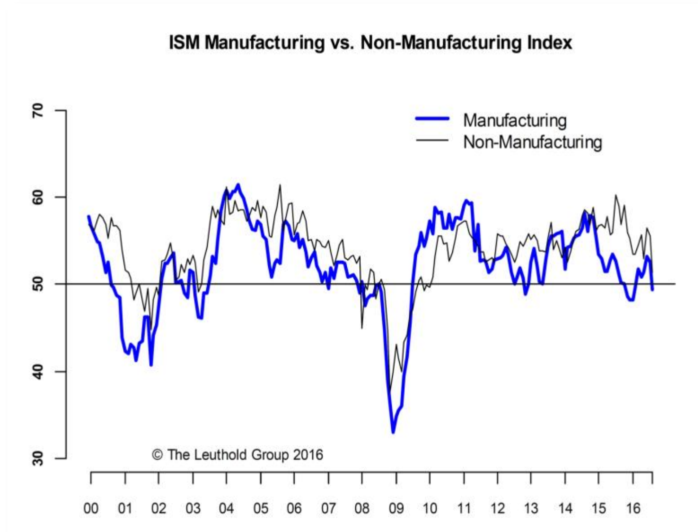
FIDUCIARY MANAGEMENT, INC.
Investment Counsel

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

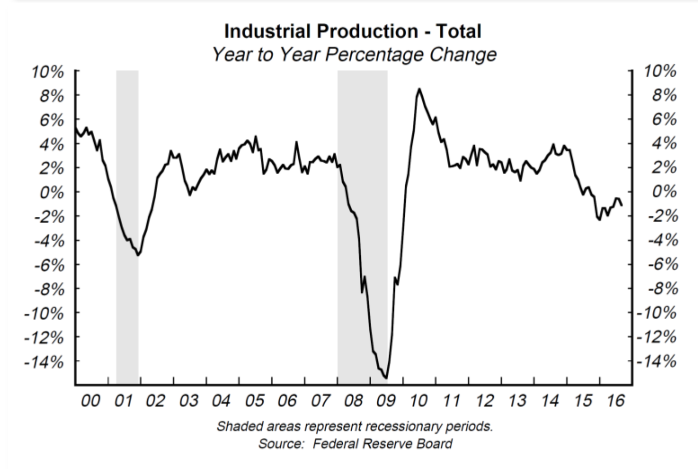
INVESTMENT STRATEGY OUTLOOK – LARGE CAP EQUITY

September 30, 2016

The FMI Large Cap portfolios returned approximately 3.3% in the September quarter compared to 3.85% for the Standard & Poor's 500 Index (S&P 500). Sectors that aided performance included Energy Minerals, Consumer Services and Consumer Non-Durables. Those that hurt performance included Retail Trade, Electronic Technology and Finance. Stocks that aided results in the period included Devon Energy, eBay and Comerica. We took advantage of the move in Comerica to swap it with JPMorgan, which we believe is a superior franchise trading at a similar multiple. Underperformers included Dollar General, Progressive Corporation and Twenty-First Century Fox. The market worries of January and February, which were bringing some sanity back to equity valuations, ameliorated through the second and third calendar quarters, keeping the bull alive. Our underweighted positions in financial, technology and health care-related industries were a drag in the quarter. We are comfortable being underweighted these sectors given the levered, opaque nature of most financials, and the high valuations in technology and health care. The top five, and eight of the top ten contributors to the S&P 500 this quarter were technology-related companies, which gives some insight into the speculative hue of this market. Rumors that Twitter was in play caused its stock to surge over 35% in the quarter. Twitter carries a $17 billion market cap, has never turned a profit (and has lost over $400 million in the last twelve months), and trades for over five times revenue. Further evidence comes from a corner of the private equity world with the impending offering of Yeti (coolers, coffee mugs, etc.) rumored at a $5 billion valuation, which is over 10 times 2015 revenue, and 36 times 2015 earnings before interest, taxes, depreciation and amortization (EBITDA).



There is somewhat of a surreal nature to the economic and stock market dialogue today. If one listens to the administration, the economy is a well-oiled jobs machine that delivers steady growth without inflation. Janet Yellen and other Federal Reserve (Fed) board members tell us the economy is sound, and that interest rates will soon be normalized (although year after year goes by with little action). The bull market recently passed 7½ years, and people with financial assets -- essentially the top 5% -- seem pleased. It's hard to reconcile this against the backdrop of persistently weak real gross domestic product (GDP) growth of roughly 1.0-1.5%, and corporate sales and earnings growth that has been negative for five quarters (with a sixth decline expected in the September quarter). If the market reflected just the decline in earnings so far, according to David Rosenberg of Gluskin Sheff, the S&P 500 would be down 20%. The combined Manufacturing and Non-Manufacturing ISM Composite Index recently



dropped to 51.2% (the weakest in over six years), industrial production remains soft, retail sales have sputtered, and the Fed's own broad Labor Market Conditions Index dropped 0.7% in August. The employment-to-population ratio for the U.S. remains mired below 60% and real incomes are lower today than a decade ago, although they rose last year for the first time in years. The average American is running in place, at best.

Consumer health care, rent/housing and educational expenses are swamping the small increases or declines in other consumer items. Perhaps someone should tell the Fed that the Consumer Price Index (excluding food and energy) was up 2.3% year-over-year in August. Health care and entitlement spending are out of control and are being funded with unsustainable increases in debt. Most people believe the real damage to balance sheets took place in 2008-09, yet over just the past five years the federal government has added $4.8 trillion of debt (bringing the total debt to $19.5 trillion), the Federal Reserve pumped up its balance sheet by $1.7 trillion to $4.5 trillion, and corporations have layered on an estimated $2.2 trillion of new borrowings. The most dangerous aspect is that debt is growing faster than GDP.

These stories, however, are old news. We've lost the ability to be surprised or moved by quarter after quarter of the same combination of runaway government spending, easy money and relatively weak economic growth. On the corporate side, financial engineering remains the go-to strategy, but this has proven to be no substitute for organic investment in people and projects. The Fed seems to think one more quarter, or one more year, of extremely low rates is all that is needed to jump-start the economy. If low rates induce capital formation, however, wouldn't we have seen explosive business investment after eight years of a nearly zero percent Fed Funds rate? Instead, it has been one of the weakest periods of fixed business investment on record.

Moreover, despite a curious but enduring belief in Keynesian economic theories, government spending doesn't seem likely to cure the growth problem. If deficit spending was the answer, wouldn't the economy be screaming after more than a decade of nonstop stimulus? It is astonishing that some pundits are calling for even more fiscal stimulus today. Few consider that there is a wide body of evidence showing that government debt accumulation (deficit spending) steals from overall economic growth. That government spending has a negative multiplier effect on the economy should not come as a startling revelation. Just look around and see where governments spend money and compare that to private capital projects and research and development expansion, and it is easy to see why the economy has underperformed.

Stocks remain elevated by just about all traditional valuation measures. Asset inflation and high valuations are also not confined to the equity markets. Bonds, private equity, real estate and other alternatives are all expensive by historical standards. Paul Singer, the highly regarded leader of Elliott Management, recently called long-term bonds the "biggest bond bubble in world history," although the 10-Year Treasury has recently backed up a bit. A relatively weak economy, negative earnings growth and high valuations wouldn't seem to be the ticket to higher stock prices. As we asked in our last letter, what are investors supposed to do? The best option is to take the long view and own quality franchises trading at relative discounts, and recognize that while nobody will be immune to a stock market downturn, this strategy offers the best chance to preserve, and eventually grow, capital. The public continues to pour money into index funds, which have beaten approximately 90% of active U.S. equity managers over the past five years. The money flows are a self-fulfilling feedback loop in the short run that will eventually collapse, as they have in the past. The last time index funds outperformed like this was in the five years ending in early 2000. The S&P 500 proceeded to drop nearly 50% and it took over seven years to recover to the prior peak.

While speculation is alive and well in the stock market, there may be a few markets beginning to crack. The high end of the Canadian and New York City real estate bubbles may be beginning to deflate. Additionally, recall our discussion in the June of 2014 letter of the tremendous excesses in the contemporary art market. In recent months the bottom has begun to fall out of this market, with a number of pieces dropping over 90% or failing to sell at auction. In a recent *Bloomberg* story, the author mentioned the work of one Lucien Smith: "Smith saw a painting he made while an undergraduate at New York's Cooper Union fetch $389,000 at Phillips in 2013, two years after it was purchased for $10,000. This week, estimates for three Smith pieces are as low as $7,000. One (to the right), from the series he made by spraying more than 200 canvases with paint from a fire extinguisher, is estimated at $12,000-18,000. A bigger spray

work sold for $372,120 two years ago." To each his own, but we know some third graders with ball point pens who would take a dollar and an ice cream cone for similar work.

It takes fortitude to avoid playing someone else's game, i.e., chasing after what is currently working even though these investments may lack true value. Using professional golf as an analogy, the best players focus not on the results, but the process. They do everything in their power to choose the right club, envision the right shot shape and put themselves in a mental mindset that will deliver a positive swing. If they can execute the process consistently, most, but not all shots will come off well. If they let their minds race after a bad shot or a bad hole and fret about the results, they are likely to compound their difficulties. You can't wish the ball into the hole, but instead, must keep your discipline and process. It is strikingly similar with investing. Fortunately, our firm has a great culture that places a lot of faith in being intellectually honest and in staying true to the process. We can't control the fact that over the past few years, investors have been willing, for example, to buy utility stocks that barely earn their cost of capital, have little to no growth, are highly regulated, and are heavily indebted and expensive. Our process would not translate into a purchase decision in this sector even though, looking in the rear view mirror, it has been rewarding. We are highly confident that in the fullness of time, this group will reflect its underlying fundamentals. Over the years, we have seen this same dynamic in many popular stocks; with few exceptions, these equities ultimately reflected the intrinsic value of their respective businesses. As Ben Graham famously said over eighty years ago, "…the market is a voting machine [popularity contest] in the short run but a weighing machine in the long run."

Below are a couple of investments we think will eventually register well on the weighing machine.

Bank of New York Mellon (BK)

(Analyst: Matthew Goetzinger)

Description

The Bank of New York Mellon (BK) is the world's largest custodian bank, with over $29.5 trillion in assets under custody. The company has the most diverse service offering within the trust bank industry. Asset-based fee businesses drive 80% of the firm's revenue. 20% comes from net interest income. The company's Investment Services business accounts for 70% of the fee-based revenue and includes core custody, back and middle office outsourcing, securities clearing, execution, debt issuance and trust services. The company's multi-manager boutique Investment Management business generates the remaining 30% of fee revenues.

Good Business

- BK operates within a rational oligopoly industry structure. The company commands a leading market share in each of its diversified businesses.
- Scale, long-standing client relationships, deeply intertwined technology platforms, and a global resource base all represent significant durable competitive advantages.
- Recurring fee-based businesses contribute 80% of the company's total revenues.
- The company's long-term average return on equity exceeds its cost of equity capital; the last twelve months' return on tangible equity is 20.4%.
- BK is securely financed with a Basel III capital ratio of 10.2%. Management remains committed to returning substantially all of net income to shareholders through dividends and share repurchases.

Valuation

- Trust banks have historically traded in line with the S&P 500 on a price-to-earnings (P/E) basis. Presently BK trades at a several multiple point discount to the market's long-term median P/E ratio.
- Giving effect to a normalization in interest rates, BK's earnings power is in excess of $4.00 per share. At a P/E multiple of 17, BK's fair value is approximately 50-75% higher.
- A sum-of-the-parts valuation places an alternative market value far in excess of the current market price of the stock.

Management

- Gerald Hassell has been the company's Chief Executive Officer since September 2011. Since joining BK over 30 years ago, Hassell has had direct management responsibility for a broad range of the company's Investment Services businesses, including asset servicing and issuer, broker-dealer, treasury and clearing services. Hassel owns roughly 0.8 million shares outright.
- Todd Gibbons is the company's current Chief Financial Officer. Previously Gibbons served as the company's Chief Risk Officer.
- Management is focused on driving organic growth, improving margins, and returns on capital, while at the same time returning excess capital to shareholders.

Investment Thesis

Bank of New York Mellon's numerous capital light financial processor franchises are underappreciated by the market. Despite operating with significant scale as the market leader in many recurring fee-based businesses, BK's valuation is comparable to that of a conventional bank. Over the next three to five years, BK's earnings growth rate and valuation multiple will improve due to stronger organic revenue growth, further operating leverage, movements toward a more normal interest rate environment, and growth in the global capital markets.

Omnicom Group (OMC)

(Analyst: Rob Helf)

Description

Omnicom Group is a strategic holding company of advertising and marketing firms that operate in more than 100 countries with more than 5,000 clients. Its business emphasizes traditional media advertising as well as more than 30 marketing services, including customer relationship management, public relations and specialty communications. Additionally, the company provides strategic media planning, buying and digital and interactive marketing.

Good Business

- Omnicom is one of the world's largest advertising and marketing services companies. Approximately 60% of its revenue comes from the U.S., while the balance comes from Europe and the rest of world.
- The company offers a diversified mix of fee-based services. Omnicom should benefit from the current and anticipated growth in digital advertising expenditures.
- Agencies have taken on a consultative role in the age of new media, as changes are rapid.
- Omnicom's largest client represents less than 4% of overall revenues.
- The integrated relationship between client and agency results in high switching costs.
- Over the past decade, the stock has generated a return on invested capital greater than its cost of capital every year, and has averaged 13%.
- The company's balance sheet is in excellent shape, with net debt about 1.0 times EBITDA.
- Omnicom recently increased its quarterly dividend to $0.55 per share, which implies an annual yield of 2.6%. The dividend has grown at over 20% per annum over the past five years as the company has focused on returning cash to shareholders.
- On average, the company has repurchased over $850 million worth of its equity annually over the past decade.

Valuation

- The stock trades at approximately 1.4 times enterprise value-to-revenues, 9.6 times EBITDA, and 16 times 2017 earnings per share (EPS) estimates.
- Over the past 10 years, Omnicom has traded at 1.1-1.7 times enterprise value-to-revenues, 8-11.5 times EBITDA, and 13-21 times EPS. The shares trade at their long-term (15 year) averages on most valuation measures, compared to the stock market, which is trading near the peak of its long-term average.

Management

- Bruce Crawford, 87, is Chairman of Omnicom. He began his career in advertising in 1956 and joined BBDO in 1963. He has previously held the positions of President and CEO at Omnicom.

- John Wren has been President and CEO since 1997. He has been in advertising since 1984, and joined Omnicom in 1986.
- Phil Angelastro is Executive Vice President and CFO. He has been in this position for two years, and has been with Omnicom since 1997. Previously, he was a partner with Coopers & Lybrand.

Investment Thesis

Omnicom is attractively valued in a generally expensive market. The company should deliver organic growth at or above GDP with stable margins, strong returns and cash flow. As marketing dollars rapidly move to digital/mobile, corporate marketers should continue to utilize the agencies due to their consultative and non-biased role in the changing landscape. Management has proven to be disciplined since the failed merger with Publicis, and should continue to return a significant amount of capital to shareholders via hefty share repurchases and a healthy dividend.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Large Cap Equity Composite
12/31/2005 - 06/30/2016

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			
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%
2014	13.52	12.81	13.69	725	0.25	8.54%	8.98%	$ 16,084.1	$ 21,001.1	76.59%
2015	-1.54	-2.16	1.38	655	0.27	9.94%	10.48%	$ 14,304.1	$ 21,042.9	67.98%
Q1 2016	3.62	3.46	1.35	630	0.12	10.34%	11.20%	$ 14,038.6	$ 21,477.7	65.36%
Q2 2016	2.17	2.02	2.46	639	0.14	10.16%	11.10%	$ 13,690.4	$ 21,521.3	63.61%

*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 - 06/30/2016. 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 - 06/30/2016. 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 $21.5 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.