FIDUCIARY MANAGEMENT, INC.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

March 31, 2016

It was an inauspicious start to 2016, as international stock markets buckled, with Europe and Japan briefly entering bear market territory before rallying hard and recovering significant ground as the first quarter came to a close. The FMI International portfolios performed well, gaining approximately 1.9% in the period, which compares with MSCI EAFE Index declines of 6.52% in local currency and 3.01% in U.S. Dollars (USD). The Finance, Electronic Technology and Consumer Durables sectors boosted the portfolios' relative performance, while Transportation, Energy Minerals, and Retail Trade weighed on the results. Individual stocks were led by Rolls-Royce, Accenture and Admiral Group, while SMC Corp., Bollore and Hyundai GreenFood Co. underperformed.

The global macro outlook continues to be muddled. Debt is still rising at a rapid pace, economic growth is weak, and central bank policies are becoming more radical and desperate by the day. Every time equity markets start to wobble, a white knight arrives to announce a new stimulus plan, quantitative easing (QE) program, or interest rate cut, i.e., negative rates. As these experimental policies inevitably fail (lacking the necessary reforms to solve deep-rooted structural problems), the central bank response is to implement even more of the same, and the game goes on. Asset prices get artificially inflated and financial markets are never able to fully correct. The further we go down this dangerous path, the deeper the eventual adjustment will need to be. The probability that this will ultimately end in a financial crisis is not trivial. When the stimulus goes away, money printing fades, interest rates normalize, and balance sheets start to unwind, someone will be left holding the bag.

With the aforementioned backdrop, we remain cautious and defensively positioned. It would be one thing if equity valuations reflected these overarching risks. Instead, valuations have sustained at levels above historical averages, and often appear disconnected from underlying business fundamentals. True "absolute values" are still hard to come by, and thus patience is warranted. When attractive investment prospects arise, we will move expeditiously. We took advantage of a few brief opportunities in early 2016 before the market's fear was quickly replaced with exuberance.

Economic Malaise

It's hard to be overly optimistic about the global economy when the World Bank, Organisation for Economic Co-operation and Development (OECD) and International Monetary Fund (IMF) are routinely cutting their growth forecasts, as they did again in the first quarter. The IMF believes the world faces a growing risk of "economic derailment,"[1] while the OECD cites weak investment and demand, poor wage growth, volatile capital flows, and high debt exposures in emerging market economies (e.g. China) among their concerns.[2] The OECD also highlighted global trade, which has dropped to its lowest level since 2009, falling by 13.8% in U.S. dollar terms in 2015.[3] Meanwhile, *Bloomberg* pens that, "The world has continued to borrow hand over fist

[1] "IMF says world at risk of 'economic derailment.'" *BBC News*, March 9, 2016.
[2] http://www.oecd.org/eco/economicoutlook.htm.
[3] Shawn Donnan and Joe Leahy. "World trade records biggest reversal since crisis." *Financial Times*, February 26, 2016.

since the financial crisis, adding nearly $60 trillion since 2007 in the process of pushing the worldwide debt load to $200 trillion, or nearly three times the size of the entire global economy. And that figure takes us only to 2014; we don't yet have fresh debt tallies from last year."[4] Company balance sheets are also stretched. According to Standard & Poor's (S&P), the second half of 2015 saw the steepest decline in the financial health of businesses since 2009, as three times as many companies were at risk of a downgrade to their credit rating, versus those being considered for an upgrade.[5] While lower energy prices are surely good for the global consumer, there's little else to get excited about.

<u>Risk of Contagion?</u>

After failing to "deliver the goods" in the fourth quarter of 2015, European Central Bank (ECB) President Mario Draghi swung for the fences in early March, lowering the bank deposit rate by 10 basis points to -40 basis points; reducing the main financing rate (MRO) by 5 basis points to 0%; expanding QE to €80 billion per month, which now includes non-financial corporate bonds; and launching a new targeted longer-term refinancing operations (TLTRO) program, which essentially pays banks to borrow money. Despite previous efforts to pump up the economy, subpar growth has persevered, as the ECB lowered the eurozone gross domestic product (GDP) growth forecast to 1.4% in 2016 (from 1.7% in December), and 1.7% in 2017 (from 1.9%). Inflation expectations also fell markedly to 0.1% (from 1.0%) for 2016.[6] Inexplicably, in January, Draghi made the comment that "time and again the critics of our [policy] decisions have been proved wrong."[7]

Elsewhere in Europe, Britain is soon approaching an important crossroad, as a referendum is set for June 23 to determine whether the country will remain in the European Union (EU). While the pros and cons of a potential "Brexit" are being fiercely debated, the rating agencies have started to weigh in on the risks, with Moody's writing that the "economic costs" of a decision to leave would "outweigh the economic benefits," while Fitch Ratings argues that it would lead to immediate "disruption" for many sectors of the economy, and raise "significant longer-term risks."[8] Even if Britain votes to exit the EU in June, it would take years to negotiate the details of a new agreement. While FMI is of the mindset that a Brexit makes sense (and that a break-up of the EU and eurozone would be a long-term positive for Europe), it's likely to create significant uncertainly in the near term, which could weigh heavily on equity prices. We suspect that it will open the door for other members of the EU and eurozone to call for similar referendums in the coming years, as there are already rumblings starting in France and Italy, among others.

The near-term risk is a reincarnation of the European sovereign debt crisis. Interest rates have been driven down to historic lows, with 10-year bond yields in Italy, Spain and Portugal now trading at 1.2%, 1.4%, and 2.9%, respectively. As highlighted in our last letter, some bonds in Italy are actually trading at a negative yield, which is hard to comprehend, given that it is an economic basket case. The implicit backing of the ECB is to thank for such generous (and unsustainable) lending terms. That said, if any of these countries were to become "independent," borrowing costs would skyrocket, as debt-to-GDP, unfunded liabilities, budget deficits, economic growth, and the health of the banking systems would come into question. Bond yields reached 7.2%, 7.5%, and 17.4% for Italy, Spain and Portugal, respectively, during the 2011/2012 debt crisis. Returning to

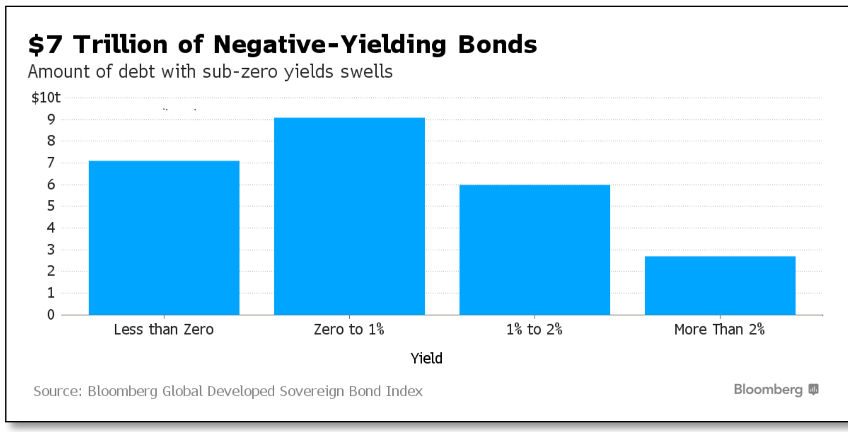
---

[4] Matthew Phillips. "The World's Debt Is Alarmingly High. But Is It Contagious?" *Bloomberg*, February 22, 2016.
[5] Dan McCrum and Gavin Jackson. "S&P says corporate credit conditions worsening at fastest pace since crisis." *Financial Times*, January 12, 2016.
[6] Johan De Mulder, et al. "ECB: It's Demand, Mr. President, and not much you can do about it now...." *Bernstein Research*, March 10, 2016.
[7] Tom Fairless. "Mario Draghi Takes On Critics of ECB Stimulus in Speech in Germany." *Wall Street Journal*, January 25, 2016.
[8] George Parker and Michael Hunter. "Sterling tumbles as Cameron takes on party rebels over Brexit." *Financial Times*, February 22, 2016.

those yields would lead to bond price declines of 40%, 41%, and 67%, respectively.[9] Layer on the growing fear that negative interest rates could "cripple banks' margins, profitability and resilience,"[10] and it's not too hard to imagine a scenario where the term "contagion" is back in vogue.

Welcome To The Club

Japan, which already has the developed world's highest debt level and most aggressive QE program, has now joined Europe with negative deposit rates. Following the announcement in January, Japan's 10-year bond yield reached an unprecedented level of -0.13%.[11] Meanwhile, GDP growth in Japan remains anemic, falling by an annualized 1.4% in the fourth quarter, following a revised 1.3% gain in the third quarter. Consumption, imports and exports all declined in the most recent period.[12] But have no fear: Bank of Japan (BOJ) Governor Haruhiko Kuroda is here! The problem is, he might be even more detached from reality than Draghi, commenting that, "If we judge that existing measures in the toolkit are not enough to achieve (our) goal, what we have to do is devise new tools. […] I'm convinced that there is no limit to measures for monetary easing."[13] It sounds as if we might be poised for a race to the bottom.



According to *Bloomberg*, in early February the total amount of negative-yielding bonds exceeded $7 trillion, or 29% of the developed world bond issuance. Additionally, over $9 trillion is trading below a 1% yield.[14] As a reminder, a negative bond yield guarantees investors will lose money if they hold the bond to maturity. Investors are apparently banking on a "greater fool theory," with the hope that a greater fool (i.e. the BOJ) will come along and pay an even more ridiculous price. Absent this, what rational investor would willingly agree to lend money at a guaranteed loss to the most indebted country in the world, which also happens to have a faltering economy and an aging and declining population?

Proponents of these radical negative interest rate policies believe that they can be used to weaken currencies, spur economic growth, increase inflation, and stem capital inflows. However, as reported by the *Financial Times*, "Some analysts argue that negative rates do not stimulate economies beyond lowering currencies. Deutsche Bank strategists have compared the policy to weapons of mass destruction, escalating a currency war that will only bring 'mutually assured destruction.'"[15] Bank of England Governor Mark Carney has warned about negative rates being a "zero sum game,"[16] while the Bank for International Settlements (BIS) has written that "there is great uncertainty about the behavior of individuals and institutions if rates were to decline

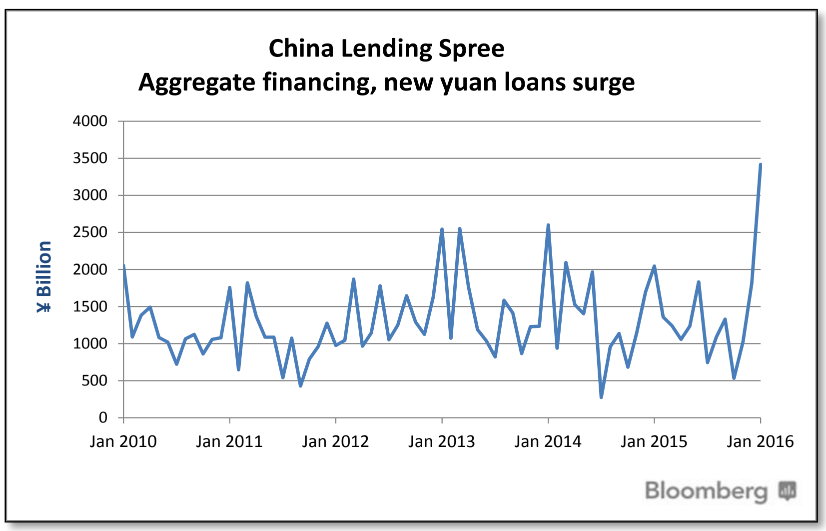
[9] Source: Bloomberg.
[10] "BIS Quarterly Review March 2016 – media briefing," On-the-record remarks by Mr Claudio Borio, Head of the Monetary and Economic Department, and Mr. Hyun Song Shin, Economic Adviser and Head of Research, March 4, 2016.
[11] Source: Bloomberg.
[12] Robin Harding. "Japan GDP drops 1.4% in fourth quarter." *Financial Times*, February 15, 2016.
[13] Leika Kihara. "BOJ Kuroda says ready to use more policy options to boost inflation." *Reuters*, February 3, 2016.
[14] Eshe Nelson. "World's Negative-Yielding Bond Pile Tops $7 Trillion." *Bloomberg*, February 9, 2016.
[15] Robin Wigglesworth, Leo Lewis and Dan McCrum. "Negative thinking." *Financial Times*, February 17, 2016.
[16] Scott Hamilton and Svenja O'Donnell. "Carney Warns G-20 Against `Zero Sum Game' of Negative Rates." *Bloomberg*, February 25, 2016.

further into negative territory or remain negative for a prolonged period." The BIS also notes that "the viability of banks' business model as financial intermediaries may be brought into question," and that, "such rates can weaken the profitability and/or soundness of institutions with long-duration liabilities, such as insurance companies and pension funds, seriously challenging their business models."[17] We are firmly in the latter camp, questioning the efficacy, risks and unintended consequences associated with negative rates. Money is not supposed to be [less than] free. Additional risks might include credit bubbles, emerging market capital flows, inflation, weak government incentives to embrace reform, industry overcapacity, uneconomic capital allocation, and the proliferation of zombie companies (which would otherwise go out of business). Buyers beware.

China: Elephant In The Room

China remains the single biggest risk to the global economy. It has been the largest contributor to global GDP growth over the last decade, before including the positive knock-on effects it has had on economies such as Brazil, Russia, Indonesia, Canada, Australia and Germany. Unfortunately, China has been on a massive debt binge, as debt has tripled since 2009 from $10 trillion to $30 trillion (an approximately 20% compounded annual growth rate), according to McKinsey & Company.[18] At the same time, growth is slowing dramatically, and the government is trying to transition away from an economy driven by fixed investment. China has been faced with a severe slowdown in manufacturing and construction, as well as a sharp decline in exports.

According to J Capital Research, a China-focused investment research boutique, it now takes around 2.5 renminbi (¥) of new credit to generate ¥1 of additional output. As articulated in a recent *Newsweek* article, "That means that at a time when most economists believe debt growth needs to slow markedly in China, an additional $1.7 trillion (¥11.0 trillion) in new loans is necessary merely for the government to hit its 6.5 percent growth target this year. Complicating matters for Beijing is the fact that an increasing amount of new debt is being issued merely to service existing debt—a sure sign, in the minds of many analysts, that a debt crisis looms." After accounting for the debt service and growth objectives, J Capital Research estimates that China will need ¥54 trillion ($8.3 trillion) of new capital in 2016, which equates to roughly 80% of last year's total GDP.[19] This is alarming, to say the least. In January, China's debt issuance didn't disappoint, growing in aggregate by ¥3.42 trillion ($525 billion, or 5% of GDP), a new monthly record.[20] According to S&P, corporate debt in China has now reached 160% of GDP, more than twice that of the U.S. (70%).[21] Due to heightened country-specific risks, emerging market companies should typically be run with less financial leverage than developed market counterparts, not more.



[17] BIS Quarterly Review, March 2016. Pages 40-41, 43.
[18] Matthew Phillips. "The World's Debt Is Alarmingly High. But Is It Contagious?" *Bloomberg*, February 22, 2016.
[19] Bill Powell. "Will China Follow Japan Into Economic Stagnation?" *Newsweek*, February 15, 2016.
[20] "China's New Credit Surges to Record on Seasonal Lending Binge." *Bloomberg*, February 15, 2016.
[21] Chuin-Wei Yap and Mark Magnier. "Rush of Corporate Bonds Inflames Worries About China's Debt." *The Wall Street Journal*, February 24, 2016.

There is also concern about the health of China's banking system. "Official" nonperforming loans (NPLs) reached ¥1.27 trillion ($196 billion, or 1.67% of total loans) at year-end, a 51% increase over 2014 and the highest level in a decade. Including "special-mention" loans, which show signs of future repayment risk but have yet to become NPLs, total troubled loans grew to ¥4.2 trillion ($645 billion, or 5.46% of reported loans).[22] The official figures, however, are believed to vastly understate the scope of the problem. Hayman Capital hedge fund manager Kyle Bass, in an eye-opening and disconcerting letter, writes that China's banking system losses "could exceed 400% of the U.S. banking losses incurred during the subprime crisis," topping $3.5 trillion. He argues that under this scenario, China may have to print more than $10 trillion of renminbi to recapitalize its banks, which could lead to a 30% devaluation of the currency. If this materializes, he portends, "what happens in China will not stay in China," and there will be severe global ramifications.[23] We'd agree.

While it's difficult to gauge the probability or timing of a meltdown in China's financial system (or in Europe or Japan for that matter), we do believe it's safe to say that current equity valuations ascribe an extremely low likelihood to such an outcome. From all that we have learned about China's economic "miracle" over the years, we remain highly skeptical, and will continue to take a more cautious view. In the meantime, we will stay true to our investment process and let valuation act as our guide. Listed below are two examples of our international holdings where we believe the investment prospects are stacked in our favor:

Admiral Group PLC (ADM LN)

(Analyst: Matthew Goetzinger)

Description

Admiral is a leading UK auto insurer with over 10% market share. The company's capital light price comparison website distribution platform offers consumers a compelling mechanism to save both time and money on a required insurance coverage. Approximately two thirds of company profits are derived from fees, with balance sheet underwriting and investment income accounting for the remaining one third of earnings. Developing western European and U.S. personal auto businesses contribute 8% of net revenues.

Good Business

- Admiral's established track record of conservative underwriting and operating efficiency are unmatched across the UK auto industry.
- Personal auto coverage is a compulsory purchase that is relevant for a very wide swath of the population.
- Admiral's capital efficient and profitable business model leads to consistent return on capital employed, averaging 53% over the past ten years (49% in 2015).
- The company's balance sheet remains conservatively financed. Balance sheet cash, investments and excess cash totals over half of the quoted share price.

Valuation

- Giving due credit to the company's excess reserves, Admiral trades at less than 12 times fully developed earnings.
- The dividend yield has averaged 6.6% over the past five years.
- Based on a conservative sum-of-the-parts analysis, we value Admiral 30% higher than the current stock price.

[22] "China's Bad Loans Rise to Highest in a Decade as Economy Slows." *Bloomberg*, February 15, 2016.
[23] http://www.valuewalk.com/2016/02/kyle-bass-china/?all=1.

Management

- Admiral has an industry reputation as one of the strongest and most efficient operators.
- The company's two founders remain steady hands, stewarding the company successfully through several market cycles. Admiral is focused on organic growth and capital return to shareholders.
- Chairman Henry Engelhardt and Chief Executive Officer David Stevens retain 15% ownership in the company.

Investment Thesis

Admiral is a capital light innovative company that has disrupted the mature UK personal lines auto insurance market place, offering consumers a compelling mechanism to save both time and money on a required insurance coverage. The company's low-cost, high-return, fee-driven business model has enabled Admiral to achieve consistent profitable growth through a cycle. The market's short-term focus on the direction of premium pricing overlooks the fact that Admiral operates in an industry where the majority of peer auto insurers are not in a position to earn sustainable profits under the current pricing environment. Admiral's focus on disciplined growth should enable the company to achieve a sustainable return on equity and pay out the majority of income to shareholders

Wolseley plc (WOS LN)

(Analyst: Jordan Teschendorf)

Description

Wolseley is the world's largest distributor of plumbing and heating products to trade professionals, with 83% of revenue generated through No. 1 or No. 2 market positions in 2015. Wolseley operates a solid franchise in the U.S. under the Ferguson brand name, generating 63% and 80% of group revenue and trading profit, respectively. The group also owns a collection of plumbing, heating, and building product distribution businesses across the UK, Nordic region, Canada, and Central Europe. Wolseley sells to a broad group of customers including plumbing and heating engineers, building contractors, mechanical contractors, industrial corporations, utilities, and even directly to end users in the business-to-consumer market.

Good Business

- In its core geographies, Wolseley's large scale and branch density provide it with a competitive advantage in terms of purchasing, fulfillment, and contractor relationships vs. generally fragmented competition.
- The company has successfully exited many unprofitable businesses over the last six years and reoriented towards organic growth, driving improved margins and returns on capital.
- Wolseley is in a strong financial position with net debt of £990 million relative to fiscal 2015 trading profit of £854 million, and lease adjusted leverage of approximately 2.1 times.
- In 2015, about 60% of the company's revenue was related to remodeling, maintenance, and improvement work, which compares favorably to the group's 40% exposure in 2007.
- The company's return on net assets (including intangibles) is currently 19%, up 300 and 900 basis points over the last 3- and 5-year periods, respectively.

Valuation

- The company's 12-month forward enterprise value-to-EBIT[24] (EV/EBIT) multiple is 11.0 times, which is 8% below the trailing 10-year average of 11.9 times. This valuation is attractive on an absolute basis.
- Wolseley trades for 15.8 times estimated earnings for the current fiscal year, which is about 19% below the weighted average multiple of the MSCI EAFE Index.

[24] Earnings before interest and taxes.

Management

- In January of 2016, the company announced that Chief Executive Officer Ian Meakins would retire in August of this year. Ian joined Wolseley as CEO in July of 2009, and is highly regarded for the improvements he has overseen at the firm.
- Chief Financial Officer John Martin will become the new CEO beginning September of 2016. John has been CFO since April of 2010, and previously worked with Mr. Meakins at Travelex.
- Simon Nicholls will be the new CFO. Simon has been the CFO of Cobham plc since 2013, and was previously CFO of Senior plc, from 2008-2013.
- There is good continuity of leadership at Ferguson Enterprises Inc., a Wolseley subsidiary.

Investment Thesis

Under the leadership of CEO Ian Meakins, Wolseley has strengthened its branch footprint by focusing on profitable organic growth and return on invested capital. This focus has permeated the organization and driven a culture of continuous improvement. John Martin is likely to continue this leadership strategy, building on the strength of the U.S. business to drive better results overseas. Recent weakness within U.S. industrial end-markets has contributed to weak share price performance. We believe the increasing exposure to remodeling, maintenance, and improvement work will enable steadier margins and returns going forward. With the recent share price underperformance, we feel that this presents us with an opportunity to invest in an above-average business at a below-average valuation.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 12/31/2015

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	*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%
2014	5.66	4.87	5.92	1	0.00	7.49	10.33	$ 771.6	$ 21,001.1	3.67%
2015	4.24	3.46	5.33	2	0.00	8.14	11.73	$ 2,832.9	$ 21,042.9	13.46%

*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 - 12/31/2015. 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 12/31/2010-12/31/2015. 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:

Up to $25,000,000	0.70%
$25,000,001-$50,000,000	0.65%
$50,000,001-$100,000,000	0.60%
$100,000,001 and above	0.55%

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 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, 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 currency and net of hedges. The International Equity composite uses the MSCI EAFE Net Local Index® as its primary index comparison.