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Investment Strategy Outlook - Large Cap Equity
March 31, 2011

The large cap portfolios gained approximately 5% in the quarter compared to 5.9% for the Standard & Poor's 500 Index. The first two months of the quarter were similar to last year in that commodity-oriented, levered cyclical and energy-related stocks did well. More defensive stocks continued to underperform. With Middle East conflicts escalating and the terrible tragedy in Japan unfolding, there was some flight back to perceived safety. We were pleased to have not lost too much ground given our conservative, defensive posture. Overall, we have been surprised at the magnitude and duration of the equity rally, now over two years old. Valuations are once again stretched for the market as a whole, particularly given the grave nature of developed country finances.

Easy Solutions?

If you ask the proverbial average American how many people in the US make over $1 million per year, the number would likely be a lot greater than 321,294. Yet that is indeed the figure.[1] The IRS shows adjusted gross income for this group of $1.076 trillion. They paid federal income taxes of $260 billion. So, think about the math. One could increase taxes on this group of people by 50% and assume they do not take any mitigating actions (defer income, hide income, delay capital gains, opt for leisure, etc.), and the additional income generated would be $130 billion. That is less than 10% of this year's budget deficit of $1.5 trillion. Forget about the $14.3 trillion of debt and any hope of chipping away at that.

4,376,000 filers make more than $200,000 per year. Their adjusted gross income in 2008 was $2.462 trillion. They paid $544 billion in taxes. Again, we could raise tax rates by 50%, assume they take no mitigating actions, and only $272 billion more in taxes would be raised. This is 18% of the current budget deficit. Incidentally, these 4.4 million filers, 1.5% of the population, paid 50% of the total federal income taxes.

There are certainly some high income filers who have found or exploited ways to avoid paying statutory rates (all the more reason to reform the tax code), but odd as it may seem, even doubling their tax rate barely dents the deficit. 13,000 filers made more than $10 million in 2008, generating taxable income of $348 billion and paying $88 billion in federal income tax. Double their tax rate, assume there is no leakage and it would generate just 6% of this year's deficit.

Some say the answer is to just tax corporations at a higher rate. There are all sorts of issues with this idea, not the least of which is that corporate taxes bring in less than $200 billion annually, just 13% of this year's deficit, and the US corporate tax rate of 35% is already the second highest amongst the 30 OECD countries. Many companies have moved operations or headquarters overseas to avoid getting taxed at the US rate for income they do not generate in the US. Armies of tax lawyers and lobbyists are employed to reduce corporate taxes and this has the effect of favoring not only certain types of businesses over others, but large corporations over small. President Obama seems open to reducing corporate tax rates to make the US more competitive.

[1] The IRS data is for 2008, the most recent available. Actual millionaires may be slightly higher in the cases where both spouses earn over $1 million and are filing jointly.

Reducing or eliminating the corporate tax, combined with a much flatter individual tax and the elimination of tax breaks, would also be more equitable and could generate more income over time. In a sense, corporations really don't pay taxes; they simply pass the burden onto consumers. Raising the corporate tax rate doesn't affect the CEO's income at all, but it does hurt the little guy, who pays more for a loaf of bread or possibly loses his job because his unit is moved offshore. Corporations are not living citizens. They are owned by living citizens who pay taxes on distributed corporate income and capital gains. If tax rates on dividends and capital gains migrated toward a broad-based flat tax rate, income would accrue to the owners, suppliers and employees and very possibly tax revenue would rise, in addition to being less regressive.

> *"We know what it will take for America to win the future. We need to out-innovate, we need to out-educate, we need to out-build our competitors. We need an economy that's based not on what we consume and borrow from other nations, but what we make and what we sell around the world. We need to make America the best place on Earth to do business… Another barrier government can remove is a burdensome corporate tax code with one of the highest rates in the world."*
>
> *- President Barack Obama (February 7, 2011)*

No discussion of the budget deficit can progress unless people understand this basic math: approximately 58% of the budget is Medicare, Federal Medicaid, social security, and unemployment entitlements. Defense is 20%. If a budget discussion fails to address 78% of the budget, it fails.

According to a recent survey by the Tarrance Group, a majority of voters (63%) incorrectly believes the federal government spends more on defense than it does on Medicare and Social Security. The hard reality is that there are no easy solutions. No sound bite call to tax the rich or stick it to corporations really addresses the problem at all. The issue has been and continues to be excessive government spending.

As this letter is being written, Congress is haggling back and forth about whether federal spending growth will be reduced by $62 billion or $10 billion (1.7% or .4% of the total budget, respectively). With little recognition or admission of the underlying fiscal realities, and almost nothing of substance being done about it (in fact, large protests against spending cuts are now commonplace), our macro outlook continues to be guarded. Stock valuations have moved considerably higher over the past year and the combo platter of a fiscal mess, an untenable monetary policy and a stretched market translates into a more cautious investment outlook. Of course, experience tells us there will always be interesting investment ideas, regardless of the big picture. Below we have highlighted two. Additionally, at www.fiduciarymgt.com/institutional-investors/additional-resources, we have posted the support work for this letter as well as some other interesting data. We thank one of our team members, Dan Sievers, for compiling this information.

Ingersoll-Rand PLC

Analyst: Karl Poehls

Business Description

Ingersoll-Rand (IR) is a diversified, global company that provides products, services and solutions to enhance the quality and comfort of air in homes and buildings, transport and protect food and perishables, secure homes and commercial properties, and enhance industrial productivity and efficiency. Its primary operating segments are: Climate Solutions (40% of 2009 EBIT), Security Technologies (31%), Industrial Technologies (17%), and Residential Solutions (12%).

Good Business

- IR's climate control and security products are critical for maintaining high standards of living.
- In 2009, approximately 75% of the company's $13.2 billion in revenue was generated from the sale of parts and services or from the replacement/retrofit market, and can be considered recurring in nature.
- IR occupies the #1 or #2 market share position in businesses that account for 80% of total sales.
- Over the past decade, IR has generated returns slightly above its cost of capital. For the trailing 5- and 10-year periods, the company's ROIC has averaged 8.8% and 9.0%, respectively. Going forward, we expect IR to generate incremental return on invested capital (ROIC) exceeding 15%.
- The company generates excess free cash flow (FCF) of approximately $1.0 billion. We expect the majority of FCF to be returned to shareholders via dividends and share repurchases.
- IR has a solid balance sheet with net debt of $2.9 billion. The company's long-term debt is rated BBB+ at S&P and Baa1 at Moody's. The interest coverage ratio is 4.4x.

Valuation

- At the current price, IR's stock is approximately 30% below its all-time high achieved in 2007.
- IR currently trades for 1.2x EV/Sales. This is slightly below its trailing 5- and 10-year average EV/Sales multiple of 1.3x.
- Over the past ten years, IR's operating margin has averaged 10.1%. We estimate the company's normalized operating margin run-rate is 13-14% based on its current business mix. This implies earnings power of between $4-5 per share. The stock trades for 8-10x this range.
- Since 1990, IR's P/E multiple has averaged 16.8x. This compares to the company's current P/E multiple of 17.0x, which is based on what we consider to be depressed margins and earnings.
- In 2011, we expect IR to pay approximately 25% of earnings through an annual dividend of $0.75 per share. This implies a dividend yield of 2%.

Management

- Michael Lamach has been IR's CEO since February 2010. Prior to joining IR in 2004, Lamach was employed by Johnson Controls for 18 years and held various management positions.
- Going forward, we expect IR's management will be focused on driving internal growth, improving productivity, and installing a high-performance operating culture. This is in sharp contrast to the company's historical focus under previous leadership.
- Over the next 3-5 years, we expect management to return a significant percentage of FCF to shareholders through dividends and share buybacks while limiting acquisition activity.

Investment Thesis

Due to struggles with past acquisitions and currently depressed end markets, IR's operating margin is meaningfully below its long-term potential. Also, investors are skeptical of management's ability to meet lofty internal margin targets and are waiting on the sidelines. We believe this presents an attractive opportunity to invest in a global industrial company with high recurring revenue, leading market share positions, and significant operating leverage to an improved economy.

Microsoft Corporation

Analyst: Dan Sievers

Description

Microsoft develops, manufactures, licenses, and supports software for computing devices worldwide. In 2010, the company's Windows & Windows Live Division, which is responsible for the Windows operating system, Windows Live services, and Internet Explorer, generated 42% of the positive segment level operating profit.

Microsoft Business Division, which is responsible for the front-end Microsoft Office products (Word, Excel, PowerPoint, Outlook, etc.) generated another 38% of the positive segment operating profit. Servers and Tools contributed 18% of segment operating profit, and the Entertainment and Devices Division contributed the remaining 2% of operating profit. Separately, Online Services Division, which is responsible for the Bing search engine and MSN, booked an operating loss of $2.4 billion in 2010.

Good Business

- The Windows Operating System and Microsoft Office are entrenched in the workflow of millions of businesses and are used by millions more consumers globally. Traditional PC sales drive revenue and both new software versions and the PC hardware cycle drive recurring purchases.
- The operating margins and ROIC at Microsoft are phenomenal. Windows OS gross margin is 95%.
- Microsoft spent $8-9 billion in R&D in each of the past three years, turning out a number of significant new products. In 2009, Apple spent $1.7 billion, and Google spent $2.8 billion in R&D.
- Microsoft's balance sheet is bulletproof with net cash of $31 billion (the vast majority is overseas).

Valuation

- Microsoft trades for 13x P/E, 9.2x P/CF, 7.1x EV/EBITDA, and 3.2x EV/Sales vs. 5-year average multiples of 17.6x P/E, 14.1x P/CF, 10.0x EV/EBITDA, and 4.1x EV/Sales.
- Microsoft offers a 10% FCF yield.

Management

- CEO Steve Ballmer, 54, was Microsoft's 30th employee and currently holds $8.5 billion in Microsoft stock (Bill Gates holds $14.9 billion).
- Microsoft has not granted stock options since 2003. Gates and Ballmer receive no stock awards.
- 2010 management departures (Ray Ozzie, Robbie Bach, Bob Muglia) have raised eyebrows, but Microsoft is widely thought to possess a deep bench of executive talent.
- Microsoft has returned an astonishing $126 billion to shareholders over the past six fiscal years through dividends and share repurchases.

Investment Thesis

Microsoft is out of favor in the market, viewed as a sleepy tech giant that is neither cutting edge nor fashionable. However, a wide range of Microsoft products is deeply and increasingly entrenched in the workflow of global business. Further, there are roughly 1 billion PCs in the world vs. a potential addressable market of 2-4 billion people. Quietly, Microsoft's forward-thinking R&D efforts have made it the world's premier cloud computing company. Almost silently, the Windows loaded notebook PC has become the lowest-cost and best-performing internet-connected device available. The targeted strategies of Apple and Google present specific risks, but we are being paid to take this risk at just 10 times free cash flow. Even if Microsoft were to achieve little or no profit growth in the future (a highly unlikely scenario), the company is likely to deliver solid returns to investors through repurchases and growing dividends. Microsoft is a high-quality cash machine.

Thank you for support of Fiduciary Management, Inc.

Fiduciary Management Inc.
Large Cap Equity Composite
12/31/2000 - 09/30/2011

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2001	20.47	19.70	-11.89	1	0.00	$ 3.6	$ 1,458.2	0.25%
2002	-13.33	-14.11	-22.10	8	0.17	$ 14.0	$ 1,731.0	0.81%
2003	34.29	33.15	28.68	4	0.86	$ 20.8	$ 2,927.0	0.71%
2004	19.32	18.46	10.88	10	0.46	$ 48.9	$ 3,085.8	1.58%
2005	10.22	9.57	4.91	28	0.29	$ 192.2	$ 3,174.4	6.05%
2006	17.91	17.15	15.79	49	0.30	$ 491.0	$ 3,589.4	13.68%
2007	5.05	4.34	5.49	86	0.48	$ 1,000.2	$ 3,960.4	25.26%
2008	-26.38	-26.91	-37.00	130	0.63	$ 1,969.3	$ 4,062.5	48.48%
2009	30.92	30.09	26.46	252	1.22	$ 3,820.3	$ 7,008.9	54.51%
2010	12.52	11.81	15.06	394	0.31	$ 5,923.2	$ 9,816.0	60.34%
Q1 2011	5.01	4.85	5.92	436	0.12	$ 6,717.9	$ 11,338.0	59.25%
Q2 2011	2.07	1.91	0.10	459	0.11	$ 7,701.2	$ 11,819.6	65.16%
Q3 2011	-13.91	-14.04	-13.87	485	0.18	$ 6,989.5	$ 10,357.9	67.48%

*Benchmark: S&P 500 Index®

Effective January 2012, 2004 – 2011 gross and net composite returns were restated due to an error.
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. (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 - 09/30/2011. 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 Large Cap Equity composite has been examined for the periods 12/31/2000 - 09/30/2011. The verification and performance examination reports are available upon request.

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 $10.3 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 FMI Large Cap Equity Composite was created in December 2000. These accounts primarily invest in medium to large capitalization US equities.

The FMI Large Cap Equity Composite reflects time-weighted and asset-weighted returns for all discretionary accounts. From December 31, 2000 thru September 30, 2002 all accounts included were managed for at least one quarter, from October 1, 2002 to present all accounts were managed for at least one month. 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 standard deviation of all accounts in the composite for the entire period.

Currently, the advisory fee structure for the FMI Large Cap Equity Composite portfolios is as follows:

Up to $25,000,000	0.65%
$25,000,001-$50,000,000	0.55%
$50,000,001-$100,000,000	0.45%
$100,000,001 and above	0.40%

The firm generally requires a minimum of $3 million in assets to establish a discretionary account. High Net Worth individuals may establish an account with a minimum of $1,000,000, however, the firm reserves the right to charge a minimum dollar fee for High Net Worth individuals depending on the client servicing involved. 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 S&P 500 Index® is widely regarded as the best single gauge of the U.S. equities market. This index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500® focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.
The Large Cap Equity composite uses the S&P 500 Index® as its primary index comparison.