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# Investment Strategy Outlook - Small Cap Equity

March 31, 2011

The small cap portfolios gained approximately 7% in the quarter compared to 8% for the Russell 2000 Index. The first two months of the quarter were similar to last year in that higher beta situations, levered cyclicals, technology and energy related stocks did well. More defensive stocks continued to underperform. With Middle East conflicts escalating and the terrible tragedy in Japan unfolding, there was some flight back to perceived safety. We were pleased to have not lost too much ground given our conservative, defensive posture. Overall, we have been surprised at the magnitude and duration of the equity rally, now over two years old. Valuations are once again stretched for the market as a whole, particularly given the grave nature of developed country finances.

***<u>Easy Solutions?</u>***

If you ask the proverbial average American how many people in the US make over $1 million per year, the number would likely be a lot greater than 321,294. Yet that is indeed the figure.[1] The IRS shows adjusted gross income for this group of $1.076 trillion. They paid federal income taxes of $260 billion. So, think about the math. One could increase taxes on this group of people by 50% and assume they do not take any mitigating actions (defer income, hide income, delay capital gains, opt for leisure, etc.), and the additional income generated would be $130 billion. That is less than 10% of this year's budget deficit of $1.5 trillion. Forget about the $14.3 trillion of debt and any hope of chipping away at that.

4,376,000 filers make more than $200,000 per year. Their adjusted gross income in 2008 was $2.462 trillion. They paid $544 billion in taxes. Again, we could raise tax rates by 50%, assume they take no mitigating actions, and only $272 billion more in taxes would be raised. This is 18% of the current budget deficit. Incidentally, these 4.4 million filers, 1.5% of the population, paid 50% of the total federal income taxes.

There are certainly some high income filers who have found or exploited ways to avoid paying statutory rates (all the more reason to reform the tax code), but odd as it may seem, even doubling their tax rate barely dents the deficit. 13,000 filers made more than $10 million in 2008, generating taxable income of $348 billion and paying $88 billion in federal income tax. Double their tax rate and it would amount to 6% of this year's deficit.

Some say the answer is to just tax corporations at a higher rate. There are all sorts of issues with this idea, not the least of which is that corporate taxes bring in less than $200 billion annually, just 13% of this year's deficit, and the US corporate tax rate of 35% is already the second highest amongst the 30 OECD countries. Many companies have moved operations or headquarters overseas to avoid getting taxed at the US rate for income they do not generate in the US. Armies of tax lawyers and lobbyists are employed to reduce corporate taxes and this has the effect of favoring not only certain types of businesses over others, but large corporations over small. President Obama seems open to reducing corporate tax rates to make the US more competitive.

[1] The IRS data is for 2008, the most recent available. Actual millionaires may be slightly higher in the cases where both spouses earn over $1 million and are filing jointly.

Reducing or eliminating the corporate tax, combined with a much flatter individual tax and the elimination of tax breaks, would also be more equitable and could generate more income over time. In a sense, corporations really don't pay taxes; they simply pass the burden onto consumers. Raising the corporate tax rate doesn't affect the CEO's income at all, but it does hurt the little guy, who pays more for a loaf of bread or possibly loses his job because his unit is moved offshore. Corporations are not living citizens. They are owned by living citizens who pay taxes on distributed corporate income and capital gains. If tax rates on dividends and capital gains migrated toward a broad-based flat tax rate, income would accrue to the owners, suppliers and employees and very possibly tax revenue would rise, in addition to being less regressive.

> *"We know what it will take for America to win the future. We need to out-innovate, we need to out-educate, we need to out-build our competitors. We need an economy that's based not on what we consume and borrow from other nations, but what we make and what we sell around the world. We need to make America the best place on Earth to do business… Another barrier government can remove is a burdensome corporate tax code with one of the highest rates in the world."*
>
> *- President Barack Obama (February 7, 2011)*

No discussion of the budget deficit can progress unless people understand this basic math: approximately 58% of the budget is Medicare, Federal Medicaid, social security, and unemployment entitlements. Defense is 20%. If a budget discussion fails to address 78% of the budget, it fails.

According to a recent survey by the Tarrance Group, a majority of voters (63%) incorrectly believes the federal government spends more on defense than it does on Medicare and Social Security. The hard reality is that there are no easy solutions. No sound bite call to tax the rich or stick it to corporations really addresses the problem at all. The issue has been and continues to be excessive government spending.

As this letter is being written, Congress is haggling back and forth about whether federal spending growth will be reduced by $62 billion or $10 billion (1.7% or .4% of the total budget, respectively). With little recognition or admission of the underlying fiscal realities, and almost nothing of substance being done about it (in fact, large protests against spending cuts are now commonplace), our macro outlook continues to be guarded. Stock valuations have moved considerably higher over the past year and the combo platter of a fiscal mess, an untenable monetary policy and a stretched market translates into a more cautious investment outlook. Of course, experience tells us there will always be interesting investment ideas, regardless of the big picture. Below we have highlighted two. Additionally, at www.fiduciarymgt.com/institutional-investors/additional-resources, we have posted the support work for this letter as well as some other interesting data. We thank one of our team members, Dan Sievers, for compiling this information.

**Sanderson Farms, Inc.**
Analyst: Andy Ramer

***Description***
Sanderson Farms is a vertically integrated poultry company engaged in the production, processing, marketing and distribution of fresh and frozen chicken products, as well as prepared chicken. The firm is the fourth largest producer of chicken in the US, with a 6.5% share of the domestic market.

***Good Business***

- Sanderson Farms is the low-cost operator. The business periodically requires significant capital outlays, and incumbents have established long-term contracts and relationships with their customers, which raises the barriers to entry.
- Chicken is a reasonably priced consumer staple. It is the most efficiently produced popular protein with a feed-to-weight gain ratio of 2:1 compared to pork at 3.5:1 and beef at 8:1.
- Sanderson Farms earns its cost of capital over a cycle. The company generated a ROIC of 21.9% in fiscal 2010 compared to the 5- and 10-year averages of 10.9% and 15.8%, respectively.
- The business is easy to understand.
- There is $10.3 million in net cash on the balance sheet.

***Valuation***

- The stock trades near the low end of its 52-week range, has declined 34% from its 52-week high, and since July 1, 2010 has underperformed the S&P 500 and Russell 2000 by 35% and 42%, respectively.
- Sanderson Farms trades for 1.33x book, which is near the low-end of its 5- and 10-year average ranges of 2.60-1.33 and 2.84-1.42, respectively. There is no goodwill on the balance sheet.
- If the company were able to replicate its historical performance and grow its book value/share by 10% over the next five years, and if the shares were to return to their 5-year average price/book multiple of 1.9, the stock would double.

***Management***

- Senior management is well regarded by the Street. The company is led by Chairman & CEO Joe F. Sanderson, Jr., 63; President & COO Lampkin Butts, 59; and CFO Mike Cockrell, 53. Their philosophy is to manage the firm for the long term.
- Sanderson Farms prefers to grow organically.
- Compensation is tied in part to ROE. All directors and executive officers as a group own 6.5% of the stock, and the ESOP (employee stock ownership plan) owns an additional 8.4% of the shares, for total insider ownership of 14.9%. Joe Sanderson owns 5.3% of the company.

***Investment Thesis***

The shares of Sanderson Farms have come under pressure due to the chicken cycle rolling over. The fiscal fourth quarter, which ended in October 2010, likely represented a cyclical peak for the business. Market participants are now losing money as chicken production grows, bird weights increase, and feed costs rise. Although it may take a year or more before supply and demand rebalance, we believe that most of the bad news is already reflected in the valuation. Sanderson Farms' status as a low-cost operator and its debt-free balance sheet position it well to weather the downturn.

## Cullen/Frost Bankers, Inc.

Analyst: Matthew Goetzinger

***Description***

Cullen/Frost Bankers (CFR) is a leading independent Texas-based regional bank focused on commercial lending. CFR operates over 110 branches across Texas. Major markets include San Antonio (32% of total deposits), Fort Worth (20%), Houston (18%), Austin (10%), Corpus Christi (6%), Dallas (6%) and the Rio Grande Valley (3%). Non-interest fee income accounts for over 30% of revenues, with trust and insurance brokerage as primary contributors. Frost Bank became chartered within the national banking association in 1899.

***Good Business***

- CFR has established a durable business model focused on middle market relationship-based lending to commercial customers with $10-100 million in annual revenues.
- Over 30% of the company's revenues are generated through fee-based income.
- Commercial lending relationships average over 10 years.
- Over the past 5- and 10-year timeframes, CFR has averaged a ROE of 14.4% and 16%, respectively.
- The company's balance sheet boasts strong capital levels (13.8% Tier 1 Risk Based Capital), low and declining nonperforming assets and strong reserves.
- The company is conservatively managed and is easy to understand.

***Valuation***

- CFR is trading on the low end of its historical price-to-book value range.
- The P/E is at the midpoint of its historical range, but the company's earnings are depressed.
- Takeovers for other good Texas banks have taken place at 3.2-4.3x tangible book compared to 2.1x for CFR.
- CFR is the last independent bank of size left in Texas.

***Management***

- Richard W. Evans, Jr., 63, has been a Director since 1993 and the Chairman and CEO since 1997.
- Patrick B. Frost, 49, is viewed as a likely successor to Evans; he has been President of Frost Bank since 1993 and Officer since 1985.
- Both Evans and the Chief Credit Officer were previously bank examiners.
- Cumulative employee ownership is 13.5%.

***Investment Thesis***

Cullen/Frost Bankers is a high quality lender focused on commercial and industrial loans, and is positioned to benefit from a rebound in the Texas economy. Credit quality has been outstanding, with just 50 basis points of net charge-offs. The loan loss reserve is three times the charge-off run rate. Capital is robust (est. $150-300 million of excess capital) and the company's low cost deposit franchise generates low cost funding (20 bps average). A steepening yield curve and inflation (commodity rich Texas economy) will also accrue to the benefit of CFR.

Thank you for 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.