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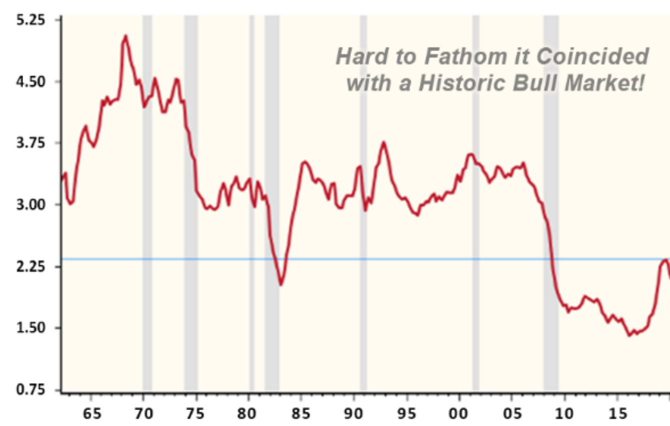
INVESTMENT STRATEGY OUTLOOK – LARGE CAP EQUITY

September 30, 2020

The FMI Large Cap portfolios returned approximately 7.9% in the quarter compared to 8.93% for the Standard & Poor's 500 Index, and 5.59% for the Russell 1000 Value Index. While not changing much in the most recent quarter, the spread between value-oriented strategies like FMI's and growth stock-dominated indices like the S&P 500, Russell 1000 Index, and Russell 1000 Growth Index has widened significantly in recent years. The year-to-date gap between the Russell 1000 Value and Russell 1000 Growth Indices was an astonishing 35.90%. The portfolios have handily outperformed the value benchmarks and most of its value peers over 3, 5, and 10-year time frames. With much of the investing world capitulating to the siren song of growth stocks, FMI remains steadfast in our belief that ultimately, fundamentals and good values will trump high valuations and unsustainable growth expectations. We are starting to see some investors call "timeout" on the mad dash to growth stocks, hedging against the idea that the most popular names and the best-looking stock charts can continue to beat value equities. In the quarter, sectors that helped FMI's Large Cap relative performance included Producer Manufacturing, Finance, and Distribution Services. Sectors detracting included Electronic Technology, Retail Trade, and Commercial Services. Eaton Corp. PLC, Berkshire Hathaway Inc., and HD Supply Holdings Inc. were positive relative contributors, while Dollar Tree Inc., Omnicom Group Inc., and Schlumberger Ltd. hurt.

Over several missives prior to the pandemic, we articulated the strange juxtaposition of relative weak U.S. corporate sales and earnings growth compared to high valuations. The S&P 500 (iShares Core S&P 500 ETF as a proxy), grew revenue and operating earnings at 3.4% and 3.6%, respectively, over the 10-year period ending 2019; this includes acquisitions and a record increase in balance sheet leverage. With the S&P 500 constituting such a large swath of the U.S. economy, it is perhaps not surprising that the last ten years has been the slowest decade of economic growth since WWII (see chart to the right). GDP growth had been so weak pundits began talking about using a different measurement for gauging economic well-being.



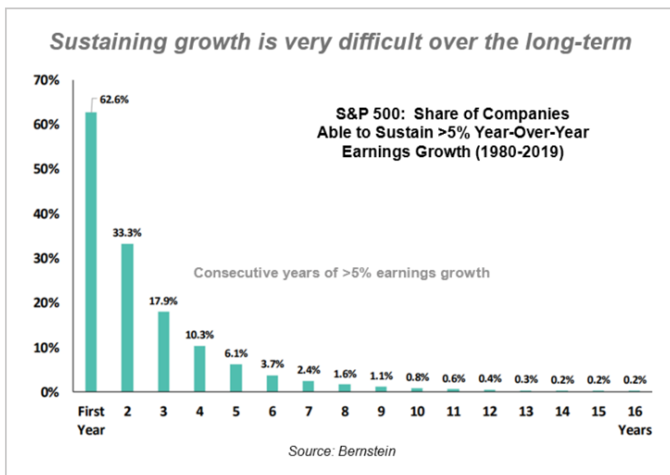
The onset of COVID-19 sent the 2020 fundamentals for the economy and most companies down further, yet the market endured just a very short 23 trading days of trouble before resurging to an all-time high. Growth stocks, including most highly speculative ventures, have continued to dominate the landscape, creating the widest performance spread to value stocks in memory. Although the popular and financial media doesn't describe it as such, it is truly a mania for many equities. Investors have seemingly thrown caution to the wind in their effort to participate. Despite a few short market contractions, to include the fourth quarter of 2018 (66 trading days) and earlier this year, the bull market that began in March of 2009 has the illusion of permanency. Many feel we are in a new, higher-growth paradigm, driven mostly by technology. If that were the case, why is economic growth so slow? Why is productivity over the past decade so weak? It doesn't add up. Perhaps it is merely the belief that a few companies will have secular growth and the remaining "old economy" companies will struggle. While acknowledging the superior growth of some of the big cap tech names, we think any stock can get too expensive and any trade can be overcrowded. Every frothy market in history has its earmarks; following are a few recent observations:

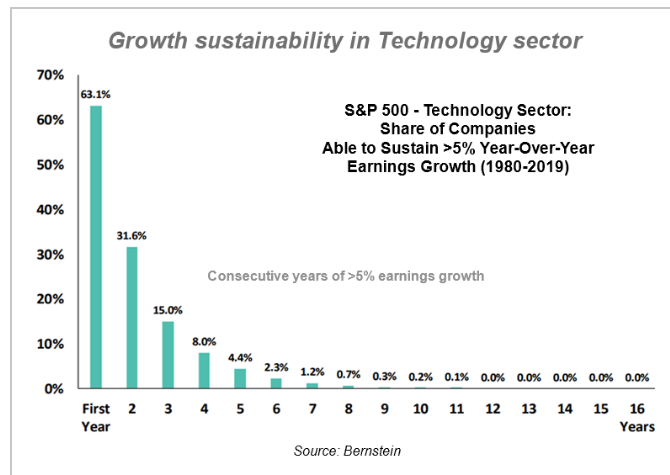
- The total market value of the NASDAQ Composite stocks recently became larger than the combined value of the developed world stock markets, ex-U.S. (MSCI World ex USA Index).
- Four tech names – Apple Inc., Amazon.com Inc., Microsoft Corp., and Alphabet Inc. -- became bigger than the entire Japanese market, as well as the combined China/Hong Kong stock market.
- Tesla Inc., barely profitable after 17 years and competing in a highly competitive industry, saw its market cap go up over tenfold (from $38 billion to over $400 billion) in the 12 months ending 8/26/20, including a 75% gain in the three weeks following the 8/10/20 stock split announcement, which has zero fundamental meaning.
- Apple, whose operating earnings peaked five years ago at $71.2 billion, saw its market capitalization go from about $600 billion five years ago to over $2 trillion recently, including a 40% gain in a little over a month after their stock split was announced on 7/30/20.
- In Q3 2020, Apple's market cap became larger than the entire Russell 2000 Index, and also overtook the FTSE 100 Index for the first time.
- The IPO market is likely to set a record in 2020, and recently Snowflake Inc., a company that had $264 million in sales and lost over $350 million in fiscal 2020, came public with a $33 billion value. On the first day of trading the market value reached $89 billion, larger than Autodesk Inc. and Cerner Corp. combined, which together have approximately $9 billion of highly recurring software revenue. Palantir Technologies Inc., a secretive big data company that has been rumored as an IPO for years, finally pulled the trigger on the last day of the September quarter. This company was founded in 2003 and as far as we can tell, has never turned a profit. In 2019, the company had $742 million in revenue and lost about $580 million. Its market cap on day one stretched to $18 billion. Asana Inc., one of many emerging software-as-a-service companies, also came public on the last day of the quarter and traded to $4.6 billion. It was valued at $1.5 billion in December of 2018; it had fiscal 2020 revenue of approximately $143 million and lost about $119 million.
- Nikola Corp., a development-stage hydrogen truck company with no revenue, reached a $27 billion market cap this summer before a short seller exposed potential serious flaws.
- Workhorse Group Inc., a company that for years has been trying to develop electric vehicles, has never made money, and managed to garner less than a half million dollars in 2019 sales, recently sported a market cap of over $3 billion.
- Gilead Sciences Inc. announced the $21 billion acquisition of Immunomedics Inc., an emerging biotech company with minimal sales and over $300 million of losses last year. Illumina Inc. announced they were buying Grail Inc., a development stage company, for a valuation of $7.1 billion and a 12-year earn-out. Johnson & Johnson announced the purchase of Momenta Pharmaceuticals Inc. for roughly $6.5 billion. It has $30 million in sales for the trailing 12 months ending 6/30/20.
- As of 9/30/20 there were 415 Health Technology sector stocks in the iShares Russell 2000, and 371 were money-losing. In nearly all cases the companies have never made money. They have been some of the best performing stocks in 2020.
- Mirati Therapeutics Inc., a company with $3.3 million in revenue and losing over $200 million, has an approximate market value of $7.4 billion and was up 1,319% over the past three years. The CEO makes more than two times the annual revenue of the company. For over 20 years this company has been on the verge of hitting it big!
- Special Purpose Acquisition Companies (SPAC), empty shell corporations set up to buy companies, have received over $50 billion so far this year. SPAC managers typically get 20% of the SPAC shares. Billy Beane (of Oakland Athletics and *Moneyball* fame) and Paul Ryan (former congressman from Wisconsin) are in on the action.
- *The High-Tech Strategist* reported in September that the top five holdings of Vanguard's Total Stock Market ETF and SPDR S&P 500 ETF were Apple Inc., Microsoft Corp., Amazon.com Inc., Alphabet Inc., and Facebook Inc. These same five stocks were the largest holdings of the iShares Russell 1000 ETF, iShares Russell 3000 ETF and Vanguard Growth ETF. While this is not surprising, one of Vanguard's largest international ETFs, the Vanguard

Total World Stock ETF, had the same top five holdings. Ditto for the Vanguard ESG U.S. Stock ETF. As of 8/31/20, the Fidelity Magellan Fund had these same five in their top six holdings, along with Visa Inc. (trading at nearly 20 times revenue). Same for the Fidelity Independence Equity Fund. The Fidelity Trend Fund had the same five plus Mastercard Inc. (21 times revenue). Fidelity Growth Discovery Fund had the same five, as did the Fidelity Disciplined Equity Fund. We surmise many of the largest fund families look similar.

- The S&P 500 is more concentrated in the top names than at the peak of the 2000 market.
- In June, Deutsche Bank estimated that roughly 19% of U.S. companies are "zombie" companies, i.e., their debt servicing costs are greater than their earnings.
- Since 1947, the median number of hours of work required to purchase one unit of the S&P 500 was 30. As of early July, it is over 140 hours.
- According to The Leuthold Group, as of 7/10/20, stocks were in the highest decile (10th) of valuations based on the median decile of approximately 50 different valuation measures.
- Robinhood Financial LLC has added over 3 million customers since the beginning of the year. Measures of retail investor speculation are near their highest ever, including small-sized option trading that now exceeds the trading volume of individual stocks.

We are not ignorant to the excitement and promise of some of the emerging software companies, and other concepts that essentially defer profits on the income statement in order to grow the top line rapidly and lock in a future stream of profit. Establishing what is perceived to be an unassailable position in the market is easier in the digital world compared to the physical world. Many companies will win with this strategy. Many more will try and fail. Our issue is that most of these companies are being priced as the eventual winners. They can't all win! Sustaining even 5% growth for more than a few years is difficult (even for the Technology sector), as evidenced by the following charts. The stocks that have captured the imagination of investors depend on sustained success over a very long time horizon. Valuations leave little room for error.





Growth stocks in particular are sensitive to discount rate changes. This is because so much of the present value depends on compounding higher earnings well into the future. Following is a table from Credit Suisse HOLT, outlining possible return outcomes in different classes of stocks as a result of changes in sector discount rates. This table reveals some interesting scenarios. For example, if sector discount rates went back to just the 3-year median, U.S. Hyper Growth stocks would fall 32% and U.S. cyclical value stocks would decline 7%. If rates went back to their 20-year median, U.S. Tech Large Cap would fall 44% and U.S. Financials would gain 46%. Realize, these are just mathematical calculations, but they inform the possibilities. Our portfolios are far less dependent on the maintenance of historically low interest rates. We are finding excellent values in the cyclicals such as Schlumberger Ltd. and Emerson Electric Co., and in financials, particularly Northern Trust Corp., JPMorgan Chase & Co., and The Charles Schwab Corp.

Probability-weighted valuation upside/downsides for various HOLT Styles, regions and sectors based on observed discount rates in a given economic regime

	Warranted Valuation Upside/Downside %														
Scenario per Fig 4 (probability weighting)	US Hyper Growth	US Tech Large Cap	US Quality Defensives	US Quality Growth	US	Europe Ex UK	UK	Developing Countries	US Cyclical Value	Top 25% Value Developed Markets	Developed Energy Large Cap	Developing Financials	UK Financials	Europe Financials	US Financials
Goldilocks (35%): discount rate@20-year min	6%	23%	4%	11%	4%	0%	7%	13%	19%	18%	43%	72%	96%	90%	84%
Normalization (35%): discount rate@3-year median	-32%	-38%	-17%	-21%	-10%	-7%	-10%	-8%	-7%	-5%	15%	14%	8%	20%	28%
Status Quo (27%): no change in discount rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Stagflation (3%): discount rate @ 20-yr median	-83%	-44%	-43%	-36%	-19%	-27%	-18%	-13%	-8%	-4%	21%	21%	38%	35%	46%
Weighted Upside/Downside	-12%	-7%	-6%	-4%	-3%	-3%	-2%	1%	4%	4%	21%	31%	38%	40%	41%

Source: Credit Suisse HOLT®, HOLT Global Viewpoint, September 28, 2020

Two additional investments we highlight this quarter are Comcast Corp. and Dollar Tree Inc.

Comcast Corp. - Cl A (CMCSA)

(Analyst: Dan Sievers)

Description

Comcast Corp. is the combination of Comcast Cable, NBC Universal (NBCU), and Sky PLC (Sky). Comcast Cable is the #1 provider of fixed broadband service in the United States (26 million residential subscribers) with an advantaged top-quality network and a strong and growing business services offering. NBCU and Sky are leading multinational media conglomerates that own strong libraries of existing content and together, invest over $23 billion in content annually. In 2019, revenue contributions were as follows: Cable (53%), NBC Cable Networks (11%), NBC Broadcast Television (9%), NBCU Filmed Entertainment (6%), Universal Studios Theme Parks (5%), Sky (18%), and Corporate & Eliminations (-2%).

Good Business

- Most of Comcast Cable's cash flow comes from recurring high-margin Residential Broadband and Business Services (not from Video). In 2019, these lines of business each reported over 9% revenue growth and combined for $24.3 billion in revenue. Second quarter 2020 residential net subscriber additions (+232,000) were the strongest 2Q net additions in thirteen years. For the fifteenth consecutive year, in 2020, Comcast is on pace to add more than 1 million broadband subscribers. Comcast Cable's broadband-centric growth is roughly composed of >4% customer volume, 2-3% price and tiering, and 2% of lost discounts due to unbundling. Comcast's broadband network is top-quality (soon to be 100% DOCSIS 3.1) and we expect broadband subscriber additions to continue to be strong despite regional investments in 5G fixed wireless (a limited value proposition), as Comcast takes further share from disadvantaged DSL-like competition (25 million subscribers nationally), benefits from demographic tailwinds (younger households have higher broadband penetration), and continues to grow its network footprint (which is over-indexed to growing population centers) beyond 58 million homes passed. Comcast cable is likely to continue to win because its similarly-priced product really is superior (better speed, better reliability, and better extras like xFi WiFi management, Xfinity Flex, and the soon-to-be launched Peacock AVOD service). Comcast's Wireless business (>2 million subscribers) should reach profitability in 2021. Underlying Cable returns on invested capital are rising.
- In 2019, Charter Communications Inc. (Comcast competitor) reported typical monthly consumption for broadband-only subscribers surpassed 450GB, which compared to about 8GB of typical monthly consumption of cellular wireless data. 5G mobile networks are likely to remain too capacity-constrained to offer suitable alternatives to cable broadband. Gradual build out of 5G fixed wireless may present a suitable alternative to cable broadband, but will suffer from difficult-to-solve technical challenges (range and reliability issues), will only be available in limited locations, will require huge fiber-centric investment on the part of carriers, and these build outs face similarly daunting overbuilder economics akin to U-verse, FiOS, Google Fiber, or others.

- NBCU and Sky are likely to face real challenges in parts of their respective businesses due to a changing media landscape, but they also possess real advantages, like strong libraries of existing content, significant annual content investment, a meaningful focus on live sports and news content, and the premiere #2 global theme parks business in Universal Studios.
- Comcast's net debt-to-EBITDA[1] (ND/EBITDA) leverage at year-end 2018 was above 3.3 times, but has now fallen below 2.7 times, on its way to Comcast's traditional 2.0-2.25 times target leverage range (lower than peers) by early 2021.

Valuation

- At $43.50, Comcast trades at 13.9 times 2019 price-to-earnings (P/E) and 8.8 times enterprise value-to-EBITDA (2019). On a P/E basis, this appears attractive in absolute terms, is well below Comcast's historical P/E multiple, and represents a substantial discount to the S&P 500.
- Bernstein recently estimated that $36 is the price investors are paying for Cable & Theme Parks while receiving the rest of NBCU & Sky for free. Additionally, at year-end 2019, noting significant value in Comcast's investment portfolio (from Hulu, Atairos, and more), Morgan Stanley also recognized the strong enduring value (and growth) in NBCU's Parks & Films divisions an investor receives at a significant discount to peers.

Management

- Brian Roberts, son of the late founder Ralph Roberts, became President in 1990, CEO in 2002, and Chairman in 2004. The Roberts family controls one-third voting interest in Comcast through non-traded B shares. Setting the Sky acquisition aside, we view the long-run Roberts track record as very good.
- Comcast's divisional performance stacks up well against direct peers in most cases, supporting our view that Comcast possesses a deep bench of strong (though excessively compensated) executive leadership.

Investment Thesis

Over the past three completed years, pure-play Cable broadband providers (including Charter Communications and Cable One Inc.) have trounced the S&P 500, reflecting strong and durable growth in subscribers, rising margins, and declining capital intensity. Though all industry observers agree that Comcast's Cable broadband business is top quality (#1), Comcast's shares lagged the S&P 500 due to investor concerns over its media businesses and its acquisition of Sky. While we take no out-of-consensus positive view of NBC Broadcast and NBC Cable Networks, we see enduring value in the catalog at Universal Studios Film & Television, Universal Studios Theme Parks, and some of Sky's true direct-to-consumer offerings. Comcast's customers, content, and brands increase the likelihood of success of its streaming service, Peacock (which just passed 15 million sign-ups). Though the pandemic has pressured Comcast's media businesses (weaker advertising, paused sports, and delayed film releases) and temporarily closed Comcast's Theme Parks, its Cable broadband business has strengthened, and continues to grow and drive the bulk of Comcast's value. As Comcast nears its target 2.0-2.25 times ND/EBITDA leverage range in early 2021 and restarts their share buyback, investor interest is likely to increase.

Dollar Tree Inc. (DLTR)

(Analyst: Matt Sullivan)

Description

Dollar Tree is a leading discount retailer in the United States and Canada, operating over 15,400 total stores, 7,652 (or 49%) of which are operated under the Dollar Tree banner. The other 7,827 stores are operated under the banner of Family Dollar, which was acquired in July 2015. The Dollar Tree banner accounts for around 52% of the combined company revenue and 78% of profits. The Family Dollar banner accounts for the remaining 48% of revenue and 22% of profits.

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

Good Business

- The Dollar Tree business model is unique within the retail landscape. The $1 price point and constantly changing inventory provide the customer with a differentiated, treasure hunt shopping experience. The ever-changing merchandise in the stores also provides management with the ability to control the company's gross margin.
- The Family Dollar banner sells a limited number of necessary consumable products and other general merchandise items at highly attractive prices. The company's scale, concentrated purchasing, and low-cost locations allows it to sell products at prices well below those of their competitors.
- Both business models are defensive and perform well in most economic environments. The consolidated company has had positive same store sales growth in each of the past fourteen years.
- The business generates attractive returns on tangible capital that exceed the company's cost of capital.
- The customer profile, low average ticket, and types of products sold protect the business from online competition.
- Both Dollar Tree and Family Dollar possess scale advantages that make them difficult to replicate.
- The balance sheet is in good shape with ND/EBITDA of approximately 1.1 times.
- The business is easy to understand.

Valuation

- Dollar Tree is trading at a valuation discount to the S&P 500 even though it's a better-than-average company.
- The stock trades for 15.8 times the next 12-month earnings per share (EPS) forecast, which is a standard deviation below its 5-year average of 17.9 times.
- The shares are also trading at 0.95 times enterprise value-to-sales, which is about one standard deviation below its 5-year average of 1.33 times.

Management

- Bob Sasser became Executive Chairman of the Board in September 2017. He was previously CEO from 2004 to September 2017. Prior to that he was Dollar Tree's COO from 1999 to 2003.
- Mike Witynski joined the company in 2010 and became President and CEO in July 2020. He was previously COO from July 2015 until December 2019, and Enterprise President from December 2019 until July 2020.

Investment Thesis

Dollar Tree is a high-quality, defensive business that performs well in most economic environments. While the pandemic has negatively impacted customer traffic at the stores and has increased costs throughout the organization, the business is holding up reasonably well this year; same store sales and EPS are both expected to grow in 2020. We believe that over the next few years, the company will expand its store base and continue to grow its same store sales, and that margins will improve. When including stock buybacks, EPS is expected to grow at a double-digit compound annual rate. The company's stock is attractively valued, trading at 15.8 times the next 12-months EPS estimate in a very expensive market.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Large Cap Equity Composite
12/31/2009 - 12/31/2019

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			
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%
2019	24.58	23.94	31.49	371	0.42	9.95%	11.93%	$ 10,493.0	$ 22,609.8	46.41%

*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 - 12/31/2019. 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 - 12/31/2019. 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 $22.6 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	0.55%
$25,000,001-$50,000,000	0.50%
$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.