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

INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

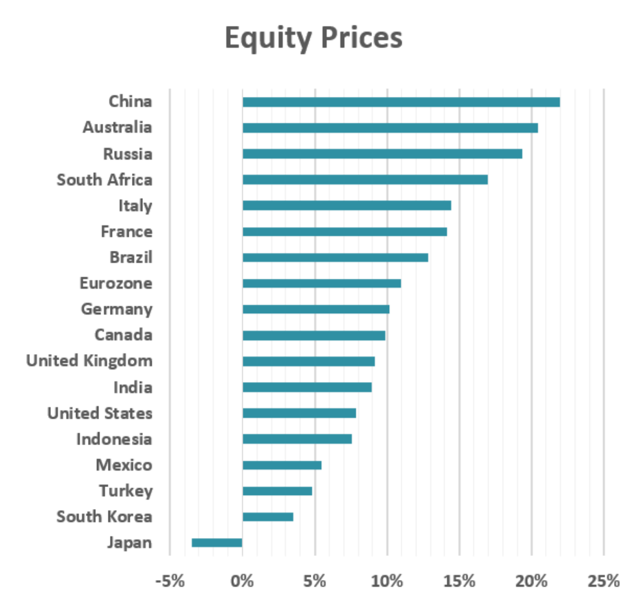
June 30, 2019

Global stock markets continued to climb in the second quarter. The FMI International portfolios gained approximately 3.0% in the period, compared with the MSCI EAFE Index's return of 2.80% in local currency and 3.68% in U.S. Dollars (USD). Sector outperformance was led by Distribution Services, Electronic Technology and Health Technology, while Retail Trade, Consumer Non-Durables, and Consumer Services underperformed. Top individual contributors included Merlin Entertainments, Ferguson and TE Connectivity, as Whitbread, Isuzu Motors and Grupo Televisa each detracted. Our underweight position in Japan helped our relative performance, while our residual cash position weighed on the results. Global growth stocks significantly outpaced value stocks in the period, which has been an ongoing headwind.

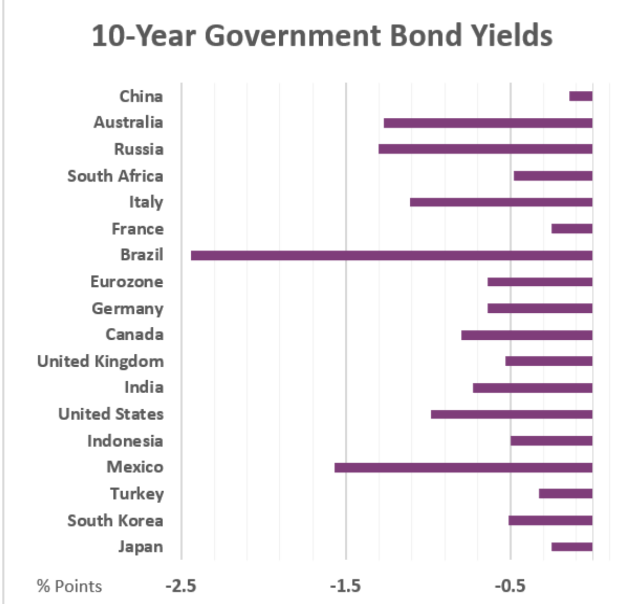
We were excited to see some volatility re-surface in the month of May, as it's important to our research process. Great businesses do not typically go on sale for no reason, so a little bad news can go a long way in terms of creating dislocation in the market. Between the fourth quarter of 2018 and some pockets in 2019, a few interesting opportunities came our way. We added B&M European Value Retail (BME LN) and Booking Holdings (BKNG) to the portfolio as the stocks came under pressure, upgrading the quality of our U.K. retail and European travel exposure by swapping out of Travis Perkins (TPK LN) and Dufry (DUFN SW). In both cases we traded up for better businesses with more favorable long-term growth prospects and secular outlooks. Unfortunately, the volatility did not last long, and markets soon rallied. Given the elevated valuation environment and subpar growth outlook, we continue to proceed with caution.

"Easy Money Is Back"

Central banks quickly sprang into action in the quarter, just as global economic growth and stock markets started to wobble. Among others, the European Central Bank (ECB) re-opened the door for lower rates and Quantitative Easing (QE), the Bank of Japan (BOJ) pledged to keep ultra-low interest rates for at least another year (and "much longer" if necessary), and the Federal Reserve (Fed) is expected to cut rates three times by year end. Investor behavior has been fairly predictable – we have seen a knee-jerk reaction into risk assets, aggressively bidding up prices with little regard for fundamental valuation. Per the charts below, the bounce in fixed income (lower bond yields) and equity markets is without discrimination:



Source: Bloomberg. 11/30/18-6/30/2019



Source: Bloomberg. 11/30/18-6/30/2019

As the cover of *Barron's* proclaimed: "Easy Money Is Back." Indeed it is. According to *Bloomberg,* negative-yielding bonds have now reached $13 trillion, exceeding their 2016 peak. ECB President Draghi's "dovish comments sent a jolt through fixed income markets," and remarkably, "pushed another $714bn worth of bonds into sub-zero yield territory," (*Financial Times)*. French and Swedish 10-year government bonds traded below zero for the first time, and the German 10-year bond yield reached -0.33% (from 0.57% less than a year ago), an all-time low. The 10-Year U.S. Treasury yield fell below 2%, the lowest level since 2016, and the average yield of the global bond market tumbled to 1.76% from 2.51% in November.[1] Five central banks have adopted negative rates, and others may eventually follow. The Federal Reserve Bank of San Francisco recently wrote an economic letter titled, *How Much Could Negative Rates Have Helped the Recovery?*[2] – a troubling development. We can only hope that the Fed doesn't take the bait.

Manipulating interest rates is a dangerous game. *Grant's Interest Rate Observer's* founder and editor James Grant describes it best:

> *Interest rates are probably the most sensitive and consequential prices in capitalism. They balance savings and investment, discount future cash flows, define investment hurdle rates, measure financial risk […] Low rates – by some measures, the lowest in 4,000 years – have penalized savers, incentivized dubious risk-taking, expedited the growth in federal indebtedness and perpetuated the lives of businesses that would have ended in the absence of easy credit. They have widened the gulf between rich and poor, thrown a spanner into our politics and inflated the cost of retirement […] The trouble is that the costs of radical monetary policy are dark and prospective; the gifts they bestow are bright and immediate. Those gifts are likewise transitory. Over-encumbered businesses finally fail, inflated asset prices ultimately revert to lower, more reasonable levels. The dividends and yields that income-needy people have stretched to reach sadly prove illusory.*[3]

It's likely just a matter of time before the unintended consequences start to surface.

Ground-hugging interest rates have led to a misallocation of resources. Instead of funding capital investment and research & development to drive organic growth, companies are all-too-often engaging in financial engineering. Balance sheets are being levered-up to chase value-destructive mergers & acquisitions and expensive share buybacks, neither of which provide much benefit to the economy. Meanwhile, the world's four biggest central banks have purchased $13.2 trillion in assets since the end of 2007.[4] At these vast sums, they are not just influencing the market's pricing mechanism – in some cases they *are* the pricing mechanism. Should the ECB have been purchasing 50% and 26% of Italy's gross bond issuance in 2017 and 2018?[5] Does it make sense for the BOJ to own nearly 80% of the country's exchange traded funds (ETFs)?[6] We think not. Central banks have ventured well beyond their mandates, and at a significant cost. In the end, printing money to prop up asset prices and suppress interest rates will not solve the world's problems. There is little to show for this extraordinary profligacy.

<u>A Time to be Bullish?</u>

We find it fascinating (and telling) that the market views easy money as an unequivocal "buy signal," despite global stock indices (i.e., MSCI ACWI) trading near all-time highs. Shouldn't investors be questioning why these policies are necessary in the first place? Do people stop to consider that central banks are easing because economic growth is faltering, geopolitical tensions have intensified, debt has reached record heights, and monetary and fiscal stimuli have not achieved the desired results? Central banks see dark clouds on the horizon (for good reason), and they are desperately trying to prevent the next recession by the wrong means.

---

[1] Robin Wigglesworth. "Value of negative yielding debt hits high of $12.5tn on signals of ECB stimulus." *Financial Times*, June 19, 2019.

[2] https://www.frbsf.org/economic-research/publications/economic-letter/2019/february/how-much-could-negative-rates-have-helped-recovery/

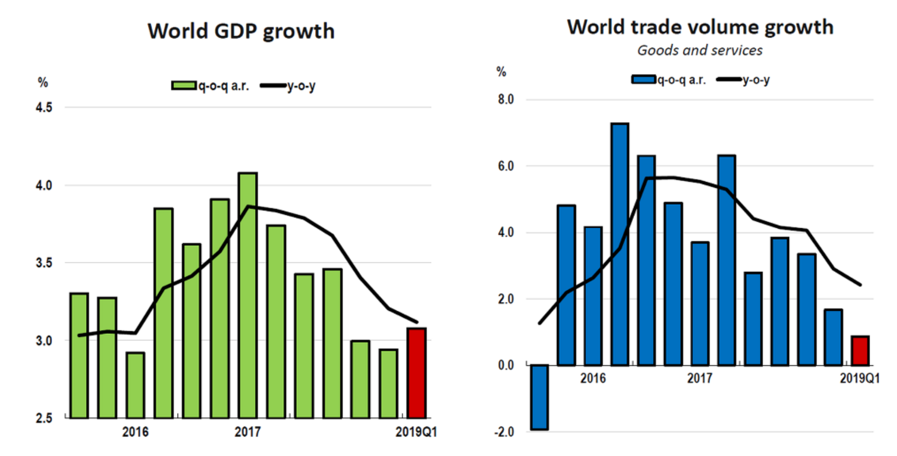
[3] "Free Interest Rates!" *Grant's Interest Rate Observer,* Vol. 37, No. 10, May 17, 2019

[4] James Grant. "Bad Actors: Hamilton Pans Central Bankers." *Barron's*, June 24, 2019.

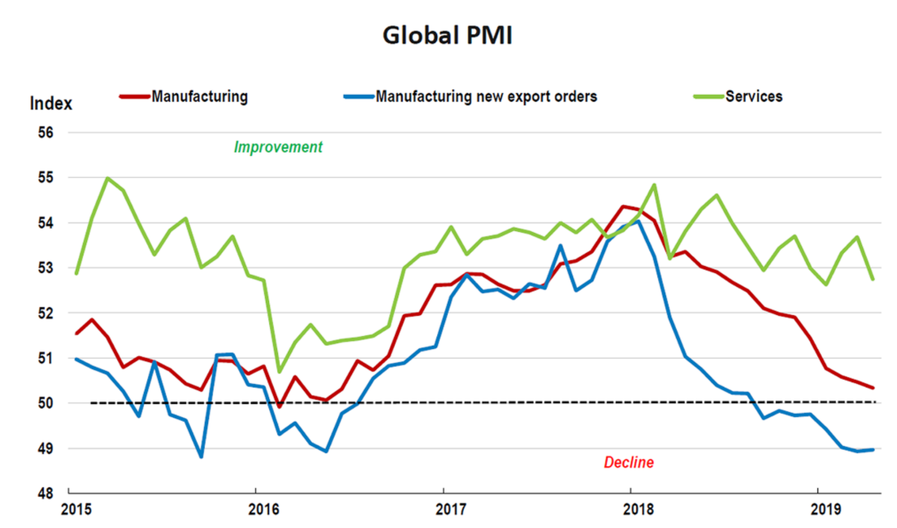
[5] Dhara Ranasinghe, Giulio Piovaccari. "Italy needs to woo private bond buyers as ECB bows out." *Reuters*, December 19, 2018.

[6] Andrew Whiffin. "BoJ's dominance over ETFs raises concern on distorting influence." *Financial Times*, March 31, 2019.

The World Bank, International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) have all lowered global GDP growth figures in their latest projections, citing plunging trade growth, weak manufacturing, subpar investment, heightened policy uncertainty, soft housing and auto markets, and a host of other factors. The latest economic readings show further deterioration. In June, the Purchasing Manager's Index for U.S. manufacturing activity declined to 50.1, the lowest level in nearly a decade (a figure above 50 indicates growth). Manufacturing activity in Europe contracted, rounding out the weakest quarter in six years, while Japan hit a 3-year low.[7] As the trade war heats up, China's industrial production is feeling the pain, growing at the slowest pace since 2002.[8] The World Trade Organization has slashed its global trade growth projections, while the IMF estimates that the U.S.-China trade war could knock 0.5% off global GDP growth, or approximately $455 billion.[9] Policy uncertainty continues to rise, as there is no end in sight for the U.S.-China trade dispute, and Prime Minister Theresa May's departure from office in the U.K. is widely thought to increase the chances of a hard Brexit. Meanwhile, debt levels are climbing and credit quality is declining. The nearby charts are all trending in the wrong direction, and do not instill confidence that we are heading down the right path:



Source: OECD Economic Outlook Presentation, May 21, 2019



Source: OECD Economic Outlook Presentation, May 21, 2019

We've seen this story play out before, with Japan as the cautionary tale. The BOJ was the first central bank in modern times to adopt a zero-interest rate policy in February of 1999. They introduced QE in 2001 and started buying ETFs in 2010. In 2016 they turned to negative rates and adopted yield curve control measures.[10] But after 20 years of aggressive policy action, economic prosperity continues to be elusive. From early 1999, Japan's economic output has compounded at less than 1%, and the broader Japanese stock market has gained only 3.2% per year,[11] yet Japan has become the single-most indebted country in the developed world, with government debt service expected to

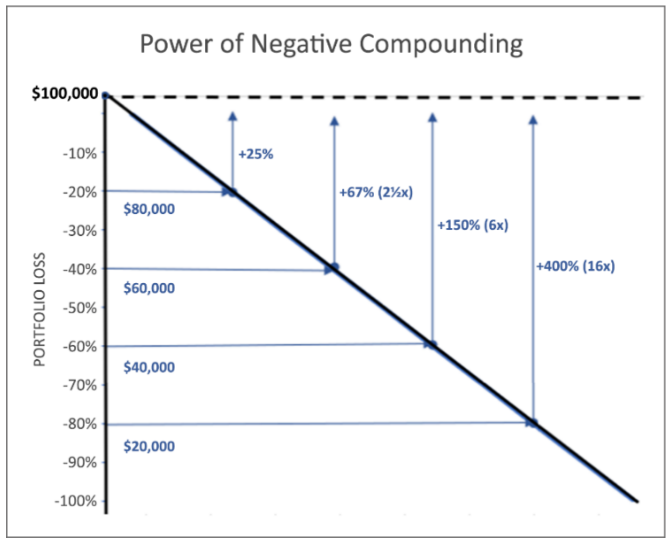
[7] Paul Hannon, Sarah Chaney, and Austen Hufford. "Factory Slowdown Casts Gloom on Global Economy." *The Wall Street Journal*, June 21, 2019.
[8] "As Trade War Hits, China Factories See Slowest Growth Since 2002." *Bloomberg News,* June 14, 2019.
[9] Matthew Rocco, Pan Kwan Yuk, and Adam Samson. "US-China tariff war will knock 0.5% off global growth, says IMF." Financial Times, June 5, 2019.
[10] Takuji Okubo. "Japan's desperate times should call for desperate measures from BoJ." Financial Times, May 27, 2019.
[11] World Bank GDP database. Bloomberg stock index database: TOPIX.

account for a whopping ~38% of their tax revenue in 2019.[12] The normalization of interest rates could cripple the country. Interestingly, they continue to use virtually the same playbook despite more than 20 years of futility. It appears they are trapped. Why else would they repeat the same thing year-after-year if it hasn't been working? Could the U.S. and Europe start to look like Japan in ten years if they continue on this journey? While we certainly hope not, it's not outside the realm of possibility.

The BOJ, Fed and ECB clearly do not have the answers. At some point we hope they will step aside and let market forces discover prices and interest rates organically, instead of by brute force.

Importance of Downside Protection

While risks are plentiful, we remain optimistic over the long term and are well-positioned for whatever the future may hold. The FMI International strategy features a focused yet diverse portfolio of high-quality businesses – durable franchises that generate attractive returns on invested capital (ROIC) and trade at a discount to intrinsic value, creating a margin of safety. Through self-selection, we seek to avoid inferior businesses and balance sheets, and pair up with management teams that think and act like shareholders. We focus more on what can go wrong than what can go right. In other words, we strive to win by not losing. Over FMI's long history (39+ years), our clients have come to expect superior performance in declining stock markets, leading to outperformance through a full cycle. As illustrated in the chart to the right, downside protection is paramount:



When a stock falls by 20%, you need a 25% recovery just to break even. Down 40%, and it will require a 67% gain. Down 60%, and a 150% return would be necessary. The power of negative compounding becomes apparent: a 40% loss is not 2 times worse than a 20% loss, it is 2.5 times worse. A 60% decline is not 3 times worse, it is 6 times worse. An 80% fall is not 4 times worse, it is 16 times worse. Navigating the big declines is absolutely crucial. Historically, FMI has strived to capture most of the upside in rising stock markets, while creating significant value when markets unravel. We've had great success not just during bear market corrections, but in the early stages of a recovery, as we look to cycle out of the more defensive stocks into some of the high-quality cyclical names that have lagged. While painful to go through, bear markets can unearth some of the best buying opportunities and prospects for future value creation. When times get tough, we're poised to act.

Never Say Never

As value managers, the 10+ year run in growth stock outperformance has been an enduring challenge. However, the deeper we venture into the cycle, the greater our conviction that there will be better days ahead for value. In prior quarterly letters, we've written at length as to why value investing works over the long term (i.e., fear and greed), and promised our clients that we would not change our stripes. Year-to-date, growth has picked up a massive 890 basis points of performance vs. value, as illustrated in the accompanying table.

Through 6/30/2019	QTD	YTD	1 Year	3 Years	5 Years	10 Years
MSCI EAFE Value Index	1.5%	9.6%	-2.1%	8.5%	0.1%	5.5%
MSCI EAFE Growth Index	5.7%	18.5%	4.2%	9.7%	4.4%	8.2%
Value performance	*-4.2%*	*-8.9%*	*-6.3%*	*-1.2%*	*-4.3%*	*-2.7%*

Source: Bloomberg

Even as the drumbeat grows louder and value continues to lose ground on a relative basis in the near term, we will not waver. It could be difficult for us to keep up in a market where growth is the only game in town and valuations are an

[12] "Highlights of the Draft FY2019 Budget." Ministry of Finance, January 18, 2019. https://www.mof.go.jp/english/budget/budget/index.html

afterthought. High-quality businesses are expensive today when compared to FMI's history. That said, we are encouraged to read some of the more recent headlines below, as these are the types of bold statements you see when you are late in a cycle.

Is value investing dead? It might be and here's what killed it. *- CNBC (June 23, 2019)*

Reversion to the Mean Is Dead. Investors Beware. *- Barron's (May 3, 2019)*

Fed, central banks have almost eliminated recessions… *- CNBC (April 30, 2019)*

What If the Bull Market Just Never Ends? *- Bloomberg (April 24, 2019)*

"I don't think rates will rise in the foreseeable future, maybe never again in my lifetime."
- National Economic Council Director Larry Kudlow (April 11, 2019)

Conventional wisdom appears to be gravitating toward the belief that value investing is dead, central banks can cure all evils (i.e., recessions and bear markets), and interest rates will stay low forever. These notions fly in the face of over a century of financial market history. This is eerily reminiscent of the lead-up to the U.S. housing bubble and Great Financial Crisis, where the prevailing belief was that "house prices will never go down." As Sir John Templeton wisely said, "The four most expensive words in the English language are, 'This time it's different.'" What people view as universal truths today, will almost certainly be proven wrong tomorrow. We would not be surprised to see the very things materialize that people are least expecting.

Flashes of volatility have returned over the past year, with a big stock market decline in the fourth quarter of 2018, followed by a stumble in May of 2019. We are encouraged to see stocks starting to once again respond to the fundamentals, with earnings misses followed by sizeable stock price declines. Perhaps investor complacency is starting to wane, although the recent easy money rally would suggest we still have some time to go. In the meantime, we will let valuation be our guide and let the business fundamentals lead the way.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 12/31/2018

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%
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%
2018	-8.63	-9.27	-10.99	3	0.06	7.22	9.69	$ 6,287.8	$ 19,833.6	31.70%

*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 - 12/31/2018. 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 12/31/2010-12/31/2018. 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 $19.8 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.