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# INVESTMENT STRATEGY OUTLOOK – LARGE CAP EQUITY

March 31, 2014

The FMI large cap portfolios returned approximately 2.7% in the March quarter compared to 1.81% for the Standard & Poor's 500 Index. Sectors that aided results in the period included Energy Minerals, Process Industries, and Health Services. Devon Energy, Potash Corp, and UnitedHealth Group led these groups, respectively. On the downside, Transportation, Distribution Services, and Health Technology all detracted from the results. Expeditors International and AmerisourceBergen were the underperformers in the first two sectors, and the relative underweighting in Health Technology also played a role. While there were a few days and weeks of consternation, the market continued to show remarkable buoyancy as this bull run reached five years in duration. U.S. stock markets hit their low this cycle on March 9, 2009, with the S&P 500 closing at 676.5. Five years later it closed at 1878.0. With dividends, the total return was a remarkable 208.8%. The table below shows all of the Dow Jones Industrial Average's bull markets since 1900 (the S&P 500 did not exist in its present form until 1957). This is the 22nd bull market of the modern era; the median price change was 83.5% and the median duration was 33 months. From the March 9, 2009 low through year-end 2013, the Dow Jones Industrials gained 153.2% in price (with dividends, the total return was 188.2%), making this bull market approximately 83% greater in price and 79% longer in duration than the median bull market over the past 114 years.

This bull market reminds us of the old movie, *Groundhog Day,* with Bill Murray. Phil Connors (Murray) repeatedly wakes up to Sonny & Cher on the radio, and has to live the same day over and over no matter what he does. Similarly, this market seems to stay the same …expensive… despite a litany of less-than-appealing fundamentals: corporate revenue growth weakening, spotty job growth (actually falling when adjusted for the drop in average workweek hours), China slowing, emerging markets swooning, Syria and the Middle East aflame, Russia swiping Crimea and acting with hostility elsewhere, biotechnology stocks soaring on sketchy fundamentals, and classic signs of over-exuberance (Whatsapp, Pandora, etc.). Of course, there are some positives, including improved bank lending and consumer sentiment, but so far precious little is being translated into sustainable economic growth. Valuations, as articulated ad nauseam in recent letters, remain extremely high from a historical perspective. Investor bullishness and the raft of low quality IPOs are additional signs of speculative excess. Added to this is the continuing fiscal crisis, a toxic political environment, and a monetary policy that all but ignores the potential ramifications of conjuring up $4 trillion of high-powered money out of thin air.

| Bull Market Dates Dow Jones Industrial Average | Price Return Only | # Days | ~ # Months |
|---|---|---|---|
| 9/24/1900 - 6/17/1901 | 47.8% | 266 | 8.9 |
| 11/9/1903 - 1/19/1906 | 144.3% | 802 | 26.7 |
| 11/18/1907 - 11/19/1909 | 89.6% | 732 | 24.4 |
| 9/25/1911 - 9/30/1912 | 29.1% | 371 | 12.4 |
| 12/24/1914 - 11/21/1916 | 110.5% | 698 | 23.3 |
| 12/19/1917 - 11/3/1919 | 81.4% | 684 | 22.8 |
| 8/24/1921 - 9/3/1929 | 495.2% | 2926 | 97.5 |
| 7/8/1932 - 3/10/1937 | 371.6% | 1706 | 56.9 |
| 3/31/1938 - 11/9/1938 | 60.1% | 223 | 7.4 |
| 4/28/1942 - 5/29/1946 | 128.7% | 1492 | 49.7 |
| 10/22/1957 - 12/13/1961 | 75.1% | 1513 | 50.4 |
| 6/26/1962 - 2/9/1966 | 85.7% | 1324 | 44.1 |
| 10/7/1966 - 12/3/1968 | 32.4% | 788 | 26.3 |
| 5/26/1970 - 1/11/1973 | 66.6% | 961 | 32.0 |
| 12/6/1974 - 9/21/1976 | 75.7% | 655 | 21.8 |
| 2/28/1978 - 4/27/1981 | 38.0% | 1154 | 38.5 |
| 8/12/1982 - 8/25/1987 | 250.4% | 1839 | 61.3 |
| 10/19/1987 - 7/16/1990 | 72.5% | 1001 | 33.4 |
| 10/11/1990 - 7/17/1998 | 294.8% | 2835 | 94.5 |
| 8/31/1998 - 1/14/2000 | 55.5% | 501 | 16.7 |
| 10/9/2002 - 10/9/2007 | 94.4% | 1826 | 60.9 |
| 3/9/2009 - 12/31/2013 | 153.2% | 1758 | 58.6 |
| Average | 129.7% | 1184 | 39.5 |
| Median | 83.5% | 981 | 32.7 |

*Source: Fiduciary Management, Inc. / Bloomberg*

The developments in China deserve special mention. Chinese leaders have recently begun to admit what many, including us, have been saying for some time: credit extension has gotten out of control. Credit has grown at more than 20% per year for over five years ($14 trillion), much of which has been spent on real estate and infrastructure where there are clear signs of excess. On March 7, China allowed its first corporate bond default, the Chaori Solar Energy Science and Technology Company. On March 18, Zhejiang

Xingrun Real Estate Company defaulted on $567 million of debt. Will the authorities continue to let the air out of the bubble by not propping up zombie companies and state-owned enterprises? Heretofore that has not been their modus operandi but it is possible that a major change is afoot. How much pain will the authorities tolerate? We will monitor the developments closely.

Unlike *Groundhog Day*, we can't stop the clock and make all the bad things turn out great. We own this set of shaky fundamentals, and we own them at high valuations. Most bull markets are impervious to fundamentals in the short run, but not over the long haul. The problem is that investors believe they can spot signs of trouble and "get out with their skin." Unfortunately, this rarely happens. Simply look at the aforementioned list of real and anecdotal signs that might typically be tipping points for a stock market. So far each one proved false but instead of investors counting their lucky stars and derisking, they actually do the opposite, becoming more emboldened and aggressive. It's why when markets turn, they rarely decline to an average or median level, but more commonly overshoot on the downside. The euphoria turns to panic and as the disillusionment deepens, the once overvalued becomes cheap. It's also why most studies show that the average investor has achieved about a 3% return in the stock market while the S&P 500 has done close to 10%.

Human nature rarely changes from cycle to cycle. The crack marketing and client service team (all four of them!) at Fiduciary Management, Inc. tell prospective and existing clients to expect our approach to lag strong markets and outperform in more difficult markets. This has been the general pattern for 30+ years of managing money, but of course there are no guarantees. Our philosophy and strategy is geared toward relative risk aversion and is focused on long-term rather than short-term performance. This has yielded fairly substantial outperformance over full market cycles but occasionally not over shorter periods. Using the FMI Large Cap Fund (FMIHX) as a proxy (because it is priced daily), it gained 194.8% from the March 9, 2009 bottom to the fifth anniversary of the current rally (3/7/2014), approximately 93% of the 208.8% return of the S&P 500. Of course the full story on this cycle has yet to be told, but if we go back to the previous peak on October 12, 2007 and measure the return through the 2008-09 bear market back to the five-year anniversary of the bull market (3/7/2014), FMIHX gained 55.0% compared to 38.5% for the S&P 500. Since the inception of FMIHX (12/31/2001), the total return through 3/31/2014 was 186.8% compared to 108.5% for the S&P 500. Despite the best efforts of our marketing people, we've seen the same phenomenon over the decades: some clients who acknowledge on the front end that our strategy will underperform in a strong up market don't have the constitution to be patient and wait for the inevitable turn. Sometimes they go to the dark side (speculative growth or momentum) and other times they find a new value-oriented or "alternative" manager. There is always going to be another manager with a better near-term track record. The performance game is cutthroat and as Warren Buffett likes to say, "You never know who is swimming naked until the tide goes out." The best approach is to ascertain whether the portfolio owns financially strong companies with good business models, and that have valuations that are reasonable, if not cheap.

On that note, we'd like to highlight a couple of investments.

## Berkshire Hathaway, Inc. (BRK.B)

(Analyst: Karl Poehls)

### Description

Berkshire Hathaway is a holding company owning subsidiaries that engage in a number of diverse business activities including property and casualty insurance and reinsurance (29% of 2013 EBIT [earnings before interest and taxes]); freight rail transportation (29%); utilities and energy (9%); finance (4%); and manufacturing, services and retailing (29%). Included in the group of subsidiaries that underwrite property and casualty insurance and reinsurance is GEICO, the third largest private passenger auto insurer in the U.S., and two of the largest reinsurers in the world, General Re and the Berkshire Hathaway Reinsurance Group. Other notable subsidiaries are: Burlington Northern Sante Fe (BNSF), MidAmerican Holdings, McLane, Iscar, The Marmon Group, Shaw Industries, Benjamin Moore, Lubrizol, NetJets, Forest River, and Johns Manville.

### Good Business

- Most of Berkshire's operating subsidiaries enjoy sustainable competitive advantages and hold leadership positions in their respective industries.

- GEICO is one of the world's most valuable insurance operations. It generates superior underwriting results and benefits from a low-cost structure. The reinsurance operations have the balance sheet capacity to write business that others cannot.
- At year-end 2013, Berkshire's insurance "float" exceeded $75 billion. Given the underwriting discipline of the company's insurance operations, this float is effectively free capital that can be deployed into attractive investment opportunities.
- The market value of Berkshire's investment portfolio is approximately $220 billion. The underlying securities provide a recurring stream of investment income.
- Over the past ten years, Berkshire's book value per share has compounded at 11% per annum.
- The company possesses a strong balance sheet. Berkshire's long-term debt is rated Aa2 and AA by Moody's and S&P, respectively.

**Valuation**

- Berkshire's current P/BV (price-to-book value) multiple is 1.38 times. This compares to its trailing 10-year average P/BV multiple of 1.42 times. CEO Warren Buffett has noted that he views a valuation below 1.20 times BV as attractive and plans to repurchase stock in the open market at valuations below this level. We estimate that 1.50-1.70 times BV is a more appropriate multiple. While highly unlikely, should Berkshire ever be broken up, the sum-of-the-parts valuation should be well in excess of the current market value.
- In 2013, Berkshire's non-insurance operations generated $15 billion in pretax earnings. Applying a 10 multiple to these earnings, we derive a value per B share of $63. In addition, the company's cash and investments are worth $220 billion or $89 per B share. Thus, this valuation approach suggests Berkshire's intrinsic value exceeds $150 per B share.

**Management**

- CEO Warren Buffett is one of the world's most successful investors. He owns a significant amount of Berkshire's common stock and is an above-average steward of shareholder capital.
- A key aspect of Buffett's approach is to partner with outstanding operating managers.

**Investment Thesis**

Warren Buffett is now 83 years old. Many investors are worried about succession planning, and are skeptical about the company's ability to grow book value at above market rates once Buffett steps down or dies. Buffett's passing will undoubtedly hurt the stock but we believe that it will be a short-term hit and it won't exactly come as a surprise. Further, investors are not giving the company credit for its increased earnings from non-insurance operations and are still valuing the enterprise like a financial institution. Given its fortress balance sheet and collection of above-average businesses, we estimate Berkshire's common stock is trading at a meaningful discount to its intrinsic value.

## UnitedHealth Group, Inc. (UNH)

(Analyst: Dan Sievers)

**Description**

UnitedHealth Group is the largest and most diversified health benefits and managed care provider in the United States, with dominant competitive positioning in each of the core managed care business segments (commercial, Medicare, and Medicaid) as well as meaningful and improving competencies outside of the core managed care business (pharmacy benefit management, healthcare IT, and healthcare data). In terms of health benefits, the company serves 30 million consumers (individual, employer risk, and employer fee-based arrangements), 10 million Medicare beneficiaries (roughly 1 in 5), 4 million people through state Medicaid programs, 2.9 million veterans (a fee-based Department of Defense plan), and 4.8 million people through the acquired Amil business. Optum is a $37 billion growth business organized around health data.

**Good Business**

- UnitedHealth controls the number one or number two market share position in each health insurance end-market. The level of local, state, and federal regulations affecting this industry continue to raise complexity and thus barriers to entry.
- Health benefits migration away from fee-for-service models and toward more sophisticated managed care arrangements (performance-based contracts, accountable care, shared savings, and data feedback) favors scale-advantaged technologically-capable players like UnitedHealth.
- The company is expanding internationally (Amil is Brazil's largest commercial insurer).
- Optum is a collection of interesting higher-growth and higher-margin healthcare service, IT, and data businesses that have the potential to improve outcomes and healthcare efficiencies.
- The 5-year average ROE (return on equity) has been 18.3%.

**Valuation**

- UnitedHealth trades for 14.8 times earnings, in-line with its 10-year trailing average.
- The stock trades at a discount to the median of its long-term enterprise value-to-sales multiple.
- The company has a higher ROIC (return on invested capital) and long-term growth prospects that are greater than the average S&P 500 company, yet sells at a significant discount.

**Management**

- CEO Steve Hemsley is highly regarded, and all of our research suggests that the company has a deep bench of executive talent. Management has purposefully diversified UnitedHealth in thoughtful ways and has invested in forward thinking (even reform-minded) businesses, especially in the construction of Optum.
- Through dividends and repurchases, the company aims to return 65%-70% of free cash flow to shareholders.
- ROE is a key compensation metric (2010-2012 target was 14.2% vs. 18.8% actual).
- Optum's performance target to advance from 8% ROIC in 2012 to 15% in 2015 looks achievable.

**Investment Thesis**

By about 2017, UnitedHealth Group's profit contribution should be roughly 1/3 Commercial, 1/3 Government programs, and 1/3 Optum. Following 2013's Medicare Advantage reimbursement reset and 2014's various Affordable Care Act (ACA)-related changes (and challenges), the company will remain a powerful scale-advantaged player poised for substantial EPS (earnings per share) growth. As in any difficult reimbursement environment, the companies with the best scale and associated low operating cost structure gain market share. On the other side of ACA implementation, we believe that industry P/E (price-to-earnings) multiples could expand, at least on a relative basis. Given the company's enviable track record and superior growth profile, we think it should trade at an expanded premium.

Thank you for your interest in Fiduciary Management, Inc.

**FMI Large Cap Fund -- DISCLOSURE INFORMATION**

**Performance for Period Ended March 31, 2014** **[ -- Average Annual Total Returns -- ]**

| FUND / INDEX | 3 Months[1] | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception[2] |
|---|---|---|---|---|---|---|
| FMI Large Cap Fund | 2.49% | 20.05% | 14.18 % | 19.75% | 9.41% | 8.98% |
| S&P 500 | 1.81% | 21.86% | 14.66% | 21.16% | 7.42% | 6.18% |

[1]Returns for periods less than one year are not annualized.
[2]Inception Date: 12-31-01.

*<u>Performance data quoted represents past performance; past performance does not guarantee future results.</u> Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of a Fund may be lower or higher than the performance quoted. The returns do not reflect the deduction of taxes that a shareholder would pay on Fund distributions or the redemption of Fund shares. Performance data current to the most recent month- end may be obtained by visiting www.fmifunds.com or by calling 1-800-811-5311.*

As of the Fund's Prospectus dated January 31, 2014, the FMI Large Cap Fund's annual operating expense ratios is 0.96.

*For more information about the FMI Large Cap Fund call 1-800-811-5311 for a free Prospectus or Summary Prospectus. Please read this Prospectus carefully to consider the investment objectives, risks, charges and expenses, before investing or sending money. This Prospectus contains this and more information about the FMI Funds. Please read the Prospectus or Summary Prospectus carefully before investing.*

Please note the FMI Large Cap Fund is currently closed to new investors.

Securities named in the Letter were held as of the date of this disclosure. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

Risks associated with investing in the FMI Large Cap Fund is as follows: Stock Market Risk, Medium and Large Capitalization Companies Risk, Non-Diversification Risk (Non-Diversified Funds are subject to higher volatility than funds that are invested more broadly), Value Investing Risk, and Foreign Securities Risk (fluctuation of currency, different financial standards, and political instability).

For details regarding these risks, please refer to the Fund's Prospectus or Summary Prospectus dated January 31, 2014.

This report is not authorized for use as an offer of sale or a solicitation of an offer to buy shares of the Fund unless accompanied or preceded by the Fund's current prospectus.

The Standard and Poor's 500 Index consists of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The Standard & Poor's Ratings Group designates the stock to be included in the Index on a statistical basis. A particular stock's weighting in the Index is based on its relative total market value (i.e., its market price per share times the number of shares outstanding). Stocks may be added or deleted from the Index from time to time.

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# Fiduciary Management Inc.
## Large Cap Equity Composite
## 12/31/2003 - 12/31/2013

| 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 % |
|---|---|---|---|---|---|---|---|---|---|---|
| 2004 | 19.32 | 18.46 | 10.88 | 10 | 0.46 | n/a | n/a | $ 48.9 | $ 3,085.8 | 1.58% |
| 2005 | 10.22 | 9.57 | 4.91 | 28 | 0.29 | n/a | n/a | $ 192.2 | $ 3,174.4 | 6.05% |
| 2006 | 17.91 | 17.15 | 15.79 | 49 | 0.30 | n/a | n/a | $ 491.0 | $ 3,589.4 | 13.68% |
| 2007 | 5.05 | 4.34 | 5.49 | 86 | 0.48 | n/a | n/a | $ 1,000.2 | $ 3,960.4 | 25.26% |
| 2008 | -26.38 | -26.91 | -37.00 | 130 | 0.63 | n/a | n/a | $ 1,969.3 | $ 4,062.5 | 48.48% |
| 2009 | 30.92 | 30.09 | 26.46 | 252 | 1.22 | n/a | n/a | $ 3,820.3 | $ 7,008.9 | 54.51% |
| 2010 | 12.52 | 11.81 | 15.06 | 394 | 0.31 | n/a | n/a | $ 5,923.2 | $ 9,816.0 | 60.34% |
| 2011 | 2.35 | 1.74 | 2.11 | 509 | 0.37 | 18.34% | 18.70% | $ 8,434.8 | $ 12,273.6 | 68.72% |
| 2012 | 16.02 | 15.32 | 16.00 | 575 | 0.32 | 13.94% | 15.09% | $ 11,270.3 | $ 15,253.5 | 73.89% |
| 2013 | 31.87 | 31.10 | 32.39 | 685 | 0.31 | 11.38% | 11.94% | $ 15,785.5 | $ 19,705.3 | 80.11% |

*Benchmark: S&P 500 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. (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 - 12/31/2013. 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 - 12/31/2013. 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 $19.7 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 with a market value greater than $500,000 as of month end beginning January 1, 2012. 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 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®.

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.