100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545
www.fiduciarymgt.com

INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

March 31, 2015

Global equity markets roared out of the gates in the first quarter of 2015, led by big gains in Germany (+22.03%), France (+18.04%), the UK (+4.77%) and Japan (+10.41%).[1] Unprecedented money printing efforts by global central banks pushed asset prices to new heights, with stock and bond valuations becoming more bloated by the day. The growing disconnect between asset valuations and fundamentals continues to widen at an alarming pace, as economic reality is being masked by free money and market manipulation. These circumstances are less than ideal for contrarian value investors such as ourselves who focus on bottom-up security analysis and downside protection -- that is, at least until some fear returns. In this context, FMI International portfolios rose by approximately 8.2% in the quarter, when compared with an MSCI EAFE Index gain of 10.85% in local currency and 4.88% in U.S. Dollars (USD). The Consumer Non-Durables, Consumer Durables, and Commercial Services sectors aided relative performance, while Process Industries, Producer Manufacturing and Industrial Services all detracted. Top performing stocks included Amorepacific Corp., Pirelli, and LG Household & Health Care, while Sociedad Quimica y Minera de Chile, Potash Corp and Schlumberger lagged the market. A higher-than-normal cash position weighed on relative performance, while currency hedging provided a boost.

In looking back over the last six years, we are simply amazed at the growing level of complacency among market participants. If someone had told us in March of 2009 that over the next six years the U.S. would have the worst economic "recovery" on record, Europe would go nowhere and fail to address the root causes of a sovereign debt crisis, Japan would have four separate recessions, China's growth would slow dramatically and a potential real estate and/or credit bubble would form, Russia would seize Crimea from Ukraine and its economy would slow dramatically, Brazil's growth would contract (in 2015), unrest in the Middle East would be on the rise, and printing money (which has never worked) would be the only game in town, we would have been shocked to learn that stock markets would go on a historic bull run. U.S. and German stock markets have nearly tripled (greater than 19% compound annual growth rate, or CAGR), while the UK, France and Japan are all up more than 2.25 times (greater than 14% CAGR).[1] For those who might think we are cherry-picking the bottom in 2009, the three-year stock market performance is equally stunning while facing a similar macro backdrop, with Japan's stock market +91.61% (approximately 24% CAGR), Germany +72.25% (about 20%), France +63.99% (around 18%), the U.S. +56.46% (approximately 16%), and the UK +36.72% (about 11%).[1] It's a remarkable run when you consider how weak both the economic and business fundamentals have been. While many of our contemporaries are "drinking the Kool-Aid," we remain highly skeptical and will continue to proceed with heightened caution.

Europe: Greater Fool

Europe has officially joined the quantitative easing (QE) party, with the European Central Bank (ECB) announcing a €1 trillion bond-buying program (€60 million per month) through September of 2016.[2] Thanks to the proliferation of the ECB [money] printing presses, the euro fell to a 12-year low versus the U.S. dollar, while some government (i.e. Germany, Holland, France, etc.) and corporate (i.e. Nestlé) bond yields turned negative, a feat that we never thought we'd see in our investing career. A negative bond yield guarantees investors a loss on their money if they hold the bond to maturity. The *Financial Times* reports that "More than a quarter of the entire market of European government bonds now has yields below zero – a total of $2 trillion, according to J.P. Morgan." Include Japan, and the global total eclipsed $3.6 trillion

[1] The following market indices are being referred to above: Japan TOPIX, UK FTSE All-Share, France CAC, Germany DAX, and U.S. Standard & Poor's 500.
[2] Brian Blackstone. "Europe's Central Bank Bets Big On Stimulus." *The Wall Street Journal*, March 10, 2015.

during the quarter.[3, 4] While we have heard all the "justifications" for buying government bonds with negative yields -- including deflation (positive real yields), currency speculation, and central bank easing (i.e. interest rate cuts or QE) -- ultimately, investors are banking on a "greater fool theory," or the "notion that any price, no matter how unrealistic, can be justified if a buyer believes that there is another buyer [fool] who will pay an even-higher price for the same item."[5] This inevitably leads to significant asset booms and busts. Investors are now depending on central banks, indexed/passive funds, commercial banks (negative deposit rates) or some other "greater fool" to bail them out. The last one standing will surely get burned, and our guess is that the taxpayer will be the one on the hook, one way or another.

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Meanwhile, ECB president Mario Draghi is already declaring victory, announcing an improvement in the economic outlook and inflation picture, and calling an end to the eurozone crisis. "Our monetary policy decisions have worked," Draghi proclaimed. "It's with some certain degree of satisfaction that the governing council has acknowledged this." He also noted that "Until a month ago, nobody had any doubts that public debt - sovereign debt - in the euro area was actually very, very big. Now some people worry we won't have enough bonds [for the QE bond-buying program]."[6] Draghi appears to have a pretty warped sense of reality. If the current economic environment in the eurozone of anemic growth, high unemployment, fat budget deficits, and ballooning debt levels is the result of policies that have "worked," we would be worried to see what failure looks like. Perhaps Draghi is really just trying to find a way to justify his shiny new €1.25 billion ECB headquarters in Frankfurt, Germany, which was more than €400 million over budget and reeks of waste. As the ECB has taken on new areas of "competence" and now has its hands in just about everything, the staff has expanded to nearly 2,600. The ECB spent over €430,000 per workspace (2,900), a cost equivalent to buying each employee a brand new home. Nearly 7,000 protestors showed up at the inaugural opening, with one cynical banner reading, "Free caviar for everyone."[7, 8] Touché. If the ECB can't stay within budget, how are they going to get eurozone countries to do so?

The short answer is they are not. The currency union's "rules" for budget deficits are laughable, as they are constantly disregarded by member countries with minimal repercussions. France, for example, which is the eurozone's second largest economy, has broken the rules in 11 out of the last 16 years and is expected to continue to do so for the next three years. In addition, exceptionally low financing conditions may exacerbate the problem, lessening the motivation for countries like France to enact necessary reforms to make their economies more competitive.[9] *The Wall Street Journal* writes that, "Since 1978, French [quarter over quarter] economic growth has clocked in at an average rate of 0.45%" and, "unemployment hasn't fallen below 7% in over 30 years."[10] Clearly the challenges France faces are deep and structural in nature. No matter how big the money printing campaign, or negative the interest rates, there is no quick fix to make these underlying problems just go away.

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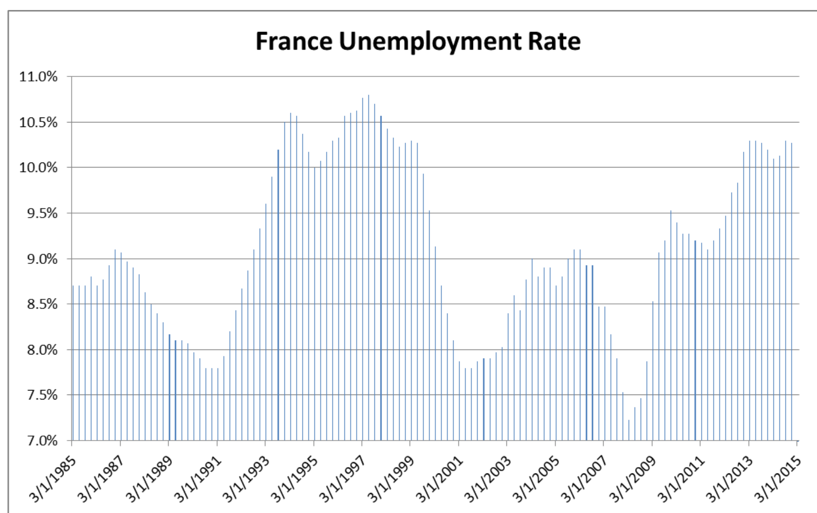
[3] Elaine Moore. "QE hopes draw investors to negative yields." *Financial Times*, February 26, 2015.
[4] Nikolaos Panigirtzoglou, et al. "F&L Library: Negative Yields." *J.P. Morgan Markets*, February 3, 2015.
[5] http://www.businessdictionary.com/definition/greater-fool-theory.html
[6] Jack Ewing. "Mario Draghi of E.C.B. Predicts an Improved Economy When Stimulus Program Begins Monday." *The New York Times*, March 5, 2015.
[7] John O'Donnell and Frank Siebelt. "Protesters, police clash near new European bank HQ in Frankfurt." *Reuters*, March 18, 2015.
[8] A.B. Sanderson. "ECB Overspends By €400 Million On Luxury Offices As It Preaches Austerity." *Breitbart*, February 25, 2015.
[9] Stefan Wagstyl and Duncan Robinson. "Eurozone hawks voice fears over dangers of QE." *Financial Times*, March 13, 2015.
[10] Bret Stephens. "Packing Time for France's Jews." *The Wall Street Journal*, January 19, 2015.

Lastly, lost in Draghi's victory dance is that nagging little Greece "issue." In late January, radical left-wing Syriza party leader Alexis Tsipras was elected as Greece's Prime Minister, on an anti-austerity platform calling for a restructuring of the country's debt. After much wrangling with what was formerly known as the Troika (ECB, European Commission, International Monetary Fund), in February Eurozone finance ministers agreed to kick the can down the road and extend Greece's €240 billion bailout until the end of June, with contentious negotiations ongoing as Greece is forced to come up with a credible reform agenda. In the meantime, the Greek economy is slowing, tax revenues are falling short of expectations, and cash is being pulled out of the banking system. While many investors seem to have already erased the European debt crisis from recent memory, we caution our readers that history has a habit of repeating itself. Near-term pain in Greece appears inevitable and once again may be difficult to contain (i.e. contagion), with an outright default, debt restructuring, or exit of the eurozone ("Grexit") appearing to be an increasingly likely outcome.



Source: Bloomberg

Japan: The Abe Put?

In a world of experimental money printing, ultra-low interest rates, and inflated asset prices, Japan may be the worst of all offenders. The "Abenomics" QE program, which is nearly three times the size (as a percentage of gross domestic product, or GDP) of the United States' unprecedented bond-buying program of 2013, is meant to drive economic growth and boost inflation. In the process, the yen has fallen off a cliff while bond prices have reached extreme levels (including negative yields). Passing under the radar, however, has been the Bank of Japan's (BOJ) increased efforts to also directly pump up domestic equity prices, mainly in the form of buying exchange-traded funds (ETFs). The Wall Street Journal reports that the BOJ is targeting an annual goal of ¥3 trillion ($25 billion) in ETF purchases, three times the size of previous levels. The report explains that in the last two years the BOJ has been entering the stock market, on average, every three days, and mostly when sentiment has been weak (76% of the days the market opened down). The BOJ estimates that it will have a book value of ¥6.8 trillion by year-end, or approximately 1.2% of the total market cap of the Tokyo Stock Exchange, which is valued at about ¥550 trillion.[11] Furthermore, the Government Pension Investment Fund, which manages ¥127.3 trillion, is more than doubling their domestic equity exposure from 12% to 25%, which equates to ¥31.8 trillion, or 5.8% of the total market.[12] With the government implicitly backing approximately 7% of all domestic equity assets, it's not hard to see (at least in part) why Japan's stock market performance has been so remarkably robust.

When looking at the fundamentals in Japan, it's hard to get excited. Economic growth is subpar, with the Organization for Economic Co-operation and Development (OECD) forecasting just 0.75% GDP growth in 2015, and 1% in 2016. While a weakening yen may optically imply some improvement, it's more of an illusion than a reality. For example, *The Wall Street Journal* writes that "Japanese households earn 7.5% less in inflation-adjusted terms now than before the 2008 financial panic, and about half of that decline has come during Tokyo's 'quantitative easing' program."[13] Not surprisingly, household spending remains weak, having fallen on a real basis for ten straight months, and eleven out of the last twelve. Additionally, while headline export numbers in yen terms might suggest a strong rebound off the bottom, after adjusting for the exchange rate, volumes remain more than 30% below the peak levels of late 2007 and early 2008. Ultimately exporters are not benefiting as much as expected with the move in the yen, as they are padding their profits in lieu of

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[11] Takashi Nakamichi and Tatsuo Ito. "Tokyo Stocks' Rally Worries Central Bankers." *The Wall Street Journal*, March 12, 2015.
[12] Anna Kitanaka, Shigeki Nozawa, and Yoshiaki Nohara. "Japan's Pension Fund Cutting Local Bonds to Buy Equities." *Bloomberg*, October 31, 2014.
[13] "Japan Devaluation Warning For Europe." *The Wall Street Journal*, March 17, 2015.

lowering prices to take market share. With valuations elevated due to the runup of the stock market, investment opportunities in Japan remain limited.

China: Near-Term Risks Remain

China's growth continues to slow rapidly. At 7.4% in 2014, it was China's slowest GDP growth in 24 years, down from 7.7% in 2012 and 2013, and an average of more than 10% from 1980-2010.[14] Premier Li Keqiang announced a 2015 growth target of "around 7%," but acknowledged that "with downward pressure on China's economy building and deep-seated problems in development surfacing, the difficulties we will encounter in the year ahead may be even more formidable than those of last year."[15] The International Monetary Fund (IMF) downgraded China's GDP growth forecast to 6.8% in 2015 (and 6.3% in 2016), largely a result of the slowdown in property and investment.[14] As expressed in prior letters, we believe the true underlying growth is materially lower than the official government figures, and would not be surprised to see China's near-term growth rate slow significantly from here.

China is in the midst of an extraordinary debt binge, with total debt virtually quadrupling in the last seven years, from approximately $7 trillion in 2007 to about $28 trillion in 2014, or a CAGR of around 22%.[16] However, approximately $21 trillion of newly-minted debt has only generated about $6 trillion in GDP growth. Subsequently, total debt as a percentage of GDP has risen from 167% in 2008 to 247% in 2014, according to Morgan Stanley; each incremental dollar of debt is driving less and less GDP growth.[17] To illustrate the challenge at hand, *The Wall Street Journal* reports that "As much as 50% of China's local government borrowing services existing debt, requiring more borrowing to produce growth." In 2005 it required less than 1.5 units of debt to produce one unit of economic growth, and by 2013 more than 4 units of debt were required for the same result.[18] Unfortunately, China's debt-fueled growth, which is reliant on fixed investment, is not sustainable. Despite China's recent interest rate cuts and additional actions to spur increased bank lending, the underlying flaws in the economic model continue to muddy the near-term outlook. While China's long-term prospects are promising, the near-term risks warrant added prudence.

Listed below are descriptions of two current portfolio holdings. Makita (6586 JT) was a recent addition to the portfolio, and provides the portfolio with exposure to a rebounding global construction market through a high-quality power tools business at a discount valuation. We have owned Rolls-Royce (RR/ LN) in the International portfolio since inception, and while the investment has not gone as we had hoped in recent times, with a clean sheet of paper we believe the long-term thesis remains intact. While we still anticipate a bumpy ride in the near-term as margins and cash compress with the launch of new civil aerospace programs, end-markets (defense, marine and energy), remain pressured and the cost base is reset, the long-term margin and secular growth opportunity is an attractive one. Rolls-Royce is an above-average business with significant barriers to entry, trading at a below-average valuation -- a favorable value proposition.

Makita Corp. (6586 JT)

(Analyst: Matthew Goetzinger)

Description

Makita is the second largest global manufacturer of power tools. The Power Tools group is the company's dominant business at 70% of revenues. Garden Equipment, Household and Other Products accounts for 15% of total revenues, and includes chain saws, petrol brush cutters, hedge trimmers, industrial vacuum cleaners, and handheld vacuum cleaners for home use. Recurring Parts, Repair and Accessories revenues account for the residual 15% of company revenues.

Good Business

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[14] Jamil Anderlini. "China expands at weakest rate in 24 years." *Financial Times*, January 20, 2015.

[15] Jamil Anderlini, Tom Mitchell and Gabriel Wildau. "Premier admits to flaws in Chinese Model." *Financial Times*, March 5, 2015.

[16] Jamil Anderlini and Tom Mitchell. "Beijing pledges readiness to bolster sagging growth as slowdown continues." *Financial Times*, March 15, 2015.

[17] "China Deleveraging – The Long, Bumpy Ride Continues." *Morgan Stanley*, March 10, 2015.

[18] Lingling Wei and Bob Davis. "Debt that once boosted its cities now burdens China." *The Wall Street Journal*, January 28, 2015.

- The global power tool market is highly concentrated, with the top four major companies controlling approximately two-thirds of the market. Positively, the market functions as a rationally competitive oligopoly.
- Makita is the industry's low-cost producer. Tool manufacturing is an assembly business.
- Approximately 55% of company sales are made into the replacement market. Tool price points are modest.
- The company's 5-year average cash adjusted return on invested capital (ROIC) exceeds 12%.
- Makita's balance sheet is pristine, with net cash of ¥169 billion (¥1,244 per share).
- The company controls its own destiny.

Valuation

- Relative to forecasted Fiscal Year 2015 estimated revenues, Makita trades at an enterprise value-to-sales (EV/S) multiple of 1.4 times. This compares to the company's 10-year average EV/S multiple of 1.46 times. Given the company's mid-teens EBIT margins (earnings before interest and taxes), Makita should trade closer to 2 times revenues.
- Over the past five years, Makita has held a fairly pedestrian median forward price-to-earnings ratio (P/E) of 16.1 times. On a cash-adjusted basis, the company's current multiple is 12 times. Peers trade at an average of 18 times earnings.
- In early 2013, Bain acquired Apex Tools for $1.6 billion -- or 8.6 times earnings before interest, taxes, depreciation and amortization, or EBITDA (12.5% EBITDA margin). At 7.3 times EBITDA, Makita trades at a discount to the private market value ascribed to a smaller and less profitable tools company.
- Down-side margin of safety is provided by a cash rich balance sheet, as well as the company's historical ability to preserve profitability in tough environments. Note that Fiscal Year 2010 margins troughed at 12.4%.

Management

- Makita has a long-tenured management team that has seen little turnover.
- The company is led by Chairman Masahiko Goto. Goto has led the company since May 1989, and owns 1.9 million shares, or 1.4% of the shares outstanding.
- In addition to a fair and transparent governance structure, Makita's capital allocation practices are aligned with shareholders. The company targets a 30% payout ratio, opportunistically buys back stock, and targets organic growth.

Investment Thesis

As the industry's low cost producer, Makita maintains a market leadership position within the consolidated global power tools market. A strong track record of innovation, and the resulting brand equity established with the company's core professional user, has resulted in a durable and highly profitable business model. Current macroeconomic and foreign exchange concerns have unduly pressured Makita's valuation relative to the long-term prospects of the business. Supported by a strong cash-rich balance sheet and a shareholder-friendly management team, Makita shares represent an attractive means to gain exposure to a rebounding global construction market.

Rolls-Royce Holdings plc (RR/ LN)

(Analyst: Jonathan Bloom)

Description

Rolls-Royce Holdings plc develops, manufacturers and services complex, integrated power systems for use on land and sea, and by air. The company operates in the following segments (as a percentage of total 2015 estimated revenue and profits): Civil Aerospace (53% revenue and 55% profits), Defense Aerospace (14% and 21%), Power Systems (18% and 15%), Marine (11% and 7%), and Energy (4% and 2%). The largest geographic segments include the United States (27%), UK (12%), Rest of Europe (22%), and Asia (30%). The Civil and Defense Aerospace (A&D) segments focus primarily on commercial and military aero engines; Power Systems includes diesel engines and power systems for marine, industrial, oil & gas, defense and power generation end markets; the Marine segment focuses on power, propulsion and motion control for ships and submarines; and the Energy segment includes nuclear systems for civil power generation and naval propulsion.

Good Business

- Wide body commercial aero engines have a duopoly market structure with Rolls-Royce and GE dominating the space. A high level of technological expertise, advanced engineering, and government regulation creates significant barriers to entry.
- Nearly 50% of group revenues come from aftermarket services, as aero engines are often sold near break-even, but come with profitable long-term service contracts. This is a razor/razorblade business model, creating an annuity-like aftermarket revenue stream. An aero engine's life cycle is around 20-30 years, with major overhauls every 5-6 years.
- Most commercial airlines opt to purchase replacement parts from the original equipment manufacturer.
- The company has an order book of £73.7 billion. Long-term drivers include emerging market demand, population growth, fuel efficiency, demand for energy, urbanization, increasing affluence, etc.
- ROIC (return on invested capital) has averaged approximately 12% over the past 5 years. With 250-350 basis points of margin opportunity in the medium term, ROIC should improve further.
- The company has a solid balance sheet, with debt-to-total capital of 26% and net debt of only £38 million.

Valuation

- Rolls-Royce trades at an enterprise value-to-revenue multiple of approximately 1.2 times, compared with an operating margin of about 11% and a mid-term target of 13.5-14.5% -- a significant discount to intrinsic value.
- The stock trades at a forward P/E of 16.0 times, a discount to the weighted average multiple of the MSCI EAFE Index at 19.5 times, despite being a better-than-average business with above-average growth prospects over a long-term investment horizon.
- Current dividend yield is 2.3%. This is issued via "C shares" which are redeemable for cash.

Management

- Mr. John Rishton took over as CEO in 2011, and has had his share of ups and downs. We are pleased with his focus on cost reduction and cash generation, but have been disappointed with execution, communication, and certain capital allocation decisions (mergers and acquisitions). Overall, the jury is still out.
- Mr. Rishton's 2014 compensation fell by more than 50% when compared with 2013, after a disappointing year. We were pleased to see that management was held accountable for performance.

Investment Thesis

Rolls-Royce is a quality business with dominant market positions, significant barriers to entry, and an annuity-like recurring revenue stream from its service businesses. The company has attractive top-line growth prospects as illustrated by its £73.7 billion order book, a significant opportunity to expand operating margins that are well below peers, and a renewed operational focus on cost reduction and cash generation. While the stock has underperformed recently due to near-term headwinds on earnings and cash, end-market pressures (defense, marine and energy), and the rebasing of its cost structure, the long-term investment opportunity remains an attractive one. At the current valuation, we have an opportunity to own a world-class business at a reasonable valuation. While it still may be a bumpy ride in the near-term, long-term investors should be rewarded for their patience.

Thank you for your support of Fiduciary Management, Inc.

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

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%
2014	5.66	4.87	5.92	1	0.00	7.49	10.33	$ 771.6	$ 21,001.1	3.67%

*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 - 12/31/2014. 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 12/31/2010-12/31/2014. 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 $21.0 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.