FIDUCIARY MANAGEMENT, INC.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2017

International stock markets continued their relentless climb in the June quarter, as the outlook for global economic growth improved. The FMI International portfolios gained approximately 3.7% in the period, compared with the MSCI EAFE Index's increase of 2.71% in local currency and 6.12% in U.S. Dollars (USD). The portfolio's performance was driven by strong relative moves in the Electronic Technology, Consumer Durables, and Consumer Non-Durables sectors, while Industrial Services, Finance, and Distribution Services detracted. Top individual contributors included Rolls-Royce, Samsung Electronics and Electrolux, with Schlumberger, Fairfax Financial, and Wolseley weighing on the results. Currency hedging and an elevated cash balance remained a headwind.

The global economy's fragile recovery is showing signs of life, with manufacturing improving, some commodity producers recovering, and trade and investment picking up from low levels. The Organisation for Economic Co-operation and Development (OECD) now predicts world GDP growth will accelerate to 3.5% in 2017 (from 3.0% in 2016), and 3.6% in 2018. However, growth remains below historical norms despite a boost from planned fiscal initiatives. In China, for example, fixed investment for infrastructure increased by more than 23% through April of 2017 (year-over-year).[1] Combined with a roaring housing market, China's ramped-up stimulus program helped drive better-than-expected growth (6.9%) in the first quarter. China is on pace to account for around a third of global growth in 2017, an outsized impact.[2] Elsewhere, GDP in Europe and Japan has also modestly improved, on the back of extraordinary (and potentially dangerous) money printing and quantitative easing (QE) efforts. Despite the recent uptick, the risks to the outlook appear skewed to the downside, and include elevated stock and bond valuations, high (and rising) debt levels, overheated property markets, unsustainable interest rates and central bank policies, weak productivity and wage growth, and geopolitical uncertainty, among others. As optimism and complacency continue to permeate the investment landscape, we remain prudently positioned with a focus on capital preservation.

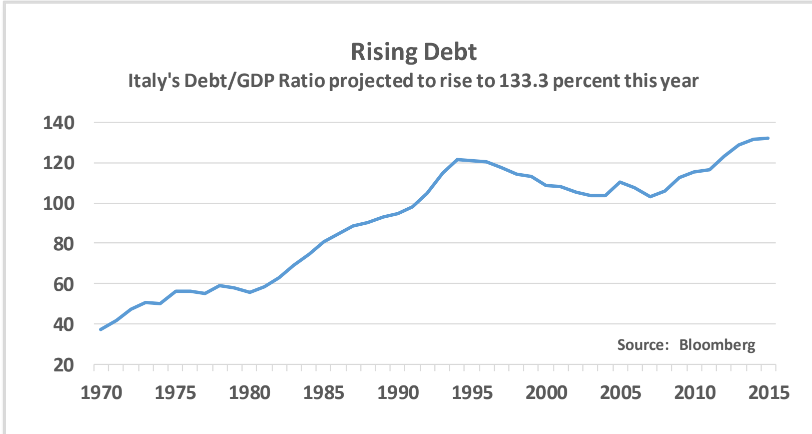
Pricing In Risk: Not Today

As we look around the world, with each passing day it becomes increasingly clear that asset values (across the spectrum) are not adequately pricing in risk. Despite what the pundits on CNBC would have you believe, stocks are expensive – both domestically and overseas. Valuations are well above historical levels using most conventional metrics. If you exclude everything bad that happens (restructuring charges, one-time costs, amortization of intangibles, etc.) and pretend stock compensation is not a real cost, you can come up with an "adjusted" price-to-earnings (P/E) ratio that suits your fancy. This is not a game we will play. While there will always be idiosyncratic opportunities in the stock market (and we are tirelessly turning over new rocks to find them), in aggregate, the opportunity set is highly-valued. This is especially true for quality, well-run companies with strong balance sheets. Finding traditional "FMI names" is as hard as it's been since we started the business over 37 years ago. Notwithstanding the aforementioned commentary, public equities still appear to be the best house (asset class) on the block.

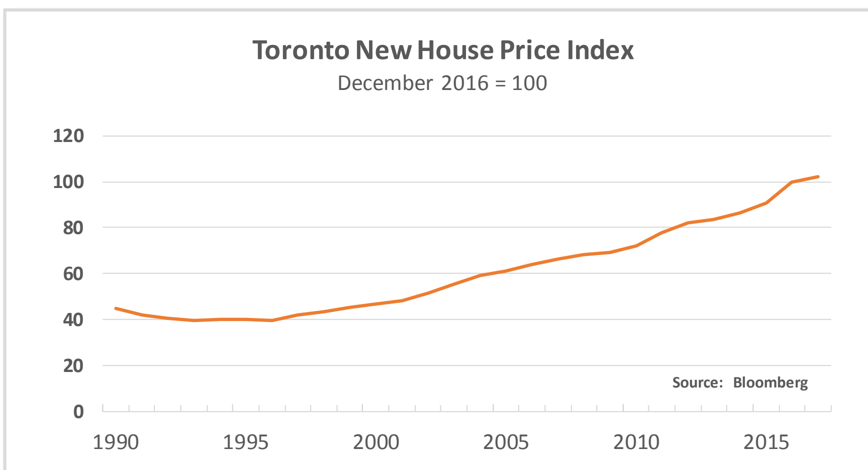
While stocks might be levitating, the bond market is completely upside down. Remarkably, negative interest rates remain prevalent, with about $9.5 trillion of sovereign debt still trading at a negative yield.[3] With no such precedent (for negative interest rates) in 5,000 years of banking history,[4] the notion of guaranteed losses on fixed income investments (if held to maturity) is hard to fathom. Common sense does not apply, as the greater fool theory is the only reasonable explanation. Meanwhile, with investors starved for yield, a country like Argentina is somehow able to come to market with a 100-year bond priced at only 7.9%. As a reminder, this is a country that has defaulted on its debt eight times, including in 2001 ($100 billion) and 2014. *Grant's Interest Rate Observer* aptly writes, "At its historical

[1] "OECD Economic Outlook" presentation. June 7, 2017. www.oecd.org/economy/economicoutlook.htm.
[2] "China Roars Back to Lift Global Outlook as U.S. Consumer Weakens." *Bloomberg News*. April 17, 2017.
[3] Jeff Cox. "Negative-yielding government debt 'supernova' jumps to $9.5 trillion." *CNBC*, June 16, 2017.
[4] Jeff Cox. "$12 trillion of QE and the lowest rates in 5,000 years...for this?" *CNBC*, June 13, 2016.

pace... [Argentina] will default more than four times over before that so very-distant prospective maturity date. From banking crises, to political dysfunction, to depression-level economic contractions and hyperinflation, Argentines (and their creditors) have seen it all, usually more than once."[5] Elsewhere in emerging markets, 10-year bond yields (in USD) for Russia and Brazil are priced at 4.28% and 4.88%, respectively. Russia is not far removed from its longest recession in two decades[6] (and energy prices have recently collapsed), while Brazil just exited its worst recession (eight straight quarters) in history.[7] Yet both sovereign issues trade at a similar yield to that of the the U.S. equivalent averaged in the decade leading up to the financial crisis (4.88%), which is much closer to "normal" than the manipulated ground-hugging environment that we have today. In Europe, the detachment from reality is just as troubling. Italy's 10-year bond trades at a lower yield (2.15%) than that of the U.S. (2.31%), despite facing weak economic growth, a troubled banking system, and ballooning public debt. Over the last 10 years, GDP growth in Italy has averaged -0.55%, while debt-to-GDP has jumped to 133%.[8] Can any rational observer make the case that Italian bonds are a safer bet than their U.S. counterparts? Amazingly, Italy's 2-year bonds trade at a negative yield.



Real estate may also be priced for perfection, as rumblings of property market bubbles in Australia, Canada, London, Japan, China and Hong Kong are all capturing their share of headlines. After riding on the coattails of China's growth miracle, Australia is now celebrating almost 26 years (103 quarters) without a recession, the longest recorded period in the developed world.[9] China's fixed investment boom has driven demand for resources from Australia, as iron ore and coal are the country's leading exports. With great economic fortune (and Chinese capital flight to overseas property markets), the Australian real estate market has been on a tear. Unfortunately, individual balance sheets are starting to get stretched, along with property prices. To quote *Grant's Interest Rate Observer* once more, "Australian households rank fourth among the world's most indebted [188.7% household debt-to-income vs. U.S. peak at 132.7% during the housing bubble] [...] the median ratio of house prices to income in Australia's major markets hovered at 6.6 vs. 3.9x in the United States. The price-to-income ratio in Sydney, the second-most expensive city in *Demographia's* survey, towered at 12.2, after Hong Kong (18.1) and above other high-flying Anglophone cities like Vancouver (11.8) and San Francisco (9.2)."[10]



Aggressive Chinese buyers have also helped prop up Canada's real estate market, in tandem with local speculation and abundant credit.

[5] Philip Grant. "'Time marches on." *Grant's Interest Rate Observer: Almost Daily Grant's.* June 19, 2017.
[6] Anna Andrianova. "Russia Is Running on More Than Just the Black Stuff." *Bloomberg.* March 6, 2017.
[7] Patrick Gillespie. "Brazil's worst recession: 8 consecutive quarters of contraction." *CNN.* March 7, 2017.
[8] World Bank data.
[9] "Eryk Bagshaw & James Massola. "GDP: Australia grabs record for longest time without a recession." *The Sydney Morning Herald.* June 7, 2017.
[10] *Grant's Interest Rate Observer:* Vol. 35, No. 12. June 16, 2017.

With Canadian property markets overheated, a near-collapse at one of Canada's largest mortgage lenders, Home Capital Group (Ticker: HCG.CA), could be an early warning sign. The stock dropped more than 60% in one day. Home Capital focuses on subprime lending, and its fall from grace has been compared with New Century Bank, the second largest U.S. subprime lender, which ran into trouble 18 months before the Lehman crisis, and was one of the first dominos to fall.[11] While history may not repeat itself, at the very least this should raise some antennas. Ours are certainly on high alert.

<u>Europe: In The Clear?</u>

Even though the herd is applauding Europe's economic revival, we still have some lingering doubts. At the source, we do not believe printing money can solve real-world problems, even if it may paper over them in the near term. The fundamental structural issues in Europe (and elsewhere) have not been addressed. Uncertainty remains high, especially after Theresa May's failed UK snap election, with more political drama likely still to come. Additionally, while the narrative is that employment in the eurozone is much improved (9.3% unemployment, the lowest in eight years), a recent European Central Bank (ECB) study paints a more troubling picture. Per the *Financial Times*, "The eurozone's labour market is in much worse shape than official jobs figures suggest, with workers unlikely to see real increases in pay because of the level of underemployment across the bloc […] A new measure of "slack" in the labour market from ECB economists indicates that between 15 per cent and 18 per cent of the eurozone workforce are without jobs or would like to work longer hours, almost double the official unemployment rate. […] The problem of underestimating unemployment is particularly acute in Europe because Eurostat, the European Commission's statistics bureau responsible for the measure, bases its official unemployment figure on a narrow definition of joblessness."[12] Therefore, we were not surprised to see a recent McKinsey Global Institute survey of European business leaders indicate "a continuing reluctance among European firms to invest, with many hoarding cash. […] European business leaders cite a range of risks and uncertainties, including concern about future crises, nervousness about rising populism and anti-globalization sentiment, and lingering fears about the future shape and direction of the European Union (EU) itself."[13] Unfortunately, weak business investment does not typically bode well for productivity and GDP growth.

Another sign of caution would be the recent failure of Spain's multi-billion-euro bank, Banco Popular. After a run on the bank, Europe's new banking resolution authority (Single Resolution Board, or SRB) had to broker an overnight sale to Santander, whose offer of €1 (without any state guarantees against hidden losses) got the deal done. It certainly brings back memories of J.P. Morgan coming to the rescue of Bear Stearns in March of 2008. Banco Popular's equity and subordinated debt holders were wiped out, with the SRB imposing approximately €3.3 billion of losses on these security holders. Per the *Financial Times*, "The origins of Popular's demise go back at least a decade, to the final years of Spain's ill-fated property boom, when Popular made an ill-timed bet by loading up on real estate assets and loans just before the financial crisis."[14] With Spain's economy humming along (at least 3% GDP growth in eight straight quarters) and European stock markets on the rise, it was somewhat surprising to see a notable bank fail, but even more telling to see complacent investors simply shrug it off and continue to push equity prices higher.

<u>BOJ: Full Throttle</u>

When it comes to money printing and QE, the Bank of Japan (BOJ) is by far the world's worst offender (vs. the size of its economy). Per the *Nikkei Asian Review*, "At around 93%, the scale of the Japanese central bank's assets in proportion to GDP has no close match. Latest data shows that the U.S. Federal Reserve held roughly $4.5 trillion in assets, which is equivalent to 23% of the country's GDP. The European Central Bank's balance sheet, at about 4.2 trillion euros ($4.71 trillion) is larger than the BOJ's, but it still sits at around 28% of the eurozone GDP."[15] The BOJ purchased approximately "114.4 trillion yen [$1.03 billion] worth of JGBs [Japanese Government Bonds] in 2016, 71.7 percent of new issues and 12.7 percent of the total market size of 903 trillion yen."[16] In 2017, the BOJ has also ramped up purchasing of exchange-traded funds (ETFs), with the balance now reaching 15.93 trillion yen ($144 billion), an

---

[11] Ben McLannahan. "Home Capital woes spark fears on Canada property market." *Financial Times.* May 18, 2017.

[12] Claire Jones and Sarah O'Connor. "Plight of eurozone jobless found to be worse than data show." *Financial Times*, May 10, 2017.

[13] Jacques Bughin, Eric Labaye, Frank Mattern, Sven Smit, Eckart Windhagen, Jan Mischke, and Kate Bragg. "The brightening mood of European business—and what it means for investment." *McKinsey Global Institute.* May 2017.

[14] Tobias Buck & Jim Brundsden. "Banco Popular caught in death spiral." *Financial Times.* June 8, 2017.

[15] "BOJ's balance sheet almost as big as Japanese economy." *Nikkei Asian Review*. June 2, 2017.

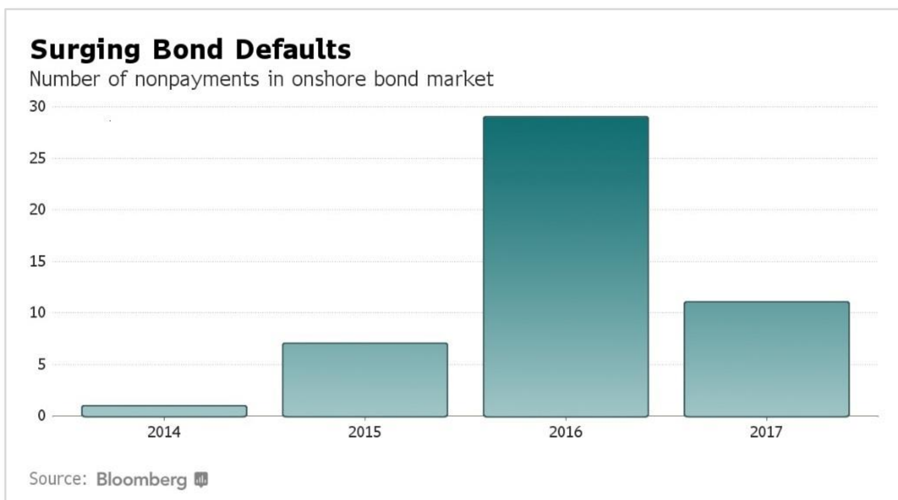
[16] Hideyuki Sano and Yasunori Fukui. "Stress in Japanese corporate bonds seen as a sign of things to come." *Reuters.* May 17, 2017.

80% rise from a year earlier. Reports that the central bank is actively attempting to support the stock market, as it "buys frequently on days when the stock market dips in the morning, serving to stabilize share prices," [17] is alarming, to say the least. Layer on the fact that Japan's government debt is the highest ever recorded in the OECD (220% of GDP) and rising, and the long-term situation appears untenable. If interest rates were ever to unexpectedly rise from near zero (or negative) levels, it could have a devastating impact.

During a recent FMI research trip to Tokyo in June, we were concerned to see how oblivious the general public appears to be with regard to the above-mentioned risks. People we talked to were not at all aware that the BOJ's policies were radical, and seemed to have complete trust in the government's ability to maintain stability. Financial markets (equity and debt) in Japan clearly reflect a similar optimism.

China: Not In The Mood

We have long been wary of the massive debt accumulation in China and the unsustainability of economic growth driven by excessive fixed investment (infrastructure spending, real estate investment, etc.). China's mountain of debt has tripled from almost $10 trillion in 2009 to approximately $30 trillion, reaching around 300% of GDP. Not surprisingly, for the first time since 1989, Moody's Investors Service recently cut its rating on China's debt (to A1 from Aa3), citing that "China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to rise as potential growth slows [to approximately 5% over the next 5 years]."[18] While the government has started a campaign to exercise greater control over its banks, *The Wall Street Journal* reports that this has made banks reluctant to lend, and led to increased funding costs, driving some companies to borrow from less-transparent lenders in the shadow banking market. For example, "New loans from so-called trusts, firms that raise money from individuals and corporations to plow into riskier areas of the economy, reached 882.3 billion yuan ($129.5 billion) in the first four months of the year, […] nearly five times as much as the same period in 2016." Trust loans can be disguised by banks as investments, making it "harder to gauge the true extent of credit in the system"[19] -- a real problem.



At the same time, despite an acceleration in the economy (per the "official" government data), through the first quarter China has had the most corporate bond defaults ever to start a year (see chart to the right). A total of 9 bond issues went bust in the first quarter vs. 29 in all of 2016. Most of the trouble is coming from heavy industry and construction end-markets. [20] In a telling statistic that is also illustrative of the mal-investment believed to be so prevalent in China, *The Wall Street Journal* reports that "state-backed companies that account for almost two-thirds of corporate debt recorded just 1% of profit growth last year, while their liabilities grew by 10%."[21] This equation will not lead to long-term prosperity.

The Chinese real estate market remains a key risk point, as new home prices continue to grow in the double digits. Total mortgage debt surged 37% in 2016, with nearly 70% of housing transactions financed with a mortgage (double

---

[17] "Japan's central bank nearly doubles ETF holdings in one year." *Nikkei Asian Review*. June 5, 2017.

[18] "Moody's downgrades China's rating to A1 from Aa3 and changes outlook to stable from negative." *Bloomberg News*. May 26, 2017.

[19] Chao Deng and Lingling Wei. "China's Debt Crackdown Is Driving Borrowers Into Riskier Territory." *The Wall Street Journal*. June 4, 2017.

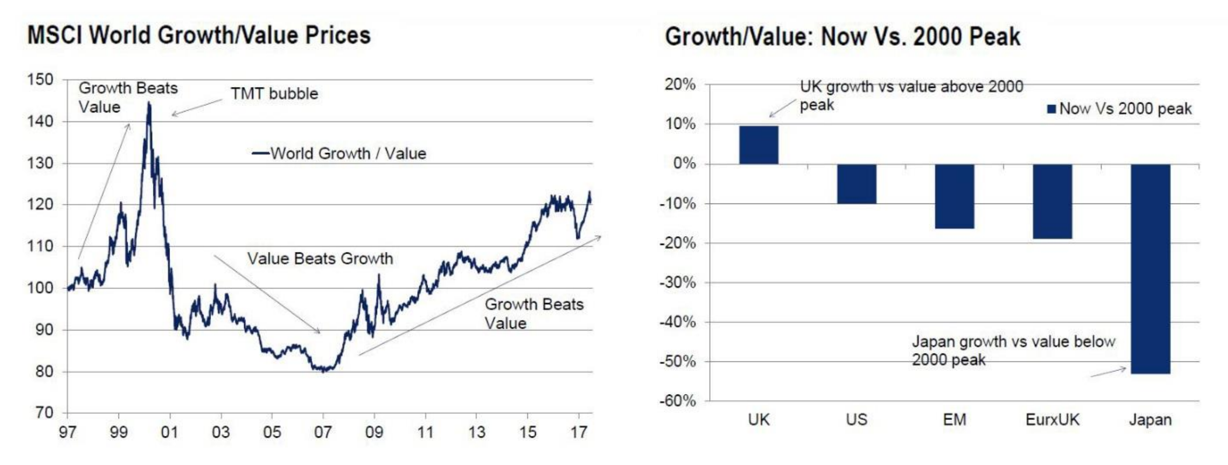
[20] "China Has Its Worst-Ever Start to a Year For Defaults." *Bloomberg News.* April 2, 2017.

[21] Anjani Trivedi. "Trouble Bubbling Under at Chinese Banks." *The Wall Street Journal.* April 3, 2017.

the rate from 2013). While the government requires down payments of at least 20% (and even more for second homes), buyers are utilizing creative workarounds. In addition to peer-to-peer lending for down payments, property developers are now offering their own loans to cover the entire down payment, with no collateral requirements. While regulators are supposed to crack down, the likely outcome is more bark than bite. A healthy real estate market is paramount. Per the *Nikkei Asian Review*, "By some estimates, property development and ancillary industries together account for more than 20% of Chinese GDP. Their importance to the economy cannot be overstated. Any downturn in the housing market, even if commercial real estate remained insulated, would jeopardize the cash flow and debt-servicing ability of heavily leveraged property developers, with potentially severe repercussions for the companies' lenders and bondholders."[22] The resulting collateral damage would be very hard to contain.

<u>Value vs. Growth: Swimming Upstream</u>

As illustrated by the Citi Research charts below,[23] it's been lonely being a value investor for much of the last decade, with growth outperforming value on a 3-, 5- and 10-year basis (MSCI World):



Sources: Citi Research, Datastream, MSCI

History books point to a plethora of empirical evidence showing value's considerable outperformance over long periods of time, but the authors admittedly had never seen the extreme levels of central bank policy (e.g., QE, negative interest rates), nor the monumental shift from active to passive management (fueling momentum strategies) that we see today. With elevated valuations and widespread complacency, we are confident that "reversion to the mean" will prove timely and relevant. While some renowned value investors have started to capitulate and throw in the towel, we will continue to stay true to our core value principles. In time, we expect our investors will be handsomely rewarded for our steadfast commitment.

Thank you for your confidence in Fiduciary Management, Inc.

[22] Diana Choyleva. "Why China's next property market drop will be more severe." *Nikkei Asian Review*. June 7, 2017.

[23] Robert Buckland, Mert Genc, et al. "Global Equity Strategist." *Citi Research.* June 22, 2017.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 03/31/2017

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%
Q1 2017	5.94	5.75	4.71	3	0.05	7.16	11.23	$ 7,376.1	$ 24,541.9	30.06%

*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 - 03/31/2017. 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 12/31/2010-03/31/2017. 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 $24.5 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 25-40) 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.