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INVESTMENT STRATEGY OUTLOOK – LARGE CAP EQUITY

September 30, 2019

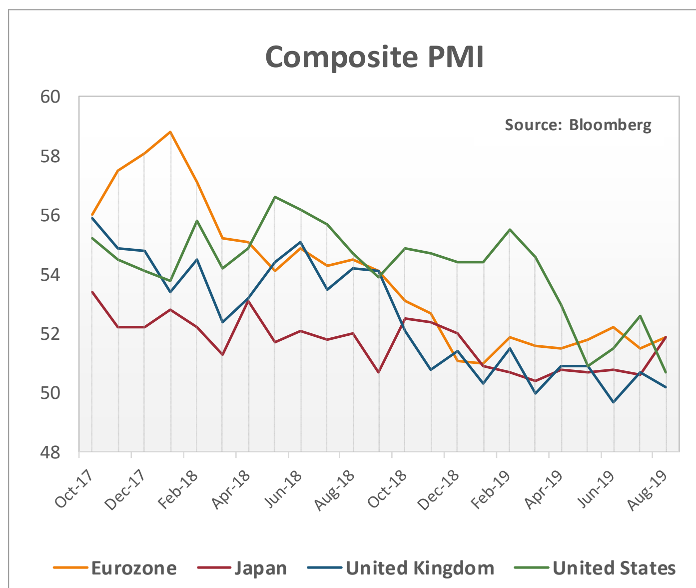
The FMI Large Cap portfolios gained approximately 0.7% in the September quarter compared to 1.70% for the Standard & Poor's 500 Index. Retail Trade, Health Technology (underweight) and Energy Minerals (underweight) drove sector performance on the positive side this quarter. On the flipside, Electronic Technology (underweight), Technology Services and Commercial Services all hurt. Stocks boosting quarterly performance included Dollar General and TJX Companies in the Retail Trade area, Smith & Nephew in the Health Technology sector, and Quest Diagnostics in the Health Services arena. On the negative side, Omnicom hurt the Commercial Services sector, Cerner detracted from Technology Services, and Franklin Resources negatively impacted the Finance sector. Franklin Resources and Bank of New York were replaced in the quarter by Charles Schwab and Northern Trust. The pullback in financials gave us the opportunity to upgrade the quality of this exposure. Despite a few high-flying money-losing tech stocks coming down to earth, investors, year-to-date, continued to favor growth styles over value ones. The difference has been remarkable, with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by about 550 basis points (5.5 percentage points) year-to-date, and by an astonishing 4,200 basis points (42 percentage points cumulative) over the past five years. The charm of today's market was captured by Jim Grant, in a recent edition of *Grant's Interest Rate Observer:* "The quest for value comes instinctively to shoppers but only cyclically to investors. The same individual who trundles home grocery bags filled with store-brand bargains may think nothing of logging on to Charles Schwab to buy shares of Netflix."

From an investment landscape perspective, not much has changed over the past three months. Stocks remain near the high end of historical valuation ranges. The long list of valuation statistics compiled by The Leuthold Group, which we frequently reference, reveals that the median valuation metric returned to the most expensive decile (10), which is not surprising considering the strong market move this year. Nearby is a chart of the of the cap-weighted average price-to-sales ratio of the S&P 500, showing a ratio that is near the tech bubble highs of early 2000. What seems to get little airtime is the fact that earnings growth has been flat-to-negative this year!

For most of the year, stocks perceived as safe have done well, despite very high valuations. Deep cyclicals have underperformed, setting up a difficult investor decision: hold on to overvalued but historically defensive names, or take a chance with relatively more attractive deep cyclicals that may already be discounting a recession. We find ourselves leaning toward the latter, but do so with some trepidation. The pullback in the fourth quarter of last year favored traditional defensive names, despite their high valuations. At some point the valuation spread will be too wide, but of course a gnome isn't going to magically appear to steer our Bloombergs. It is a judgment call whose correctness will only be apparent in the fullness of time. Mergers and acquisitions (M&A) activity continues unabated, apparently driven by a belief that low interest rates are here to stay, along with the idea that *this* deal is going to work out better than the prior ones! While just a guess, we'd estimate that the typical CEO spends twice as much of their time on deals versus 25 years ago. This would include evaluating, consummating, integrating, fixing or selling prior acquisitions. Return on invested capital (ROIC) is hardly more than a talking point

for many CEOs. Instead, "proforma adjusted EBITDA[1]" three years in the future, which typically depends on speculative growth assumptions, is seemingly what drives many transactions today. We admit to some cynicism regarding today's deal culture, but numerous academic and consultancy studies show that most acquisitions are value-destructive to the buyer.

Despite significant weakening in many Purchasing Managers Index (PMI) figures and other recession indicators, economic growth has continued at around a 2% rate (the Atlanta Fed's GDPNow third quarter estimate is 1.9% as of September 25th). We have been stuck in a low-growth world for nearly twelve years (U.S. real GDP growth since the end of 2007 has averaged just 1.6%), and continued tepid growth seems to be the consensus opinion for the future. We are more optimistic about future growth, as long as people begin to realize that rate suppression, high government borrowing, and unbridled M&A are not pathways to prosperity. Academics and economists have promulgated these policies for a very long time with the same results (low growth and dangerously levered balance sheets). As Friedrich Hegel famously said, "The only thing we learn from history is that we learn nothing from history."



Growth-friendly conditions, in our opinion, involve having a normal risk premium reflected in interest rates, engendering organic rather than inorganic investment, having free and fair trade, growing our population and reducing government borrowing, leaving more money for private investment. Profit-seeking enterprises are almost always better asset allocators than governments, although in recent years corporations have been levering up to do deals and to buy back stock. The Federal Reserve reports that corporate debt has grown by approximately $1.2 trillion in the last two years alone and now is nearly $10 trillion, which is a record high percentage of GDP (47%), according to *The Wall Street Journal*. Ginning up debt to such a high level doesn't have a great historical track record of success. Morgan Stanley recently documented a notable drop in the price of loans within collateralized loan obligations. While corporate credit problems remain mostly anecdotal at this point, we will be closely monitoring the situation.

Before our customary discussion of two portfolio holdings, we want to briefly review our background and philosophy. Fiduciary Management, Inc. (FMI) is independently owned and has managed money for over 39 years in the same disciplined, fundamentally-driven and value-oriented way. FMI operates from a single office in Milwaukee, Wisconsin, away from the bustle and groupthink sometimes prevalent in big cities. We are not a "product shop"; we have one investment team, one philosophy and one process. We do not manage any hedge funds. We're not like many large investment managers who constantly open new funds and strategies, and close underperforming ones. Approximately 5,300 mutual funds have been closed or merged since 2009; it certainly makes peer group statistics suspect! Instead, we stick to our knitting, and our team invests right alongside our shareholders and clients. FMI has a focused approach to investing, with high active share. We are the antithesis of an index fund. While not popular today, this approach has been both a winning one, and a less volatile one, over the long run. As the small print always says, past results may not repeat but rest assured, we have not changed our stripes.

[1] Earnings before interest, taxes, depreciation and amortization

FMI's investment philosophy can be summarized as follows:

- We seek undervalued stocks. That typically occurs when there is a cloud over the business.
- We make our research count by focusing on a limited number of companies for the portfolio.
- We invest in businesses that are likely to earn above their cost of capital over the business cycle.
- We invest in management teams who we believe will act like shareholders.
- We are highly attuned to avoiding value traps, i.e., secularly challenged businesses.
- We want to minimize financial risk by sticking to companies with good balance sheets.
- We focus on the downside risk before the upside opportunity.

In addition, all of our investments have to pass a common-sense test. Recall, last quarter we expressed astonishment with a number of so-called unicorns, including WeWork (recently changed to The We Company). It had a valuation of $47 billion. In three short months that value has collapsed to an estimated $10 billion and the initial public offering is currently on ice. As we said in the June letter, the business has few barriers to entry and operates what is essentially a mismatched loan book. Corporate governance was a disaster, although the board is now scrambling to improve it. The We Company cleverly tried to pass themselves off as a technology company and it worked for a while, but to us, it never passed the common-sense test. Similarly, Uber and Lyft also seem to fail a common-sense test. Their respective business models depend on drivers underestimating the true cost of operating automobiles. These companies can't charge enough to make money and grow rapidly. They whipped investors into a frenzy by underpricing their service to drive rapid top line growth. Economies of scale have yet to surface, as evidenced by the escalating losses, even as the revenues grow. Ride-sharing economics will be further damaged if regulatory bodies treat independent drivers as employees. Perhaps as a premium service they will thrive; meanwhile, they are eating capital like crazy. These kinds of stories play poorly when markets are risk-averse. The common-sense litmus test applies to all our investments, as well as company strategies and acquisitions.

Today it is more important than ever to have an experienced and steady team behind your investments. Using the Dow Jones Industrial Average as a proxy, the current cycle (through September 30th) has returned approximately three times (438%) the bull market average since 1900 (145%) and has also lasted three times longer (roughly 126 months versus 42 months). Characterizing this phase of the market cycle as *long in the tooth* would be an understatement. Anecdotally, it seems many of today's investors implicitly believe at least two things: one, that stock market returns will continue to be much higher than underlying economic or earnings growth; and two, that investing in index funds is a risk-mitigating maneuver. We simply don't believe the first, since there is little historical evidence of it over long periods of time, and regarding the second, we recognize that fund flows have driven outperformance in many index products, but those who think an index fund is less risky than a carefully-constructed and risk-sensitive approach may be in for a rude awakening.

Below we discuss two portfolio holdings.

Northern Trust Corp. (NTRS)

(Analyst: Dain Tofson)

Description

Northern Trust is a provider of asset servicing, wealth management, investment management, and banking solutions. The company reports three segments: Corporate & Institutional Services (C&IS); Wealth Management; and Treasury and Other. C&IS provides services such as custody, fund administration, investment operations outsourcing, investment management and securities lending, to pension funds, insurance companies, foundations, fund managers, and other institutional investors. Wealth Management provides such things as advisory services, investment management and custody, to high-net-worth individuals and family offices. Other includes corporate items not allocated to C&IS and Wealth Management. In 2018, net income was split, 58% C&IS, 51% Wealth Management, and -9% Other.

Good Business

- Organic, fee-based revenue growth has averaged 4-5% over the last 15-20 years.
- Return on equity was 16.2% last year and exceeds the cost of capital through a cycle.

- The balance sheet is strong with relatively low-risk earning assets, largely a deposit-based funding structure, and industry-leading capital ratios.
- The company has paid a dividend for over 120 consecutive years and was one of only two large banks that didn't cut their dividend during the global financial crisis.
- We believe the company is best-in-class, as highlighted by recent accolades including Private Equity Fund Administrator of the Year, and Outstanding Fund Technology Innovation Award in C&IS; and Best Private Bank for Family Offices and Technology in Wealth Management.

Valuation

- The company trades at 14.3 times 2019 earnings per share (EPS), versus its 10-year average of greater than 17.0 times.
- Historically, the company has traded at a premium to the S&P 500 on a price-to-earnings (P/E) basis. Today, the company trades at a discount to the S&P 500 long-term average.
- The dividend yield plus the company's gross share buyback authorization combine to produce a shareholder yield of almost 10%.
- The intrinsic value of the business is greater than the current equity value when you consider private market transactions, particularly in the Wealth Management segment.

Management

- The management team led by Michael O'Grady is shareholder-oriented with a focus on achieving revenue growth, improving productivity, and increasing shareholder returns.
- The company is managed for the long term; it has had only ten chief executive officers since 1889, and the founding Smith family continues to own shares and sit on the board.
- The company was largely built through organic investment, and capital allocation priorities remain sensible today, with a focus on maintaining superior capital ratios.

Investment Thesis

Northern Trust is a high-quality compounder with an attractive business mix that is trading at a discount to its history, the market, and intrinsic value largely due to macro concerns, most notably the challenging interest rate environment. While we acknowledge these concerns, we believe that the company's strong value proposition – outstanding customer service and financial stability – and shareholder-oriented management team, will enable it to navigate this more challenging environment and ultimately create shareholder value over time.

HD Supply Holdings Inc. (HDS)

(Analyst: Jordan Teschendorf)

Description

Headquartered in Atlanta, Georgia, HD Supply is one of the largest industrial distributors in North America, with leading market positions in two distribution businesses: Facilities Maintenance, Repair & Operations (51% of fiscal 2018 sales, and 66% of EBIT[2]) and Specialty Construction & Industrial (49%, and 34%). The company serves 500,000 professional customers through a network of approximately 310 locations in the U.S. & Canada (44 distribution centers and 266 branches) and has 11,500 employees. Its sales exposure to facilities maintenance, restoration and overhaul, non-residential construction, and residential construction markets is approximately 57%, 32%, and 11%, respectively.

Good Business

- HD Supply has become a more focused and disciplined entity since it came public in June 2013, selling non-core businesses in power, electrical, water, and hardware markets, while paying down a significant amount of debt. This has significantly raised the company's full cycle growth rate, margins, and ROIC.
- Adjusting for the sale of non-core assets, the company has grown sales at nearly a 10% compound annual growth rate (CAGR) over the last eight years, outperforming its end markets by an estimated 5-7% per

[2] Earnings before interest and taxes

annum on average. Further, operating margins have improved five percentage points over the last five years to 12.0%, and return on tangible capital has more than tripled to 39%.

- HD Supply occupies the number one market position in each of the specialized distribution markets in which it competes. National scale, local density, and knowledgeable associates provide it with competitive advantages in terms of purchasing, fulfillment, and contractor relationships vs. generally fragmented competition.
- The company's largest business, Facilities Maintenance, has proven to be defensive in down markets, growing 5% organically in 2008 while declining a modest 3% in 2009. Most sales are driven by replacement demand for products that break and need to be fixed quickly, with customers often requiring products same-day or next-day.
- The most important volume driver is the installed base of occupied renter housing units, which has grown at a 2% CAGR over the last decade, and the business is also able to pass through cost inflation over long time periods.
- Across both businesses, we expect the majority of future growth to be achieved through deeper penetration of existing accounts as the company widens its service advantage and adds more value to clients over time.
- HD Supply carries a reasonable amount of net debt (2.4 times EBITDA) and generates very healthy free cash flow.

Valuation

- The company's forward P/E multiple is at a 13% discount to its long-term average of 13.7 times.
- The shares trade at a significant discount to leading industrial and specialty distribution peers. Ascribing peer multiples to the company's two businesses yields an upside of around 26%.
- The company should generate approximately $500 million of free cash flow this year, which equates to a 7.5% yield for shareowners.

Management

- Joseph DeAngelo has been Chief Executive Officer and Chairman since January 2005 and March 2015, respectively. He also served as Executive Vice President and Chief Operating Officer of The Home Depot in 2007, prior to its sale of HD Supply to private equity sponsors.
- Evan Levitt has served as Senior Vice President and Chief Financial Officer since December 2013. Prior to his appointment as CFO, he served as VP and Corporate Controller since 2007, when he joined the company from The Home Depot.
- Under this leadership team, the company has pruned its portfolio of businesses and transformed into a faster-growing, more profitable and higher-returning enterprise. Net disposal proceeds of $3.15 billion since 2013, along with strong growth in the core businesses, have doubled return on total assets and tripled return on tangible capital.

Investment Thesis

HD Supply Holdings is a high quality, durable business that occupies the leading market position in each of the specialized and growing markets in which it competes. Recent concerns, including slower end market growth, unfavorable weather, tariffs, and a temporary service interruption at one of its distribution centers, have provided an opportunity to invest at an attractive valuation. Through the cycle, we expect the business to generate mid-single-digit organic sales and double-digit organic EPS growth, which compare conservatively to the company's historical performance. An increasingly focused, defensive, and high ROIC business mix, combined with a strengthened balance sheet, have simplified the investment case and should lead to a higher earnings multiple over time.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Large Cap Equity Composite
12/31/2008 - 12/31/2018

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			
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%
2016	14.85	14.16	11.96	636	0.32	10.48%	10.59%	$ 12,562.9	$ 22,626.7	55.52%
2017	19.90	19.24	21.83	628	0.32	9.70%	9.92%	$ 12,722.2	$ 25,322.0	50.24%
2018	-3.07	-3.62	-4.38	540	0.29	9.85%	10.80%	$ 9,901.1	$ 19,833.6	49.92%

*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 - 12/31/2018. 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 - 12/31/2018. 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 $19.8 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	0.60%
$25,000,001-$50,000,000	0.55%
$50,000,001-$100,000,000	0.45%
$100,000,001 and above	0.35%

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.