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Investment Strategy Outlook - Small Cap Equity
December 31, 2010

Overview of Performance and Markets

FMI small cap portfolios gained approximately 13% in the quarter compared to 16.3% for the Russell 2000 Index. In the calendar year-to-date period, FMI small cap portfolios gained about 23%, lagging the 26.9% return of the Russell 2000. For the quarter, the market was driven by strong performance in a number of sectors, including Electronic Technology, Technology Services and Producer Manufacturing. We were underweighted in these sectors. Our strong groups, Health Technology and Energy, were not good enough to offset other sectors that lagged the benchmark. A similar sector story played out for the calendar year. Additionally, for the year, Carefusion hurt as did Eagle Materials and cash. Carefusion was sold and we remain optimistic about Eagle's long-term prospects.

So-called growth stocks also outperformed value stocks over both the quarter and year-to-date period. That was particularly evident in benchmark companies such as Travelzoo, which gained over 237% in 2010 and now sports a P/E ratio of 62! There are obviously a large number of stocks that do not fit our value criteria and methodology, Travelzoo being one, but there were also a number of great stocks in the cyclical sectors that we missed over the past couple of years. We seriously considered but passed on Joy Global, for example, in mid-2009 at approximately $30. We were concerned about order cancellations and the stock had already had a sizeable move off the March 2009 low. At 12/31/10, the stock is $86.75! In June of 2009 Joy traded at an enterprise value-to-sales multiple (EV/Sales) of 1.16. At the current EV/Sales multiple of 2.5, the stock is a full standard deviation above its ten year average. While we underestimated the fervor the market would have for stocks addressing the emerging markets and commodities, we certainly wouldn't look to these areas for performance over the next three to five years. With 46.3% of China's economy tied to fixed investment and construction (compared to 12.2% in the U.S.), see-through office and apartment buildings, bridges to nowhere, 5% "official" inflation (but undoubtedly much higher in reality), and a regional/shadow banking system that may be in trouble, count us among the skeptics, at least on a near term cyclical basis. Anecdotal events, such as the recent purchase of Bucyrus (surface and underground mining equipment) by Caterpillar at a large premium add to our skepticism.

In spite of our jaundiced near term view of China, red-hot commodities and commodity-driven stocks, corporate earnings overall look like they should remain relatively bouyant over the near term. Heavy cost cutting from the recession continues to have residual benefits. There is still plenty of slack in the system, both from a plant capacity and labor standpoint. The piper will have to be paid down the road from an inflation perspective, but in the meantime, earnings look like they will advance at a reasonable clip, perhaps 5-10%. Valuations are now above long-term median ranges across a wide variety of measures, but they are not near extreme levels. Many consistent, perhaps even unexciting, stocks have lagged this stock market rally. We own a number of them and are pleased with the way the portfolio is structured.

2010 completed our 31st year of operation. Since inception, FMI small cap portfolios have gained approximately 5850% (after fees) compared to 2345% for the Russell 2000. That works out to a 14.1% versus 10.9% compound annual return. Over the past ten years, FMI small cap portfolios (after fees) have gained

approximately 186% compared to 85% for the Russell 2000. Despite how we feel about the current portfolio structure, we caution our clients that our investment time horizon (3-5 years) and view of where value resides is periodically out-of-phase with the market. We will never compromise our investment principles in order to bend toward prevailing sentiment.

The Economy

The economy seems to be grinding along at a 2-3% GDP growth clip. Very slow progress, but progress nonetheless is being made on the employment front. The consumer's balance sheet also continues to heal. A few quarters ago we indicated our belief that the housing market would not necessarily have to recover for the economy to improve. Housing indeed remains very difficult. Home prices are generally still slipping slightly on a year-over-year basis. Inventories and foreclosures remain high and financing is still tight. Yet the economic recovery proceeds. In 2009, there was widespread belief that the economy would remain in recession for an extended period, owing to the fact that 70% of GDP came from consumer spending, and the consumer was down-and-out. Merrill Lynch recently published some interesting data showing how consumer spending is much less discretionary than it used to be. In 1960, health care was 7% of consumer spending; today it is 22%. Merrill calculates that just 25% of consumer spending (20% of GDP) is truly discretionary. The bulk of spending is on housing, health care, energy and food eaten at home. Viewed from this angle, it is not surprising that once business spending recovered from the depths, it was enough to push the entire economy back into a growth mode.

Of course, only a fool would say that things are back to normal. Many people wonder why the economy and employment are not stronger. It is a complex subject, but we have our theories and opinions. The cost to make a capital investment or to hire is quite significant. The cost to recruit, train and maintain an employee continues to go up at a much higher rate than has capital deployment. Expectations of future costs, whether they are health care, social security, or pension related, impact the hiring decision, as does the mobility of labor. High tax rates affect both the labor and capital decision and the United States has the second highest corporate tax rate in the OECD (Organisation for Economic Co-operation and Development). Income tax also plays a major role, as it affects the willingness to start businesses, work longer hours, exchange work for leisure or hide income. Policy decisions influence employment; more jobless benefits, more unemployment. A recent study by the Federal Reserve Bank of San Francisco confirmed this notion. Uncertainty about all of these things breeds caution.

Long time readers know of our skepticism toward Keynesian economic theory. Anyone with a keen eye at the local level could see where much of the stimulus money has been going. A large portion of it has gone to plug shortfalls in state and local government budgets. Money was also thrown at a hodge-podge of pork barrel projects, with very little going to long-term infrastructure programs that could yield multi-year economic benefits. One could literally watch private businesses taking a step back to evaluate the various public spending initiatives. The pro-stimulus argument that it saved the U.S. from a depression is not supported by the facts. In a recent Wall Street Journal piece, Stanford economist Michael Boskin cited a number of studies showing a negligible spending multiplier from government stimulus. This spending simply crowds out private sector spending.

Debt/Spending

One thing the stimulus did achieve: a massive increase in the budget deficit. Today, the $1.5 trillion U.S. budget deficit is approximately 10% of GDP and our total debt of $13.8 trillion is 94% of GDP. These figures don't even count the deficits or the debt that reside at the state and local level. Ironically, the 16 countries in the Euro Zone collectively have a budget deficit of 6% of GDP and a total debt ratio of 84%. Yet a crisis atmosphere exists across Europe as austerity plans are met with violence and the European Central Bank

struggles to avoid "contagion." The solution so far on both sides of the Atlantic is to print money. The feckless central banks truly believe that the answer to our problems is to inflate the asset markets, generate a "wealth effect" of spending increases, which will jump-start the economy and then everything will be just fine. This would almost be funny if it wasn't so pathetic.

Nobody wants to face the problem that our governments spend too much. We've created a transfer payment monster supported by unwieldy government bureaucracies. All politicians claim they don't like deficits, yet they continue to vote for programs that increase our deficit. One party's solution is a broken record… raise taxes… even though six decades of data show that tax revenues as a percentage of GDP almost always average around 19%, despite vastly different marginal tax rates. The other party doesn't have the guts to eliminate programs in their districts or cut defense spending. One party prosecutes expensive and unwinnable wars. Then the other party prosecutes expensive and unwinnable wars.

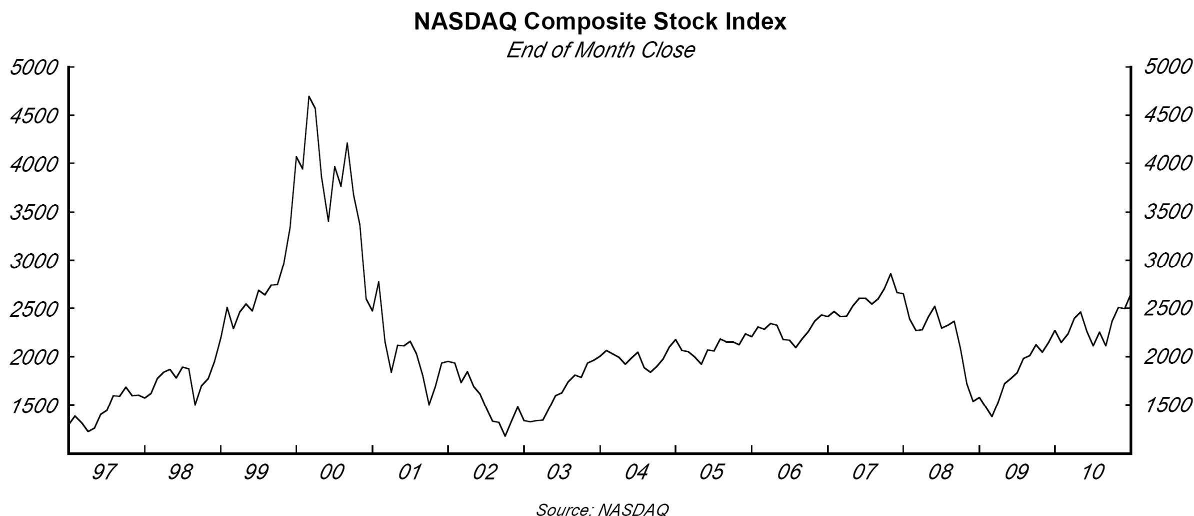
In the September letter, prior to the mid-term elections, we said the results might be a referendum on our spending policies. If the recent tax bill is any indication that the parties are serious about deficit reduction, then we have a problem. In exchange for tax "cuts" (keeping tax rates the same) the bills are larded with giveaways and expensive programs. The Congressional Budget Office estimates a ten year cost of $858 billion for this legislation.

Corporate Compensation

Of the many topics we've covered over the years, public company executive compensation, seems to rile the most feathers. One side wants their comp viewed from the standpoint of a professional athlete or actress. The other side views corporate executives as greedy opportunists. Although there are reasonable arguments on both sides, on balance we feel that U.S. public company executive compensation has gotten out of hand over the past few decades. The average top executive pay for S&P 500 companies in 2009 was over $8 million. In 1976, CEO pay was 36 times that of the average hourly worker. By 2005, it was 369 times; today's figure is between 250 and 400 times, depending on whose figures are used. You would have a hard time convincing us that today's executives are ten times better than 34 years ago. It is particularly exasperating when one considers the fact that in the vast majority of situations, public company executives are "hired guns." They are not the quintessential private entrepreneur who mortgaged his house or put all her capital on the line, hit a home run and now reaps a large payoff. Top executives unduly benefit from a system where boards don't wish to make enemies, but instead hire compensation consultants that manage to get companies to adopt plans that target a peer group median or higher for remuneration, and then magically the median rises every year! Performance bonuses are often paid based on very low targets, making a mockery of the process. Perks and benefits that could easily be afforded are added to the kitty, furthering the sense of unfairness relative to the little guy. Shareholders, often through their fund managers, rubber-stamp the plans out of laziness or indifference.

The worst offender in the executive pay controversy is the option plan. As you know, Fiduciary Management has, for over a decade, voted against most option programs. What started out as a good idea in theory has been corrupted in practice. Options have become a huge part of total compensation yet they misalign risk with reward. Options inherently place executives at odds with shareholders because they will be exercised only when it is advantageous to the executive and thus harmful to the company's shareholders. Additionally, since there is no downside to an option, management has the temptation to make decisions that may not be in the best interest of the corporation from a long-term perspective, knowing they can take advantage of an interim rise in the stock price. It's like a baseball slugger who has unlimited strikes. The option problem is further abetted by Wall Street analysts, who "allow" firms to exclude the cost of these options when calculating earnings per share (non-GAAP EPS). The NASDAQ is "Exhibit A" in this scheme. Companies in the NASDAQ continue to be the most liberal users of options, yet where is the evidence that it has done any good?

The Index is down about 50% from the late 1990s, yet hundreds of companies have generated billions of dollars of option profits for executives.



We've analyzed profit margins, return-on-invested capital, and numerous other measures of corporate performance, as well as stock prices, and cannot find any evidence that options have made companies perform any better fundamentally or in the stock market. To suggest that options are needed to "attract and retain" talent rings hollow. Furthermore, despite companies having to expense options today, they no longer have to disclose the estimated future value of all option grants. We find the disclosure around these programs to be opaque.

The outsized comp of public corporate executives is a lightning rod for criticism from anti-capitalists and others who don't trust business. Boards and shareholders have created what some feel is a corporate elite and one has to question the effects of this on society. At best it has engendered a more hostile environment toward business, the life-blood of our country. Shareholders need to take a stronger role. We are starting to see some companies drop options and move toward aligning true risk with reward, but it will be a long process. Every executive believes they've earned their comp and every comp consultant will target the median (or higher!).

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.