FIDUCIARY MANAGEMENT, INC.
Investment Counsel

**100 East Wisconsin Avenue, Suite 2200**
**Milwaukee, Wisconsin 53202**
**414-226-4545**
**www.fiduciarymgt.com**

# INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2011

FMI Small Cap portfolios declined approximately 16% in the three months ending September 30th. This compares to the benchmark Russell 2000 Index fall of 21.9% in the corresponding period. Through nine months small cap portfolios lost about 9.5% and the benchmark retreated 17.0%. Economically sensitive groups such as Producer Manufacturing, Non-Energy Minerals and Finance dropped significantly as worries about a global recession intensified. From an individual stock perspective, SPX Corporation, Eagle Materials, and Cullen Frost Bankers suffered steep declines, reflecting worries about industrial growth and financial turmoil. We continue to feel strongly about the strength and long-term prospects of these businesses. Consumer Non-Durables, Retail and Technology Services, while all down in the period, were relatively strong. Lancaster Colony, Family Dollar, and Jack Henry & Associates led the way in these three sectors.

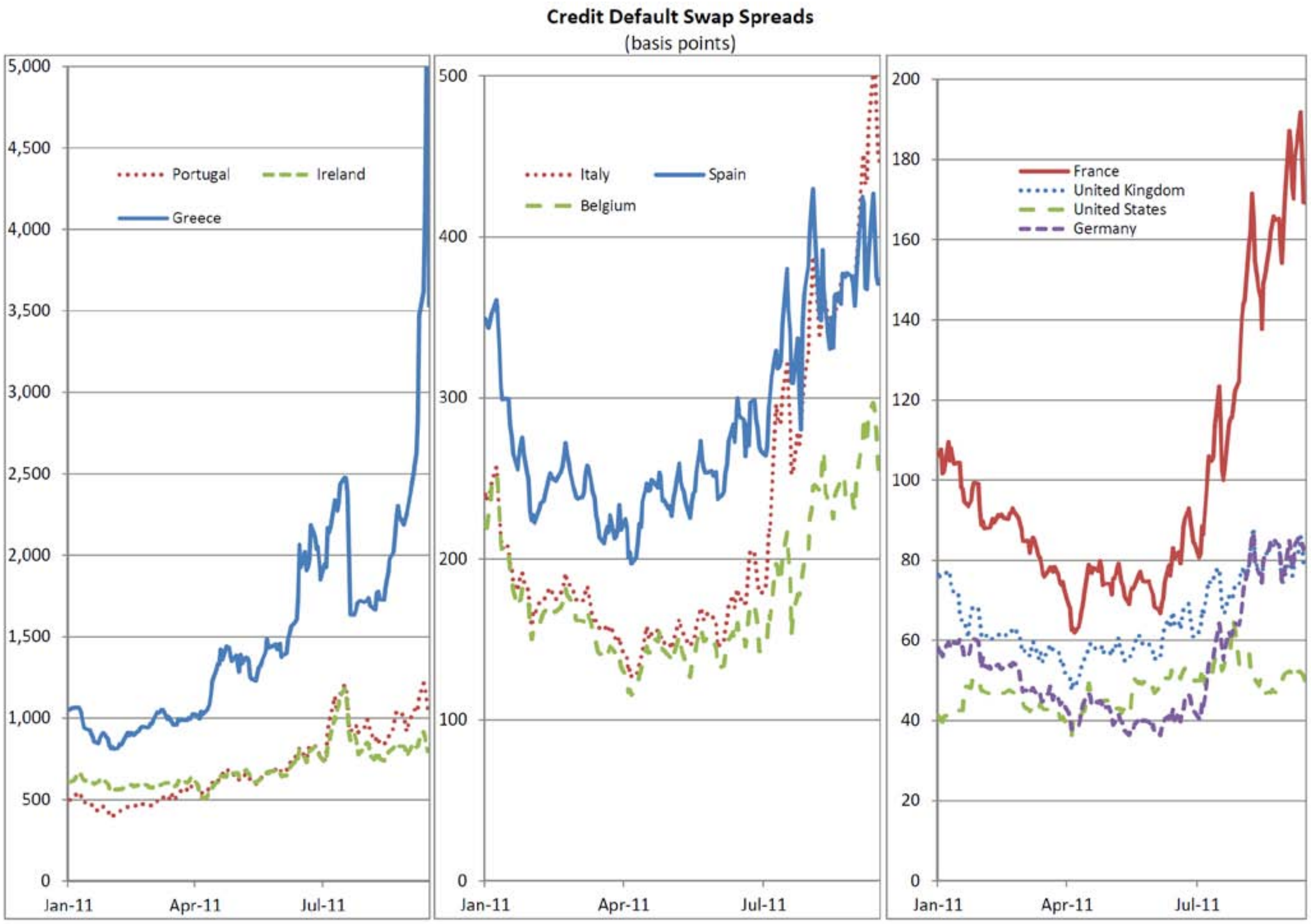
While there are a multitude of issues causing investor angst, and we will touch briefly on a few of these, valuations have become more attractive. Small cap portfolios have added to a number of existing positions as prices have fallen. The portfolio currently sells for a median of 13.8 times earnings and 1.0 times annual revenue. The profitability and financial position of the constituents are solid. Of course there is no way to predict when the current bear market will end, but we are confident in the quality and durability of the portfolio's investments.

As a reminder, the March 31st and September 30th letters touch briefly on big picture issues before discussing a couple of investments, while the June 30th and December 31st letters delve deeper into various issues that impact the investment landscape. An archive of letters for the small cap portfolios can be found on our website, www.fiduciarymgt.com.

Weakening global economic growth has been added to the worries about excessive sovereign debt in Europe, America and elsewhere. Growth has slowed across Europe, and even in Germany--which heretofore has been the pillar of strength--business activity has downshifted. As we foreshadowed in last quarter's letter, and despite very real inflation, China is showing signs of slowing. Chinese industrial production appears to be contracting, as evidenced by HSBC's flash Purchasing Managers Index (PMI) figure of 49.4. We have felt for some time that China has been on an unsustainable growth path, driven by massive state funded infrastructure expansion. Part of the funding apparatus resides in the regional bank system controlled by party officials. These officials earn compensation and preferred status from the party for sales of state-owned land to developers. Local government income from land sales accounted for 7% of China's gross domestic product (GDP) last year. Credit has been expanding rapidly in recent years at a much higher rate than economic growth and may today be at dangerous levels. A recent International Monetary Fund (IMF) report shows bank credit in China growing over 30% compared to the official GDP growth of approximately 10%.

There is a growing body of evidence that suggests massive overbuilding of not only Chinese public infrastructure, but housing and commercial property, too. Construction spending, as a percentage of GDP, is up over four fold in the past 12 years. Recently Chinese residential real estate prices and transaction volumes appear to be falling significantly, with reports of 20-30% price declines in Beijing and Shanghai and two-thirds of the country experiencing a negative growth rate. We take all Chinese figures with a grain of salt, but the slowdown seems also to be reflected in a steep decline in copper prices (down nearly 30% over the past two months), oil and other industrial commodities. Chinese leaders may be able to pull a rabbit out of the hat again by pumping up infrastructure spending but our feeling is that this is an unsustainable policy. Their economy is significantly imbalanced, driven by a surfeit of infrastructure spending and a shortage of domestic consumption spending.

The debt woes of Europe remain intractable. In the September 21st global financial stability report, the IMF had this to say about European sovereign debt: "Nearly half of the €6.5 trillion stock of government debt issued by euro area governments is showing signs of heightened credit risk." Credit default swap spreads (essentially what investors pay to insure against default) have risen dramatically, not just for so-called PIIGS, but also for the rest of Europe.




*Source: Bloomberg, Fiduciary Management, Inc.*

The cognoscenti appear to be pinning their hopes on containment, i.e. a restructuring of Greek debt, an exchange of sovereign debt held by banks for new debt backed by another euro authority and a bet that this bailout facility is large enough to forestall a domino effect from other countries on the brink. Details are sketchy at this point. It is likely to take further restructuring, additional austerity measures and a resetting of relative wage rates to set a course for sustainable recovery. Realistically, the vast majority of the UK and European banks would be insolvent if the sovereign debt of Greece, Portugal, Ireland and Spain were marked to market (not to mention Italy). While we don't anticipate outright bankruptcies of these financial institutions, we think many will have to raise capital, diluting existing shareholders and stunting earnings per share for years to come. We are unsure about how European instability will impact the financial stocks in the small cap portfolios, but we continue to monitor and evaluate the situation closely.

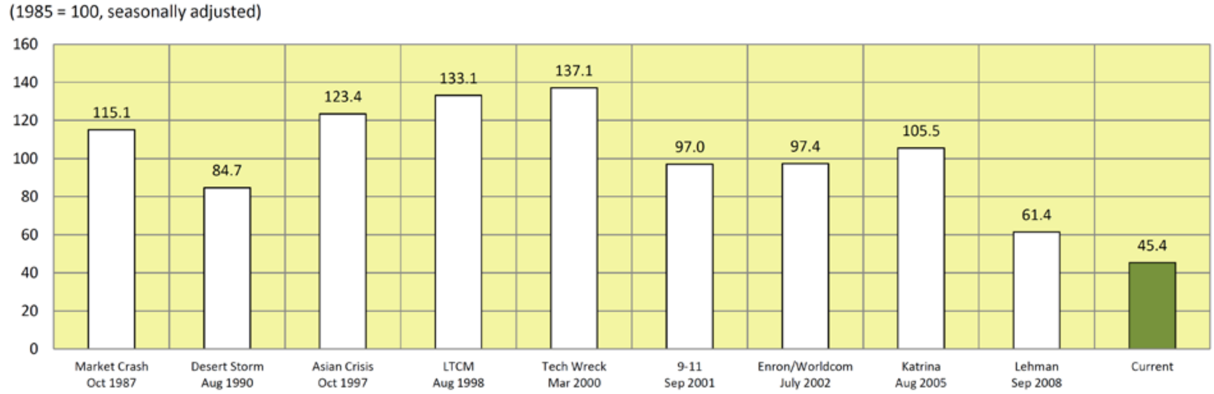
Unfortunately, the fiscal and monetary situation in the United States isn't very good either. Policy makers continue to spend more on the same kind of ideas that didn't work in the 1930s and certainly haven't worked in the 2000s, with the latest iterations adding unprecedented amounts of debt to the country's balance sheet. Apparently, none of the policy makers feel comfortable doing nothing, much less reducing government's involvement in the economy. The Federal Reserve's actions are especially noteworthy since there is essentially no congressional oversight and Bernanke can run his experiments with virtual impunity. Imagine a policy that eliminates nearly all of the income of the risk-averse saver (think elderly widow with CDs and T-Bills) yet provides nearly free money to the billionaire hedge fund borrower! Business managers remain fearful of health care mandates and higher taxes and are not adding employees or significant capital to their businesses. Productivity is reasonably high but the economy needs more job creation and capital formation. An improvement in tax policy might go a long way toward improving these metrics. Right now smaller businesses (the engines of employment growth) pay a significantly higher effective tax rate than the large corporations, who employ complicated tax avoidance strategies. Personal tax rates are a crazy mishmash where a factory worker could, as Buffett said, find himself paying a higher rate than a billionaire. Perhaps the budget turmoil will have a collateral benefit of a better tax policy.

The US economy remains mired in a pattern of slow growth followed by retractions. Some of the traditional drivers of renewed growth, such as housing, continue to be highly depressed. Housing inventory remains very high, prices are still trending down on an annual basis, and transaction volume is well below normal.

Twenty-seven months after the recession, consumer confidence remains extremely low (see accompanying chart). It is difficult to envision a good recovery until these conditions change:

**TODAY'S CONSUMER CONFIDENCE IS EVEN LOWER THAN PREVIOUS CRISES**

**United States: Conference Board Consumer Confidence Index**
(1985 = 100, seasonally adjusted)




*Source: Gluskin Sheff + Associates Inc. (From Breakfast with Dave, David A. Rosenberg, September 28, 2011. If you would like to view the entire report, please go to www.gluskinsheff.com\research.aspx to subscribe.) Used with permission.*

The short summary of the macro picture is generally not very positive. Greater recognition of this has impacted stock prices quite significantly in the quarter. We think the valuations of the companies in the small cap portfolios are attractive, and the business, franchises first rate. Long-term investors should consider buying into prevailing concerns and uncertainty when valuations and strong companies are on your side. History shows good equity returns have accrued to those who have the fortitude to invest in difficult times.

Below we highlight two relatively recent additions to the portfolios:

**Dun & Bradstreet Corp. (DNB)**
(Analyst: Dan Sievers)

**Description:**

Dun & Bradstreet (DNB), founded in 1867, is the global leader in providing commercial credit information and insight on businesses and industries, allowing customers to make more informed decisions when dealing with creditors, debtors, suppliers, distributors, sales leads, and end-users. The scope and coverage of DNB's commercial database is unparalleled with over 200 million global business records, and the value of these records is enhanced by applying the DUNSRight Quality Process, which typically matches, links, and refines record entries, provides indicators of behavior, and organizes records in a searchable format.

**Good Business**:

- DNB controls more than 200 million business records (its largest competitor controls about 45 million), and is the global leader in providing vital commercial credit information to businesses. DNB data and products are well entrenched with important customers (financial institutions and large corporations).
- Data and reports have long been purchased by customers in a recurring manner, but the rapid conversion of customers to the DNBi subscription service has resulted in more predictable recurring revenue.
- DNB has a strong track record of reducing structural fixed cost and headcount (often through minor restructuring) and now generates operating margins between 25%-30%, and an even higher return on invested capital (ROIC).
- The business requires little capital spending and generates impressive excess free cash flow, much of which is used to pay dividends and repurchase shares.
- Recent investments in its database and technology infrastructure have yielded strong new product development initiatives that are likely to elevate DNB's recent tepid growth.

**Valuation**:

- DNB shares are down 43% from the July 2008 peak. The shares trade for 10.8 times 2011 earnings per share (EPS), 7.6 times enterprise value-to-earnings before interest, taxes, depreciation and amortization (EV/EBITDA), 2.2 times EV/Sales, and 11 times price-to-free cash flow (P/FCF), vs. 5-year average comparable multiples of 17, 9.9, 2.6, and 17, respectively.
- DNB is a predictable advantaged business that generates high returns, and has a reasonable balance sheet. A premium multiple is warranted.
- Despite its defensive qualities, DNB will benefit from an increase in general business activity and U.S. loan volume, as a significant portion of revenue (especially among large customers) is transactional and therefore sensitive to somewhat cyclical aspects of corporate spending and borrowing.

**Management**:

- Sara Matthew (54) became the CEO in January 2010, but came to DNB in 2001 as CFO and has also served as COO. Previously, Ms. Matthew held various executive positions at P&G. She holds a number of degrees from India and a U.S. MBA.
- Rich Veldran was promoted to CFO in May 2011 from Chief Strategy Officer. Previously, Mr. Veldran was CFO of North America, Treasurer, and Leader of Global Reengineering. He joined DNB in 2003 from ADP.

**Investment Thesis:**

DNB is a high quality franchise in possession of an immense database of difficult-to-replicate value-added business credit records. The firm's predictable revenue, high margins, high returns, and solid balance sheet argue for premium multiples, though high market penetration among large customers limits the growth rate. Poor economic conditions and commercial loan activity have weighed on the smaller transactional portion of DNB's business. Separately, the 2010 reacquisition of DNB Australia and the $110-$130 million strategic technology investment have weighed on recent cash returns to shareholders. That said, as loan volumes improve and new products like DNB360 and DNB Pro bear fruit with smaller customers, DNB is likely to trade at higher multiples.

## Kennametal (KMT)

(Analyst: Matthew Goetzinger)

**Description:**

Kennametal is a leading global supplier of tooling, engineered components, and advanced materials consumed in production processes. The company operates through two segments, Industrial and Infrastructure. Both segments provides consumable metal-cutting tools and tooling systems to manufacturing companies for use in the mining, construction, and engineered applications. The company markets its products under the Kennametal and WIDIA brand names. In aggregate, KMT controls approximately 18% share of an estimated $13 billion global market.

**Good Business:**

- Kennametal's respected industry position, history of quality and innovation, and global scale all substantiate the durability of the company's market position.
- Tooling represents 3 to 5% of customers' total manufacturing costs, and yields productivity enhancements of approximately 20%.
- Approximately 80% of KMT's revenues are derived from recurring sales of cutting tools. A cutting tool's average useful life ranges from as short as one shift to as long as several days.
- Future capital requirements of the business are low.
- Incremental returns on invested capital should reach the mid-teens over the next two years.
- The company's balance sheet leverage is low (0.2 times net debt/EBITDA).
- The business is easy to understand.

**Valuation:**

- Over 2001-2007, KMT averaged a forward price-to-earnings (P/E) ratio of 16, ranging from 11 to 22. Today the P/E is under 10.
- Using a conservative mid-cycle P/E multiple of 13 results in a fair value estimate that is over 75% higher than today.
- A company characterized by recurring consumables revenue growth in the mid-to-high single digits, generating operating margins in the mid-to-high teens, with a sound balance sheet merits a 1.8 to 2 times revenue multiple. This suggests 75-100% upside.

**Management:**

- Carlos Cardoso joined Kennametal in 2003 as COO, taking over as CEO in 2007. Mr. Cardoso is well respected within the industry, and brings a deep level of manufacturing experience to the company.
- Frank Simpkins is the company's CFO. Mr. Simpkins joined Kennametal in October 1995. He is also a member of the Board of Directors of Kennametal India.
- The company's Board of Directors has a diverse industry perspective.
- Long-term compensation is tied to earnings before interest and tax (EBIT) and return on invested capital (ROIC).

**Investment Thesis:**

Over the past several years, Kennametal has done an admirable job of restructuring its product portfolio, simplifying its business (reducing lower margin stock keeping units (SKUs), selling non-core businesses, combining and closing redundant facilities), investing in new products, and diversifying its business mix across end markets, and geographies. The 2008-2009 downturn accelerated the company's cost reduction actions, resulting in a significantly lower fixed cost structure. There is ample capacity to absorb a resumption in order growth beyond the near term economic concerns.

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.