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# INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

September 30, 2016

The Global stock markets rallied in the third quarter as Brexit fears eased. Fortunately, the sky didn't fall as some economists had predicted. The FMI International portfolios captured most of the upside, advancing approximately 5.7% in the quarter, while the MSCI EAFE Index gained 6.04% in local currency and 6.43% in U.S. Dollars (USD). Strong relative performance by Producer Manufacturing, Distribution Services, and Commercial Services sectors was partially offset by weaker results in Finance, Consumer Durables and Consumer Non-Durables. Top performing stocks were Smiths Group, Electrocomponents, and SMC Corporation, while LG Household & Health Care, SCA Group, Hyundai GreenFood each declined in value.

With each passing quarter, we do our best to avoid sounding like a broken record. Unfortunately, the story hasn't changed a whole lot, and if anything, risk has increased. Experimental central bank monetary policies are dangerous (and ineffective), economic and business growth continues to falter, debt is high and on the rise, and stock valuations remain elevated. While negative interest rates and quantitative easing (QE) have pumped up financial asset prices, to believe that printing money out of thin air and artificially suppressing rates will solve the world's problems is beyond our comprehension. In our view, markets are upside down, and with each passing day we venture further into uncharted territory. At some point there will be a day of reckoning, at which time we will be eagerly waiting to sift through the bargain bin. In the meantime, we remain cautious and highly skeptical, with a continued focus on downside protection.

## Return-Free Risk

The negative interest rate frenzy is reaching new heights. In Europe, Henkel and Sanofi were added to the list of corporations to issue bonds at a negative yield. *The Wall Street Journal* reports that "Roughly €706 billion of eurozone investment-grade corporate bonds traded at negative yields as of Sept. 5, or over 30% of the entire market, according to trading platform Tradeweb, up from roughly 5% of the market in early January."[1] The global figure for negative-yielding debt (primarily government bonds in Europe and Japan) is staggering, topping $13.4 trillion in the period (from close to zero at the start of 2014).[2] It is remarkable (and quite alarming) that we've gone from a world where sovereign debt once provided a supposed "risk-free return," to today, when investors are lining up in droves for corporate bonds offering "return-free risk." According to Richard Sylla (co-author of *A History of Interest Rates* in 2005), there is no such precedent (for negative interest rates) in at least 5,000 years of banking history.[3] For good reason.

To make matters worse, central banks are running out of things to buy. In Europe, despite expanding the €1.6 trillion QE program into corporate bonds, some analysts believe the European Central Bank (ECB) could run out of bonds by year end.[4] Reports are surfacing that companies are creating bonds to sell to the ECB through private placement, which is troubling.[5] While the ECB has yet to buy equities, we wouldn't be surprised if it happens. In Japan, the Bank of Japan (BOJ) holds around a third of Japan's government bonds, and analysts estimate that it could reach 60% by the end of 2018. They are currently buying bonds at roughly twice the pace at which the government is issuing them.[6] The BOJ is also well down the path of acquiring equities, as it is already a top ten shareholder in around 90% of the Nikkei 225 index,[7] and is on course to become the number one shareholder in 55 of those companies by the end of 2017.[8] This is not normal.

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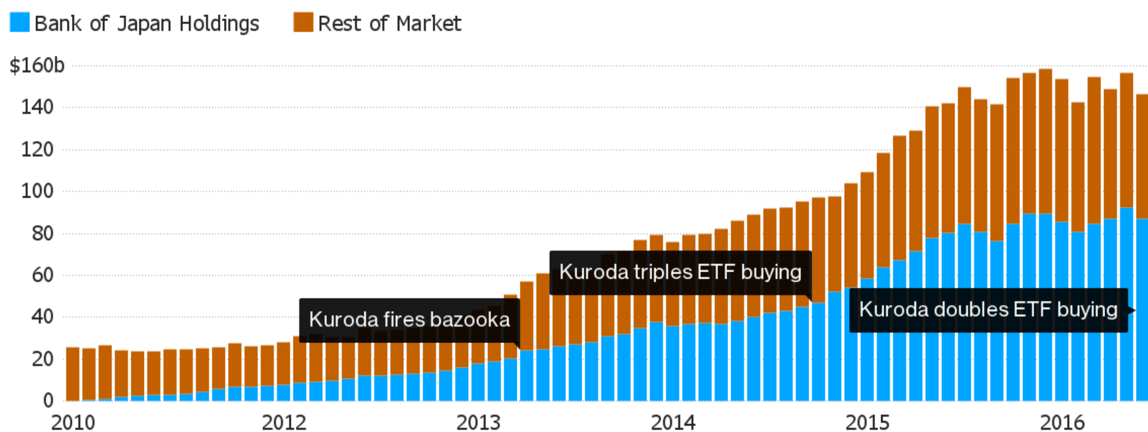
1 Christopher Whittall. "Now Companies Are Getting Paid to Borrow." *The Wall Street Journal*, September 6, 2016.
2 Robin Wigglesworth and Eric Platt. "Value of negative-yielding bonds hits $13.4tn." *Financial Times*, August 12, 2016.
3 James Grant. "Hostage to a Bull Market." *The Wall Street Journal*, September 9, 2016.
4 Elaine Moore. "When will the ECB run out of bonds to buy?" *Financial Times*, September 8, 2016.
5 Christopher Whittall. "Seller's Paradise: Companies Build Bonds for European Central Bank to Buy." *The Wall Street Journal*, August 21, 2016.
6 Rachel Rosenthal and Suryatapa Bhattacharya. "Bank of Japan Risk: Running Out of Bonds to Buy." *The Wall Street Journal*, September 9, 2016.
7 Yuji Nakamura, Anna Kitanaka and Nao Sano. "The Tokyo Whale Is Quietly Buying Up Huge Stakes in Japan Inc." *Bloomberg*, April 24, 2016.



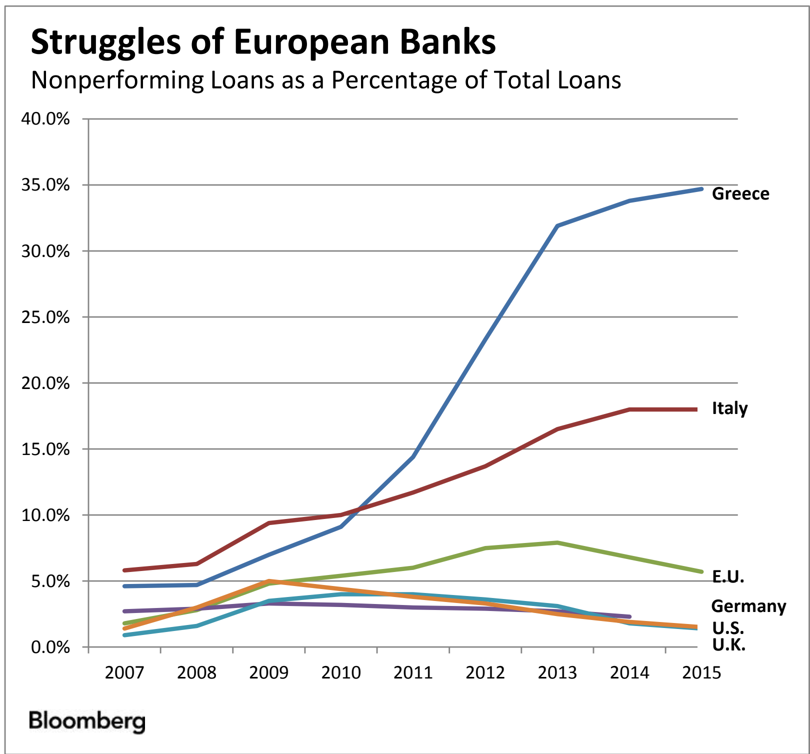

Since the 2008 financial crisis, central banks have printed more than $12 trillion and cut interest rates more than 650 times,[9] yet, "global economic output growth is about to enter a sixth year below the average rate since 1990, marking one of the longest eras of weak output in decades," per *The Wall Street Journal*.[10] In addition, McKinsey Global Institute writes, "Between 65 and 70 percent of households in 25 advanced economies, the equivalent of 540 million to 580 million people, were in segments of the income distribution whose real market incomes—their wages and income from capital—were flat or had fallen in 2014 compared with 2005. This compared with less than 2 percent, or fewer than ten million people, who experienced this phenomenon between 1993 and 2005."[11] The conventional wisdom was that low interest rates and inflated asset prices would help spur demand, with an increase in business and household spending. But the reverse has transpired, as business investment has been anemic and households have padded their savings. Despite a plethora of evidence suggesting that monetary policies have failed, central bankers continue to plow ahead with more of the same. This is very unlikely to create a path to prosperity, in our view. Money is not supposed to be free. Our children and grandchildren will likely look back at this period with bewilderment as the economic textbooks are re-written. When policies and valuations get stretched to the extreme, so too will the inevitable consequences.

**In Banks We Trust**

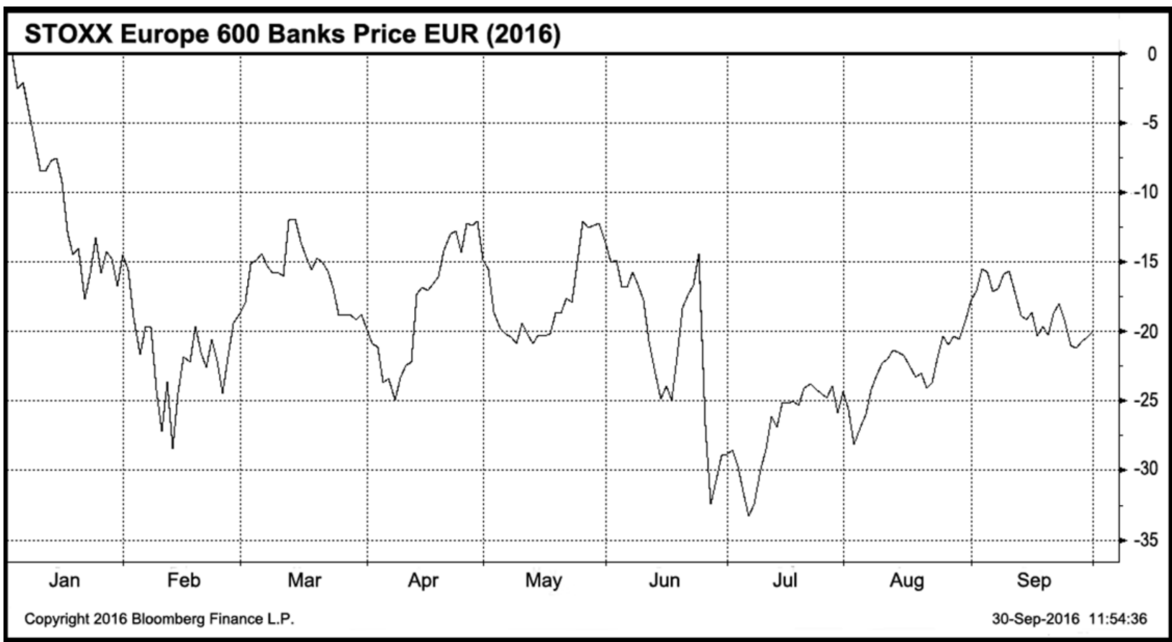
In doing "whatever it takes" to preserve the eurozone and resurrect growth, ECB President Mario Draghi has put a major squeeze on one of his most troubled sectors: European banks. Negative interest rates are debilitating to bank margins and profitability, and earnings have suffered as a result. Furthermore, European banks are lugging around approximately €900 billion ($1 trillion) of bad debt, with Southern Europe being the most heavily weighted to these distressed loans[12] (which is not a big surprise). Meanwhile, banks have recently been increasing their exposure to sovereign debt, as it is treated as "risk-free" and does not incur capital charges. As the European sovereign debt crisis should have demonstrated, Europe's government bonds are hardly "risk-free." Regulators have (rightly) expressed an interest in introducing capital charges on

8 Anna Kitanaka, Yuji Nakamura and Toshiro Hasegawa. "The Bank of Japan's Unstoppable Rise to Shareholder No. 1." *Bloomberg*, August 14, 2016.
9 Jeff Cox. "$12 trillion of QE and the lowest rates in 5,000 years...for this?" *CNBC*, June 13, 2016.
10 Ian Talley. "IMF Signals Another Downgrade to Global Growth." *The Wall Street Journal*, September 1, 2016.
11 "Poorer Than Their Parents?" *McKinsey Global Institute*, July 2016.
12 Tom Fairless and Todd Buell. "ECB Proposals Aim to Clear Europe's Bad Debt Mountain." *The Wall Street Journal*, September 12, 2016.

these holdings, but Fitch Ratings has warned that a policy shift could result in banks having to raise as much as €170 billion in extra capital, or sell €500 billion in debt.[13] In reality, European bank balance sheets are likely far worse than meets the eye, and regulators' softball "stress tests" do little to create comfort.




Absent Greece, the Italian banks are clearly in the worst shape, as 17% of total loans have gone sour. This equates to over €360 billion, quadruple the level reached in 2008.[14] As articulated by Mauldin Economics, "Italian GDP [gross domestic product] is around $2 trillion. At today's exchange rate, Italy's nonperforming bank loans total roughly 25% of GDP. Compare Italy to the U.S., where nonperforming loans amount to only 1.2% of GDP, or $128 billion. If nonperforming loans in the U.S. were 25% of U.S. GDP, they would amount to an astronomical $4.5 trillion. Italy is one good global recession away from a major crisis."[15] While the eurozone was barely able to manage through the contagion risks associated with the Greece debacle, a bank and/or sovereign debt crisis in Italy, at ten times the size of the Greek economy, would be a whole different animal. Needless to say, time is of the essence in terms of putting forth a credible path to sustainability.




13 "European banks raise government debt holdings." *Financial Times*, June 21, 2016.
14 Giovanni Legorano. "Bad Debt Piled in Italian Banks Looms as Next Crisis." *The Wall Street Journal*, July 4, 2016.
15 John Mauldin. "Brexit Doesn't Change the Sad Reality of Europe." *Mauldin Economics*, July 8, 2016.

Despite the stock price decline in European banks earlier this year, we will continue to keep our distance and watch from the sidelines. The black box nature of the businesses, highly-levered balance sheets, and concerns around solvency keep us at bay. Permanent impairment of capital is a material risk.

**Fiscal Stimulus To Save The Day?**

With monetary policy failing to deliver, some are hoping fiscal stimulus will come to the rescue. In the U.S., Japan and United Kingdom, budget deficits are set to be larger this year than last year, or larger than originally planned.[16] As a reminder, with rising deficits comes rising debt. When interest rates inevitably start to normalize (increase), perhaps the cost of debt will come back into focus. Like monetary policy, fiscal stimulus is no magic bullet. If that was the case, Japan's economy would be on top of the world. Since 1990, Japan has delivered 25 economic stimulus packages,[17] and what do they have to show for it? Lackluster growth and the world's largest accumulation of government debt (as a percentage of GDP).

**Mind The Gap**

Speaking of profligate spending, the Chinese government continues to prop up its economy as the private sector wanes. Fixed-asset investment, the key driver of China's growth engine in recent years, hit a 17-year low (8.1%) through August. Investments made by state-run companies were up a massive 21.4%, but investment by private companies, which account for 60% of the total, rose by only 2.1%.[18,19] In June, private investment fell for the first time since China started tracking the data in 2004. This is quite a slowdown, considering that it had grown by nearly 30% on average over the prior decade (10.1% in 2015).[20] While fixed investment has driven exceptional headline GDP growth, a significant portion of capital appears to have been poorly allocated. A recent *Oxford Review of Economic Policy* study writes, "Evidence suggests that over half the infrastructure investments in China made in the last three decades have been NPV [net present value] negative. Far from being an engine of economic growth, a typical infrastructure investment has destroyed economic value in China due to poor management of risks that impact cost, time, and benefits." They also note that "The majority of the investments China has made since 2000 have been debt-fueled,"[21] which further compounds the problem.

As we have highlighted in a number of our prior letters, China's debt levels are of great concern. New data from the Bank for International Settlements (BIS) and Standard & Poor's (S&P) Global Ratings further reinforce our trepidation. The BIS publishes a quarterly "Credit-to-GDP gap," which tracks the buildup of excessive credit and is defined as "the difference between the credit-to-GDP ratio and its long-run trend." It has "been found to be a useful early warning indicator of financial crises." Typically, a reading over 10% is a cause for concern, indicating an elevated risk to the country's banking sector. In March, China logged in at 30.1%, the highest level of any nation on record (from 1995).[22,23] In addition, S&P reports that China's total outstanding corporate debt has reached $17.8 trillion, or 171% of GDP. Per the *Financial Times*, this makes "China's corporate debt mountain by far the world's largest in both absolute and relative terms. Not only is the ratio of Chinese company debt-to-GDP more than double that in the U.S. and eurozone, it is projected to grow far more quickly as an increasing number of heavily-indebted corporations ramp up their borrowing simply to repay debts that are coming due. By 2020, China's outstanding corporate debt will be $32.6 trillion, while its share of global company borrowings will have risen to 43 per cent from 35 per cent last year, according to S&P estimates."[24] Buyers beware. A credit crisis in China would have significant global ramifications.

As we attempt to navigate through some of the potential landmines in the world economy, below are a couple stocks where we see an attractive risk versus reward. In the months ahead, our clients can expect us to remain defensively postured, as we continue to search for high-quality, durable businesses trading at a discount to their intrinsic values.

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16 Greg Ip. "Fiscal Policy Makes a Quiet Turn Toward Stimulus." *The Wall Street Journal*, September 15, 2016.
17 Issaku Harada. "Japan Strategy Views." Goldman Sachs, July 26, 2016.
18 "China's fixed-asset investment hits 17-year low through July." *Nikkei News*, August 12, 2016.
19 "China retail, industrial production beat expectations in August." *Financial Times*, September 12, 2016.
20 Mark Magnier. "The Private Pain of China's Economy." *The Wall Street Journal*, August 9, 2016.
21 Atif Ansar, Bent Flyvbjerg, Alexander Budzier and Daniel Lunn (2016). "Does infrastructure investment lead to economic growth or economic fragility? Evidence from China." *Oxford Review of Economic Policy, Volume 32* (Number 3), 360–390.
22 Gabriel Wildau. "Global watchdog warns over China's debt levels." *Financial Times*, September 19, 2016.
23 Paul Panckhurst. "Warning Indicator for China Banking Stress Climbs to Record." *Bloomberg*, September 18, 2016.
24 James Kynge. "China: the former EM darling." *Financial Times*, September 2, 2016.

## TE Connectivity Ltd. (TEL)

(Analyst: Jordan Teschendorf)

**Description**

TE Connectivity (TE) is the global leader in connectors and sensors, with the broadest portfolio of products in this $170 billion market. Transportation is the company's largest end market, at over 50% and 60% of sales and operating profit, respectively.

**Good Business**

- Approximately 90% of the portfolio provides leading connectivity and sensor solutions. A focus on providing increasingly complex, application-specific solutions raises the barriers to entry; 80% of sales are generated from harsh environment applications that require highly-engineered solutions.
- Connectors and sensors are a ubiquitous feature in electronic devices. The proliferation of electronics and increasing content penetration is driving demand for TE's products, which represent a low single-digit percentage of the bill of materials.
- Return on invested capital (ROIC) was 9.6% in fiscal year 2015. Returns have averaged 11.4%, 10.9%, and 9.7% over the last 3, 5, and 10-year periods, respectively.
- The balance sheet is strong and the company generates a prodigious amount of free cash.
- This business is easy to understand.

**Valuation**

- TE trades for 16.0 times fiscal year 2016 earnings per share forecasts, a significant discount to the S&P 500 multiple, as well as its closest peer Amphenol, which trades for 24.9 times.
- Koch Industries announced the acquisition of competitor Molex in September 2013 for 22 times consensus calendar year 2014 earnings per share (EPS) estimates. Ascribing a similar multiple to TE would represent upside of around 35%.
- Free cash flow approximates net income, and thus yields 6.4% on fiscal year 2017 forecasts.

**Management**

- Tom Lynch has served as Chief Executive Officer since January 2006, and was elected Chairman in January 2013. Terrence Curtin serves as President, and is responsible for all of the Connectivity and Sensors businesses, and merger and acquisition activities. Heath Mitts joined as Chief Financial Officer in September 2016.
- Since being spun off from Tyco International in June 2007, management has worked to reposition TE as a faster-growing, more profitable enterprise. In January of 2015, the company announced the sale of its volatile and underperforming BNS business to CommScope for $3.0 billion, or 10 times earnings before interest, taxes, depreciation and amortization (EBITDA), with the majority of the sale proceeds used for share repurchases.
- TE expects to continue to return roughly two-thirds of free cash flow to shareholders over time, with the remaining one-third dedicated to making small and mid-sized acquisitions.

**Investment Thesis**

TE Connectivity is well positioned to benefit from the trend towards hybrid, electric, and autonomous vehicles, which carry rising connector and sensor content. Increasing electronic content and design wins are expected to result in organic sales growth of 5-7% per year over the long term, which, in turn, should drive 50 basis points of annual operating margin expansion. Combined with stock buybacks, EPS should grow at a double-digit compounded annual rate. TE is an above-average company that is trading at a well-below-average multiple.

## Isuzu Motors (7202 JP)

(Analyst: Dan Sievers)

**Description**

Isuzu Motors, founded in 1916 and headquartered in Tokyo, is the number five global producer of commercial vehicles by units. The company manufactures and sells heavy, medium, and light-duty commercial vehicles, pickup trucks, sport utility vehicles (SUVs), truck parts, buses, and industrial diesel engines. In fiscal year 2016, Isuzu sold 319,000 heavy

duty/medium duty commercial vehicles (CVs), and additionally, sold 349,000 light commercial vehicles (LCVs), and 70,000 separate industrial diesel engines. CVs (more than twice as expensive as LCVs) were 47% of revenues and LCVs were 25% of revenues, such that “vehicles” represented 72% of revenues. The remaining 28% of revenues can be expressed as either, (1) 5% parts & components, 5% parts for overseas production, and 18% other, or as, (2) 5% parts & components, 23% knock-down kits (KD sets) and parts. In 2016, geographic revenue was 36% Japan, 28% Asia, 7% North America, and 29% Other.

**Good Business**

- Isuzu vehicles hold at least one number one category position in 37 countries. In Japan (81,000 units in fiscal year 2016), the CV market is a rational duopoly (with Hino). In Thailand (130,000 units), Isuzu is number one in most CV and LCV categories. Isuzu should experience secular growth in CV Overseas (238,000 units) and LCV Export (183,000 units). Demand for CVs is likely to grow throughout the Association of Southeast Asian Nations (ASEAN) block, where Isuzu is strong.
- In the early 2000s, Isuzu set out to restructure operations, rationalize and realign capacity, and de-lever. Isuzu increased emphasis on a narrow set of products as well as plant efficiency, profitability, and returns. Five-year average margins of earnings before interest and taxes (EBIT) have been 8.8% and 12.7% for ROIC. Isuzu lacks a large financing subsidiary.
- Isuzu’s balance sheet is in a net cash position, though capital expenditure was high in fiscal 2016, and will be in fiscal 2017, due to manufacturing investments in India (mainly) and China.
- Isuzu is focused on growing its profitable parts business, which will be aided by its strength in diesel engines.

**Valuation**

- At headline multiples of 1.4 times price to book value, 0.6 times enterprise value-to-sales (EV/Sales), 5.3 times enterprise value-to-EBITDA (EV/EBITDA), and 8.8 times 2017 estimated price-to-earnings, Isuzu is inexpensive and trades at or below its 5-year average multiples of 1.8 times, 0.6 times, 5.8 times, and 10 times, respectively. Adjusting for Isuzu’s 60 million shares in treasury, its EV/EBITDA multiple drops to 5.0 times. The multiple would be lower still if we adjusted for Isuzu’s minority investments in Qingling Motors (1122-HK) and others.
- Isuzu trades at a wide discount to leading Western truck companies (Paccar, Daimler, Volvo, MAN Truck & Bus) and quality domestic vehicles manufactures like Toyota, each of whom trade in excess of 1.0 times EV/Sales. Only Paccar has a lower (efficiency) ratio of selling, general and administrative expenses-to-sales.

**Management**

- Chairman Susumu Hosoi (67), along with prior Chairman Yoshinori Ida, enacted difficult reforms while President of Isuzu, reorienting the company around profitability, utilization, and efficiency.
- President (as of June 15) Masanori Katayama (62) began as an engineer with Isuzu 37 years ago.
- Isuzu promotes continuity of strategy via its 3-year mid-term business plans.
- Isuzu has not grown through acquisition, and uses return on equity as one of four key financial indicators.

**Investment Thesis**

Investors overstate Isuzu’s dependence on its domestic Japanese market (somewhat cyclically strong at present), where Isuzu sells just 12% of total vehicle units (25% of CV units) and generates 36% of sales. Isuzu is a strong, efficient, and well-capitalized diesel truck manufacturer with strong market positions throughout the growing ASEAN block (35% of units) and parts of the Middle East & Africa (24% of units). We further expect the company to grow in China and in India, where they are building a new LCV plant. We view the current valuation as attractive, and are encouraged by the fact that Isuzu repurchased 45 million shares in fiscal year 2016 (5.3% of total shares).

Thank you for your confidence in Fiduciary Management, Inc.

## Fiduciary Management Inc.
## International Equity Composite
## 12/31/2010 - 06/30/2016

| Year | Total Return Gross of Fees % | Total Return Net of Fees % | *Benchmark Return % | Number of Portfolios | Dispersion % | Three Year Ex-Post Standard Deviation Composite | *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 | 0.01 | 8.01 | 11.96 | $ 3,464.9 | $ 21,477.7 | 16.13% |
| Q2 2016 | 1.78 | 1.59 | -0.74 | 2 | 0.06 | 7.75 | 11.77 | $ 4,059.2 | $ 21,521.3 | 18.86% |

*MSCI EAFE Net Local Index®

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

Fiduciary Management, Incorporated (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 06/30/2016. 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 12/31/2010-06/30/2016. 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 $21.5 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.