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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2016

A historic United Kingdom (UK) Brexit vote stole the show in the June quarter, sending financial markets into a frenzy as the period came to a close. With the UK voting to leave the European Union (EU) in a closely contested referendum, near-term uncertainty and volatility are all but guaranteed in the months ahead. The FMI International portfolios bent but didn't break, increasing by approximately 1.8% in the quarter, compared to an MSCI EAFE Index retreat of -0.74% in local currency and -1.46% in U.S. Dollars (USD). Relative performance was aided by the Consumer Non-Durables, Finance, and Consumer Services sectors, while Commercial Services, Transportation and Process Industries were a drag on the results. LG Household & Health Care, Compass Group, and Henkel were the top individual contributors, while Adecco, Bollore, and Samsonite International each lagged the market.

We welcome (with open arms) the return of fear in the market. Investors have been complacent in recent years, supporting elevated stock valuations despite subpar economic growth and business fundamentals. They have become enamored with central bank policies aimed at driving up asset prices, and paying less attention to absolute valuation and fundamental security analysis. As the rising tide lifted most boats and passive investing strategies gathered increasing momentum, value investing has quietly underperformed growth for over a decade. With history as our guide, we are confident that these trends will reverse over time. We expect recent events to help illustrate the power of active investing and stock selection, as markets are far from efficient. There are always excess returns to be had, especially when fear, greed and emotion start to take hold. We are excited about what lies ahead; with volatility comes opportunity.

Brexit: The House View

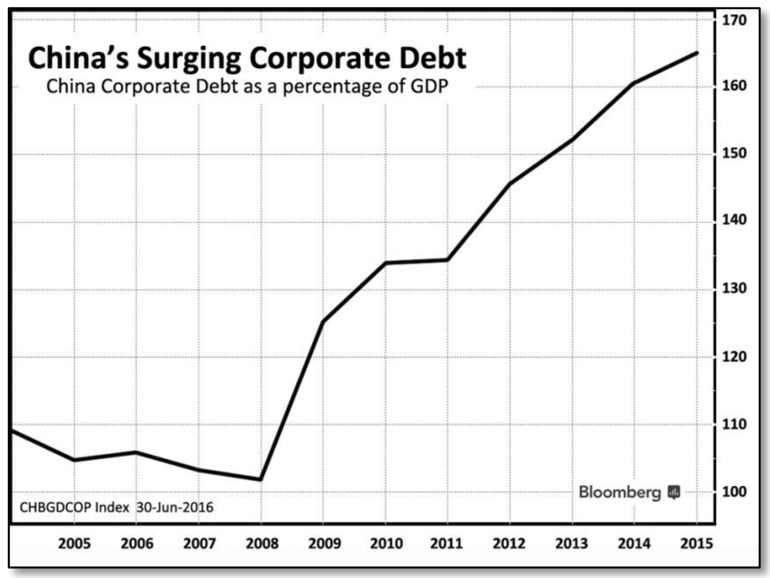
An abundance of ink was spilled leading up to the Brexit referendum. While consensus expectations called for the UK to vote "remain," it was a humbling reminder that forecasters can (and very often do) get it wrong. It's worth noting that at FMI we employ a bottom-up approach to investing, as we're skeptical that anyone can predict the macro picture with great accuracy. While we read extensively about the macro environment and take new information into account (even sharing our views in this forum), at our foundation we make investment decisions at the company level, which is really our core competency.

That said, Brexit will be top-of-mind for many, so we're happy to weigh in. At a high level, we view it as more of an opportunity than a risk. There is likely to be significant uncertainty in the near term regarding economic growth, trade deal negotiations, currency fluctuations, political posturing, a potential call for similar referendums (with Eurosceptic parties in Italy, France, Netherlands, Denmark and Sweden already piping up), et al. Stock prices may continue to come under pressure. However, if this means that great businesses will be offered up at value prices (including some of our own holdings), then we will look to capitalize as people throw out the baby with the bath water. History has shown that some of the best buying opportunities come when the herd runs for the exits. As contrarians, we live for this moment.

Reflecting on the referendum, if faced with the same choice as a UK citizen, we too would have voted to leave the EU. Why would the UK want to tie their future to the EU, which has demonstrated an inability to reform, a lack of desire to address their own structural problems, and where debt loads are off the charts and growth is anemic? We support the UK's desire to take back their independence, and free themselves of the regulatory burden, financial obligations (around £10 billion per year),[1] red tape and bureaucracy. Distancing themselves from the fate of the euro is also a prudent move. The UK has the world's 5th largest economy -- their trading partners will not abandon them -- and now they will have increased flexibility. Sometimes you need to take on some near-term pain to ensure future progress.

On a long-term view, we didn't buy into the fear mongering of the "remain" camp, and actually think a restructuring of the EU and Eurozone would be good for Europe. We have long questioned the sustainability of the Eurozone construct, as a monetary union without a political and fiscal union has little chance of working. If countries were forced to stand on their own, perhaps they'd address their problems instead of kicking the can down the road and using the European Central Bank as a perpetual crutch.

<u>China: On Borrowed Time?</u>



Risks in China continue to magnify, as incremental data points paint a troubling backdrop. International Monetary Fund (IMF) First Deputy Managing Director David Lipton recently warned that China's "Corporate debt remains a serious and growing problem that must be addressed immediately and with a commitment to serious reforms." This followed an IMF sustainability report which estimated that $1.3 trillion in corporate debt was owed by companies that generate less income than they owe in interest payments alone.[2] This "conservative estimate" of bad debt equates to nearly one-sixth of total loans to the corporate sector, or 7% of Gross Domestic Product (GDP). Data compiled by Bloomberg suggests that listed companies' ability to service their debt is the weakest on record.[3] The IMF calculates that around 55% of corporate debt is held by state-owned enterprises (SOE), and they generate only 22% of economic output,[4] which is part of the problem. Not surprisingly, in a recent Moody's release, the rating agency said, "The share of rated issuers in China with a negative outlook bias [ratings on review for a downgrade or with a negative outlook on rating]… has increased to a record high of 69 percent." This is up from 15.7% at the end of last year.[5] Unfortunately for China's policy makers, debt-for-equity swaps and the securitization of non-performing loans are unlikely to fix the problem.

Meanwhile, China is pulling out all the stops to keep its growth engine going, issuing $1 trillion in new credit in the first quarter while ramping up stimulus.[6] Bloomberg reports that the government's "stealth" stimulus efforts are reaching new heights, as "The fiscal deficit when taking off-budget spending into account will exceed 10 percent of GDP this year -- more than triple the government's stated ratio of 3 percent, according to economists at UBS Group AG and JPMorgan Chase & Co."[7] As private sector investments have waned, the Chinese government has swooped

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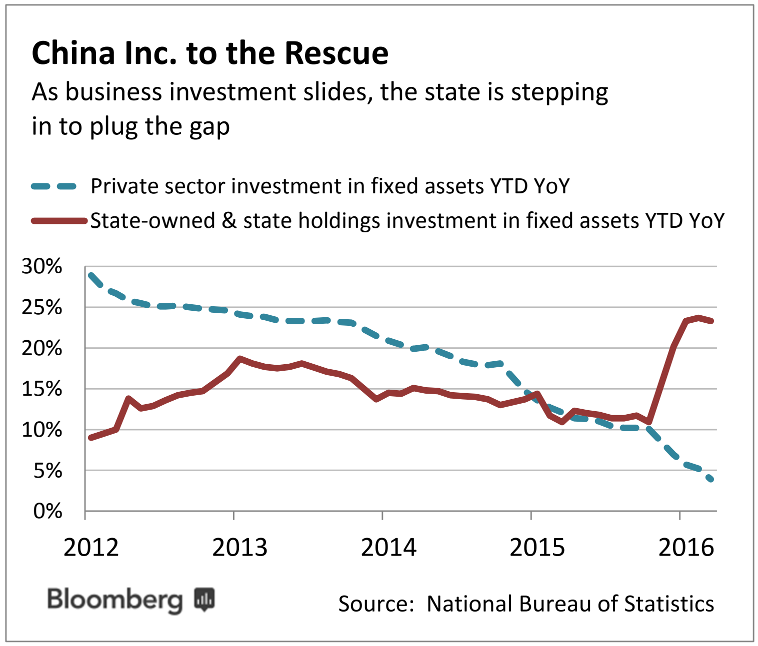
[1] Gerard Lyons. "We will prosper from Brexit." *Evening Standard*, April 12, 2016.
[2] Scott Lanman. "IMF Urges China to Tackle 'High' Corporate Debt Immediately." *Bloomberg*, June 10, 2016.
[3] Lianting Tu. "It's Never Been This Hard for Chinese Debtors to Pay Interest." *Bloomberg*, April 11, 2016.
[4] Mark Magnier. "IMF Warns China of Risks of Mounting Corporate Debt." *The Wall Street Journal*, June 12, 2016.
[5] James Kynge. "Chinese firms' financial outlook worsens at record rate." *Financial Times*, May 27, 2016.
[6] Jim Edwards. "Goldman Sachs nails the staggering size of China's debt in 3 simple charts." *Business Insider*, May 4, 2016.
[7] "Stealth China Stimulus Means Fiscal Gap Over 10%, Economists Say." *Bloomberg*, June 22, 2016.

in to pick up the slack. In relatively short order, China has reinvigorated their real estate market, which was already in bubble territory. In the first four months of the year, housing sales rose 61.4%, construction starts increased 21.4%, and new mortgages reached a record level.[8] Prices in Shenzhen and Beijing skyrocketed, up 62% and 28%, respectively, versus last year.[9] Land prices per square meter for the top 100 cities jumped 50%.[10] These are exceptional price movements for any asset class, let alone real estate, which can often be highly levered. Speculation is clearly running rampant (once again).



While there are plenty of risks clouding banks' balance sheets in China (including the aforementioned), Autonomous Research partner Charlene Chu believes that it's what is buried off-balance-sheet that should be the biggest concern. In a recent interview, she commented that "Over the near term, we think the biggest risk is banks' WMP [wealth management product] portfolios. The stock of Chinese banks' off-balance-sheet WMPs grew 73 percent last year. There is nothing in the Chinese economy that supports a 73 percent growth rate."[11] WMPs are short-term investment vehicles sold by banks, offering customers attractive yields (versus deposit rates). Banks then invest these funds in a "hidden pool of liabilities and assets." The outstanding value of WMPs is substantial, reaching $3.6 trillion in aggregate, or 35% of China's GDP. Per Chu, "The products used to be predominantly sold to the public, but now they're increasingly being sold to banks and other WMPs. We're starting to see layers of liabilities built upon the same underlying assets, much like we did with subprime asset-backed securities, collateralized debt obligations, and CDOs-squared in the U.S."[11,12] This could be a recipe for trouble, and we all know how the U.S. played out. With the Chinese economy slowing and risks on the rise, we will remain cautious.

<u>Where Has All The Growth Gone?</u>

World growth remains weak. The World Bank recently projected global economic output of 2.4% in 2016, down from a 2.9% estimate in January. Growth in the U.S., Eurozone, and Japan is expected to be 1.9%, 1.6%, and 0.5%, respectively. Emerging market growth is projected at 3.5% (China at 6.7%), low by historical standards.[13] These estimates were pre-Brexit. We believe lackluster capital investment and productivity growth are among the culprits (along with misguided monetary and fiscal policies, elevated debt levels, unsustainable social programs, the China "miracle" nearing an end, et al.). Productivity, or the improvement in output per hour worked, is key to driving economic growth. Without productivity improvements, growth can only come from people working more hours, or more people working. As capital stock ages, new investment (and research & development) is necessary to drive innovation and productivity. As the adage goes: "You have to spend money to make money." With sluggish investment, we are not surprised to see weak productivity growth. Most leading economies have been impacted. In

[8] Esther Fung. "China Housing Revival Buffers Economy." *The Wall Street Journal*, May 16, 2016.
[9] Li Yuan. "How Shenzhen Mimics Silicon Valley." *The Wall Street Journal*, June 1, 2016.
[10] Jacky Wong. "Why China's Developers Can't Stop Overpaying for Property." *The Wall Street Journal*, June 20, 2016.
[11] Paul Packhurst. "Massive Bailout' Needed in China, Banking Analyst Chu Says." *Bloomberg*, May 23, 2016.
[12] "China Default Chain Reaction Threatens Products Worth 35% of GDP." *Bloomberg*, May 29, 2016.
[13] Paul Wiseman. "World Bank downgrades its forecast for 2016 global economy." *Associated Press*, June 8, 2016.

the U.S., productivity growth has slowed from 2.5% in 1995-2005,[14] to 0.3% a year from 2010-15, and is projected to turn negative this year for the first time in more than three decades. In China, it fell from 7% in 2007-2013, to 3.3% in 2015. In the Eurozone, productivity has slowed from around 1.5% in 1999-2006, to 0.6% in 2007-2013, with recent data predicting further deceleration.[15] The status quo will obviously need to change in order to buck the trend, but at this point we struggle to see the near-term catalyst.

Business fundamentals are suffering alongside the economic malaise. Financial engineering (thanks to historically low interest rates) is not helping the cause at the company level, as firms far too often are opting to buy back shares or pursue expensive mergers and acquisitions, in lieu of investing in their businesses. To say that earnings have been weak would be an understatement. In Europe, first quarter earnings were down 20% (-11% ex-financials, and -16% ex-energy). In Japan, earnings were also down 20% (-30% ex-financials, and -20% ex-energy), but a stronger yen is partially to blame.[16] Amazingly, stock valuations have remained above historical averages. The growing disconnect will eventually have to be reconciled.

Risk Management

We were recently asked at a Morningstar conference why our investment process results in less risk. Given the recent market volatility, we thought this would be an opportune time to share our thoughts. Downside protection is a key tenet of our investment process; avoiding the permanent impairment of capital is vital to long-term investment success. As Oaktree Capital's Howard Marks is often quoted, "If we avoid the losers, the winners will take care of themselves." We agree. Over FMI's 35+ year history, our investment strategies have tended to hold up better in market corrections, while capturing the majority of the upside in good times, leading to superior investment returns through a cycle while taking on less risk. In the 5 ½-year history of the FMI international portfolios, the international strategy has largely fit the same mold, creating the most value for our clients when markets capitulated in 2011 and 2016. Why is that the case?

First and foremost, we focus on what can go wrong. This relates to the three pillars we look for in every investment: a good business, attractive valuation, and strong management. We look for solid businesses with sustainable competitive advantages and barriers to entry. We want to find companies with durable franchises, strong brands, and attractive return on invested capital (ROIC) prospects. These businesses can weather cycles and volatility. Through self-selection, we try to avoid inferior businesses and balance sheets. Equity investing is always risky; we don't want to add financial risk through a highly levered balance sheet. In terms of valuation, we aim to buy businesses well below their intrinsic value, with a significant margin of safety, which helps mitigate risk. We also look for management teams that think and act like owners, which will make capital allocation decisions that drive long-term shareholder value. We avoid empire builders focused on value-destructive mergers and acquisitions, and would much rather find management teams that invest organically in their business.

From a portfolio perspective, while we have exposure to most economic sectors (and geographies), if companies within a given sector do not earn their cost of capital or are expensively valued, we will simply pass and/or avoid that sector entirely. We are focused on finding great companies first, with sector and geographic considerations second. We let businesses and valuations dictate how the portfolio evolves. Lastly, we'd mention that we have decided to hedge currency exposure, as we want our stock selection to shine. While hedging generally has had a neutral impact in our first three years (2011-2013), it has been a benefit since 2014 as the dollar has strengthened.

Thank you for your support of Fiduciary Management, Inc.

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[14] Robert Samuelson. "Solving the productivity mystery." *Washington Post*, April 3, 2016.
[15] Sam Fleming and Chris Giles. "US productivity slips for first time in three decades." *Financial Times*, May 25, 2016.
[16] Emmanuel Cau, et al. "Equity Strategy: Q1 Earnings Season Tracker." *J.P. Morgan Cazenove Global Equity Research*, May 24, 2016.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 03/31/2016

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%
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%
Q1 2016	1.90	1.71	-6.52	2	0.12	8.01	11.96	$ 3,464.9	$ 21,477.7	16.13%

*MSCI EAFE Net Local Index®

Returns reflect the reinvestment of dividends and other earnings.
The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss.

Fiduciary Management, Incorporated (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 03/31/2016. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The International Equity Composite has been examined for the periods 12/31/2010-03/31/2016. 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 $21.4 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.