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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

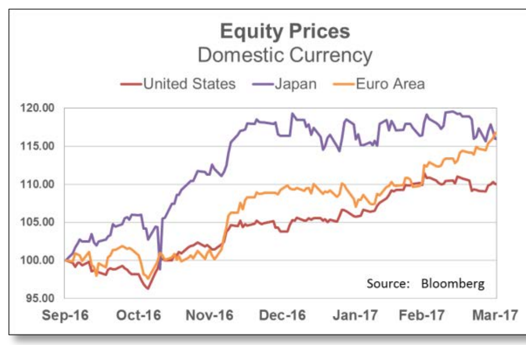
March 31, 2017

Investor euphoria carried over from late 2016 as global stock markets continued to climb in the first quarter. A handful of positive economic data points added fuel to the fire, with market pundits citing the reawakening of investor "animal spirits" while momentum gathered pace. Unfortunately, a disregard for valuation was also on the rise, which has been amplified by an industry-wide shift to passive investing, where an appraisal of business value (vs. price) is irrelevant. From our vantage point, stock prices have run too far ahead of the fundamentals, and it is doubtful that the growth rates embedded in today's equity valuations will come to fruition. We are hopeful that the global economy's nascent recovery is here to stay and that Main Street will pick up enough steam to catch up with Wall Street's lofty expectations, but view a smooth realignment as highly unlikely.

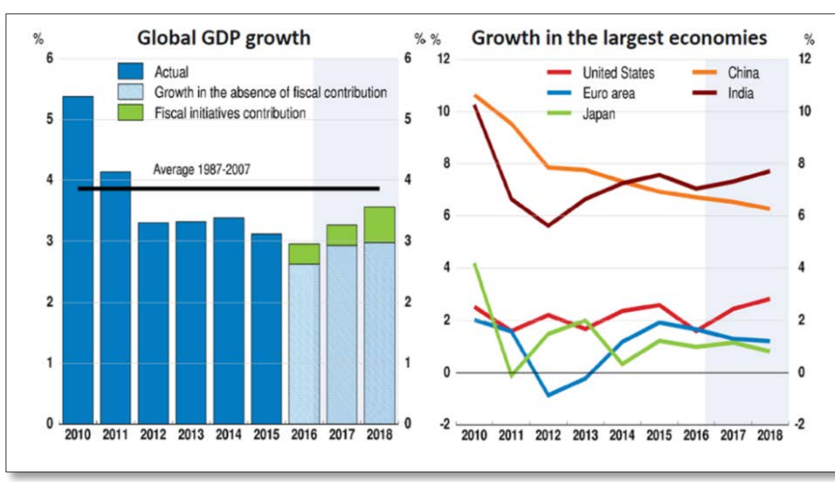
Despite taking a conservative approach, the FMI International portfolios advanced approximately 5.9% in the first quarter of 2017, compared with the MSCI EAFE Index gain of 4.71% in local currency and 7.25% in U.S. Dollars (USD). The Producer Manufacturing, Electronic Technology, and Consumer Durables sectors were strong contributors, while Industrial Services, Finance, and Technology Services detracted. Akzo Nobel, Unilever and Jardine Strategic Holdings boosted the strategy's relative performance, as Schlumberger, Potash Corp. and Fairfax Financial Holdings each weighed on the results. Currency hedging and an elevated cash balance were additional headwinds.

Up, Up and Away

Optimism, both for the global economy and the financial markets, is clearly rising. The Bank of Japan (BOJ) and European Central Bank (ECB) have each increased their domestic Gross Domestic Product (GDP) growth estimates in recent months, manufacturing purchasing-managers indexes are improving across geographies, business and consumer confidence is increasing, eurozone unemployment is falling, corporate profits are expected to rebound in 2017, and capital investment has finally shown some initial signs of life. Layer on enthusiasm for the Trump economic policy agenda, and public equity markets were off to the races, as can be seen in the chart to the right.

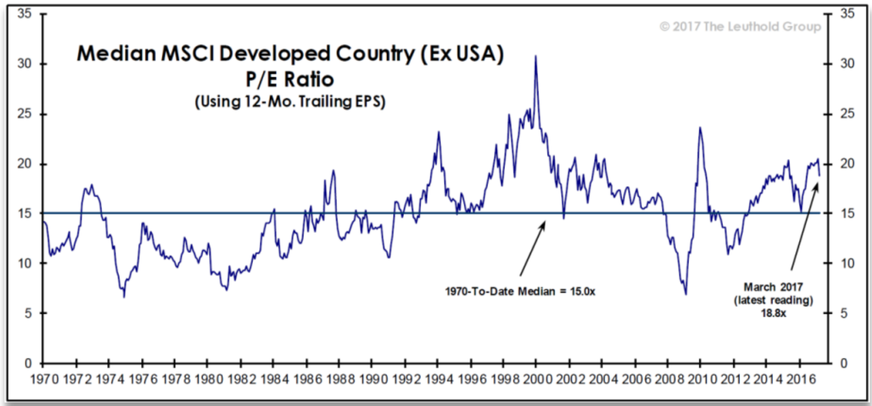


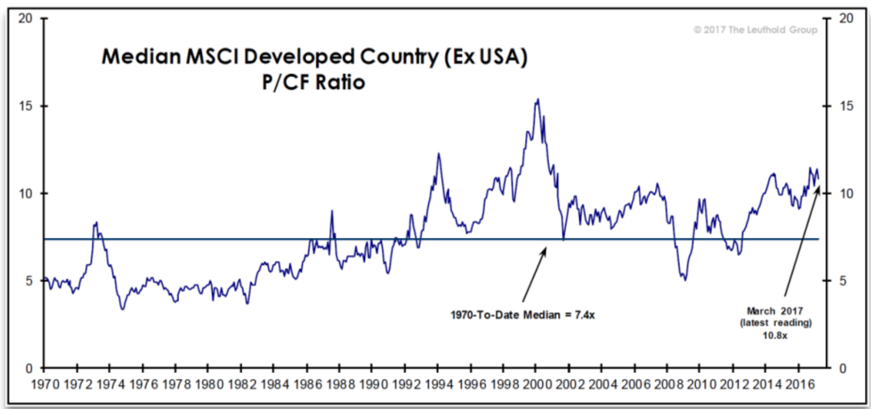
While we acknowledge that there might be some "green shoots" in economic activity, we want to remind our readers that we are in the midst of an historic period of extreme (and experimental) monetary policy. Central banks are pulling out virtually all the stops, with unprecedented negative interest rates and massive quantitative easing initiatives. Potential long-term consequences (and risks) are likely to outweigh the short-term benefits we are seeing today. Unfortunately, printing money and suppressing interest rates will not solve the world's problems.



When we peel back the onion, the global economic "recovery" does not appear to be particularly robust, especially in light of all the levers being pulled. While the BOJ and ECB are raising GDP forecasts, growth rates are expected to plateau in 2017 (Eurozone: 1.8%, Japan: 1.5%), before falling in subsequent years. Global GDP is projected to grow at 3.2% in 2017 (up from 3.0% in 2016), which is well short of historical norms (see chart to the right). Eurozone unemployment has dropped from 12.1% to 9.5%, but remains quite high.[1] Corporate profits in developed markets have started to tick up in the last few months, but are still below 2014 levels. Per J.P. Morgan, "global (excluding China) business equipment spending strengthened to 4.1% annualized last quarter [4Q16], a notable increase from the 1% contraction in the year through 3Q16."[2] However, we would caution extrapolating one quarter into the future; in aggregate, full-year capital investment was weak. While confidence is on the rise, consumption and investment have not kept pace. Productivity growth also remains sluggish, which is a key headwind for growth.

Meanwhile, the apparent disconnect between economic reality and financial markets is widening. Valuation multiples continue to climb, as illustrated by the charts to the right. In developed markets (excluding the USA), price-to-earnings and price-to-cash flow metrics have now reached 25% and 46% above historical medians, respectively. Absolute value is becoming harder to find.





Ultimately, a combination of high asset prices (and expectations), slow growth, vast credit build-up, investor complacency, and ineffective central bank policies could leave investors vulnerable to a sizeable market correction. In addition, just as passive investment vehicles purchase equities with no regard for valuation, so too will they sell when asset flows reverse. As Warren Buffet is often quoted, "Only when the tide goes out do you discover who's been swimming naked," which we think will ring true. We believe it is a matter of when -- and not if -- stock markets will correct, and when the time comes, we will become more aggressive. Some of the best investments are made in periods of fear and distress. A value investing (contrarian) discipline in times of despair is essential to taking advantage of these rare opportunities.

Closer Than They Appear

While the eurozone debt crisis might "appear" to be in the rearview mirror (for now), according to *Reuters* the European Union has warned its banks that they might be facing higher bad loan risks when the ECB takes its foot off the gas and starts to tighten monetary policy. European banks are already lugging around more than €1 trillion of non-performing loans, with more than a quarter held by troubled Italian banks (discussed in the September 2016 letter). Greece, Cyprus, Slovenia and Portugal's banks are also stressed.[3] Per *Reuters*, "While banks are likely to benefit from higher interest rates, which improve the margin they make on their loans, this may be offset by the effects of another economic slowdown."[4] In addition, rising interest rates means increased borrowing costs for companies and households that are already struggling to keep up with their existing debt obligations, which could trigger rising defaults. The ECB will undoubtedly have its hands full once it starts to reverse course. There is no quick fix.

[1] Source: Bloomberg

[2] Joseph Lupton, Bruce Kasman and David Hensley. "Profits prime global liftoff." J.P. Morgan, March 22, 2017.

[3] Martin Arnold and Jim Brunsden. "EU needs to create 'bad bank' for €1tn toxic loan pile, says EBA chief." *Financial Times*, January 30, 2017.

[4] Francesco Guarascio. "EU warns banks may face higher bad loan risk when ECB tightens." *Reuters*, July 17, 2015.

Not surprisingly, Greece has recently crept back into the headlines. In a new sustainability report issued by the International Monetary Fund (IMF), they describe Greece's debt as "highly unsustainable" and on an "explosive" path. The IMF concludes that "Greece cannot be expected to grow out of its debt problem, even with full implementation of reforms" and "requires significant debt relief from its European partners to ensure debt sustainability," something other creditors (European commission, ECB) have been reluctant to embrace. The IMF predicts that Greece's debt as a percentage of GDP will reach about 184% once the 2016 figures are tallied.[5] Per *The Telegraph*, "A fresh crisis over Greek debt could be triggered as soon as July when Greece is due to repay some €7 [billion] to its creditors – money the country cannot pay without a fresh injection of bailout cash."[6] While creditors appear optimistic, we have concerns that the worst is yet to come. Europe has continually kicked this can down the road, as the IMF study confirms. Absent a default or restructuring of their debt, Greek financial distress will continue to resurface again and again. How many other countries are one step behind Greece?

China: Keeping Our Distance

Fear of a real estate bubble in China continues to linger, despite the government's attempts to cool the property market. According to the *Financial Times*, "Property investment grew at its fastest pace in two years in January and February at an annual rate of 8.9 per cent, while sales accelerated to 25.1 per cent growth in floor space terms." During the same time, house prices were up around 12% nationally.[7] Affordability also remains an issue. According to a People's Bank of China survey, approximately 52.2% of urban households perceive housing prices as "unacceptably high."[8] *Forbes* reports that the average property price in Shanghai ($725,000), for example, is more than 50 times the city's median salary ($13,620), which compares with New York, the U.S.'s most expensive city, at about 32 times. The author suggests that China's housing market is "worth watching," as China "consumes nearly half of the world's steel and cement production" and accounts for "a third of global GDP growth."[9] We agree. Property investment remains an important driver of economic growth in China, and the government faces a daunting challenge of balancing internal growth objectives against the increasing risk of a property-induced credit crisis.

China's astonishing accumulation of debt in recent years has been well documented. To further augment our concerns, recent data from China's elaborate shadow banking system is increasingly worrisome. *The Wall Street Journal* pens that as banks retreat and credit markets face strains, Chinese companies have been stepping in to lend to one another. Per the report, "Company-to-company loans in China jumped by 20% last year to 13.2 trillion yuan ($1.92 trillion), according to research firm CEIC. That is roughly double the size of the loan book at Wells Fargo & Co., the U.S.'s biggest lender." These "entrusted loans," where banks serve as middlemen, can earn interest rates of up to 20%. The majority of these loans (about 60%) are being used to "prop up companies in sectors like mining and property where Beijing wants to reduce excess capacity."[10] The quality and pricing of entrusted loans is highly questionable, as "few Chinese companies have the personnel to adequately assess credit risk,"[10] which is alarming. On a much smaller scale, but in a similar vein, China has also seen an explosion of peer-to-peer lending. Peer-to-peer loans have grown to 885.7 billion yuan, or $128 billion, up 8 times in only about 2 years. Lenders can expect yields of 8-12%, offering credit to high-risk consumers who are not able to get traditional bank financing.[11] With wealth management ($3.8 trillion) and trust products ($2.2 trillion)[12] also rapidly growing, shadow banking in China is becoming ever more popular and fraught with risk.

Speculation isn't limited to China's property and lending markets, however. The *Financial Times* reports that money has also started to flood into domestic private equity, as "overseas acquisitions become increasingly challenging amid Beijing's clampdown on moving money offshore." Nearly one-fifth of global early-stage private equity investments are made in China (approximately $15 billion). Valuations have sky-rocketed, with multiples coming in at around 30 times

[5] "Greece. IMF Country Report No. 17/40." International Monetary Fund, February 2017.

[6] Time Wallace. "EU faces crisis as IMF warns Greek debts are on 'explosive' path." *The Telegraph*, February 7, 2017.

[7] Gabriel Wildau. "Chinese cities revive crackdown on home loans as property bubble concerns grow." *Financial Times*, March 20, 2017.

[8] Huileng Tan. "China's property bubble represents a social risk: Renowned Chinese economist." Bloomberg, March 24, 2017.

[9] Kenneth Rapoza. "Shanghai Housing Prices Completely Unsustainable." *Forbes*, March 19, 2017.

[10] Rachel Rosenthal and Anjie Zheng. "Chinese Companies Rush In With Nearly $2 Trillion Where Bankers Fear to Lend." *The Wall Street Journal*, February 9, 2017.

[11] Yusho Cho. "China's yield-strapped investors spark peer-to-peer explosion." *Nikkei Asian Review*, March 17, 2017.

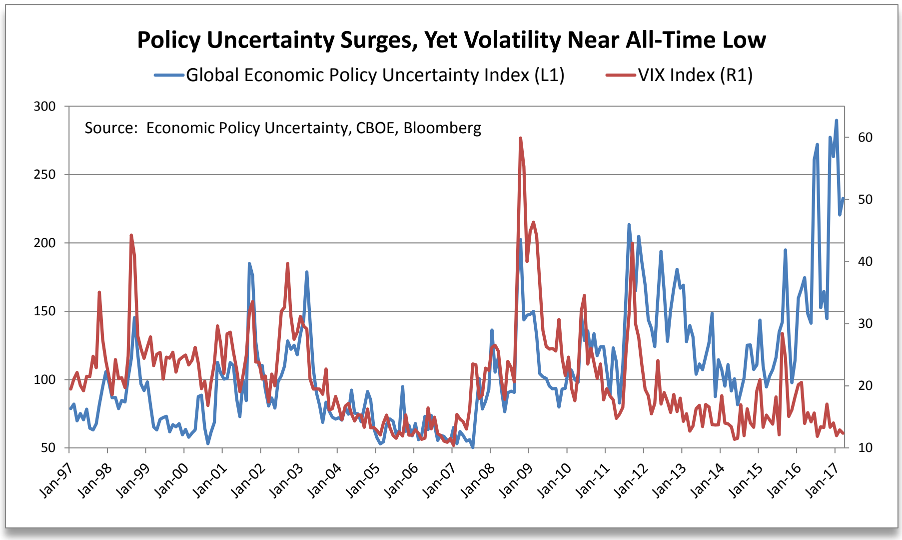
[12] "China's $9 Trillion Moral Hazard Is Now Too Big to Ignore." *Bloomberg News*. February 21, 2017.

earnings before interest, tax, depreciation, and amortization (EBITDA), which compares with around 17 times in Asia-Pacific and 10 times in the U.S.[13] It's hard to earn your cost of capital at these nosebleed valuations. Overpaying, then trying to protect your intellectual property in China? Priceless.

Despite what may be an attractive long-term outlook for China, near-term risks continue to keep us at bay. Our indirect exposure to China (via existing holdings) is heavily weighted toward the Chinese consumer vs. fixed asset investment, which is not likely to change for the foreseeable future.

Calm Before The Storm?

The following Bloomberg chart illustrates the complacency we are seeing from today's market participants. While global economic policy uncertainty is near multi-decade highs (e.g. Brexit, European elections, the Trump presidency, impeachments in Brazil and South Korea), stock market volatility (per the VIX Index) is approaching all-time lows. The recent divergence, compared with a more correlated historical relationship, is revealing. One would typically expect increased market volatility in periods of high economic policy uncertainty, yet we are seeing the exact opposite. Is this the calm before the storm?



It's certainly possible. When the masses start to brush aside risk factors (and valuation) and throw caution to the wind, one is better off doing the opposite. As "animal spirits" have taken hold and stock prices drift away from economic reality, finding suitable investments has become especially challenging. That said, we will continue to keep our heads down in search for the next attractive investment opportunity. We are eager to put our cash to work, but will remain disciplined in our approach, with a keen focus on downside protection. Highlighted below are a few examples where we've recently found value:

Whitbread PLC (WTB LN)

(Analyst: Jordan Teschendorf)

Description

Whitbread is the largest hospitality group in the United Kingdom, with over 730 hotels and 2,000 coffee shops, operating primarily under two strong brand names, Premier Inn and Costa. Premier Inn is the largest branded budget hotel chain in the U.K. and Costa is the largest branded coffee chain in the U.K. Whitbread also operates over 400 restaurants, nearly 95% of which are co-located with a Premier Inn. The group owns and operates the majority of its hotels, while it utilizes a number of channels to bring its Costa brand to market, including equity stores, franchised stores, wholesale arrangements, and express kiosks. The company is headquartered in Dunstable, U.K. and generates over 95% of its revenue in the U.K.

Good Business

- Whitbread is the U.K. market leader in the economy hotel and branded coffee shop market with two strong and focused brands. Economies of scale are present in each business.
- The company has successfully exited non-core businesses over the last ten years and focused on organic growth, driving improved margins and returns on capital.
- Premier Inn derives a high and growing proportion of its bookings directly from its online bookings platform, PremierInn.com, which allows it to sell its inventory of rooms with very low distribution costs, invest at higher rates than competitors, and maintain a superior product.

[13] "Chinese private equity: look elsewhere." Lex column, *Financial Times*, March 15, 2017.

- The company’s lease-adjusted return on invested capital was 11.7% in fiscal year 2016. Returns have averaged 11.5%, 11.0%, and 10.0% over the last 3-, 5-, and 10- year periods, respectively, well in excess of the company’s cost of capital.
- Whitbread maintains a solid balance sheet with net leverage of 1.3 times EBITDA at the end of the most recently completed period, earning a BBB credit rating from Fitch. Adjusted for off-balance sheet leases, net debt is a reasonable 3.3 times earnings before interest, taxes, depreciation, amortization, and rent costs (EBITDAR), and the company is committed to keeping it below 3.5 times.

Valuation

- The stock is down over 24% from its high in spring 2015, significantly underperforming the FTSE All-Share Index since that time.
- The company’s 12-month forward price-to-earnings multiple is 15.0 times, which is below the 5-year and 10-year averages of 17.4 times and 15.7 times, respectively.
- Shares currently yield 5.2% on our estimate of fiscal year 2017 underlying free cash flow.

Management

- Alison Brittain joined Whitbread as CEO Designate in September 2015 before taking over as CEO in December 2015. She previously served as Director of Retail at Lloyds Banking Group (2011–2015).
- Nicholas Cadbury has been Group Finance Director since November 2012, previously serving as CFO of Premier Farnell Plc.
- The management team prioritizes returns on capital when considering growth and this measure is linked to the long term incentive plan.

Investment Thesis

Premier Inn and Costa have proven to be relatively defensive businesses, capable of growing organically and taking market share in many economic environments. After a period of impressive growth, Whitbread’s shares have come under pressure over the past 18 months as investors have grown cautious on the U.K. hotel cycle and the general sentiment of the U.K. consumer. This has provided us with the opportunity to invest in a high-quality and steadily-growing company, at a relatively attractive valuation.

Vivendi SA (VIV FR)

(Analyst: Dan Sievers)

Description

Vivendi SA is a media holding company headquartered in Paris, France. Following a multi-year transition, Vivendi’s value lies principally in its two leading content-media businesses, Universal Music Group (UMG) and Canal+, followed by net cash and public equity investments worth about €7 billion. UMG (€5.2 billion in 2016 revenues) is #1 globally in recorded music and music publishing, and returned to growth in 2015 and 2016. Canal+ (€5.3 billion in 2016 revenues) contains the leading European film studio (StudioCanal) and is a leader in premium PayTV channels and packages in France and PayTV channels in Poland, Vietnam, and thirty French-speaking African countries.

Good Business

- Global recorded music industry revenues fell by more than 50% between 1999 and 2014 but returned to growth in 2015, and accelerated in 2016. Absolute dollar decreases in physical sales have become smaller while digital streaming and subscription revenues continue to grow rapidly (Spotify, Apple Music, etc.), appealing to new customers and markets due to broad content libraries and attractive interfaces that are steering listeners away from piracy at the margin. In 2016, global recorded music industry revenue share was 29% for Vivendi’s UMG, 22% for Sony Music, and 17% for Warner Music Group. While the industry remains very competitive, these three players are unified in their pursuit of artists’ interests and copyright protections.
- Canal+ has a French premium channels business that is generating significant losses (high sports rights costs and an irrational competitor), but “everything is on the table” to reach break-even by Fiscal Year 2018, and this is just one piece of Canal+. Canal+ also owns CanalSat (France), which is nicely profitable, and ongoing profit growth is expected from StudioCanal and the Canal+ International PayTV businesses, where subscriptions grew 14% to 6.2 million in 2016.

- Both businesses have difficult-to-replicate content libraries, are leaders in their respective industries, and offer growth potential. Neither business requires significant incremental fixed capital investment, and both are capable of attractive returns on capital employed.

Valuation

- Vivendi trades for less than 1.2 times adjusted enterprise value to sales. This compares to UMG segment operating margins of 13% (and rising), and Canal+ segment operating margins of 6% including the aforementioned losses with potential well into the double digits as those losses are reduced.
- If the Canal+ French premium channels business were break-even today, we believe Vivendi would be trading at less than 8 times adjusted enterprise value-to-trailing EBITDA. The losses distort near-term valuation metrics. As Vivendi makes progress toward break-even in Fiscal Year 2018, we note that our adjusted enterprise value to estimated Fiscal Year 2019 EBITDA is 7.4 times.
- Our sum of the parts value for Vivendi exceeds €22, offering more than 20% upside at present.

Management

- Vivendi is actively chaired by Vincent Bollore, an astute capital allocator whose controlled-company owns 20% of Vivendi's shares (and about 29% of the voting rights).
- Vivendi has excess cash and securities and CEO Arnaud de Puyfontaine has placed some emphasis on returning capital to shareholders through buybacks and both regular and special dividends.

Investment Thesis

Despite lingering investor bias against recorded music, the value of UMG's content library and UMG's growth outlook look more positive now than at any time in the last 15 years. While Canal+ Group has a loss-making French premium channels business, it also has a valuable content library in StudioCanal, and an attractive growing International PayTV business (especially throughout French-speaking Africa). Net cash and public investment stakes of about €7 billion provide balance sheet safety, strategic optionality, and return potential. We view the current valuation as providing adequate downside protection and attractive upside, should management achieve break-even at Canal+ French premium channel in Fiscal Year 2018.

Thank you for your confidence in Fiduciary Management, Inc.

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

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	*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%
2016	11.04	10.23	5.34	3	0.38	7.39	11.53	$ 5,946.2	$ 22,626.7	26.28%

*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 - 12/31/2016. 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 12/31/2010-12/31/2016. 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 $22.6 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.