantially in the short run, but our stance sets up well for the inevitable consequences of this reckless policy.

Europe: What Stress?

Growth expectations in Europe continue to grind down, with the European Central Bank (ECB) now forecasting eurozone GDP growth of 0.8% in 2014, 1.0% in 2015 and 1.5% in 2016. This is a significant reduction from three

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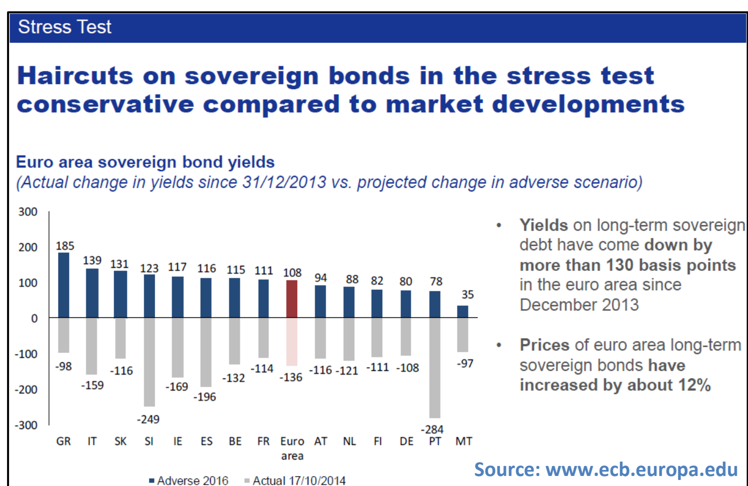
[2] Real GDP, Annualized, Quarter on Quarter.
[3] Mariko Ishikawa and Shigeki Nozawa. "Kuroda Bazooka Drives Down Yields as GPIF to Sell." *Bloomberg*, November 4, 2014.
[4] Szu Ping Chan. "'Godfather' of Abenomics: Japan's sales tax hike must be delayed." *The Telegraph*, November 15, 2014.
[5] "Japan's Economy: About That Debt." *The Economist*, November 11, 2014.
[6] Noah Smith. "Japan's Debt Trap." *Bloomberg*, September 24, 2014.

months earlier when they were projecting 0.9%, 1.6% and 1.9%, respectively.[7] After cutting interest rates to the bone and planning over €700 billion of new stimulus, ECB President Mario Draghi is running out of magic tricks. If the latest stimulus efforts fall short, Draghi and Vice President Vitor Constancio have hinted that full-blown QE could be on the horizon in early 2015. Draghi stated, "Unconventional measures might entail the purchase of a variety of assets, one of which is sovereign bonds," while Constancio commented, "We expect that the [previously] adopted measures will lead, within the time of the program, the balance sheet to go back to the size it had in early 2012. If not, we will have to consider buying other assets, including sovereign bonds," and, "To explore new channels of transmission of monetary policy that have worked in other countries like the U.K. and the U.S., we are aiming at increasing the size of the monetary base and our balance sheet by directly injecting money also into non-bank economic agents."[8]

Meanwhile, European sovereign debt yields have fallen near historic lows, reflecting very little perceived risk by investors. We find it amazing how short investors' memories have now become, as we are less than three years removed from the heart of the European debt crisis, and little has changed fundamentally. Take the recent European bank stress tests, for example, where the ECB and European Banking Authority's "comprehensive assessment" led to headlines such as "ECB Says Most Banks Are Healthy," and "ECB Stress Tests Seen as Bolstering Confidence in Banks." *The Wall Street Journal* reported that, "Investors and analysts mostly applauded the tests, saying they appeared to be much more rigorous than previous years' versions," and, "Previous versions of stress tests, in 2010 and 2011, were widely criticized due to computational problems and because banks that received passing marks required taxpayer bailouts soon after."[9] Is this time really different? We have our doubts, and remain skeptical that the true underlying health of the banking system is as strong as the ECB would like to have everyone believe. Take the sovereign bond stress test, for example, which is summarized in the accompanying illustration directly from the ECB's analyst presentation.



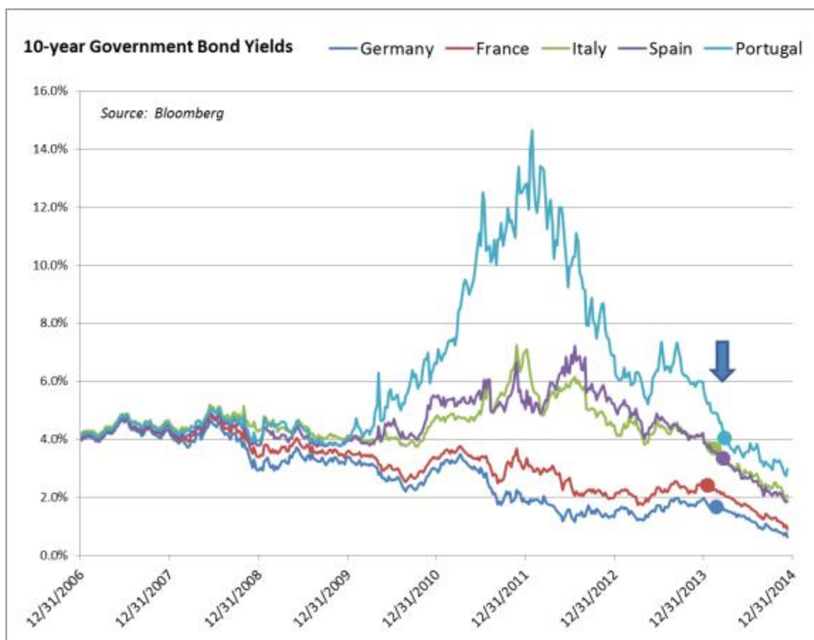
The bars along the bottom illustrate the change in bond yields from December 31, 2013 to October 17, 2014, a period where yields became exceptionally low, to levels not seen in France and Spain in over 200 years. The bars along the top show the ECB's "adverse 2016" or "stress" test scenario, which merely projects bond yields returning back to the levels seen in late 2013 or early 2014, which were already relatively benign. The circles on the charts below illustrate the "adverse" bond yields used by the ECB in the context of actual historical rates. We would argue that this hardly reflects an "adverse" or "stress" scenario, and calls into question the credibility of the ECB's findings. As illustrated by the charts below, you don't have to go very far back (i.e. 2011 and 2012) to see what a true "adverse" scenario looks like, and it's a whole lot worse than is being advertised. Ironically, in the last month Greek yields have already returned to the ECB's "stress" threshold on fears that a new snap presidential election may throw a wrench in the country's bailout program.

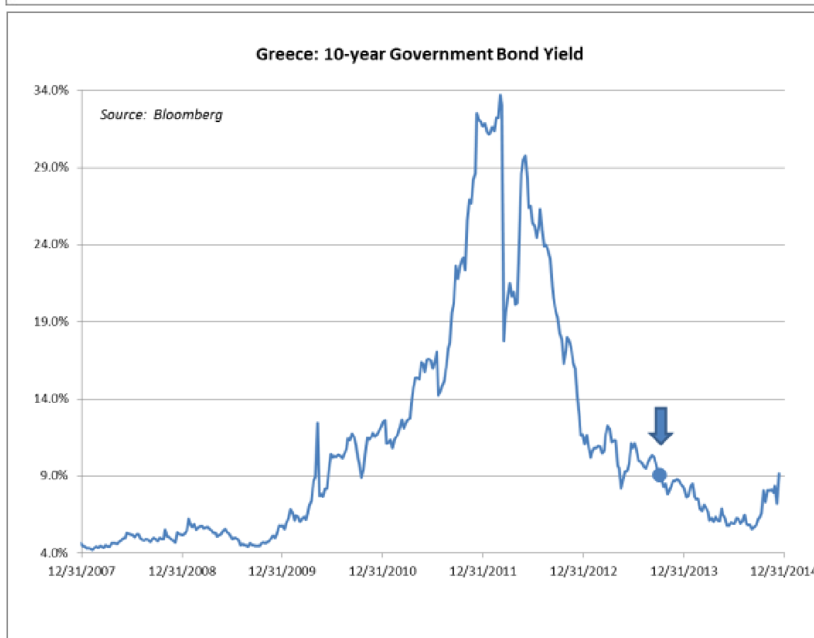
[7] Claire Jones and Ferdinando Giugliano. "ECB slashes eurozone growth and inflation forecasts." *Financial Times*, December 4, 2014.
[8] Jeff Black and Jennifer Ryan. "ECB May Consider Sovereign QE Next Quarter, Constancio Says." *Bloomberg*, November 26, 2014.
[9] Gabriele Steinhauser, David Enrich and Max Colchester. "ECB Says Most Banks Are Healthy." *The Wall Street Journal*, October 27, 2014.

Historically, FMI has avoided investing directly in European banks, and we do not expect this to change in the near-term. With the outlook in Europe dimming and bank balance sheets remaining suspect, we have even greater conviction that this is the right decision for our investors.

Wild cards: Oil & Russia

Since June, oil prices have plunged by over 50%, with Brent Crude falling below $60 per barrel for the first time since 2009. An unexpected surge in production combined with weaker global demand has weighed heavily on the commodity. Typically, falling oil prices are viewed as a positive for the global economy (at the expense of oil producing countries), but many have voiced concerns that this time may be different, with fears of deflation, the strength of the USD, and general economic malaise pulling in the opposite direction. In Europe, while the EU imports 88% of its oil, the *Financial Times* writes that "its celebrations over plunging prices have been muted," as "13 European countries will see their inflation rates fall below zero, at least temporarily, in 2015" at $60 oil prices.[10] While we are far less concerned about the risks of deflation than the ECB, it would likely lead to additional runs on the [money] printing presses, which we do view as problematic.





On the flip side, Russia will be especially hard hit from the fall in oil prices, as more than half of their budget revenue and as much as 25% of GDP is estimated to come from the energy industry. The Economic Ministry's latest projection for -0.8% growth in GDP in 2015 could fall to -4.7% if oil prices remain at $60, according to the Russian Central Bank. As the impact of falling oil prices has combined with sanctions from the U.S. and Europe, Russia's currency has utterly collapsed. The ruble has fallen by more than 40% vs. the USD since the start of 2014, including a 20% drop in a single day. Russia has spent over $80 billion of its foreign reserves to prop up the ruble, and announced an emergency interest rate hike of 6.5% to 17%.[11] A repeat of the 1998 financial crisis

[10] Chris Giles. "No guarantee of a magic stimulus in new low price era." *Financial Times*, December 16, 2014.
[11] Olga Tanas and Anna Andrianova. "Russia Defends Ruble With Biggest Rate Rise Since 1998." *Bloomberg*, December 16, 2014.

when Russia defaulted on its domestic debt is not out of the question, let alone concerns about Russia's $600 billion of foreign debt.[12] The economic impact is unlikely to be contained in Russia, and Europe is among those at risk. The European Commission had estimated that the EU sanctions on Russia would knock 0.2% to 0.3% off the EU's economic growth in 2014 and 2015,[13] and that was before oil and the ruble completely fell off a cliff. This doesn't factor in the unpredictability of Russian President Vladimir Putin, who could look to replicate Crimea in an act of desperation. Needless to say we will be monitoring the situation closely in the coming quarters.

China: Time Is Of The Essence

The economic slowdown in China continues to deepen, with factory output, housing prices, property sales and construction, exports, and non-performing loans among the key areas of concern. As China's economic model eventually transitions away from growth by fixed investment, it becomes obvious that 7%+ GDP will no longer be sustainable. While long-term growth might look more like 4%, it may have to drop to 0% (or even turn negative) before China gets to a more sustainable run rate. As outlined in a number of our prior letters, we continue to believe the near-term risks of a housing bubble and/or credit crisis are substantial. That being said, the long-term secular outlook for China is more promising. In a recent report by *Bernstein Research*,[14] they highlight that "Over the last five years China has built something like 33 new airports, 11,000 kilometers of new high speed rail lines, 175,000 kilometers of new high voltage and ultra-high voltage transmission lines, 44,000 kilometers of new highways, 6,345 new port berths, 455 gigawatts of new power generation capacity, 210,000 kilometers of gas transmission pipelines, 1,635 kilometers of new subway systems and almost 5 billion square meters of real estate." These figures are staggering, especially considering the timeframe. With Moody's Analytics estimating that property sales, housing renovations and construction activity has accounted for approximately 23% of China's GDP,[15] one can easily see how growth can slow in a hurry, once the heavy lifting has been done. On the other hand, China has developed a tremendous amount of infrastructure which may be generating a low return today, but over the long run will be of great value. There may eventually be pain in the near-term as the workforce will need to get retrained, speculators will get burned, borrowers will default, and lofty growth expectations will have to come back down to earth, but eventually there will be a light at the end of the tunnel.

As the global central banking experiment unfolds, we will continue to strive to identify high-quality businesses trading at attractive valuations. Our goal is to generate above-average returns while taking below-average risk, with a particular focus on downside protection and the preservation of capital. Our clients can take comfort in knowing that the FMI team will always "eat our own cooking," investing alongside them in each of our investment products.

Thank you for your confidence in Fiduciary Management, Inc.

[12] Anders Aslund. "The only cure for what plagues Russia." *Financial Times,* December 17, 2014.
[13] Laurence Norman. "EU Projects Impact of Sanctions on Russian Economy." *The Wall Street Journal*, October 29, 2014.
[14] Michael Parker and Flora Chang. "Asia-Pacific Strategy: Initiation – Turn Down For What…" *Bernstein Research*, November 11, 2014.
[15] Esther Fung. "China Housing Slows, Ripples Follow." *The Wall Street Journal*, June 19, 2014.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 09/30/2014

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation		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%
Q2 2014	3.93	3.74	3.41	1	0.00	9.75	12.41	$ 330.3	$ 20,679.0	1.60%
Q3 2014	-1.13	-1.31	0.93	1	0.00	8.42	10.62	$ 472.5	$ 19,890.9	2.38%

*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 - 09/30/2014. 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 12/31/2010-09/30/2014. 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 $19.8 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.