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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

December 31, 2016

International stock markets finished the year with a bang, as Japan rallied 14.95% in the fourth quarter, while the UK, Germany, and France expanded by 3.90%, 9.23%, and 9.72%, respectively.[1] The FMI International portfolios advanced by approximately 1.3% in the period, which compares with an MSCI EAFE Index gain of 7.07% in local currency and a loss of 0.71% in U.S. Dollars (USD). Performance was driven by solid results in the Commercial Services, Communications, and Distribution Services sectors, while Finance, Producer Manufacturing, and Consumer Durables lagged the market. Adecco Group, Shin-Etsu Chemical and Isuzu Motors were the strongest individual contributors, as Fairfax Financial Holdings, Accenture and Rolls-Royce Holdings all detracted. The USD had been a headwind through September (year-to-date), but strengthened dramatically to close out the year, providing a boost to results through our passive currency hedging. Conversely, an elevated cash balance and an underweight position in Japan negatively impacted our relative performance.

For the full calendar year, the strategy generated an approximately 11.0% return, outpacing the MSCI EAFE's gain of 5.34% in local currency and 1.00% in USD. Our conservatively-managed portfolio outperformed in the first half of the year when overseas markets were under pressure, but lagged during a more euphoric second half rally. This is consistent with the firm's historical track record. Unfortunately, high quality businesses continue to be richly valued, as quantitative easing (QE) and exceptionally low (or negative) interest rates are providing a boon to financial asset prices and valuations. Markets looked right past Brexit, the Italian referendum, rising debt levels, and weak economic and business fundamentals, demonstrating a complacency which has become commonplace in recent years. While risk and uncertainty remain high, so too do the herd's inflated expectations for asset appreciation. In this context, we will continue to err on the side of caution and exhibit patience as we wait for attractive valuations to come our way.

A Dangerous Path

At a high level, we are quite concerned with the direction of the global economy and its most important actors (i.e., the U.S., Europe, Japan and China). Simplistically, in a slow-growth world we struggle to see how countries can continue to spend funds that they don't have, print money or raise mountains of debt to meet their obligations or buy financial assets, suppress interest rates, drive financial markets to extreme heights, and somehow expect that there will be a happy ending. In taking a step back and using common sense, it should become apparent that deep-rooted problems will not just magically disappear. It may be easier to look the other way and neglect dealing with fiscal and monetary profligacy, but this will only delay the inevitable. Just because a crisis hasn't happened, doesn't mean that it won't. We fear that as the years go by and the troubles continue to magnify, the house of cards will eventually fall.

According to the McKinsey Global Institute, global debt levels have reached a record high of $200 trillion (and rising), which has more than doubled in the last 15 years. This equates to nearly 300% of world Gross Domestic Product (GDP).[2] On the subject, the International Monetary Fund (IMF) has warned that "rapid increases in private debt often end up in financial crises," and "financial recessions are longer and deeper than normal recessions."[3] The IMF has singled out China and the eurozone as economies where it is especially important to deleverage. We'd add Japan and the U.S. to that list. Low interest rates have allowed all these countries to continually increase spending without consequence. As economist Marc Faber aptly writes, "US interest payments on the government debt are no higher than in 1995 although government debt is up almost 5-times since then."[4] A similar story can be told elsewhere. Nevertheless, should central banks lose their grip on ground-hugging interest rates, the sustainability of their debt and social obligations will likely come into focus.

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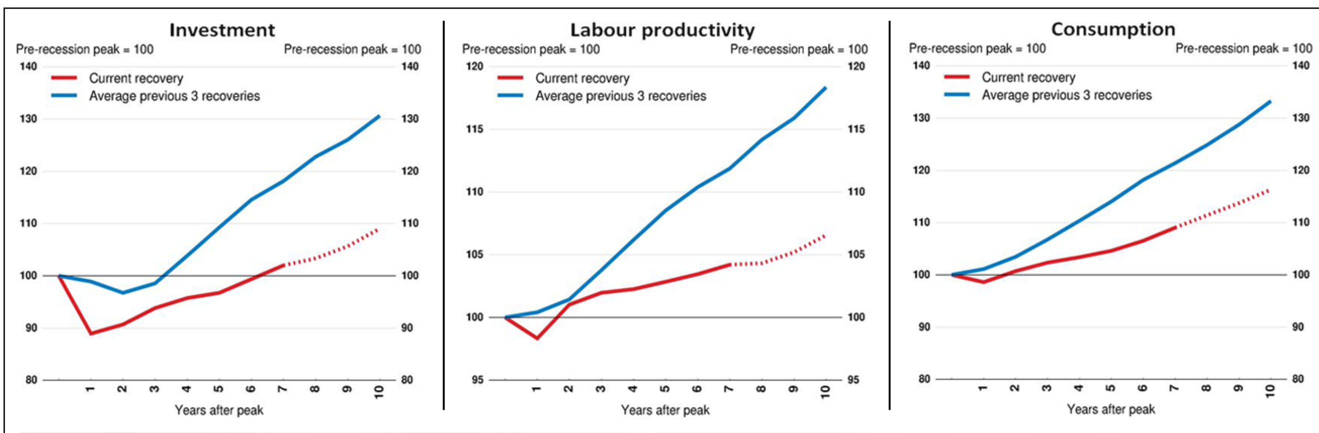
[1] The following market indexes are being referenced: Japan TOPIX, FTSE All-Share (UK), Germany DAX, and France CAC.
[2] Emmanuel Hatzakis and Christopher Wolfe. "Global Debt: Challenges and Opportunities." Merrill Lynch, April 2016.
[3] Vitor Gaspar, Director, Fiscal Affairs Department. "Debt: Use It Wisely - Press Conference Opening Remarks." October 6, 2016.
[4] Marc Faber. "The Monthly Market Commentary Report." November 1, 2016: 33.

Meanwhile, central bank balance sheets have also ballooned, reaching over $13 trillion, and with no end in sight.[5] Despite Mario Draghi trimming the monthly QE spend of the European Central Bank (ECB) from €80 to €60 billion, the extension of the program through the end of 2017 means that the new QE target (€2.3 trillion) is now more than double the size of the original €1.1 trillion announced in January of 2015.[6] He left the door open in case "the outlook becomes less favorable" so that they can "increase the program in terms of size and/or duration."[7] In Japan, where they are implementing QE on steroids, they recently unleashed a new "unlimited" bond buying plan.[8] Between the ECB and Bank of Japan (BOJ), monthly asset purchases stand at nearly $160 billion per month, an annual run rate approaching $2 trillion.[9] Not surprisingly, neither economy is seeing the results that they expected when they opened the printing press floodgates. Inflation is well short of expectations (for now; hyperinflation is a potential risk) and GDP growth is stuck in the mud.

The Wall Street Journal (*WSJ*) pens that "European companies happily take ECB's cheap cash, but don't spend it" as the "high-profile experiment aimed at spurring private investment" is not having the desired result. "Companies aren't spending, executives say and data suggest, because they see few opportunities amid feeble growth and because credit was already cheap."[10] As we've mentioned in prior letters, weak capital investment does not bode well for productivity, a key component of economic growth. To further illustrate the program's lack of efficacy, European think tank GEFIRA reports that the ECB is printing €18.5 billion of QE to generate an incremental €1 billion of GDP growth. In the first half of this year, the ECB printed roughly €600 billion while GDP increased by only €31 billion.[11] The Organisation for Economic Co-operation and Development (OECD) is forecasting Eurozone growth of 1.7% in 2016 (falling to 1.6% in 2017), which is nothing to write home about. Japan is generating a similar outcome, as business capital investment in the third quarter fell for the first time in nearly four years, with "uncertainty over the economic outlook eroding companies' confidence."[12] The OECD expects Japan's growth to be 0.8% and 1.0% in 2016 and 2017, respectively. As illustrated by the following charts (advanced economies), the current recovery is not up to par:[13]



Source: OECD Economic Outlook Presentation, November 28, 2016

Perhaps now might be a good time (before it's too late) for central bankers to do an honest assessment of their monetary policies. The current predicament and charted path forward is deeply troubling.

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5 Elaine Moore. "QE purchases near record even as doubts grow." *Financial Times*, October 4, 2016.
6 Paul Gordon and Piotr Skolimowski. "Draghi Says $2.4 Trillion Stimulus May Not Be Enough for ECB." *Bloomberg*, December 8, 2016.
7 "Highlights: Draghi comments at ECB press conference." *Reuters*, December 8, 2016.
8 Mehreen Khan. "BoJ unleashes unlimited bond-buying plan: analysts react." *Financial Times*, November 17, 2016.
9 Marc Faber. "The Monthly Market Commentary Report." October 1, 2016: 18.
10 Christopher Whittall and Mike Bird. "European Companies Happily Take ECB's Cheap Cash, but Don't Spend It." *The Wall Street Journal*, November 22, 2016.
11 QE in Europe is an Embarrassment: 18 QE euros generate a growth of 1 euro. (2016, September 23). Retrieved from https://gefira.org/en/2016/09/23/qe-in-europe-is-an-embarrassment-18-qe-euros-generate-a-growth-of-1-euro/
12 "Japan Q3 corporate capex falls for first time in nearly 4 years." *Reuters*, December 1, 2016.
13 OECD Economic Outlook Presentation, November 28, 2016

China Risks Mounting

We believe the single biggest risk to the global economy is still China. With three consecutive quarters of suspiciously steady 6.7% growth, some market participants have gained comfort that the world's second largest economy has stabilized. Unfortunately, many economists and investors, including ourselves, do not put much stock in the "official" Chinese numbers. Our unwavering skepticism was reinforced when Ning Jizhe, director of China's National Bureau of Statistics (NBS), acknowledged that the country has problems with the falsification of economic data, writing in the *People's Daily*, "Currently, some local statistics are falsified, and fraud and deception happen from time to time, in violation of statistics laws and regulations."[14] The admission of guilt was the only real surprise. Interestingly, the former head of the NBS is under investigation by the country's anti-corruption watchdog, which is probably telling.

A lack of trust does not end with the government. The *WSJ* writes that China's banks are hiding approximately $2 trillion in loans. With an "accounting sleight of hand," the banks are classifying loans as investment receivables, which allow them to avoid setting aside capital for potential losses. Investment receivables reached $2 trillion by June, up from $334 billion at the end of 2011, growing at an annual rate of nearly 50%. These investment receivables equate to 20% of the banks' total loan values, up from 6% at the end of 2011. UBS Investment Bank estimates that Chinese banks would need to raise $212 billion in capital if these receivables were treated as loans.[15] With shadow banking and off-balance sheet shenanigans well-documented across China, there is clearly more credit risk than meets the eye.

After a period of rapid growth, China's debt levels have now reached $30 trillion, or nearly 300% of GDP.[16] This has been driven by monetary stimulus, real estate and infrastructure investment, and corporate borrowing, among other factors. Autonomous Research partner Charlene Chu estimates that a staggering 22% of this debt ($6.6 trillion) will be nonperforming by year-end 2016. She says, "I don't know whether China faces a slow burn in economic growth ahead or some kind of financial crisis… but you can't continue on a path of allowing new credit infusions to grow at more than twice the pace of GDP growth." We agree. The pace of debt accumulation is alarming, as is China's reliance on fixed investment. Morgan Stanley's chief global strategist Ruchir Sharma's work reinforces our fears. Per a recent *Barron's* article: "Sharma's concerns arise from a study, done by his team, of nations that saw their private (corporate and household) debt-to-GDP ratio increase by 40 or more percentage points over a period of five years since 1960. They suffered mightily in the succeeding five years. China's debt-to-GDP ratio more than doubled that ominous pace between 2009 and 2014. In all 30 cases studied, output growth slowed by 50% or more over the following half-decade. Likewise, 18 of the same 30 countries suffered serious financial crises. By Sharma's reckoning, China is already two years into the throes of a GDP slowdown that figures to get far worse."[17]

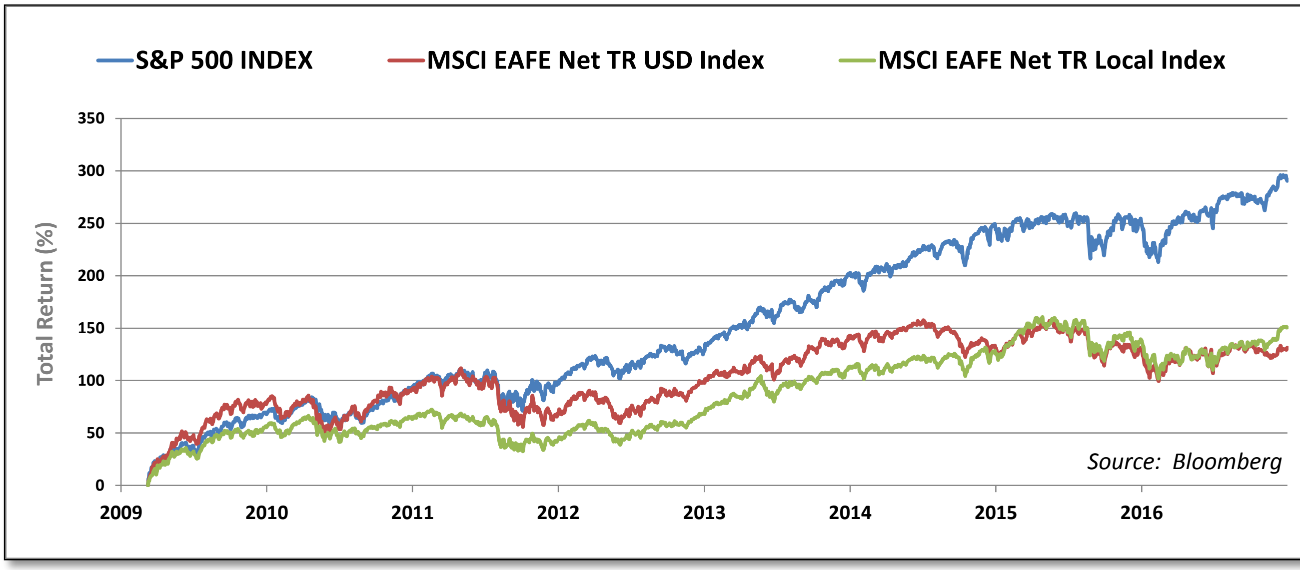
In the second quarter, mortgages in China grew by more than 30%, accounting for over 70% of all bank lending, compared with 33% of lending in 2015. Rumblings of a renewed housing bubble have returned to the forefront. With prices up by as much as 25% or more in cities like Beijing, Shanghai, and Shenzhen, the local municipalities are starting to introduce much-needed measures to cool the property market.[18,19] Only time will tell how this balancing act will unfold. Per the *Financial Times*, "Analysts believe the [housing] sector accounts for more than half of all investment, after factoring in demand for everything from concrete to household goods."[20] With fixed investment (including infrastructure) still the key driver of China's GDP, the government will have a choice of doing whatever it takes to keep the growth engine going, or rein in the excess to avoid a housing or credit crisis. With history as our guide, we expect the former. While we don't have any direct investments in China, the impact of a financial crisis would be felt worldwide.

[14] Gabriel Wildau. "China's statistics chief admits some economic data are false." *Reuters*, December 8, 2016.
[15] Lingling Wei. "China's Banks Are Hiding More Than $2 Trillion in Loans." *The Wall Street Journal*, December 16, 2016.
[16] Emmanuel Hatzakis and Christopher Wolfe. "Global Debt: Challenges and Opportunities." Merrill Lynch, April 2016.

[17] Jonathan Laing. "China's Debt Addiction Could Lead to a Financial Crisis." *Barron's*, November 5, 2016.
[18] Anjani Trivedi. "China's Ballooning Mortgage Debt Built on Shaky Foundation." *The Wall Street Journal*, October 14, 2016.
[19] Yuan Yang, Tom Mitchell and Wan Li in Beijing. "Property risks loom over China's economy." *Financial Times*, October 19, 2016.
[20] Tom Mitchell and Yuan Yang. "China GDP on target with 6.7% growth." *Financial Times*, October 19, 2016.

Market Divergence

Since the depths of the 2008-09 bear market, there has been a significant divergence between equity returns in the U.S. and overseas. As depicted in the chart below, from the March 2009 lows the Standard & Poor' 500 Index (+290%) has nearly doubled the return of the MSCI EAFE in local currency (+151%) and USD (+131%).



On a forward-looking price-to-earnings basis, *Bloomberg* estimates that European stocks (Stoxx 600 Index) are trading at their biggest discount (around 15%) to the S&P 500 since 2009.[21] While we believe the opportunity set is a bit more favorable overseas than domestically, the valuation spread is widened by especially cheap European financials, some of which are un-investable and likely insolvent. We would characterize U.S. stocks as very expensive (9^{th} decile valuation according to The Leuthold Group),[22] but in reality, high-quality international equivalents are really not that different. Finding great businesses at attractive valuations is as hard as it has been in the 36-year history of our firm, and overseas markets are no different.

If there were a reversion to the mean, it could indicate good news for the MSCI EAFE's relative return versus the S&P 500, and likely lead to outperformance overseas. That said, we think the impact for the international strategy might be more muted, as a strong USD the last three years has been a meaningful tailwind which could reverse. Since the launch of the international strategy, we have hedged a significant portion of the currency exposure, and will continue to do so.

In Bonds We Trust?

European and Japanese fixed income markets remain at extreme levels, as negative yielding bonds are still prevalent, albeit below June's peak. With the recent global bond market retreat, investors in "risk-free" sovereign debt might be getting a rude awakening. For instance, for those who were tempted to "stretch for yield" by buying 50-year French bonds at a 1.11% yield (April 20, 2016), they woke up at year-end with a bond price down approximately 22%.[23] For investors banking on the "greater fool theory," perhaps the music stopped a little too early. If forced to sell before maturity, losses (and regrets) will run deep.

[21] Namitha Jagadeesh and Sofia Horta E Costa. "European Stocks Are Trading at Their Biggest Discount Since 2009." *Bloomberg*, December 7, 2016.
[22] www.leutholdgroup.com
[23] Source: *Bloomberg.*

Political Uncertainty

The year 2016 did not lack political drama. We watched the United Kingdom vote to leave the European Union (Brexit), a failed coup attempt in Turkey, the unexpected election of Donald Trump as U.S. president, the impeachment of Brazil and South Korea's presidents, and an Italian referendum which led to the prime minister's resignation. In 2017, we have a number of important elections in Europe that could ultimately determine the fate of the eurozone. The establishment in France, Germany, the Netherlands and Italy will look to battle populism and Euroscepticism. Meanwhile, Greece might be heading toward a new crisis as they are considering snap elections in 2017 with the Syriza party losing popularity. Factor in uncertainty around the impact of Brexit, and Europe will have its hands full. We have long questioned the sustainability of the eurozone. A monetary union is unlikely to succeed without political and fiscal unity. We would not be surprised if 2017 turned out to be the beginning of the end of the eurozone as we know it today.

Even though global stock markets have emphatically embraced the recent "Trump rally," we think it is far too early to tell whether the U.S. president-elect will meet lofty stock market expectations. While we are in favor of tax cuts and reduced regulation, his protectionist rhetoric and policies could be detrimental for global growth. Furthermore, there has been little mention of the U.S. getting its fiscal house in order, which is a concern. At this point we have our doubts, but will continue to reserve judgement as we gather more information.

In a challenging environment, we will proceed with caution and stay true to our disciplined valuation framework. In recent months, with each subsequent sale or trim, finding the next replacement has become more difficult. Although our cash position is temporarily elevated, it is residual to our investment process; we are eager to put cash to work as prudent investment prospects arise. Today the masses are optimistically cheering on the rally, but tomorrow they might be running for the exits. As contrarians, we welcome this volatility, and the irrational behavior of market participants that comes with it. In time, we will have an opportunity to do our best work.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 09/30/2016

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation		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%
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%
Q3 2016	5.65	5.46	6.04	2	0.14	7.55	11.55	$ 5,056.4	$ 22,087.2	22.89%

*MSCI EAFE Net Local Index®

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

Fiduciary Management, Incorporated (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 09/30/2016. 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 12/31/2010-09/30/2016. 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 $22.0 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 25-40) 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.