

INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2021

International stock markets climbed again in the June quarter. Despite a litany of global challenges, vaccines were administered, many economies reopened, and growth prospects brightened. After two quarters of reprieve, momentum and growth stocks were back in the driver's seat, outperforming the value trade yet again. Speculation remains afoot as central banks and governments keep the stimulus firehose ever-flowing.

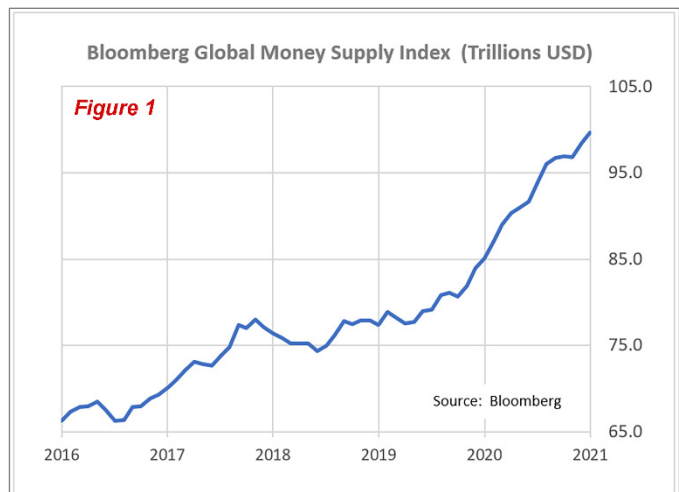
The FMI International portfolios gained approximately 4.0% (currency hedged) and 4.2% (currency unhedged) in the period, respectively, which compares with an MSCI EAFE Index gain of 4.79% in local currency (LOC) and 5.17% in U.S. Dollars (USD). The MSCI EAFE Value Index advanced 2.72% in LOC and 3.01% in USD, lagging their respective MSCI EAFE Growth Indices by over 4.2%. FMI International portfolio performance was driven by the Distribution Services, Industrial Services, and Finance sectors, while Consumer Non-Durables, Health Technology, and Electronic Technology underperformed. Ferguson PLC, Schlumberger Ltd., and B&M European Value Retail S.A. were the strongest individual contributors, as Koninklijke Philips N.V., Sony Group Corp. and Yokogawa Electric Corp. weighed on the results. A weak USD detracted from FMI's currency hedged performance.

In a break from our normal format, we'll address the most common questions we are getting from clients:

Revived economic growth, post-vaccines?

While our approach to investing is from a bottom-up, fundamental perspective, we are often asked about our macro views. Our two cents: we are encouraged by the global economic rebound, which has gathered strength in recent months. Per the World Bank, global GDP is expected to grow 5.6% in 2021, the "fastest post-recession pace in 80 years." While robust, the recovery has been uneven, with strong rebounds in countries like the U.S. and China and a lag in developed Europe, but with continued struggles in many developing and emerging markets due to a very slow pace of vaccination. Growth in low-income economies in 2021 is expected to be at the lowest rate in 20 years (not including 2020).¹ However, as vaccines continue to be rolled out, virus spread is slowed, and economies continue to reopen, the near-term outlook looks promising.

On the flip side, inflation is on the rise, exemplified by soaring commodity prices, wage pressures, increasing transportation costs, rising home prices, supply bottlenecks, semiconductor chip shortages, and more. According to a recent global fund manager survey by Bank of America, 72% of investors believe inflation will be temporary.² We are increasingly skeptical. After more than a decade of extraordinary quantitative easing (a.k.a. money printing), we have seen an astounding \$30 trillion of global fiscal and monetary stimulus over the last 18 months.³ Global money supply has grown ~22% since March of 2020, as illustrated in the chart in Figure 1. Nobel prize-winning economist Milton Friedman (1912-2006) is well-remembered to have said (and it seems particularly relevant today): "Inflation is always and everywhere a



¹ "Global Recovery Strong but Uneven as Many Developing Countries Struggle with the Pandemic's Lasting Effects." *World Bank*, June 8, 2021.

² Michael Hartnett, David Jones, Shirley Wu and Myung-Jee Jung. "Global Fund Manager Survey: 72% say inflation is transitory." *BofA Global Research*, June 15, 2021.

³ Michael Hartnett, David Jones, Shirley Wu and Myung-Jee Jung. "The Flow Show: Inflation to hit the inflation trade." *BofA Global Research*, June 10, 2021.

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.” Only time will tell.

The long-term prospects for the global economy appear less certain. After a massive amount of spending, we are left with record budget deficits and debt levels, which will inevitably weigh on future growth. The political appetite for fiscal discipline is virtually non-existent. In addition, weak demographics are clouding the growth algorithm, as working-age populations in Europe, Japan, and China are forecasted to decline indefinitely.⁴ Growing an economy requires some combination of three factors: more people working, people working more hours, and/or productivity growth (more output per worker). Given the demographic headwinds, *productivity* will be paramount, yet productivity growth has disappointed since the global financial crisis, slowing from an annual rate of 2.6% between 2000-2007 to 1.7% between 2011-2019 (and only 1% in 2019). After falling 0.9% in 2020, productivity is projected to rebound to 2.9% this year, but has benefited from the reopening and a waning pandemic.⁵ Recent research by McKinsey Global Institute (MGI) provides a glimmer of hope, as it cites the *potential* to double the pre-pandemic rate of productivity in North America and Europe, with research & development and capital investment focused on digitization and automation.⁶ MGI’s expectations seem optimistic (to us) given the more recent history, but we’d be happy to be proven wrong.

Portfolio check-up: positioned for higher rates and inflation?

In short, we believe our portfolio is well-situated. We strive to invest in companies that are “all-weather vehicles” – businesses that can thrive in virtually any economic environment. This starts with our focus on business quality. We want to own companies that have sustainable competitive advantages and barriers to entry (e.g., economies of scale, cost advantages, brand differentiation, and proprietary technology) that allow them to earn a return above their cost of capital, creating economic value. These differentiated businesses often have pricing power, in part due to their strong competitive positioning, and can pass along price increases (albeit some with a lag) to offset inflationary pressures. Lower-quality businesses that lack pricing power will have to absorb more of these rising input costs, resulting in decreased profitability, which can potentially weaken their relative market position versus peers during a period of adversity.

Our focus on balance sheet strength also plays an important role. If interest rates rise, so too will debt service costs for such things as variable-rate loans and fixed-rate loan refinancing. With increased corporate leverage post-pandemic, businesses with fragile balance sheets may find themselves in a compromised situation, struggling to service their debt, and/or having difficulty refinancing. A levered balance sheet can also limit a company’s ability to invest, opening it up to market share loss and competitive attack. In periods of financial distress, investors often abandon stocks with weak balance sheets, as concerns around liquidity and solvency come to the forefront. Our portfolio companies operate from a position of balance sheet strength and stability, which we believe will ultimately be a differentiating factor. Elevated leverage hasn’t mattered much in recent years, but if history is any indication, it is only a matter of time before it will.

Lastly, our value-oriented approach should work to our advantage, especially from a relative standpoint. As articulated in a number of our past letters, long-duration growth stocks have been a significant beneficiary of low rates and inflation, with their valuations gaining the most from ultra-low discount rates (given the value being derived from expected future earnings years down the road). Rising rates could splash cold water on some of these highfliers, after a period where growth stocks have beaten value stocks by nearly 80% (LOC) over the past decade. Our companies generate cash and earnings today, and are not dependent upon aggressive discount rate assumptions to justify their current valuations. Sound, fundamental analysis and a valuation discipline ought to prove vitally important if we see higher rates and inflation.

Biggest risks... what could go wrong?

We view the world’s enormous mountain of debt (Figure 2) – \$289 trillion, or 360% of GDP⁷ – as the greatest risk to financial markets. We’re not alone. The European Systemic Risk Board, which monitors the European Union financial system, recently warned of a potential “tsunami” of corporate insolvencies once the governments’ crisis-era support is

⁴ <https://population.un.org/wpp/>

⁵ “Global Productivity Growth Remains Weak, Extending Slowing Trend.” *The Conference Board*, April 21, 2021.

⁶ “Will productivity and growth return after the COVID-19 crisis?” *McKinsey Global Institute*, March 30, 2021.

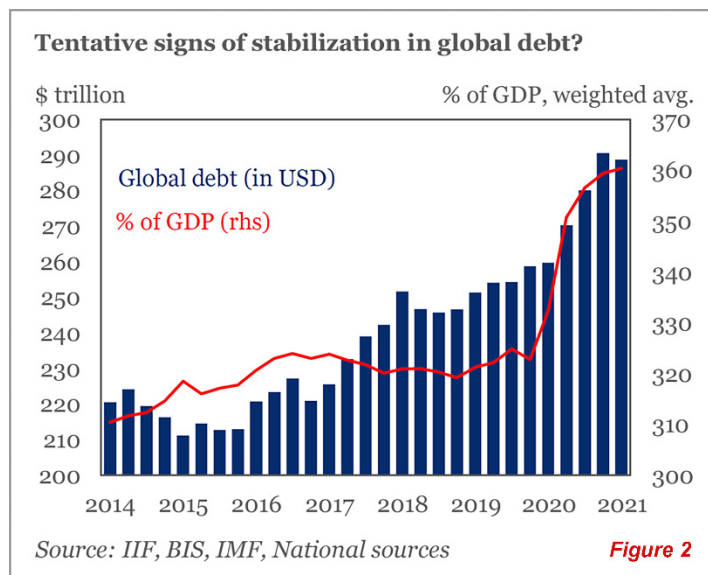
⁷ “Global Debt Monitor: Chipping away at the mountain?” *Institute of International Finance*. May 13, 2021.

withdrawn.⁸ Meanwhile, the European Central Bank (ECB) believes that Eurozone banks are underestimating the risks from the pandemic, “deliberately ignoring signs that problem loans could spike once emergency measures expire,” according to the New York Times.⁹ Additionally, ECB Vice-President Luis de Guindos cautioned,

We are optimistic that financial and economic conditions will bounce back. There is, however, a reality that the pandemic will leave a legacy of higher debt and weaker balance sheets, which — if unaddressed — could prompt sharp market corrections and financial stress or lead to a prolonged period of weak economic recovery [...] Vulnerabilities from the outstanding stock of debt appear higher than in the aftermath of the global financial crisis and the euro area sovereign debt crisis.¹⁰

Unfortunately, ultra-low (or negative) interest rates anchor the financial stability in that region (and worldwide), driven by unprecedented manipulation by central banks. Remarkably, there is *still* over \$13 trillion of negative-yielding bonds, globally. Greek 5-year debt recently made the cut (-0.11 on 6/11/21) ...not bad for a country with a BB junk bond credit rating and a sovereign debt crisis in its recent past.¹¹ Investors must *pay* (via negative yields) to take on a significant level of risk, which defies logic.

Finally, according to a survey by the biggest debt collector in Europe (Intrum AB), around two-thirds of companies see a growing risk of late payments in 2021.¹² If businesses indeed run into financial turmoil as safety nets are lifted, an investment portfolio’s downside protection will be imperative.



Valuation thoughts, given rising costs?

At the risk of sounding like a broken record, stock valuations remain expensive in absolute terms, especially when considering that material and labor costs are on the rise. Corporate margins are likely to come under pressure, especially for weaker businesses in competitive industries. Higher interest rates are also a risk, and could weigh on profitability (financing costs), as well as valuation multiples (higher discount rates).

On a relative basis, a compelling case can be made for foreign versus U.S. stocks. According to The Leuthold Group, using normalized earnings per share, the foreign discount versus the U.S. is around 39%, which is near the highest level it has been since 1975. Similarly, the valuation spread for value versus growth stocks continues to stand out: using a basket of standard valuation metrics (P/E LTM, P/E FY1, EV/EBITDA, P/S, P/B),¹³ the MSCI EAFE Value Index trades at a 55% discount to the MSCI EAFE Growth Index, bolstering the relative opportunity set.

New opportunities... when, where, and why?

As disciplined investors, we find ourselves leaning into the wind time and again, and 2021 has been no different. Given the weakness in emerging markets, companies with significant revenue in emerging markets provided a handful of interesting opportunities. For example, we added to our position in Unilever PLC, a blue-chip consumer staple. The

⁸ Martin Arnold. “EU warned about insolvency ‘tsunami.’” *Financial Times*, April 28, 2021.
⁹ Jack Ewing. “Eurozone banks are underestimating risks from the pandemic, E.C.B. warns.” *The New York Times*, January 28, 2021.
¹⁰ Martin Arnold. “ECB warns pandemic debt burden puts financial stability at risk.” *Financial Times*, May 19, 2021.
¹¹ Bloomberg.
¹² Hanna Hoikkala. “Europe’s Biggest Debt Collector Sees Rise in Late Payments.” *Bloomberg*, June 16, 2021.
¹³ Price-to-earnings last twelve months; price-to-earnings fiscal year 1 (current year); enterprise value-to-earnings before interest, taxes, depreciation, and amortization; price-to-sales; price-to-book. Valuations are estimates based on the following scrubbing criteria: money losing companies are ascribed a 40 P/E ratio to them (which is probably conservative) and those with P/E ratios greater than 100 are capped at 100. For P/S, those with greater than a 30 multiple are capped at 30x. We assign the same multiple for no sales. The EV/EBITDA calculation excludes financials, and uses a cap of a 200 multiple, while those with a negative EV/EBITDA receive a 20 multiple in the calculation. For P/B, those with greater than a 10 multiple are capped at 10x. We assign the same multiple for no book value.

company's large emerging market exposure (over 50% of revenue), which, historically, had been viewed positively by the market due to better long-term growth prospects, has weighed on the stock more recently. Growth is expected to rebound as these geographies recover, and the stock trades at a meaningful discount to its peers. We also initiated a new position in DBS Group Holdings Ltd., the largest bank in Singapore. The CEO, Piyush Gupta, is regarded as one of the best banking CEOs in Asia and is known for investing early and aggressively in technology capabilities, which we consider a competitive advantage. The bank has an attractive runway for growth in the region (double-digit earnings per share compound annual growth rate over the last decade) and has earned multiple awards and accolades, including "World's Best Bank" and "Safest Bank in Asia." We view the business as a high-quality franchise with a conservative underwriting culture, that is trading at an undemanding valuation.

An idiosyncratic opportunity presented itself at SAP SE, which we purchased in February. SAP is one of the largest software companies in the world, with a focus on Enterprise Resource Planning (ERP), Customer Relationship Management and Human Resources. SAP can be characterized by strong customer relationships, a complex product set with high switching costs, a huge installed base, and significant recurring revenue (72% of sales moving to 85% by 2025). The company is integrating its product portfolio to provide a better user experience and migrating its on-premise ERP customers to the Cloud. SAP's plan calls for muted revenue growth and flat-to-slightly declining operating profit through 2022 as it goes through the transition, before accelerating to double-digit growth from 2023 onward. Unlike the market, which is obsessed with near-term earnings momentum (leading to the stock sell-off), patience is our advantage. The transition to the Cloud should increase SAP's revenue by over two times, provide better performance and functionality, and save customers money: a win-win.

We sold two successful long-term holdings in the quarter, parting ways with Nestlé S.A. and Compass Group PLC because of elevated valuations. Every day, we evaluate new opportunities, actively populating our monitor and wish lists as we look for the next compelling investment, knowing they will be the drivers of future performance.

Thank you for your continued support of Fiduciary Management, Inc.

Fiduciary Management Inc.
International Equity Hedged Composite
12/31/2010 - 12/31/2020

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		Percentage of Firm Assets %
						Composite	*Benchmark	Assets End of Period (\$ millions)	Total Firm Assets End of Period (\$ millions)	
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	\$ 22,609.9	33.27%
2020	0.98	0.25	0.84	3	0.27	17.52	15.65	\$ 3,576.9	\$ 16,284.2	21.97%

*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, Inc. claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Fiduciary Management, Inc. has been independently verified for the periods 12/31/1993 - 12/31/2020. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The International Equity Hedged Composite has had a performance examination for the periods 12/31/2010 - 12/31/2020. The verification and performance examination reports are available upon request. As of January 1, 2021 the International Equity Composite was renamed the International Equity Hedged Composite.

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 \$16.2 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 Hedged Composite was created and inception on 12/31/2010. 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 Hedged 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®. FMI uses gross returns to calculate these.

Currently, the advisory fee structure for the International Equity Hedged 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 and FMI distributed mutual funds are 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 Hedged composite uses the MSCI EAFE Net Local Index® as its primary index comparison.

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International Equity Unhedged Composite
12/31/2019 - 12/31/2020

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			
2020	4.88	4.09	7.82	1	0.00	n/a	n/a	\$ 56.7	\$ 16,284.2	0.35%

*MSCI EAFE Net Index (USD)®

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