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# INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

December 31, 2018

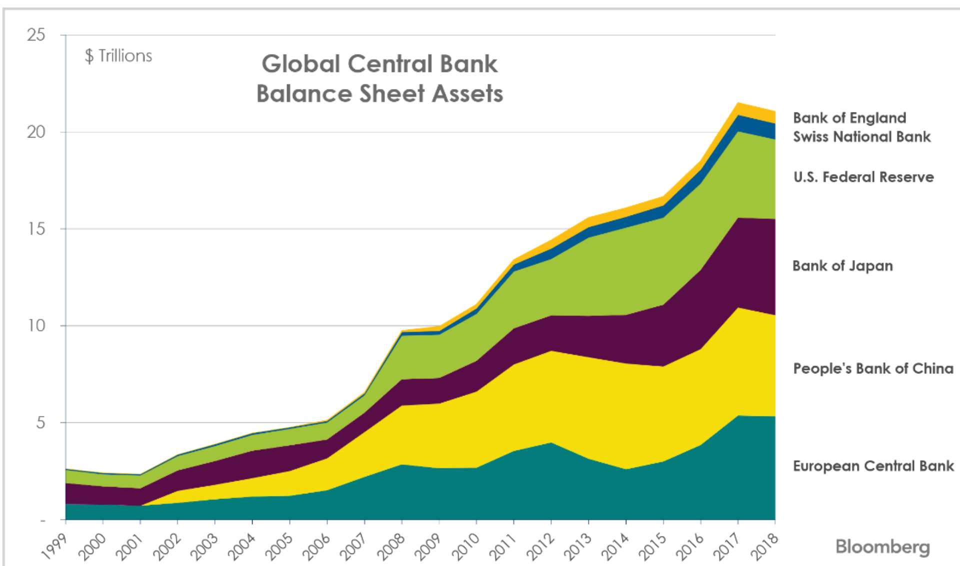
Global stock markets came under intense pressure in the fourth quarter as economic growth weakened, political and geopolitical tensions escalated, and monetary policy tightened. The FMI International portfolios declined by approximately 8.9% in the period, which compares with an MSCI EAFE Index retreat of 12.20% in local currency and 12.54% in U.S. Dollars (USD). The Producer Manufacturing, Consumer Durables and Communications sectors helped relative performance, as Industrial Services, Retail Trade, and Distribution Services each detracted. Solid stock performance came from Millicom International, Smith & Nephew, and Jardine Strategic; while Schlumberger, Ferguson and WPP plc landed on the negative side of the ledger.

For the full calendar year, the FMI International portfolios fell by approximately 8.6%, which is less than the MSCI EAFE's decline of 10.99% in local currency and 13.79% in USD. Growth continued to outperform value during the year, which has been an ongoing headwind. Our overweight exposure in South Korea (underperforming the market) also hurt our relative performance. Conversely, our overweight exposure in the United Kingdom (outperforming), underweight exposure in Japan (underperforming), currency hedging, and an elevated cash balance were positive contributors.

Even though the recent market sentiment might appear grim, we remain optimistic for the long run. When opportunity knocks… we'll answer. A lengthy period of elevated valuations has made it difficult to find value, but opportunities are starting to develop in a tougher market.

***Together They Fall***

For years, global central banks have been aggressively printing money, purchasing financial assets (aka Quantitative Easing, or QE), and suppressing interest rates at unsustainably low (or negative) levels. It is the ultimate in policy *experiments*, and it comes with risks and unintended consequences, which we have highlighted in prior letters. Part of the objective was to drive up asset prices, and in this regard, central bankers have "succeeded." As major central bank balance sheets have ballooned to over $21 trillion (see chart), we have witnessed significant asset inflation across a wide spectrum: stocks, bonds, real estate, private equity, alternative investments, art, etc. Asset classes that, historically, were not highly-correlated, were rising in unison with little regard for fundamental valuation. The rich got richer, wealth inequality expanded, and Wall Street left Main Street in the dust.




The hope was that all this newfound wealth would filter into the economy and drive better growth. Yet, the pace of economic recovery didn't reach historical levels. While the full story has yet to be written, recent data points suggest that economic growth is now faltering. The Organisation for Economic Co-operation and Development (OECD) writes that "growth has peaked amidst escalating risks," and they have lowered their GDP forecasts to 3.5% in 2019, from 3.7% in 2018. Trade growth has slowed, industrial production is softening, retail sales are decelerating, residential real estate prices are falling, and financial markets are correcting.[1] *The Wall Street Journal (WSJ)* recently reported some remarkable data points: "All told, 90% of the 70 asset classes tracked by Deutsche Bank are posting negative total returns in dollar terms for the year through mid-

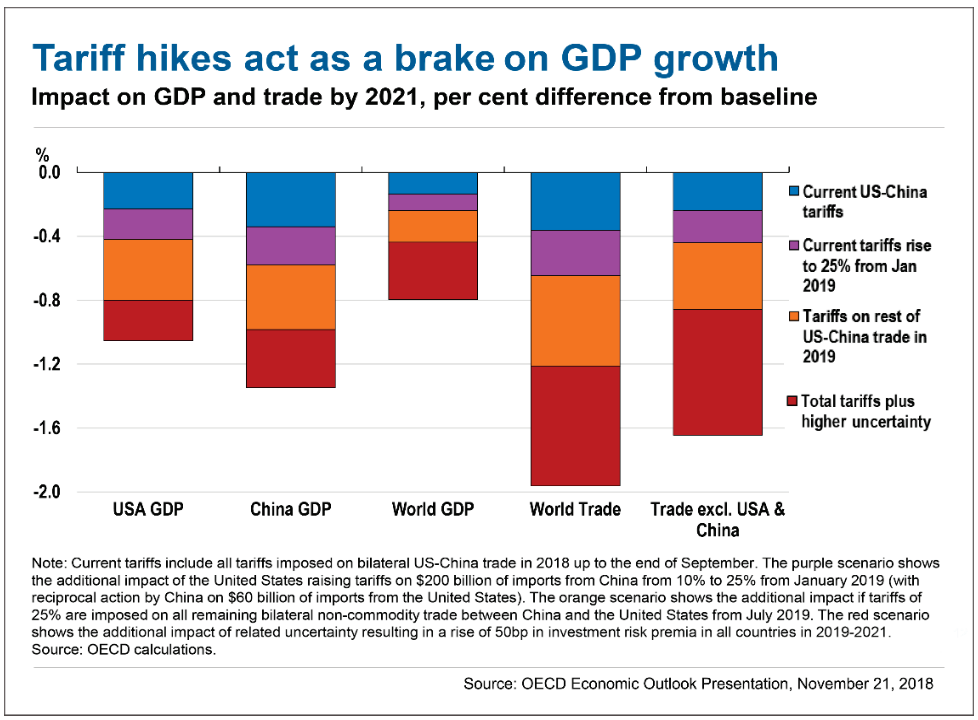
[1] OECD Economic Outlook Presentation, November 21, 2018.

November. The previous high was in 1920, when 84% of 37 asset classes were negative. Last year, just 1% of asset classes delivered negative returns." Furthermore, "Data show global stocks and bonds could both finish the year in the red for the first time in at least a quarter-century," according to BlackRock Inc.[2] This actually did come to pass. Thanks to radical monetary policies, we have strayed far from what most people would consider *normal* times. The tidal wave of asset classes falling in harmony is alarming, to say the least. In moving from a period of euphoria and market manipulation, to one of fear and risk aversion, the asset reflation trade appears to be starting to play out in reverse. That said, we do not expect markets to move in a straight line, as the inevitable transition from growth to value will not be smooth. Everything considered, this remains a time to proceed with caution.

***Tighten Your Belt***

While the Federal Reserve (Fed) has set the U.S. on a path toward normalization through rising interest rates and balance sheet disposals, its counterparts overseas have merely started taking baby steps. The European Central Bank (ECB) has officially ended its QE program, and will no longer be growing its balance sheet through government and corporate bond purchases. That said, the ECB expects to reinvest maturing securities for an "extended period of time" and "for as long as necessary." In other words, they will not be winding down their balance sheet any time soon. In addition, they plan to keep interest rates at current ultra-low levels at least through the summer of 2019.[3] While the Bank of Japan (BOJ) has yet to formally halt their QE program, they have tapered their asset purchases and hinted that tightening may be on the horizon. It's about time … the BOJ recently won the dubious honor of becoming the first G7 central bank to own assets collectively worth more than the economy that it is trying to stimulate.[4]

Despite these attempts to tap the brakes on experimental monetary policies, somehow negative-yielding bonds have been on the rise in recent months, up over $2 trillion to $7.9 trillion, globally.[5] One of the objectives of free money and low (or negative) interest rates is to pull consumer demand from the future into the present. If indeed that has taken place over the last few years, helping to accelerate economic growth, what does that mean about expectations for future demand? We have our reservations.




***Political Crisis du Jour***

There has been no shortage of drama on the political crisis front, with the U.S. and China trade war intensifying; Brexit uncertainty reaching a fever pitch; yellow vest protests, violence and tear gas in the streets of France; and the Italian government's budget deficit battle with Brussels, to name a few. We'll save discussions on the turbulence in emerging markets (and their respective currencies) for another day.

It remains to be seen whether President Trump's aggressive strategy with China will work. If China blinks first and compromises, it could end up being an unequivocal positive for the U.S. and the rest of the world. However, if Trump raises tariffs to 25% and puts tariffs on the rest of U.S.-China trade, it would have a significant negative impact on trade and GDP growth (see chart above). Many view this as the single biggest risk to the global

[2] Akane Otani and Michael Wursthorn. "No Refuge for Investors as 2018 Rout Sends Stocks, Bonds, Oil Lower." *The Wall Street Journal*, November 25, 2018.
[3] Balazs Koranyi. "ECB formally ends QE, keeps reinvestments open-ended." *Reuters*, December 13, 2018.
[4] Hideyuki Sano and Tomo Uetake. "Bank of Japan's balance sheet now larger than country's GDP." *Reuters*, November 12, 2018.
[5] Source: Bloomberg.

economy. China is already feeling some of the pain, as growth has slowed to 6.5% in the third quarter, the slowest pace since the financial crisis. China's factory output and retail sales came in weaker than expected, and the World Bank now expects GDP growth to slow to 6.2% in 2019.[6] We hope cooler heads will prevail, but with Presidents Trump and Xi Jinping at the helm, virtually *anything* is possible.

Heretofore, we have had a favorable view of the UK's decision to exit the European Union (EU). As we articulated in our June 2016 letter, "Why would the UK want to tie their future to the EU, which has demonstrated an inability to reform, a lack of desire to address their own structural problems, and where debt loads are off the charts and growth is anemic?" That said, we were disappointed to see the Brexit agreement that Prime Minister May's team negotiated. It makes sense that four of May's cabinet members resigned, as the agreement all but undoes what the referendum sought to achieve in the first place: national sovereignty. Highlights include a $50 billion divorce bill, a lengthy transition period where almost nothing changes until at least the end of 2020 (at which point it can be renewed), continued oversight from EU courts for 8 years from the end of the transition period,[7] a "backstop" to ensure that Northern Ireland's border with Ireland remains open, and inclusion in the EU's customs union, "not merely until the end of the transitional period […] but until a replacement trade agreement can be negotiated, or (potentially) indefinitely if none can be agreed."[8] The EU is trying to make sure that no one else defects by punishing the UK, but perhaps they are overplaying their hand. In our opinion, the UK would be better off with a hard Brexit rather than accepting these terms. Undoubtedly, the probability of a hard Brexit or a delay of an official agreement has increased, as the UK is unlikely to submit to these conditions. In either scenario, increased uncertainty and economic risk will be a concern for some time.

While the International portfolio has an overweight exposure to UK-traded stocks, at approximately 26.3% of the portfolio versus the MSCI EAFE at 17.4%, it is important to note that a number of these companies are multinational and have very little revenue generation in the UK. According to FactSet estimates, the strategy's revenue exposure to the UK is only about 10.3% of the portfolio, compared with the MSCI EAFE, at 6.6%. As high-quality UK-traded stocks have been impacted by Brexit fears, we have looked to capitalize. Some of the best buying opportunities arise in periods of maximum uncertainty, such as those in which we appear to be today.

Meanwhile, turmoil in France and Italy tie back to a lack of fiscal discipline. Both countries have made promises that are unsustainable over the long term, and any effort to dial back the welfare state is met with resistance. This is exacerbated by the effects of recent monetary policies, wherein the wealth gap is widening, creating general unrest and animosity. The *Financial Times* reports that French president Macron's recent concessions of "a higher minimum wage paid by the state, tax breaks on overtime, higher pensions for poorer retirees plus the scrapping of fuel tax rises next year are expected to cost up to €10bn in 2019. That would push France's deficit to about 3.5 per cent of gross domestic product next year, significantly higher than Italy's and a clear breach of EU limits. Rome is locked in a stand-off with Brussels over its plans for a deficit of 2.4 per cent of GDP."[9] France has acquiesced to the masses, despite lacking the financial wherewithal. In Italy, regardless of their sky-high debt-to-GDP ratio of over 130% (second in the eurozone to Greece), budget discipline is nowhere to be found. With debt crisis fears creeping back in, Italy's bond yields have spiked, and the Bank of Italy has warned that interest expenses could increase by €9bn in 2020.[10] Unfortunately, neither France nor Italy are ready to make the hard decisions, and instead continue to pass the buck to the next in line. No wonder the UK wanted out!

***<u>Holiday Wish List</u>***

As we detailed in our September letter, stock valuations remain elevated, especially for the high-quality compounding businesses that we hope to own. As we wait patiently for valuations to cooperate (i.e., stocks to get cheaper, providing a margin of safety), we maintain an active "Wish List" of about 75 companies that we know reasonably well and that we'd like to own at the right price, but where the valuation is 20-40% away from what we might be willing to pay. If we find ourselves in the teeth of a bear market, this will be the first place we look for new ideas. If a company falls within the 20% threshold, we move it to our "Monitor List," which is a smaller subset of companies that we follow closely, or on which we are actively doing deep-dive research for the portfolio. Our Wish List and Monitor List are living and working documents, updated by our research team weekly. Companies are often flipped from one list to the other, or removed entirely if the valuation is too high or we learn

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[6] Kevin Yao. "World Bank expects China's economic growth to slow to 6.2 percent in 2019." *Reuters*, December 19, 2018.

[7] Christopher Caldwell. "Brexit: The empire strikes back." *The Weekly Standard*, December 3, 2018.

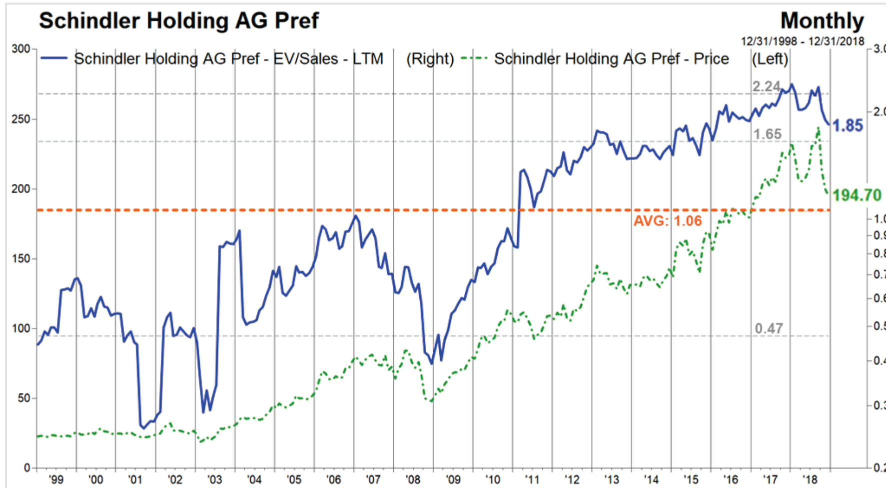
[8] Frances Coppola. "Why Theresa May's Brexit Deal Is Terrible For The U.K." *Forbes*, November 23, 2018.

[9] Ben Hall. "Macron reckons on surviving reputational hit to fiscal discipline." *Financial Times*, December 11, 2018.

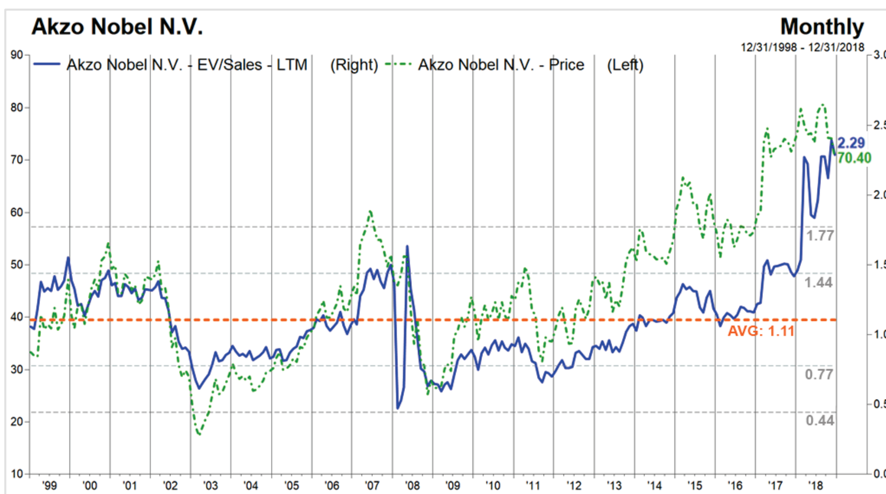
[10] Kate Allen an, London Miles Johnson. "Bank of Italy warns higher bond yields will cost an extra €9bn a year by 2020." *Financial Times*, November 23, 2018.

something new that is a story-killer. We formerly owned the following three companies (Schindler, Akzo Nobel, and Shimano), and they are currently on our Wish List; these are all stocks that we would love to own again, but where valuation is the primary roadblock despite the recent pullback in the market.

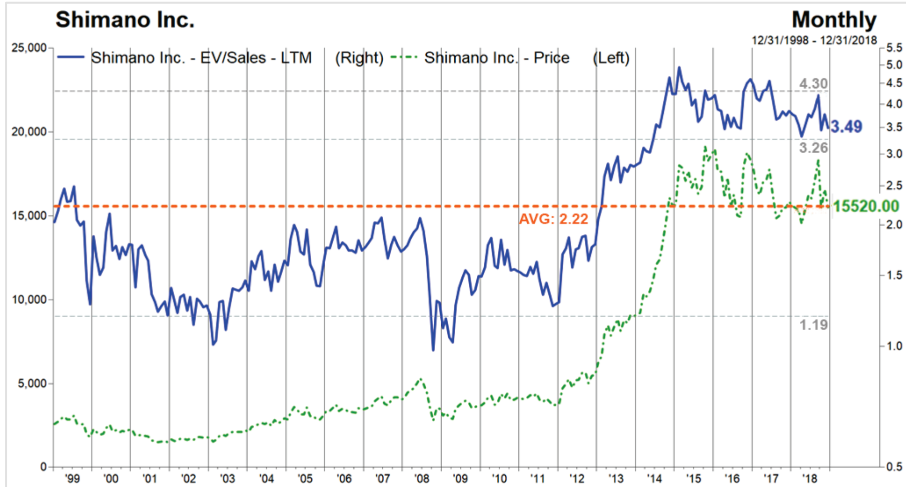
**Schindler Holding AG Pref (SCHP-CH)** - Schindler is the world's second largest player in the manufacturing, installation, modernization and servicing of elevators & escalators (E&E). More than 50% of the company's revenue is believed to come from maintenance and modernization (service), which is recurring in nature and high margin. It is estimated that the top four E&E companies account for around 70% of the new global installations. Schindler benefits from economies of scale and the density of its install base, creating competitive advantages and barriers to entry. The company earns a return on invested capital (ROIC) of over 20%, creating economic value. Management has a strong long-term track record, and the Schindler family has significant skin in the game ($9.4 billion). The company has a robust balance sheet, with a net cash position. Schindler has room for margin expansion and operates in a market with attractive growth prospects due to the global trend toward urbanization. However, the stock trades at an enterprise value-to-sales multiple of 1.9 times, over a standard deviation above the long-term average of 1.1 times, while sporting a trailing price-to-earnings ratio of 23.1 times.




**Akzo Nobel N.V. (AKZA-NL)** - Akzo Nobel is one of the largest manufacturers of paints and coatings in the world, with a diversified portfolio of products across consumer and industrial end-markets. The intensifying technical specifications and performance qualifications from customers is an advantage for sophisticated companies like Akzo Nobel; industry consolidation is leading to a critical mass in research and development (R&D) that few can replicate. Akzo Nobel's products are used by customers to protect their assets from corrosion (thus extending useful lives) and for aesthetic and functional purposes. The industry has pricing power, as the cost of the product is typically small compared with the labor or capital costs of the customer's application process, but the product is critical to the end-customer's satisfaction. The business is capital-light and labor-intensive, and the supply chain is relatively short, making it easier for Akzo Nobel to react to business cycles. ROIC exceeds the company's cost of capital, and the balance sheet is investment grade-rated. Management has a meaningful opportunity to improve margins, which lag peers. The long-term growth outlook for the business appears attractive. Unfortunately, the stock trades at an enterprise value-to-sales multiple of 2.3 times, over two standard deviations above the long-term average of 1.1 times, with a forward price-to-earnings ratio of roughly 23.7 times.




**Shimano Inc. (7309-JP)** - Shimano is the world's leading manufacturer of bicycle components, with a dominant market share of over 50% in the mid- and high-end portion of the market. The company benefits from economies of scale related to manufacturing, R&D spend, sales and marketing, and global distribution. There are significant barriers to entry, as patents and advanced performance requirements make entry into the market very difficult -- as illustrated by a 3-player oligopoly (Shimano, SRAM and Campagnolo). The company has steadily earned a double-digit ROIC, well above its cost of capital. Management has an excellent long-term track record, and there is a high level of insider ownership. The company has a very strong balance sheet, with a net cash position. The industry has benefited from long-term structural growth, and with a rise in global income and increased awareness for the importance of exercise and healthy living, demand for high-quality bicycles is expected to continue to increase over time. Similar to the first two examples, the stock trades at an enterprise value-to-sales multiple of 3.5 times, over a standard deviation above the long-term average of 2.2 times, with a trailing price-to-earnings ratio of 28.6 times.




As international stock markets have come unhinged (along with 90% of all asset classes), the opportunity set is naturally starting to improve. Complacency is being replaced with trepidation, and even the most defensive equities are starting to crack. Investors all too often sell when times get tough and ask questions later. We hope to capitalize on these emotions as we endlessly seek to upgrade the quality of the holdings in our portfolio, and look forward to deploying more capital when suitable candidates present themselves.

Thank you for your confidence in Fiduciary Management, Inc.

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

| Year | Total Return Gross of Fees % | Total Return Net of Fees % | *Benchmark Return % | Number of Portfolios | Dispersion % | Three Year Ex-Post Standard Deviation Composite | Three Year Ex-Post Standard Deviation *Benchmark | Total Composite Assets End of Period ($ millions) | Total Firm Assets End of Period ($ millions) | Percentage of Firm Assets % |
|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | -0.78 | -1.52 | -12.15 | 1 | 0.00 | n/a | n/a | $ 16.7 | $ 12,273.6 | 0.14% |
| 2012 | 19.35 | 18.46 | 17.31 | 1 | 0.00 | n/a | n/a | $ 76.3 | $ 15,253.5 | 0.50% |
| 2013 | 25.89 | 24.95 | 26.93 | 1 | 0.00 | 9.78 | 12.22 | $ 165.8 | $ 19,705.3 | 0.84% |
| 2014 | 5.66 | 4.87 | 5.92 | 1 | 0.00 | 7.49 | 10.33 | $ 771.6 | $ 21,001.1 | 3.67% |
| 2015 | 4.24 | 3.46 | 5.33 | 2 | 0.00 | 8.14 | 11.73 | $ 2,832.9 | $ 21,042.9 | 13.46% |
| 2016 | 11.04 | 10.23 | 5.34 | 3 | 0.38 | 7.39 | 11.53 | $ 5,946.2 | $ 22,626.7 | 26.28% |
| 2017 | 16.51 | 15.70 | 15.23 | 3 | 0.02 | 7.04 | 11.20 | $ 8,209.3 | $ 25,322.0 | 32.42% |

*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 - 12/31/2017. 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 12/31/2010-12/31/2017. 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 $25.3 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.