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Investment Strategy Outlook - Small Cap Equity

Quarter Ended March 31, 2008

April 1, 2008

Client portfolios declined approximately 2-3% in the March quarter. The benchmark Russell 2000 Index fell 9.9% in the period. Stocks that aided the strong relative performance included Navigant Consulting, Watson Wyatt and J.B. Hunt. On the flipside, recession worries and continued concerns about financials hurt Meredith, Harte-Hanks, and Old Republic. We sold Liz Claiborne in the quarter due to two primary factors. First, the fundamental thesis has changed over the years. Liz used to be largely a wholesaler of women's apparel across a broad spectrum of price points and channels. Recently they have been downsizing this operation and aggressively expanding their high fashion retail business. While this strategy may ultimately prove successful, it is a higher risk model that makes us uncomfortable. Second, the fundamentals for apparel sales in general are very difficult and the company is in the midst of significant restructuring. We thought it was better to redeploy these funds into three interesting new ideas, which we highlight below.

As you know, our custom is to discuss individual investments in the letters following the March and September quarters, with longer, macro comments at mid-year and year-end. We will stick to that format, but given the very significant events in recent months, we want to make some general observations first.

One year ago we quoted a managing director of one of the largest private equity firms in the world, who said, "[Liquidity] has enabled us to do transactions that were previously unimaginable. Frankly, there is so much liquidity in the world financial system that lenders (even our lenders) are making very risky credit decisions." He continued, "…most investors in most asset classes are not being paid for the risk being taken." That firm was Carlyle Group, a primary sponsor of the Carlyle Capital fund, which, in an irony that is all too common on Wall Street, was virtually wiped out in the first quarter of 2008. This $22.7 billion fund stood on just $940 million of equity. Like the Bear Stearns hedge funds last summer, this fund was built on credulity and optimism, rather than prudence and risk sensitivity. The same can be said for many of the investments held by Wall Street brokers, banks and insurance companies. The losses on mortgages and derivatives are now approaching $400 billion and some estimate the eventual total will exceed $600 billion.

The Bear Stearns problems from 2007 spiraled out of control in March and resulted in a highly unusual takeover of the firm by J.P. Morgan. The Federal Reserve and the Treasury assisted the deal, providing $30 billion of guarantees on dicey Bear Stearns' investments along with the opportunity for large brokers to borrow from the Fed, the first time since the Great Depression that the government lent money to securities firms. At the same time, federal regulators loosened the capital requirements of Fannie Mae and Freddie Mac, allowing them to purchase an additional $200 billion of mortgage securities. Although it is April 1 today, this is not an April Fool's joke. Wall Street brokerage firms made billions of dollars of profit speculating on mortgages and mortgage derivatives, while their executives took home hundreds of millions of dollars in compensation, yet the government is there to bail them out when the going gets rough? Fannie and Freddie are in trouble precisely because their capital was weak and they encouraged profligate and undisciplined lending. Now the government wants to solve that problem by allowing them to buy even more mortgages? This will likely result in yet another taxpayer bailout.

The Fed's complicity in this heist is shocking. On March 18, they lowered the Fed Funds rate 75 basis points to 2.25%, following an unscheduled cut of 50 basis points earlier in the quarter. It is no surprise the dollar continues to reach new lows, while commodities and inflation reach new highs. It will be difficult for the Fed to restore trust in the financial system while turning a blind eye to the dollar. As Reuven Brenner, a professor at McGill University, stated recently in a *Wall Street Journal* editorial, "The liquidity crisis and the stable dollar are related. The vast extension of credit since 2002 could have never happened if the Fed had sustained a stable value for the dollar."

The *coup de grace* is the Paulson Plan, the Bush administration's blueprint to remodel the U.S. financial system. While there are a few laudable aspects to the plan, namely the consolidation of some government agencies and increased disclosure, it dramatically increases the Fed's charter and the role of the Federal government. Five new federal agencies would be created, with comforting names like The Prudential Financial Regulatory Agency and the Conduct of Business Regulatory Agency. This plan, along with the bailouts articulated above, is just another slap to the free market system. Capitalism works precisely because it sometimes delivers fatal blows to participants. These blows force capitalists to pay attention to risk and adjust their behavior.

As much as we despise what the Fed has done over the past many years, and particularly the response to the financial turmoil in 2008, our job as investors is to survey the landscape and deal with the world as it is, not as we would want it to be. The Paulson Plan faces an uphill battle in Congress over the next several years. More worrisome are the actions the Fed and Treasury can take without any congressional oversight. It is particularly ironic, given all the political rhetoric in favor of the little guy, that Congress cheers the Fed's moves. Any student of economics knows that inflation is one of the most regressive "taxes" there is. We will have to weigh the macro more carefully over the next few years than we ever have in the past.

Perhaps not so surprising, the tumultuous environment is providing interesting valuations on a number of companies. Below we have highlighted three new ideas.

Group 1 Automotive Inc. (GPI)

Description

Group 1 Auto is the fifth largest auto dealer in the United States. The company owns and operates 96 auto dealerships and 24 collision service centers in the U.S., and three auto dealerships and two collision service centers in the U.K. New Vehicles account for 63% of sales and 27% of gross profit, Used Vehicles account for 23% of sales and 13% of gross profit, Parts & Service accounts for 11% of sales and 39% of gross profit (and a far greater amount of net profit), and Finance & Insurance accounts for 3% of sales and 21% of gross profit. Import and luxury vehicles account for 75% of New Vehicle unit sales.

Good Business

- Many private dealers are struggling with their profitability, which should discourage potential entrants and encourage continued contraction in capacity. Public dealers have a capital advantage over private dealers, which should enable Group 1 to make the necessary investments to distance itself from the competition.
- The Parts & Service business contributes the lion's share of the profits. This business is more dependent upon the number of vehicles in operation rather than unit sales. The revenue from Parts & Service is recurring in nature.
- The outlook for return on invested capital (ROIC) over the next three to four years is attractive given the prospects for improved and more consistent same-store sales performance, improved

margins, stable capital expenditure (CAPEX) in absolute dollars, a slight reduction in working capital intensity, and a focus on acquiring dealerships that sell import and luxury brands.

- This is an easy business to understand.
- The debt-to-capital ratio is 43.1%, or 37.5% excluding the mortgage facility. There are no significant debt maturities over the near to intermediate term. Coverage of interest and fixed charges appears adequate. According to Standard & Poor's (S&P), the earnings quality is high at Group 1.

Valuation

- The stock trades at the low-end of its 52-week range, having declined over 60% from its 52-week high, and has underperformed the S&P 500 by 55% over the last twelve months, 35% over the last two years, and 44% over the last five years.
- The trailing price-to-earnings (P/E) multiple has declined to 6.5, which places the stock below the low-end of its five-year (19.1-8.5) and ten-year (27.6-10.4) average valuation ranges. Group 1 trades for only 7.7x the 2008 estimate. Clearly, the market is expecting a very difficult environment.
- The Parts & Service business alone contributes approximately $3.00 to earnings per share. This implies that investors are paying 7x Parts & Service profits and receiving the rest of the business, which accounts for about 90% of revenue, for free.
- Group 1 earned $3.69 per share in 2006. If it were to take the company another five years to return to this level, and the stock were accorded a forward P/E multiple of 12, Group 1 would trade for $44 per share in four years' time. This would represent a compound annual capital return of close to 20%.

Management

- There is a new team at the helm that is focused on transforming Group 1 from a holding company to an operating company. Earl Hesterberg, 53, has served as President and CEO since April 2005. He came to Group 1 with more than thirty years of auto industry experience, which includes stints as an executive at various dealerships and in dealer relations at several auto manufacturers, including Ford, Toyota, and Nissan.
- John Rickel, 45, has served as CFO since December 2005. From 1984 until joining Group 1, he held a number of executive and managerial positions of increasing responsibility with Ford Motor Company.
- The company repurchased $60 million worth of stock in 2007, which represents approximately 7% of the shares. Insiders have been buying stock on the open market as well. Group 1 also initiated a dividend in 2006 that currently amounts to $0.56 per share on an annual basis, or a 2.6% yield at the current stock price.

Investment Thesis

The stock appears to be discounting much of the bad news associated with the expected decline in auto sales over the near to intermediate term. However, the company makes most of its money on recurring parts and service revenue. Group 1 should benefit from its transformation into an operating company, which, when combined with an eventual upturn in its end market, should result in a powerful earning recovery.

DST Systems Inc. (DST)

Description

DST is a leading provider of information processing software and services. The Financial Services segment (68% of revenues, 91% of earnings before interest and tax [EBIT], 26% margins) provides mutual fund processing, healthcare claims processing software and investment management products and services. Output Solutions (32% of revenues, 9% of EBIT, 5% margins), manages statement production, mailing, processing and electronic payment and bill presentment. Joint venture affiliates complement DST's core processing businesses and contribute approximately $60 million of minority interest income annually. In addition, the company has financial and real estate holdings with a market value of approximately $2.2 billion.

Good Business

- DST is the number one provider of mutual fund transfer agency services and one of the largest providers of output solutions. Operating with a single core platform, DST's business model is durable, generating a 25% plus margin in its core Financial Services processing business. Significant capital investment, modest top line growth and large established players limit competitive entry.
- DST's client relationships are extremely sticky given the embedded nature of DST's software and services. Importantly, revenues in the Financial Services segment is primarily account based and not asset (market value) based.
- Excluding excess capital held in the company's various investments, DST's ROIC has averaged 10.6% over the past seven years.
- DST's business is reasonably easy to understand.
- DST's net leverage ratio is approximately 1.7x. Interest coverage is 9.2x.

Valuation

- DST's valuation is compelling, trading at the lower end of its historical valuation range.
- Excluding the $2.2 billion ($35.40 per share) of investments, the adjusted earnings multiple is 11x.
- On a sum-of-the-parts basis, DST's fair value is 30-40% higher than the stock.

Management

- DST's management team carries a long established tenure. Insider ownership of 16.4% reflects the long-term strategic manner in which the company is run.
  - Thomas A. McDonnell, age 61, has been a director of DST since 1971. McDonnell has served as CEO since 1984 and as President since 1973.
  - Thomas A. McCullough, age 64, has been a director since 1990 and an Executive Vice President since 1987. He was named COO in May 2001.

Investment Thesis

DST is a unique special situations investment idea. Recognized as a stalwart processor within its industry, the company receives little attention from Wall Street, given that the company is managed for long-term profitability, with little regard to meeting quarterly expectations. Management has a long established track record of creating shareholder value through joint venture partnerships, business combinations and $1.8 billion of buybacks over the past three years. Since 2001, DST has reduced the float from 120.4 million shares to 62.3 million.

Affiliated Managers Group Inc. (AMG)

Description

Affiliated Managers Group is the holding company for a diverse set of high quality boutique affiliate investment management firms cumulatively managing approximately $270 billion. AMG's business model relies upon acquiring majority interests in mid-sized ($1 billion to $15 billion assets under management [AUM]) investment managers, leaving 30-40% equity ownership in the hands of managers to encourage growth. Over 150 investment products are offered across 35 investment styles through the Institutional (50% of earnings), Mutual Fund (40%) and High Net Worth (10%) distribution channels. In terms of mix, International equity contributes 35% of earnings before interest, taxes, depreciation and amortization (EBITDA); U.S. Growth equity, 30%; U.S. Value equity, 15%; Alternative, 15%; and Balanced, Fixed and Other, the remaining 5%. A total of six affiliates (Tweedy Browne, Friess Associates, Third Avenue, First Quadrant, AQR and Genesis) generate approximately 75% of AMG's EBITDA.

Good Business

- AMG has a proven business model aligning the interests of partner affiliate managers while preserving each firm's culture and investment process.
- Over the long-term, AMG's revenues are fairly predictable, based directly on a diversified pool of assets.
- The holding company requires little operating capital investment. Acquisitions are the only significant use of funds. The combination of low capital requirements and high margins translates into high free cash flow.
- Over the past nine years AMG's ROIC has averaged approximately 15%.
- AMG's balance sheet is appropriately levered.

Valuation

- If we assume the acquired affiliates' value does not decline over time, "Cash earnings per share (cash EPS)," which adds back amortization, is the preferred valuation metric. On this basis the company currently trades below the mid-point of its historical range. On average over the past ten years, AMG has traded for a cash EPS multiple of 14-15x.
- AMG trades for less than 7x EBITDA, nearly one standard deviation below its ten-year mean.

Management

- Sean Healey has been AMG's CEO since 2005, having joined the company in 1995. Prior to AMG, Healey was a Vice President in the Mergers and Acquisitions (M&A) department at Goldman Sachs, focusing on financial institutions. Healey received an A.B. from Harvard College, an M.A. from University College, Dublin, and a J.D. from Harvard Law School.
- William J. Nutt founded AMG in 1993 and currently serves as the company's Chairman. Prior to founding AMG, Nutt was President and Chief Operating Officer of The Boston Company.

Investment Thesis

AMG provides liquidity for senior partners of investment firms who also have a strong second-generation management team willing to grow the business. The business model is unique in that it carves out compensation and growth capital and only acquires the remaining cash flows of the target affiliate. An AMG investment provides much more stability than a direct investment in a pure-play (growth, value, international, alternative, etc.) investment advisor. The company's management team has a solid track record of identifying high quality managers and creating shareholder value. AMG has approximately $1 billion in available capital.

Thank you for your confidence in 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.