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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

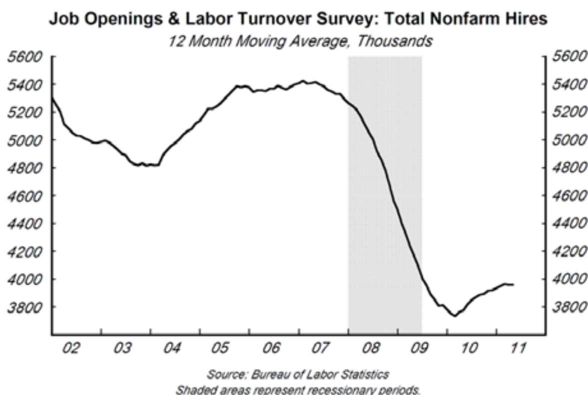
June 30, 2011

The FMI small capitalization portfolios gained approximately 1.0% in the quarter compared to the 1.6% decline for the Russell 2000 Index. Producer Manufacturing, Electronic Technology and Retail Trade were three groups that aided relative performance. Detracting from results this quarter were Health Technology, Consumer Services and Utilities. We sold ***Beacon Roofing Supply, Inc.*** in the quarter due to valuation and purchased ***Kennametal, Inc.***, ***Federated Investors, Inc.*** and ***Avery Dennison Corp***.

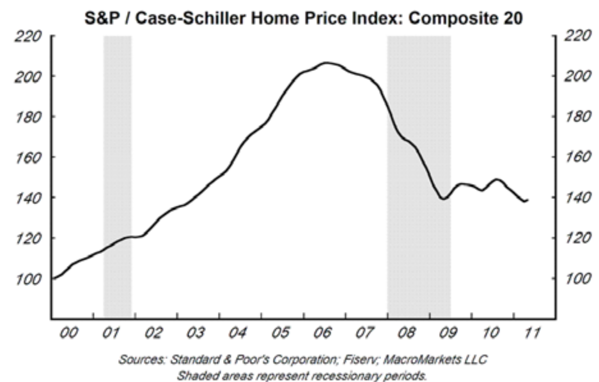
Over the past several years these letters have delved extensively into areas we see as long-term problems for investors -- particularly U.S., European and Japanese fiscal deficits, debt levels, policy responses, monetary intervention and equity valuations. The normal pattern for our letters is to focus on economics or some other broad subject at December 31 and June 30. The March 31 and September 30 letters typically make brief big picture comments followed by a highlight of a company or two. This letter will deviate somewhat from normal by taking just a brief view of the big picture landscape, as well as a few other macro subjects, in order to spend a little more time discussing the portfolio itself.

Fiscal disasters abound both here and abroad. The austerity measures that are required to make American, European and Japanese economies healthy are painful and have already resulted in social unrest. The debt problem will not disappear regardless of the demonstrations, marches and riots, whether in Athens or Sacramento. Longer term, without fiscal discipline, it is either inflation or restructuring. So far it is clear that the U.S. and European Union have chosen loose monetary policy, which partially manifests itself in currency debasement and eventually could spell high inflation. Over the past five years, the dollar has declined 31.3% relative to the Swiss Franc, reflecting a much sounder fiscal situation in Switzerland. The Euro has declined 22.1% against the Swiss Franc during the same period. The U.S. is borrowing 40% of its annual spending and overall debt is approaching 100% of GDP, truly astounding figures. There appears to be an appalling lack of understanding and urgency at the Federal level in addressing the fiscal problems from a policy perspective, both here and abroad. We are seeing cities and states beginning to balance budgets, however, which gives us some hope.

The U.S. economy is certainly stronger than it was two years ago, but job creation (see chart) is almost nonexistent and GDP growth is anemic. House prices remain depressed (see chart) and home inventories remain high. The rapid earnings growth exhibited from the early 2009 bottom appears to have run its course. Profit margins are at all-time highs and we would not be surprised to see some retrenchment in profitability.



Source: Bureau of Labor Statistics
Shaded areas represent recessionary periods.



Sources: Standard & Poor's Corporation; Fiserv; MacroMarkets LLC
Shaded areas represent recessionary periods.

China's rapid growth may continue, but as articulated in recent letters, their economy appears to be heavily dependent upon unsustainable infrastructure and construction investment. Emerging markets like China have been a source of strength for U.S. and global companies and while the long term is still promising, history shows development rarely takes a smooth upward arc.

Surprisingly, one area of controversy appears to be how equity valuations are perceived. Some think stocks are cheap, but we have a hard time making that case. Every quarter The Leuthold Group publishes 39 different valuation series, whose data goes back 50-90 years, with the information divided into decile rankings (1 the cheapest, 10 the most expensive). There are 15 different P/E ratio series, along with multiples of cash flow, book value, revenue, GDP and many others. The average decile ranking of the 39 series is 8.1. Stocks are not cheap. Does this mean stocks will fall? That is a difficult question. Stocks can stay expensive or cheap for a long, long time. Stocks very briefly dipped below the median in late 2008 and early 2009, but for most of the past twenty years, valuations have been well above average. Conversely, for virtually all of the 1970s and into the mid-1980s stocks were cheap. Money can be made in both environments *but it is difficult doing it during the transition from expensive to cheap.* It is a safe bet that at some point this transition will take place.

Readers new to these letters might be alarmed by our tone, but this is not unusual for us. We always try to give an honest assessment of how we see the world and our basic belief is that excellent long-term investment results are best achieved by careful and cautious security selection, avoidance of popular or frothy themes and a deep appreciation for valuation. If stocks truly make a transition from expensive to cheap, we like our chances to outperform more aggressive peers. How this will look from an absolute return standpoint is impossible to predict.

FMI portfolios are constructed with a desire to remain exposed to most of the major economic sectors in our society. While we are certainly aware of the Russell 2000 weightings for each industry, this is far less important than making sure the portfolios are economically diversified. In the late 1990s many "conservative" pools of capital and index funds were invested alongside the Russell 2000. Unfortunately, tech and telecom had grown dramatically so investors that mimicked this index (as well as the S&P indices) were not buying a diversified portfolio and subsequently suffered significant losses. While striving to be diversified, we understand owning too many stocks accomplishes little in the way of diversifying risk while dooming the portfolio to average performance over time. Several studies show that the portfolio diversification benefits drop dramatically after as few as ten stocks (as long as they are in different industries). Our portfolios generally hold 40-50 stocks, relatively concentrated compared to our peers. There is an automatic assumption that this type of portfolio is more volatile, but the 31-year FMI record in small cap show just the opposite. We believe this is due to a focus on buying companies that have superior underlying franchises, solid balance sheets and valuations that already reflect relative pessimism. By avoiding the popular stocks and industries, the portfolios have conceded some of the upside but have more than made up for it by side-stepping the brunt of the downside as the ardor faded; overall, the performance has been steadier. Of course there are no guarantees for the future, but rest assured that our approach will remain the same.

FMI portfolios will generally have less exposure than our peer competitors in a number of industry groups, including electronic technology, financials, energy and utilities. We are not attracted to most technology business models because they are characterized by short product cycles, unpredictability, cutthroat competition and excessive use of stock options. Though technology is an important economic growth driver, it has been an exceptionally tough place to execute a successful investment track record. Nevertheless, we want exposure to this sector of GDP and we generally get it "through the side door," with companies such as ***Arrow***

Electronics, Inc., an electronics and technology systems distributor that captures the growth in high tech without the obsolescence risk. Currently we have about a half of the benchmark exposure to financials. Our lack of enthusiasm for many financial enterprises stems from the fact that they are typically characterized by high leverage and low margins. This gets them in trouble when the credit tide turns or there is financial turmoil. One stock we prefer in this area is ***Arthur J. Gallagher & Co.***, a leading insurance broker. While still tied to the fortunes of property and casualty markets, it has no underwriting risk. Many energy companies struggle to earn their cost of capital. As a general comment, most management teams in this sector seem to lack investment discipline. Our preferred approach to gaining energy exposure is through the oil service channel, where there are more companies that exhibit the proverbial moat around their business. ***Bristow Group, Inc.***, a provider of helicopter services, and ***Dresser-Rand Group, Inc.***, a manufacturer of specialized equipment used in both upstream and downstream applications, are differentiated businesses in this sector. The utility group is also plagued by low returns. We could accept utility investments that barely earn their cost of capital if the valuations were attractive, but they are not. Utilities are an important economic sector, however, and we continue to look for opportunities here. We do have indirect exposure to water utilities through our investment in ***PICO Holdings, Inc***.

The restaurant and retail sectors are generally highly competitive, tough to manage and mostly not too attractive from an investment standpoint. Still, they are very important from a GDP perspective so we desire involvement in some way. Occasionally we find an interesting turnaround story in the restaurant space but today our only exposures are through suppliers such as ***Sanderson Farms, Inc***. and ***Flowers Foods, Inc.*** Our retail investments include ***Family Dollar Stores, Inc.***, a niche player addressing the middle to lower-income customer through a small box format. With the exception of a brief period when the stock got to be too expensive, ***Family Dollar*** has been in the portfolio for over ten years. ***Ruddick Corp.*** is a supermarket chain in the Carolinas and Washington D.C. areas, focused on the higher-end niche. It has consistently earned its cost of capital in a tough business. Typically our investments in the retail space are turnarounds. We look for solid defendable franchises that have new management focused on returns rather than growth. Both ***Ruddick*** and another retail holding, ***PetSmart, Inc.***, entered the portfolio as turnarounds and each has executed quite well. They could become harvest candidates if the stocks continue to advance more rapidly than the fundamentals.

The action in the stock market in recent years has been in commodities, precious metals and heavy cyclicals -- sectors that have prospered from relative high growth in emerging markets. We've sold a couple of stocks that had benefitted from this trend because of valuation. We continue to own companies such as ***Woodward, Inc.*** and ***SPX Corp.*** that will gain from an ongoing build-out of basic industries worldwide, but we do not have meaningful exposure to global branded consumer goods, such as ***Nestlé S.A.*** or ***Kimberly Clark Corp.*** (owned in our large cap portfolios). It is very difficult to find these types of franchises amongst small capitalization stocks.

Value investors constantly struggle with buying into stocks or sectors that stay depressed (value traps). The Pharmaceutical sector has been an enormous value trap over the past decade or so. We have written periodically about why we haven't invested significantly in this sector. In essence, the marginal development of new compounds became uneconomic. The productivity of pharmaceutical R&D plummeted (cost, FDA approval time, and hit rates have all gone the wrong way). The stocks were cheap on a retrospective basis, but not on a prospective basis. This held for the large recognizable pharmaceutical names as well as the smaller ones. Currently we are undertaking yet another underwriting of this sector as some of the negative factors may be ameliorating. In the meantime, we are participating in this sector through our holding of ***Covance, Inc.***, one of the top providers of contract research and other services to the pharmaceutical and biopharmaceutical industries. We capture additional health care exposure through ***Patterson Companies, Inc.***, the leading

distributor of dental consumables and equipment. We like ***Patterson*** for a number of reasons but especially because very little of their revenue depends on government reimbursement.

The health care sector in general has been a difficult area to analyze or in which to have a reasonable level of confidence. Knowing that as a society we spend way too much on health care, that Federal and State governments already pay over 50% of health care expenditures, and that new health care mandates are going to take this figure much higher, it is hard not to fathom eventual government cutbacks, rationing, reduced reimbursements, etc. Today the spending just goes up and up, but eventually this has to change. If the majority of the people believe health care is a public good and that it should be provisioned by the government like national defense, then we think the return structure of the industry is going to fall significantly. As with all groups, we constantly revisit the facts and circumstances and make our judgments as to whether conditions have changed. We may have a completely different thesis on health care in three years.

Each investment is vital to the success of the overall portfolio. There are no “throw-away” stocks or “flyers.” Taking small positions is often a defense mechanism for lack of conviction or subpar research. We invest in sizeable stakes after we determine that the idea adds to the diversification of the portfolio and when our in-depth research yields a positive conclusion. When we get the thesis wrong or the valuation becomes unattractive, we sell.

Finally, you may notice the cash level in the portfolio is higher than normal. This reflects an unusual level of difficulty finding the types of investments that fit our criteria combined with the sale of a few stocks that have become expensive. The market is usually pretty good about giving us corrections or simply idiosyncratic declines in individual stocks or industries. With the exception of a small hit recently, stocks have had a remarkable and consistently higher run for over two years. We anticipate better opportunities in the near future.

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.