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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

March 31, 2012

FMI Small Cap portfolios gained approximately 10.3% in the quarter ending March 31. While positive on an absolute basis, they were behind the 12.44% return of the Russell 2000 Index. From a sector standpoint, our exposure in Retail Trade, Technology Services and Health Services lagged the market. So-called high beta stocks were significant drivers of performance in the Russell 2000 this quarter and included a number of stocks that aren't our type of investments, such as Hot Topic (+55.05%), SourceFire (+48.64%), and eResearch Technology (+66.74%). Of course the Monday morning quarterback would say we were idiots for not owning these stocks but investing is a forward looking endeavor and as we look at the picture today, we believe the stocks we have in each of the aforementioned sectors have a superior 3-4 year outlook, taking the quality of the business franchise, downside risk and valuation into account.

Stocks of homebuilders and those leveraged to a housing recovery have also had a sharp bounce off the bottom and we don't have significant exposure to this area. Weather and consumer confidence were more favorable recently, which aided the optics around this business, but we do not think the data supports a sustained improvement in home building or prices in the near term. We do expect existing home turnover to continue to improve. While people can argue about the exact numbers, it would appear that there are somewhere between 11 and 14 million homes that are in foreclosure, delinquent, or "under water" (market value less than mortgage value). Corelogic and Amherst Securities report that there are 11.2 million homes "in jeopardy," including 4.8 million mortgages that are nonperforming with an expected default rate of 95%. There are between two and three million vacant homes, depending on whose figures are used. New home starts are running at approximately 0.5 million. We think the shadow inventory is very significant and will continue to depress new home building and prices for quite some time. Despite the favorable weather, new home sales were down 5.4% in January and 1.6% in February.

On the positive side, sectors that contributed nicely to our performance in the quarter included Energy Minerals, Producer Manufacturing and Utilities. Overall, we feel the portfolio of companies is strong and best suited to perform in a bumpy or trendless stock market. If the recent rally is the start of a growth stock-driven environment characterized by expanding valuations, there is a high probability that we will underperform, just as we did in the March quarter. For years we have monitored The Leuthold Group's 46 different fundamental valuation measures for the stock market. These data series typically go back fifty to eighty years. As of the most recent period measured (12/31/11), the average valuation was in the seventh decile (one being the cheapest, ten being the most expensive). While not "negative" on the stock market, we don't think valuations will be a tailwind given very substantial ongoing macro concerns.

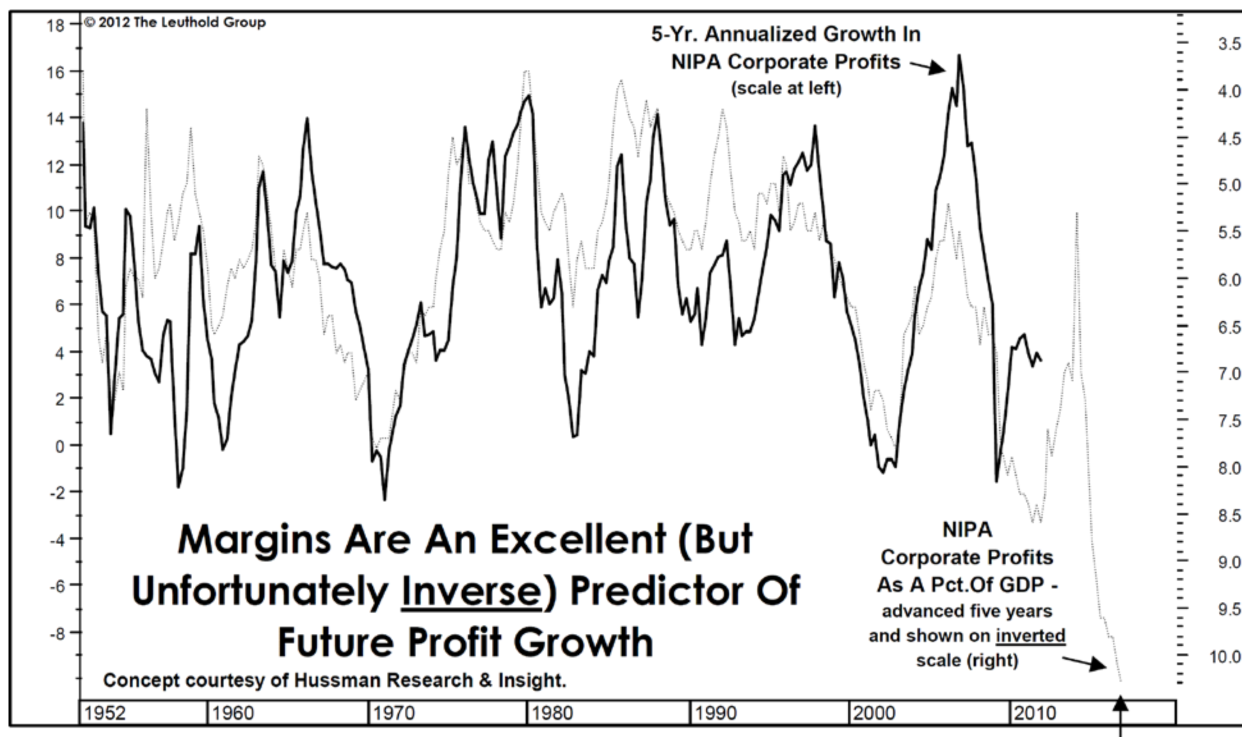
For new investors, the March and September letters include just a brief overview of pertinent investment topics before a couple of specific investment ideas are discussed. The June and December letters are generally longer and usually delve into various macro concepts in more detail.

Investors seem more hopeful that the February employment numbers indicate that the United States is on a healthier economic trajectory. Nonfarm payrolls gained 227,000 in February and finally, both the employment-to-population ratio and labor participation rate inched higher. With over 20 million people unemployed or underemployed, it is a long road back. The labor numbers, however, are notoriously volatile; a year ago we had an almost identical February employment report and then the numbers slipped significantly. One labor commentator indicated that adjusting for this year's balmy winter weather would have resulted in a 90,000 nonfarm gain instead of 227,000 and that if the household survey's figures were replaced by the payroll figures, the unemployment rate would be over 9% rather than 8.3%. Our conversations with businesspeople, with respect to hiring, have turned from uniformly negative over most of last year to more of a mixed bag today. Employment feels like it is getting better, but it is worth noting that wage rates, otherwise known as the price of labor, remain weak.

In spite of the sense that there is a more positive tilt to the employment picture, GDP revisions haven't reflected this over the past six months in the United States. A *Bloomberg News* survey of 63 economists last September averaged 2.2% for estimated 2012 real GDP growth; the March survey had the exact same estimate for 2012. The March 22 report from FedEx, normally a harbinger of near term economic activity, showed a weaker U.S. outlook. Grainger and some other broad-based companies are not seeing a slowdown, however. European and Chinese growth rates, on the other hand, have slowed significantly. Europe may be in a recession right now and China is undoubtedly weakening, although the reliability of their statistics remains very suspect. This fact was revealed recently in a separate *Bloomberg News* story, where the following was stated: "In 2011, the 31 provincial-level governments reported a combined GDP of 51.8 trillion yuan ($8.2 trillion), 4.6 trillion yuan higher than the national figure calculated by the statistics bureau, the state-backed Economic Daily reported in February." Anecdotally, Clarcor, Otis (United Technologies) and a host of other global players are reporting significant declines in their Chinese orders, and real estate prices continue to fall.

The severe debt and budgetary problems across Europe, the United States and Japan have not improved and are likely to continue to weigh on growth. Various programs, such as the European Central Bank's long-term refinancing operation (LTRO), mimic the Fed's monetary actions and have provided a temporary respite from having to actually solve real spending and taxation problems. Greece defaulted, as expected, but what may say more about the future of Greece and perhaps other "peripheral" countries is the fact that the newly issued (post default) Greek debt securities are trading at 29 cents on the dollar. Uncompetitive countries, with structurally high labor rates and high government employment ratios, which are also tied to a high-priced currency, have little chance of establishing a sustainable growth model. The U.S. and Japan continue to pile on debt at a record clip. It is our feeling that the press and the public have grown weary of the debt discussion. Just about the time complacency sets in, we are apt to see something shake us back to reality. The U.S. and Japan are not likely to restructure, and politics are preventing progress towards even balancing budgets, much less reducing debt, so this problem may be with us for a long time.

One of the few economic bright spots over the past several years has been corporate profit margins. As long as they stay near a record high, it makes the valuation argument less negative. Historically, however, profit margins have been quite volatile and unfortunately, have been inversely correlated with future growth. In other words, competitive pressures eventually eat away at high margins, negatively impacting growth, as illustrated in the nearby chart. In a recent article in *The Wall Street Journal*, Brown Brothers reports that corporate profits fell 40 basis points in the December quarter. We'll continue to carefully watch this situation.



Today's profit margins are so inflated that substantially slower profit growth over the next three to five years is almost baked in the cake.

This background discussion illuminates why we see uneven terrain for investors. We don't think the big issues are quite yet in the rear view mirror, although we hasten to add that historically we have made money for our investors through some pretty rough market environments. We approach investing with a 3-5 year time frame, knowing there will be periods when we are either out of favor or lose money. Below we highlight a couple of companies that we like for the long haul.

Innophos Holdings Inc. (IPHS)

(Analyst: Jonathan Bloom)

Description

Innophos Holdings Inc. is one of the world's leading producers of specialty grade phosphates for food, beverage, pharmaceutical, oral care and industrial end markets. The group reports four product lines: specialty ingredients (60% of 2011 sales), food & technical grade purified phosphoric acid (17%), technical grade sodium tripolyphosphate (STPP) & detergent grade acid (11%), and granular triple super phosphate (GTSP) & other (12%), which is a non-core co-product. Innophos' products provide critical functionality, nutritional value, and consumer benefits including enhanced taste, texture and performance. Products include flavor enhancers in beverages, electrolytes in sports drinks, texture modifiers in cheeses, leavening agents in baked goods, calcium and phosphorus sources for nutritional supplements, pharmaceutical excipients, cleaning agents in toothpaste, et al. In 2011, approximately 74% of sales were completed in North America (U.S., Mexico, Canada) with 26% overseas.

Good Business

- Return on invested capital (ROIC) has averaged 16% in 2010-11, with Innophos targeting over 20%.
- There are significant barriers to entry, including a very high cost to establish manufacturing.
- Competition from China is limited. Their technology is more energy intensive and polluting.
- The products are modestly priced and often represent less than 1% of a customer's cost of goods sold.
- With high switching costs customers have little incentive to switch suppliers, which has resulted in a customer retention rate of over 90%.
- Innophos and Israel Chemicals Ltd. (ICL) control ~70% of the U.S. specialty phosphate market, operating in a virtual duopoly.
- Nearly half of the company's sales are sold to food, beverage, pharmaceutical, and oral care end markets, which are defensive in nature. Some industrial uses such as water purification are also defensive.
- Reasonable balance sheet: Debt/Capital: 0.28; interest coverage (earnings before interest and tax [EBIT]/Interest Expense): 23.4.

Valuation

- The price-to-earnings (P/E) ratio (2012E) of 12.8 is undemanding for a quality business with attractive growth prospects. Earnings per share (EPS) is expected to grow in the high single digits (annually) over the medium term.
- An enterprise value-to-sales (EV/S) multiple of 1.5 compares favorably with 2010 and 2011 operating margins of 16%.
- An EV/EBIT of 9.3 times compares with ICL's 2005 acquisition of Astaris (#2 player in U.S.) at 12 times, so the stock trades at a significant discount to private market value.

Management

- Management has deleveraged the balance sheet, improved execution, and focused on value-added higher-margin consumer end markets while phasing out more commoditized products (STPP).
- The long-term incentive plan is based on ROIC and contribution margin (sales less variable costs).
- The company's stock ownership policy requires the CEO to own 5 times base salary, with the CFO and general counsel at 2 times, and other executives at 1 times.

Investment Thesis

With limited sell-side coverage and a steadier business than historic financial statements might imply, Innophos is underappreciated and is priced at a discount to its intrinsic value. It has many characteristics of a quality business, as demonstrated by the company's ability to generate a ROIC well above its cost of capital. The company sells modestly priced products to captive customers, creating a stream of recurring revenue with an implied retention ratio of over 90%. More than half of the company's sales are defensive in nature, which is a valuable attribute during uncertain times. At 12.8 times 2012 EPS estimates with attractive growth prospects, Innophos provides a favorable investment opportunity over a 3-5 year time horizon.

ScanSource, Inc. (SCSC)

(Analyst: Rob Helf)

Description

ScanSource (Greenville, SC) is a leading value-added distributor of specialty technology products in North America, Europe and Latin America. The company's two major segments are Automatic ID/IP Security products and Communication Systems. ScanSource distributes bar code printers, scanning devices, point of

sale terminals, receipt printers, Internet protocol (IP) video cameras and voice over IP (VOIP) communication systems. The company sells over 68,000 products from 220 vendors to 30,000 value-added resellers. Key vendors include: Motorola, Avaya, Zebra, Intermec, Polycom, Honeywell and Cisco.

Good Business

- As a distributor of technology products, ScanSource has a higher degree of predictability and a lower degree of risk than inventors of technology.
- The company has a diversified lineup of vendors, customers and end-markets. No customer is greater than 6% of overall revenues.
- The company has a distinct size advantage over the competition, allowing it favorable procurement costs, greater inventory and technology support.
- ScanSource consistently generates a return-on-capital in the low teens, which is greater than its cost-of-capital. Management compensation is based on return-on-capital.
- Over the past 10 years, sales, EPS and cash flow have grown at 11-14% per annum and we anticipate above average growth rates in the future.
- The balance sheet is modestly levered with a debt-to-total capital ratio under 15%.
- The business requires very little capital to maintain and grow. Growth should come from international markets, a greater reliance on the distribution channel by vendors and new product areas.

Valuation

- ScanSource is valued at 13 times forward EPS estimates and 0.3 times revenues.
- The mean valuation for the company over the past 10 years has been 15 times EPS and 0.4 times sales. The P/E range has been 13-23 over the past 10 years.
- The company trades at 1.6 times book value compared to a ten year average of 2.2.

Management

- Michael Baur, 54, is a co-founder and CEO. He had prior experience at Gates/Arrow. Much of Baur's career has been in technology and specifically value-added distribution.
- Scott Benbenek, 55, has served as President of the company since 2007. He joined SCSC in 1998 from Gates/Arrow.
- Richard Cleys, 60, has been ScanSource's CFO since November 2002. Prior to ScanSource, Mr. Cleys was Controller of Lanier, an office product distributor.

Investment Thesis

ScanSource is a leading, niche distributor in growing technology markets. Many technology companies struggle to earn their cost of capital as they chase short product cycles and face obsolescence. The company gives a relatively low risk pathway to capturing technology growth. The stock trades at an attractive valuation relative to its historic parameters and at a discount to smaller cap companies.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2000 - 12/31/11

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	Three Year Ex-Post Standard Deviation *Benchmark	Total Composite Assets End of Period	Total Firm Assets End of Period	Percentage of Firm Assets %
2001	20.42	19.57	2.49	125	1.88	n/a	n/a	$ 587.2	$ 1,458.2	40.27%
2002	-4.78	-5.46	-20.48	154	1.47	n/a	n/a	$ 649.7	$ 1,731.0	37.53%
2003	27.18	26.22	47.25	167	1.93	n/a	n/a	$ 1,206.9	$ 2,927.0	41.23%
2004	20.92	20.02	18.33	181	1.00	n/a	n/a	$ 1,486.6	$ 3,085.8	48.18%
2005	11.12	10.26	4.55	186	0.69	n/a	n/a	$ 1,605.8	$ 3,174.4	50.59%
2006	18.46	17.56	18.37	147	0.73	n/a	n/a	$ 1,606.8	$ 3,589.4	44.77%
2007	-0.92	-1.72	-1.57	161	0.85	n/a	n/a	$ 1,520.2	$ 3,960.4	38.39%
2008	-21.06	-21.69	-33.79	145	1.16	n/a	n/a	$ 1,212.4	$ 4,062.5	29.84%
2009	35.72	34.56	27.17	165	0.97	n/a	n/a	$ 2,004.6	$ 7,008.9	28.60%
2010	23.45	22.43	26.85	170	0.48	n/a	n/a	$ 2,477.7	$ 9,816.0	25.24%
2011	5.64	4.79	-4.18	179	0.34	21.17%	24.99%	$ 2,523.2	$ 12,273.6	20.56%

*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 - 12/31/2011. 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 - 12/31/2011. 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 $12.2 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. As of 12/31/2011, the trailing three year annualized ex-post standard deviation for the Composite and Benchmark are required to be stated per GIPS®.

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.