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Investment Strategy Outlook - Small Cap Equity

Quarter Ended March 31, 2007

<u>*April 2, 2007*</u>

Client portfolios appreciated approximately 5% in the quarter, compared to roughly 2% for the benchmark Russell 2000 Index. Being underweight in the financial group and overweight in the distribution sector both contributed to positive performance, as did having four stocks subject to announced takeovers. Cash levels may be temporarily higher than normal until we find suitable replacement investments. Electronic technology and consumer durables lagged in the period.

Deals, deals, deals! According to the *Wall Street Journal*, first quarter transactions totaled $1.1 trillion worldwide, up 27%, and domestic deals grew 32% to $439 billion. The number and dollar value of transactions have expanded for five years and the growth rate appears to be accelerating. We do not know when this deal rush will end, but frenzies usually spike before they fall. The Nikkei in 1989, and the Nasdaq in 2000 had similar profiles. We move closer to the end of this cycle with each spectacular deal announcement; today it was a $20 billion bid from Kohlberg Kravis Roberts (KKR) for First Data at over 13 times enterprise value-to-earnings before interest, taxes, depreciation and amortization (EV/EBITDA).

Although the mergers and acquisitions market feels like a bubble today, we remember how long it took the technology stock bubble to burst in the late 1990s. Valuations that were extreme became absurd, and the game lasted at least two years longer than we ever thought possible. Having just read that deflation is back in Japan, and noting that the Two-Year Japanese Treasury is priced to yield .835% (decimal to the *left* of the eight), the carry-trade that fuels this mania appears to be going strong.

Debt is dirt cheap in Japan, and nearly everywhere there is enormous liquidity that, in the words of the managing director of one of the largest private equity firms in the world, "…has enabled us to do transactions that were previously unimaginable." In a memorandum to all of this firm's investment professionals, he goes on to say, "Frankly, there is so much liquidity in the world financial system that lenders (even our lenders) are making very risky credit decisions." He adds, "…most investors in most asset classes are not being paid for the risk being taken." While he states that the liquidity period could last another 12-24 months, he concedes, "And I know that the longer it lasts, the worse it will be when it ends."

One can feel his discomfort as he instructs his troops on how to structure deals in this environment. But honestly, what you have here is a titan of the private equity universe more or less admitting that the situation today is tantamount to a game of musical chairs. He knows the game and knows it will end badly, but can't quite bring himself to quit early. At least the parting advice to his people included the phrase, "be careful."

Another topic currently receiving airtime is the sub-prime mortgage debacle. Our letters foreshadowed problems in the housing market for more than a year. There is a certain amount of guttural satisfaction in seeing risky stocks get slammed, however, nobody is immune if the sub-prime problems are the first sequence in a nasty credit cycle or "financial contagion." We have alerted our clients repeatedly about the vast, rapidly-growing and difficult-to-grasp derivative market that could buckle under certain circumstances, but as long as the economy remains reasonably healthy -- especially with respect to employment -- the sub-prime issue is unlikely to spread. The real negative housing story begins with higher unemployment, and that is not visible at this point.

As a reminder, it is our practice with our letters following the March and September quarters to make a few brief comments before highlighting a number of investments, while our letters following the quarters ending June and December discuss the economy and the stock market in greater detail.

Cabot Microelectronics Corporation

Description
Cabot Micro is the leading supplier of slurries used in the manufacture of advanced integrated semiconductors, in a process called chemical mechanical planarization, or CMP. CMP polishes surfaces, enabling integrated circuit (IC) device manufacturers to produce smaller, faster, and more complex IC devices with fewer defects.

Good Business
- CMP is a difficult process that is becoming even more challenging. Cabot Micro has the people, technology, scale, facilities, and financial resources that position it to help its customers meet these challenges. The company has a 40-45% share of the CMP slurry market.
- CMP slurries are consumable items, so there is a recurring nature to the sale.
- The CMP slurry market is undergoing a shakeout because the technology is increasingly fragmenting, which, in combination with highly specified customer process designs, means that only the largest, most well capitalized and committed companies will win. Consolidation will likely stabilize pricing and margins, and thus result in improved returns on incremental invested capital.
- The company has a net cash balance of $155 million, or $6.51 per share.

Valuation
- The stock has declined nearly 70% from its peak in February 2001, and has significantly under-performed the market indices over the last few years. Sentiment is negative.
- The enterprise value-to-sales multiple of 1.81 is one standard deviation below the 2-year average, and not far from 1.56, its lowest recorded multiple. Recent private market transactions lend support to the stock.
- The stock traded higher than 2.5x sales as recently as the January-April 2006 time frame. As the competitive market stabilizes, the stock could very well regain this multiple.
- On a calendar 2007 earnings per share (EPS) basis, the price-to-earnings (P/E) multiple is 18.5, backing out the net cash and the associated interest income.

Management
- The senior executives are young, have solid pedigrees, have all been appointed to their respective positions within the last three to four years, and are taking the right steps to position the company for future growth.
- Bill Noglows, 48, has been Chairman, President, and Chief Executive Officer since 2003. He is one of the primary founders of Cabot Micro and was responsible for identifying and encouraging the development of the CMP application.

- Bill Johnson, 49, has been Chief Financial Officer since 2003. Prior to joining Cabot Micro, he served as CFO for Budget Group, and spent 16 years at BP Amoco in various senior finance and management positions.
- Adam Weisman, 44, was appointed Vice President, Operations in 2004. He previously held various engineering and senior operations management positions with General Electric.
- Research & Development chief Cliff Spiro, 52, has served in this role since 2003. He previously held R&D management and senior technology positions at General Electric.

Investment Thesis

The market is undergoing a shakeout that could last for a few years. Unlike most technology companies with short and unpredictable product cycles, Cabot Micro is more of a materials and services company. They have good people, products and strategy, and a dynamite balance sheet. Earnings should grow 10-15% per year over the next five years, and the stock is attractively priced.

Watsco, Inc.

Description

Watsco is the largest distributor of heating, ventilation and air conditioning (HVAC) products in the United States. The company has 380 locations in 32 states. Watsco primarily distributes residential air conditioning (A/C) products to over 40,000 contractors. Equipment accounts for one-half of total revenue, with the remainder derived from parts and supplies.

Good Business

- Watsco provides the products to repair or replace HVAC systems at a scale greater than anyone else. The company maintains a close relationship with, and a strong service commitment to its customers. Watsco is the dominant player with a 7% share of the fragmented market, and is positioned to take share from smaller, less-capitalized competitors who are unable to commit the resources necessary to serve the contractor market.
- Approximately 75% of Watsco's sales to the residential market are replacement in nature. A/C is a necessity, particularly in the Sunbelt, which accounts for roughly 90% of revenue. Systems are replaced more often in the Sunbelt relative to other parts of the country due to wear and tear and coastal corrosion.
- The return on invested capital (ROIC) has doubled over the last five years to the current 16% as improved margins helped drive net operating profit faster than the growth in invested capital. The Sunbelt is benefiting from favorable demographic and migration trends. The operating margin is targeted to improve to 9% from the current 7.5%, driven in part by the company's private label and direct sourcing programs. The business has minimal capital expenditure requirements, typically less than 0.5% of sales.
- This is an easy business to understand.
- Debt-to-capital is 7.2%, and net of cash, declines to 1.1%.

Valuation

- The stock is off more than 30% from its 52-week high amid near-term concern about tough comparisons following the transition to 13 SEER (an efficiency regulation), and the company's exposure to new construction, which accounts for 25% of revenue and 10% of gross profit for the residential portion of the business (85% of total company sales).

- The stock trades roughly in line with its long-term average P/E ratio, despite being more profitable and more dominant than it has been historically.
- The multiple is in line with transactions over the past two years, and at a discount to other niche distributors.
- On an enterprise value-to-trailing sales basis the multiple is 0.78. Although slightly above the 5-year average, the profitability of the business has improved. The trailing EBIT margin is 7.5% compared to the 5-year average of 5.3%.
- The company has an above-average yield of 2.6%.

Management

- Founder Albert Nahmad, 65, leads Watsco. He has served as Chairman, President, and Chief Executive Officer since December 1973. Although Nahmad has voting control over the company (this is a dual-class stock), he owns a 15% economic interest.
- Nahmad should be given credit for his decision earlier this decade to rationalize the business structure following the rapid rollup phase in the mid-to-late 1990s, which involved the closure of underperforming branches and consolidation of subsidiaries. The company has also been disciplined on the mergers and acquisitions (M&A) front.
- Barry Logan, 43, has served as Senior Vice President since November 2003, and Secretary since 1997. He previously served as Watsco's Chief Financial Officer from 1997 to October 2003.
- Ana Menendez, 41, has served as Chief Financial Officer since November 2003, and as Treasurer since 1998.

Investment Thesis

The stock has come under pressure due to transitory factors. There are 120 million installed central cooling and heating units, all of which will eventually wear out, providing a growing and substantial replacement market. The company has a durable business franchise and a bright growth outlook over the next five years. The valuation does not reflect this expectation.

Thank you for your support of Fiduciary Management, Inc.

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

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2001	20.42	19.57	2.49	125	1.88	$ 587.2	$ 1,458.2	40.27%
2002	-4.78	-5.46	-20.48	154	1.47	$ 649.7	$ 1,731.0	37.53%
2003	27.18	26.22	47.25	167	1.93	$ 1,206.9	$ 2,927.0	41.23%
2004	20.92	20.02	18.33	181	1.00	$ 1,486.6	$ 3,085.8	48.18%
2005	11.12	10.26	4.55	186	0.69	$ 1,605.8	$ 3,174.4	50.59%
2006	18.46	17.56	18.37	147	0.73	$ 1,606.8	$ 3,589.4	44.77%
2007	-0.92	-1.72	-1.57	161	0.85	$ 1,520.2	$ 3,960.4	38.39%
2008	-21.06	-21.69	-33.79	145	1.16	$ 1,212.4	$ 4,062.5	29.84%
2009	35.72	34.56	27.17	165	0.97	$ 2,004.6	$ 7,008.9	28.60%
2010	23.45	22.43	26.85	170	0.48	$ 2,477.7	$ 9,816.0	25.24%
Q1 2011	7.18	6.96	7.94	182	0.19	$ 2,699.2	$ 11,338.0	23.81%
Q2 2011	1.16	0.96	-1.61	179	0.11	$ 2,718.9	$ 11,819.6	23.00%
Q3 2011	-16.12	-16.29	-21.87	178	0.31	$ 2,188.9	$ 10,357.9	21.13%

*Benchmark: Russell 2000 Index®

Effective January 2012, 2004 – 2011 gross and net composite returns and dispersion were restated due to an error.
Returns reflect the reinvestment of dividends and other earnings.
The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss.

Fiduciary Management, Inc. (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 09/30/2011. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Small Cap Equity composite has been examined for the periods 12/31/1993 - 09/30/2011. The verification and performance examination reports are available upon request.

FMI was founded in 1980 and is an independent investment counseling firm registered with the SEC and the State of Wisconsin. The firm manages over $10.3 billion in assets of pension and profit sharing trusts, mutual funds, Taft-Hartley funds, insurance company portfolios, endowments and personal trusts. The firm includes both institutional and mutual fund business. Although the firm has participated in wrap programs, it is a separate and distinct business, and is excluded from firm-wide assets.

The FMI Small Cap Equity Composite was created in January 1980. These accounts primarily invest in small to medium capitalization US equities.

The FMI Small 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. A small percentage of composite assets (typically ranging from 0-5%) historically has been invested in unmanaged fixed income securities at the direction of account holders. From December 31, 1993 thru September 30, 2002 all accounts included were managed for at least one quarter, from October 1, 2002 to present all accounts were managed for at least one month. All returns are calculated using United States Dollars and are based on monthly valuations using trade date accounting. All accounts in this composite are fee paying. Gross of fees returns are calculated gross of management fees, gross of custodial fees, gross of withholding taxes and net of transaction costs. Net of fees returns are calculated net of actual management fees and transaction costs and gross of custodial fees and withholding taxes. Dispersion is calculated using the standard deviation of all accounts in the composite for the entire period.

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

Up to $25,000,000	0.90%
$25,000,001-$50,000,000	0.85%
$50,000,001-$100,000,000	0.75%
$100,000,001 and above	0.65%

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 Russell 2000 Index® measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 8% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Small Cap Equity composite uses the Russell 2000 Index® as its primary index comparison.