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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2020

Despite the global economy heading for the worst economic downturn since the Great Depression (1930s), stock markets emphatically rebounded in the June quarter. Expensive growth stocks led the charge once again, as value stocks continued to languish. Investors appeared willing to look past weak economic and business fundamentals; rapidly-expanding government, corporate and consumer debt; increasing fiscal deficits; depression-like unemployment; and a potential fallout from a second wave of COVID-19. With unprecedented stimulus, governments and central banks have blown open the money-printing floodgates, to the speculators' delight. Momentum-driven equity markets have become unhinged from economic reality, which unfortunately has not played well for conservative, valuation-conscious portfolios.

The FMI International portfolios appreciated by approximately 14.3% (currency hedged) and 14.5% (currency unhedged) in the second quarter, respectively, which compares with an MSCI EAFE Index gain of 12.60% in local currency (LOC) and 14.88% in U.S. Dollars (USD). The MSCI EAFE Value Index gained 12.43%, losing another 4.52% to the MSCI EAFE Growth Index in the quarter (16.95%), and is now trailing by a remarkable 15.75% year-to-date, and 18.63% over the past 12 months. For the International strategy, Distribution Services, Industrial Services, and Electronic Technology sectors were among the strongest performers in the period, while Consumer Services, Producer Manufacturing, and Communications weighed on the results. B&M European Value Retail, Ferguson, and Akzo Nobel outperformed on a relative basis, as Compass Group, Whitbread, and Fairfax Financial Holdings each underperformed, respectively.

We continue to have great confidence in our portfolios over the long run. We own a collection of high-quality businesses with sound balance sheets, that trade at a significant discount to their intrinsic values, our benchmarks, and many of our value-oriented peers. Buying above-average businesses at below-average valuations has been a winning combination throughout FMI's 40-year history, and we expect more of the same in the years to come.

A Long, Slow Road Ahead

The near-term economic outlook is uncertain at best, and dire by any normal standards. While we have seen a modest bounce off the bottom in some of the fundamentals, stock markets appear to be pricing in a strong "V-shaped" recovery, of which we are quite skeptical. The Organisation for Economic Co-operation and Development (OECD) forecasts a global GDP decline of 6% in 2020, and that's if COVID-19 continues to recede. In an "equally possible" scenario, which includes a second wave of COVID-19, they are forecasting a 7.6% contraction. They expect that the road to recovery "will be slow and the crisis will have long-lasting effects, disproportionally affecting the most vulnerable people."[1] We share these concerns. When the support runs out, growth will be much harder to come by than most people are expecting.

In Europe, for example, the employment situation is far worse than it appears on the surface. While Eurozone unemployment is expected to reach 10% by the end of June, employment subsidy programs have been propping up around *45 million jobs, or one third of the workforce,* in Germany, France, Britain, Italy, and Spain. This allows companies to furlough employees or reduce their hours temporarily, while the state pays a significant portion of their wages. A fifth of those jobs (9 million) may be at risk of permanent loss when the employment protection schemes come to an end in the fall, according to a recent study by Allianz.[2] Unfortunately, low-wage workers without degrees have been the hardest hit by COVID-19, expanding the wealth and income inequality gap.[3] Quantitative easing (QE) and negative interest rate policies have padded the pockets of asset owners (stocks, bonds, real estate, art, etc.), exacerbating the issue. Protests

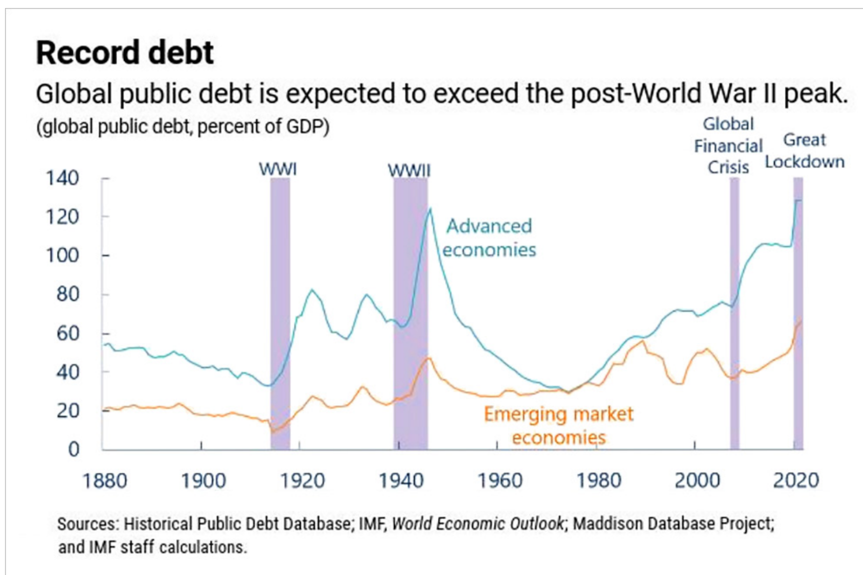
[1] Laurence Boone, OECD Chief Economist. "OECD Economic Outlook: The World Economy on a Tightrope." Presentation slide deck. June 10, 2020.

[2] Ben Hall, Delphine Strauss, Daniel Dombey. "Millions of jobs at risk when furlough ends." *Financial Times.* June 20, 2020.

[3] Kalyeena Makortoff. "Workers without degrees hardest hit by Covid-19 crisis – study." *The Guardian.* April 20, 2020.

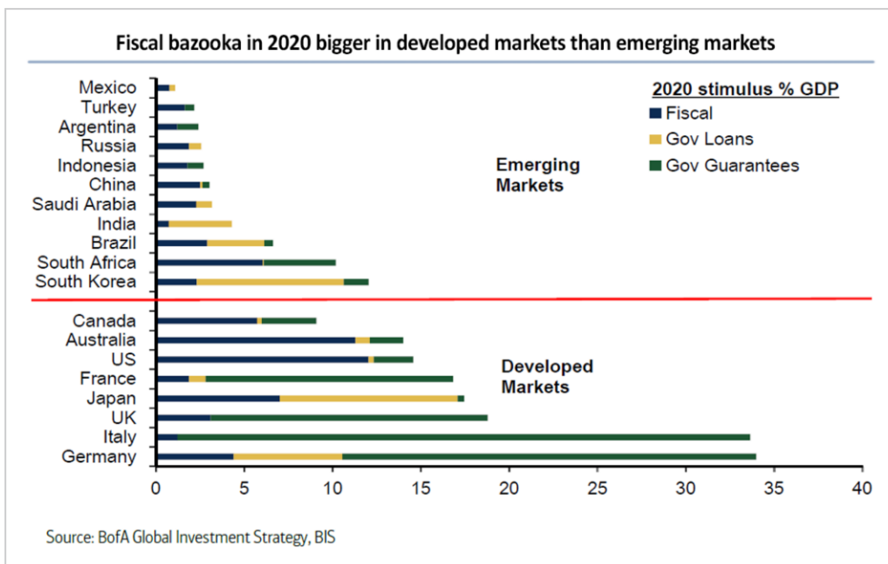
that occurred across the globe included the topic of racial inequities from these imbalances. Social unrest has largely been ignored from a stock market perspective, but can have a real fundamental impact on the economy.

Meanwhile, debt levels are on a sharp upward trajectory, as falling corporate earnings and increasing job losses will weigh heavily on businesses and households, and governments are issuing debt at a record pace. According to the Institute of International Finance in April, "Global debt across all sectors rose by over $10 trillion in 2019, topping $255 trillion. At over 322% of GDP, global debt is now 40 percentage points ($87 trillion) higher than at the onset of the 2008 financial crisis -- a sobering realization as governments worldwide gear up to fight the pandemic." They expect debt-to-GDP to reach upwards of 342% by year-end. With over $20 trillion of bonds and loans coming due this year, refinancing could prove difficult.[4] For years, balance sheets have been an afterthought for investors, which is no longer the case today. Rates are exceptionally low, *for now*, helping ease the debt service burden, but that can change in the blink of an eye.



Prevailing Wisdom: Rates Will Stay Low Forever

Markets have rebounded strongly in large part due to unparalleled (eye-popping) stimulus programs. By early May, governments and central banks had unveiled *$15 trillion* of fiscal and monetary stimulus (and counting), equal to an *astounding 17% of an $87 trillion global economy* last year. These are "record sums that will swell balance sheets and deficits to peacetime highs," per a *Reuters* report. "Shaken by turmoil in financial markets in March, with their economies heading into freefall and a decade of job creation wiped out, policymakers have seized upon tool after tool to rescue their economies -- including taboo policies such as cash handouts and buying 'junk' bonds."[5] As can be seen in the chart to the right,[6] it's safe to say that the European Union will not be adhering to their 3% deficit ceiling from the 1992 Maastricht Treaty any time soon.



[4] "Global Debt Monitor: COVID-19 Lights a Fuse." *Institute of International Finance.* April 6, 2020.
[5] Tommy Wilkes, Ritvik Carvalho. "$15 trillion and counting: global stimulus so far." *Reuters.* May 11, 2020.
[6] Michael Hartnett, Shirley Wu. "The Flow Show." *BofA Global Research.* June 18, 2020.

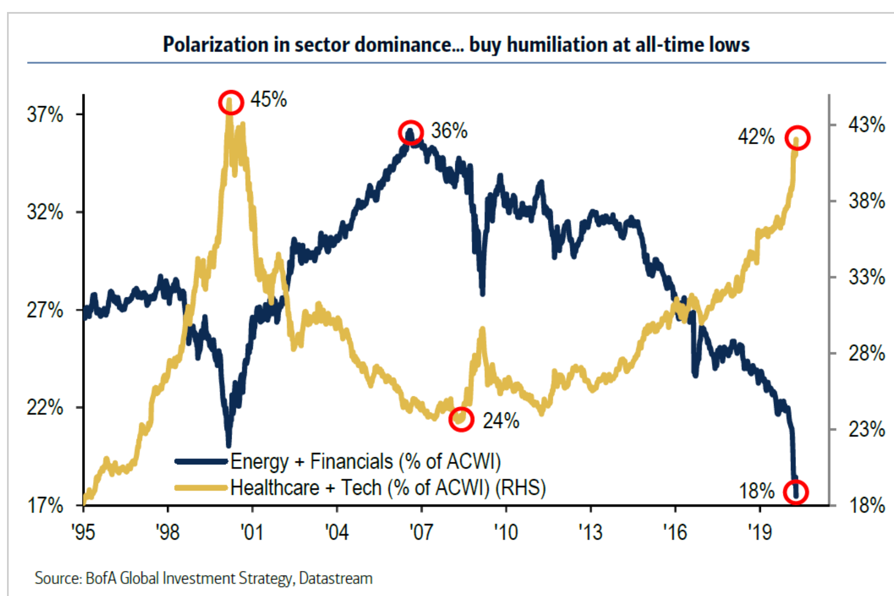
Conjuring up $15 trillion out of thin air in a matter of months could have significant long-term ramifications and unintended consequences. Inflation (and higher rates), which almost no one seems to be expecting, is a risk that is widely underappreciated. The notion that rates will "stay low forever" has essentially become a universal belief, which is dangerous. Nobel prize-winning economist Milton Friedman (1912-2006) described it best: "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."[7] Sound applicable today? While the near term may prove deflationary, inflation will likely follow. The question is when?

There are several paths that could lead to inflation and/or higher rates. For one, let's assume money printing *actually* works (we do not think it will) and we enter a lasting recovery. In such a scenario, there will be a lot more money chasing the same amount of goods, or fewer goods, assuming it takes years to return to 2019 output levels. Alternatively, if money printing fails, then the economy will be weaker for longer. We would not be surprised, as economic growth has been disappointing despite unprecedented levels of accommodation. In this scenario, defaults and bankruptcies are likely to rise dramatically, which will eventually cause the cost of capital to increase as lenders demand appropriate interest rates for the risk they are taking. This could impact governments, corporations, and individuals alike.

Interestingly, low rates have been a big tailwind for growth investments. Compared with value stocks, growth stocks have a greater proportion of their value derived from future earnings (years down the road). The present value of a business is the sum of its future cash flows, discounted back at a specified rate of return (discount rate). The higher the discount rate, the lower the present value of those future cash flows. The lower the discount rate, the higher the present value. With negative rates across Europe and Japan, and rates near zero in the U.S., ultra-low discount rates have been used to justify growth stocks' sky-high valuations. In 5,000 years of financial market history, however, we have never had negative rates until recently,[8] so we view the current situation as more the exception rather than the rule. Money isn't supposed to be free. The era of *return-free risk* will eventually end. If rates go up, growth stocks will feel the pinch.

To Beat the Market, You Need to Do Something Different

In recent years, growth stocks have outperformed in a rising bull market (March 2009 - February 2020), a COVID-19 bear market (February - May 2020), and a subsequent recovery. However, even after a decade of dominance, the returns for growth stocks still pale in comparison over the long run. Since inception (12/31/74), the MSCI EAFE Value Index has more than doubled its growth counterpart, with a return of 7,593% (10.01% compounded annually) vs. 3,696% (8.32%), respectively. Value investing is contrarian in nature and, as a result, can fall out of favor over long periods of time. As the chart to the right illustrates,[9] the sentiment around value stocks could not be much worse than it is today. Nonetheless, to beat the market you need to do something different than the market. Buying unloved, undervalued businesses with a margin of safety *does work*, and it's been proven over time.



[7] https://miltonfriedman.hoover.org/friedman_images/Collections/2016c21/IEA_1970.pdf
[8] Jeff Cox. "$12 trillion of QE and the lowest rates in 5,000 years...for this?" *CNBC.com.* June 13, 2016.
[9] Michael Hartnett, Jared Woodward, Shirley Wu. "The Flow Show." *BofA Global Research.* April 23, 2020.

Looking at the valuations for the growth stocks driving the market can be informative. For example, the MSCI EAFE Growth Index, which trades at over twice the valuation of the FMI International portfolios (see table), has over 100 stocks valued at more than *6 times* price-to-sales (P/S), or 23% of the index. In comparison, the FMI International portfolios have only one stock that trades at over *4 times* P/S, and three holdings that trade at less than *6 times* price-to-trailing earnings -- Jardine Strategic, CK Hutchison, and Hyundai Motor. At a wide enough valuation spread, the risk-to-reward will eventually become too compelling to overlook. We think we are already there today -- to us there's little to debate. Buy Samsung Electronics at around 10 times forward earnings, or ASML at 39 times? LG Household & Health Care at 14 times, or L'Oreal at 38 times? B&M European Value Retail at 16 times, or Fast Retailing at 42 times? Lloyds Banking at 11 times, or London Stock Exchange at 35 times? These seem like no brainers. At some point the market will wake up.

Weighted Average Valuations*	Valuation Premium to FMI International (6/30/20)		
	iShares MSCI EAFE	iShares MSCI EAFE Value	iShares MSCI EAFE Growth
P/E (1 Year Trailing)	37%	-5%	84%
P/E (1 Year Forward)	13%	-16%	41%
P/S	157%	29%	293%
EV/EBITDA	59%	0%	109%
Average Premium	***67%***	***2%***	***132%***

** Estimated valuations for FMI and the iShares are weighted average valuation calculations, not reweighted to exclude cash, and financial companies are excluded from the EV/EBITDA calculation. Valuations for both the portfolio and the ETF are modified based on criteria identified by FMI. For more detailed information regarding these valuations, please contact FMI.*

As can be seen in the table, the FMI International portfolios trade at a significant discount to the MSCI EAFE and EAFE Growth indices, and in-line with the MSCI EAFE Value Index. Compared with the value index, we believe our companies are stronger, with better growth prospects, return profiles (returns on invested capital, and on equity) and balance sheets.

While investors have thrown caution to the wind on valuations, rank speculation caused by easy money will not be sustainable. We do not know what will cause growth's long reign to topple, but we have high conviction that it will in the fullness of time. For example, will people return to more sensible views on valuation? Will rising rates cause investors to rethink their discount rates? Will growth stock expectations disappoint and collapse under their own weight (they are tethered to the same economy, after all)? Will central banks finally take their foot off the gas? Will we see a credit crisis, where speculative borrowers are no longer awarded a free pass? Will there be a reversion to the mean (a recovery in value multiples or a decline in growth multiples), like so many other periods in the past? It remains to be seen, but we take comfort in knowing that there are several paths that could lead to value's resurgence. In the meantime, we are investing right alongside our clients and will continue to stick to our discipline. With patience comes great reward.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 12/31/2019

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%
2018	-8.63	-9.27	-10.99	3	0.06	7.22	9.69	$ 6,287.8	$ 19,833.6	31.70%
2019	18.11	17.29	21.67	3	0.08	8.30	9.48	$ 7,522.0	$ 22,609.8	33.27%

*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 - 12/31/2019. 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 12/31/2010-12/31/2019. 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.

Fiduciary Management Inc.
International Equity Unhedged Composite
12/31/2019 - 06/30/2020

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 %
Q1 2020	-29.09	-29.22	-20.55	1	0.00	n/a	n/a	$ 26.5	$ 15,121.8	0.17%
Q2 2020	14.54	14.32	12.60	1	0.00	n/a	n/a	$ 31.7	$ 15,293.9	0.21%

*MSCI EAFE Net Index (USD)®

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Up to $25,000,000	0.70%
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