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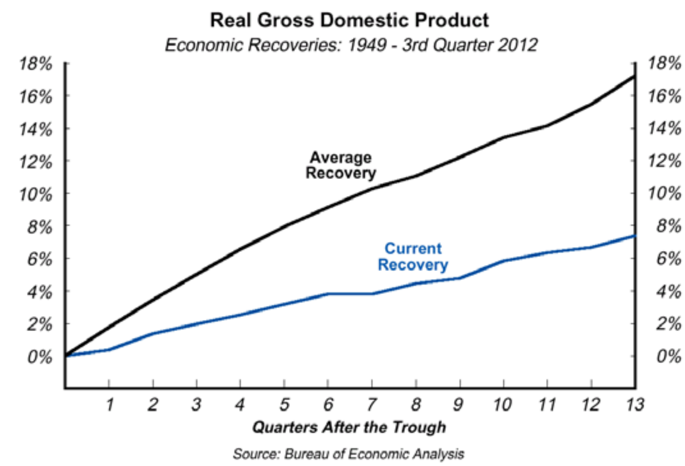
INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

December 31, 2012

FMI Small Cap portfolios gained approximately 4.5% in the quarter ended December 31 and 11.3% for the calendar year. The Russell 2000 gained 1.85% and 16.35% for the corresponding periods. Groups that contributed to the quarterly return included Health Technology, Health Services and Producer Manufacturing. Sectors that hurt performance included Industrial Services, Process Industries and Electronic Technology. Covance, Arrow and Ryder Systems all aided the quarterly performance while McDermott, AptarGroup and Harte Hanks dragged down the numbers. Harte Hanks has been sold from the portfolio due to a fundamental change in our assessment of its future earning power. The calendar year performance, while not surprising in that we typically lag in strong up markets, was nevertheless frustrating. The market's results had a big assist from REITs and aggressive biotechnology names, two groups in which we did not find value twelve months ago, and certainly do not today. The 95 REITs in the Russell 2000 increased 27.8% in 2012. Of the 98 companies in the benchmark biotech industry segment, 80 are losing money and this group gained 35.2%! In fact, for the benchmark Russell 2000 as a whole, there were 545 companies that lost money in 2012 and those stocks were up 14.4%. But the frustration went beyond this, as we came to grips with some long-term holdings whose fundamentals just no longer look appetizing over a three- to five-year investment time horizon. We are not yet finding attractive new ideas to take the place of these stocks. Valuations are extended in the small cap space. The extra cash is hurting near-term performance but having it gives us the ability to pounce when good values do surface, which can happen quickly in the small cap world.

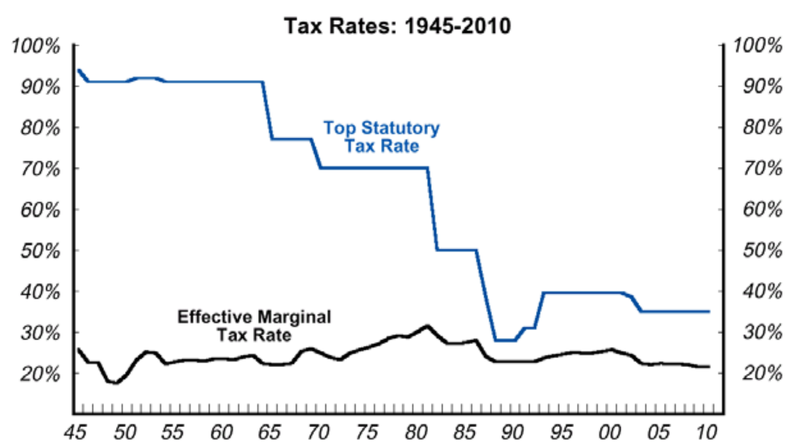


The U.S. economy really never got going after the financial meltdown in 2008-2009. Typically, following a recession, real GDP growth is two times higher than it is today.

As this letter is being written in December, it feels like the economy is rolling over. Orders for capital equipment have been weak in recent months and backlogs are falling. Corporate revenue growth has lost what little momentum it had and overall is now running near zero.

Darden, Yum! and Wendy's recently reported negative same store sales, as did Kohl's, Nordstrom and Macy's in the retail space. Apple and Amazon, however, continue to buck this trend but even with their spectacular performance (in Amazon's case, the revenues are great but the profits are almost nonexistent) the overall tone is subdued. Consumer confidence, recently at 65.1, is close to the trough typically seen in recessions rather than what would normally be seen two and half years after the bottom. Unemployment remains stubbornly high. The unemployment rate has fallen slightly, but that is largely due to the denominator in the equation shrinking (350,000 fewer workers in November alone). Labor participation rates continue to fall. This statistic is much more meaningful as it measures how much of the population who is able to work is actually working. Astonishingly, at the *trough* of the last recession in June of 2009, this figure was 65.7% compared to the recent figure of 63.6%. According to the labor department, in the last year alone the number of working age non-workers grew to 89.2 million from 86.8 million. It appears we're going in the wrong direction.

Government budgetary woes continue, despite various agreements and future promises. The government is borrowing over 40% of what it is spending and continues to avoid dealing with the major entitlement programs and defense. U.S. government spending is now 24% of GDP compared to a long-term average of under 20%. There is almost no precedent for the U.S. to collect more than 20% of GDP in taxes, regardless of the highest prevailing marginal tax rate. Blaming the budget woes on the "rich" insults the intelligence of anyone who has a computer and can look at the public tax data. We applaud those who espouse getting rid of all deductions, the carried interest rules and other vehicles that allow some truly rich people to have a low tax rate. In exchange for this we need a broader, flatter tax. The so-called "Buffett Rule" would raise approximately $8 billion according to the Joint Committee on Taxation and the Brookings Tax Policy Center. We're all for it, but it is small change compared to an annual deficit of $1.3 trillion. With the top 3.5% of the population paying 50% of income taxes, it is difficult to say the tax schedule isn't progressive enough. The nearby chart shows the highest statutory tax rates over the past 65 years juxtaposed with the average marginal tax rate paid.



Sources: Internal Revenue Service; Bureau of Economic Analysis; National Bureau of Economic Research; Robert J. Barro and Chaipat Sahasakul, Measuring the Average Marginal Tax Rate from the Individual Income Tax, Journal of Business, 1983, Vol. 56, No.4

In the 1950's, '60s and '70s, there were not only far more ways to avoid paying high marginal taxes through various real estate and investment schemes, there were also simply far fewer people in those high tax brackets. We don't know the magic number for what the "rich" should pay or even who the rich actually are, but it's clear to us that trying to solve the spending problem by raising taxes will require treating people who earn more than $100,000 per year as "rich." Tax rates (combined federal and state) that exceed 45% appear to be the upper limit of what people will pay. Other countries with rates higher than 50% seem to struggle with barter, black markets and noncompliance. Besides that, governments everywhere have not proven themselves to be good allocators of capital. One thing we know for sure: the threat of higher taxes, the reality of expensive new regulations and the fear that comes from government spending run amok has the everyday entrepreneur and the professional business manager in a state of caution and inaction. We have already seen companies downsize and move employees to part-time status in an attempt to game the rules of Obamacare. In short, our fiscal nightmare continues and it isn't helping domestic economic growth, employment or business creation.

American companies need healthy trading partners to drive exports and to sell overseas, but Europe doesn't look like it's going to be of much help on either of these fronts in the near-term. In fact, most of Europe, including Germany, seems to be in recession. Nearly all of the companies we monitor are reporting increasingly difficult European business conditions. We see large European companies expanding their operations in many places but rarely in Europe. That speaks volumes about their assessment of the situation. In the ongoing Euro debt saga, the gap between where spending is and where budgets need to be is as wide as ever; a weakening economic trajectory makes a return to fiscal health that much harder. The terms of the late November Greek rescue plan seem implausible. Even Wolfgang Schäuble, the German Finance Minister, admitted in an interview that it might not be enough to stave off insolvency. Greek debt is over 170% of GDP and, as is the case with all of the EU bailout blueprints, assumes Greece will somehow grow their way out of their problem.

Another important geography for U.S. multinationals and exporters is Asia. Here, driven mostly by China, growth has slowed significantly. China's well-documented slowdown has affected a great number of global companies, including Joy Global, Caterpillar, and United Technologies. Mining, steel, construction and heavy machinery have been hit particularly hard as the massive infrastructure spending over the past several years has slowed. Cracks are beginning to show in China's shadow banking system and this is reflected in falling real estate prices for most of 2012. Corruption and corporate espionage remain rampant. China recently implemented more government stimulus, which seems to have given infrastructure spending a boost in November, but the size of the current stimulus program is nowhere near the scale of the prior one. Japan continues to be the truly sick man of Asia. Debt is over 220% of GDP and their politicians have been as ineffectual as ours in dealing with the budget and debt situations. Economic growth has been poor for decades and the near-term outlook appears to be especially soft.

To reiterate a statement we've made in recent letters, the macro picture is just about as difficult as we've ever experienced. That said, it's important to take inventory of the positives and entertain outcomes that may seem remote but perhaps are not. Recently we came across an appropriate quote from George Washington in a 1777 letter to his generals: "We should never despair, our situation before has been unpromising and has changed for the better, so I trust, it will again. If new difficulties arise, we must only put forth new exertions and proportion our efforts to the exigency of the times."

One of the most positive developments of the past few years is the growth and development of the domestic oil (particularly shale) industry. To put this in perspective, 60.3% of our oil needs were imported in 2005 versus 45% in 2011. A U.S. government contracted study estimated that worldwide there was 6.6 quadrillion cubic feet of natural gas (not including Russia or the Middle East), which is a 50-year supply. Domestic reserves are 862 billion cubic feet. Energy self-sufficiency is not a pipe dream. The U.S. is a leader in shale technology and the reinvigoration of the energy industry provides a big boost to jobs and the economy. To wit, North Dakota, home to the Bakken Shale Formation, is growing rapidly and has a 3% unemployment rate. Texas (Permian Basin and others) has much better than average growth and a 6.6% unemployment rate. Pennsylvania is also benefitting dramatically from the Marcellus Shale Formation. Natural gas remains a great stepping stone technology as we move beyond coal and oil to greener technologies. Chemicals, plastics and numerous other industries that use natural gas as a feedstock are now competitive with the Middle East and the supplies are secure. The price of natural gas on the worldwide market is approximately three times the North American price. If we can overcome the political hurdles, the U.S. could be a major exporter of liquefied natural gas. Ultimately the natural gas boom could even benefit the transportation industry. Already some large fleets, including Waste Management, are moving exclusively to natural gas powered trucks. Perhaps most importantly, it has the potential to substantially change the political equation of the Middle East. Having spent hundreds of billions of dollars fighting for our “interests” in the Middle East over the past decade, the potential positive geopolitical and financial implications from being energy independent are enormous.

New education models and the greater use of technology have the potential to jumpstart innovation and propel economic growth. Start-ups such as Codeacademy, where more than one million people have signed up for a free coding class on-line, and Khan Academy, which boasts 3,500 educational videos and 217 million views on YouTube, may portend a radical shift in education in which students learn at their own pace from world-class instructors. Similarly, *The Economist* recently told the story of eLimu, a start-up that provides tablets to African students. After the introduction of eLimu’s tablets, science grades increased from 58 to 73 in one term at a Kenyan school. In higher education, world class universities such as Stanford, Yale, Oxford, and Harvard offer free on-line classes to students across the world. The impressive desire to learn and the parental dedication further demonstrate the vast potential that we have as a global society. In Kenya, eight out of ten parents pay for tuition for courses outside of normal school work. In the U.S., motivated parents helped propel charter schools, which introduce competition and tend to increase educational attainment, from 0% of the educational system in 1992 to almost 5% today.

Similarly, technological advancement continues to hold great hope for our societies and others across the globe. 75% of the world’s population owns a mobile phone, according to a World Bank study, and the relentless march of Moore’s Law continues to give the world more powerful technology at cheaper prices. Paul Taylor of the *Financial Times* writes that “two decades ago, it took a machine the size of a refrigerator weighing 500 pounds to store a single gigabyte of data,” but today we carry 32GB smartphones in our pockets. Modern toasters have more sophisticated operating systems than the Apollo 11 spacecraft and the iPad 2 would have rivaled the world’s fastest supercomputer in 1985. This computing power will continue to revolutionize industries. IBM’s recently released Sequoia supercomputer performs 16,000 trillion calculations per second, which the senior vice president of IBM’s Systems & Technology division claims could reduce the simulation time for the heart’s reaction to new medicine from two years to two days and provide earthquake predictions that are 40 times more accurate. Other advancements, such as handheld diagnostic systems that improve access to health care, precision farming equipment that allows tractors to more accurately fertilize crops, and smart tags that instantly change prices at physical retail stores convincingly demonstrate the world’s innovative capacity.

Another positive is that a couple of important end consumer markets have been rebounding: housing and automobiles. In the case of the former, prices across the Case Schiller 20 metro areas rose 2% year over year in August and 3% in September. New home building has moved sharply off the bottom to approximately 894,000 units (including multifamily), even though it is still well below the 1.3 million units many housing experts believe is normal. Household formation has picked up significantly in the past twelve months, to 1.15 million compared to 650,000 in the prior four years. While encouraging, it’s hard to imagine that the housing recovery can continue without a bona fide improvement in employment. It appears in many markets that investors, rather than actual house dwellers, are buying up the properties in advance of a better economy and higher employment. Depending on whose figures are used, there are still 3-4 million empty or soon-to-be foreclosed homes in the inventory pipeline. Nevertheless, a modest recovery, however short-lived, is better than nothing. Automobile sales have returned to a reasonable level of approximately 14 million units. There is much more of an economic necessity in the car equation as one generally needs a car to get to work so we do not anticipate much of a backslide in automobile sales relative to housing. Additionally, the average age of cars and light trucks has increased to 10.8 years and has gone up substantially in recent years. Increased automobile quality accounts for a fraction of the gain, but there is likely remaining pent up demand.

Average Age of Passenger Cars and Light Trucks

Year	Passenger Cars	Light Trucks	Total Light Vehicles
1995	8.4	8.3	**8.4**
1996	8.5	8.3	**8.5**
1997	8.7	8.5	**8.6**
1998	8.9	8.5	**8.8**
1999	9.1	8.5	**8.8**
2000	9.1	8.4	**8.9**
2001	9.3	8.4	**8.9**
2002	9.4	8.4	**9.0**
2003	9.6	8.5	**9.1**
2004	9.8	8.6	**9.4**
2005	10.1	8.7	**9.5**
2006	10.3	8.9	**9.7**
2007	10.4	9.0	**9.8**
2008	10.6	9.3	**10.0**
2009	10.8	9.8	**10.3**
2010	11.0	10.1	**10.6**
2011	11.1	10.4	**10.8**

Source: Polk

Note: figures are from July 1 each year

We've occasionally lamented the very poor demographic profile of the developed world. Even in the U.S., the recent 1.9 fertility rate has slipped below the replacement figure of 2.1 births per woman of childbearing age. Most of Western European countries are below 1.5 and Japan and China clock in at 1.4 and 1.6, respectively. Even with increasing technology and productivity, it's more difficult to grow your economy when the population is shrinking. Moreover, due to the fact that the most rapidly growing countries (Niger 7.5, Uganda 6.6, Mali 6.3, Somalia 6.3, etc.) are largely poor and uneducated, there are grave concerns that we're headed for an economic and political catastrophe. In a recent *Financial Analyst Journal* article, Laurence Siegel reminds us that there is a consistent, well-established trend toward lower birth rates as countries industrialize and modernize. While the world population recently went over 7 billion from 6 billion just 13 years ago, the growth rate has already slowed substantially. He believes the data points to a peak world population of 10-11 billion by the end of this century. As population growth slows and industrialization picks up, people become richer and greener. When everyday existence is driven by securing food, there is simply no time or effort spent on environmental problems or education. We are already seeing technological advancements helping to speed up this demographic transition. This is an unequivocal positive for everyone, including the United States.

It is also possible that our political leaders will tackle social security, Medicare, Medicaid and defense. Everyone knows that social security was conceived in an era when life expectancy was roughly 62. Benefits were set to kick in at age 65. There were 33 workers for every beneficiary. Today, life expectancy is 79 and there are just 3 workers (soon to be 2) for every beneficiary. Politicians have to overcome the 45 million strong voting bloc that is the AARP and other groups that seem to thwart a sensible approach to this subject. The nonpartisan Simpson Bowles Commission (SBC) recommended a policy of gradually raising the retirement age over the next 20 years, along with an increase in social security taxes. We would also strengthen the conditions that have led to an explosion in the number of people on social security disability. The SBC recommended significant cuts to the $740 billion U.S. defense budget. Almost all deductions would be eliminated. Additionally, capital gains and dividends would be taxed at ordinary rates and we would go to three tax rates: 12%, 20% and 27%. We think such a plan would result in explosive economic growth and job creation. Medicare economics are terrible today but are fixable if our leaders begin to make common sense decisions about what care is really vital (and paid for) and what is not. Extraordinary end-of-life spending comes to mind. It is also possible that Obamacare will not be as costly as is widely believed. If indeed many employers get out of the health care business, making individuals more responsible for their own care, health care spending rates could potentially fall. It is not hard to imagine a scenario where employers will give employees what they were formerly paying in health care premiums minus the government fine. These employees will then individually buy health insurance on the exchanges. It is probable that most of these people will select high deductible policies. To the extent they will be paying out-of-pocket up to the deductible limit, the incentive to shop, change behavior, and ration could result in lower health care spending, at least for this sub-segment of the population. Of course, if the exchanges lose money, the Federal Government would have to fill the breach and the U.S. would be at least 75% of the way toward a single payer (government) health care model.

While the absence of a catastrophe is hardly a positive, we also have to note that one year ago we thought there was a very high probability that the European Monetary Union would disintegrate. We believed that most large European banks would have to restructure. That hasn't happened. We still think that most of these banks are insolvent, if their investments were properly marked-to-market, but most have avoided restructuring to this point. The EU budgetary discussions were a farce and there is still no good framework in place to reach anything approaching a sustainable union, either politically or monetarily. Nevertheless, the delay-and-extend approach by EU policymakers has worked so far. That seems to be the same path that the U.S. is on as well. On the monetary front, Bernanke's admittedly experimental interest rate policies may have had a role in keeping us out of a recession, so one could call this a positive. Saving fat cat bankers and giving borrowers and speculators a free lunch isn't a particularly cheery development and eventually we will likely have to deal with the long-term consequences of an unprecedented easy money policy, but for now the wolf is at bay.

Regarding our investments and outlook for 2013, the summary is that it is more of the same. The Bernanke rally has kept the market trading higher, even while fundamentals appear to be darkening. Of course, there is a chance we are reading the tea leaves incorrectly. A mid-December purchasing managers survey showed expectations for a pick-up in growth in 2013 versus 2012 (4.6% higher). We hope these expectations come to fruition but we are not staking the portfolio on such an outcome. It remains fairly balanced with a mixture of cheap cyclicals and more defensive businesses. Overall, it is still tilted toward the cautious side. This has led to underperformance recently, as growth stocks and "risk on" trades outpace value stocks.

The extensive stock market valuation work that we do every quarter again shows stocks to be well above their long-term averages. The average of the 48 valuation metrics we study put the market in the 7th decile (the 1st being the cheapest and 10th being the most expensive). Valuations for the market have been elevated for almost three years. Our stocks continue to sell at a significant discount to the benchmark on nearly all valuation measures. We do not see great opportunities in some of the assets that have been hot the past several years: gold, bonds, farmland, timber and REITs. Owning high quality equities of well financed and durable business franchises seems like the prudent approach, and that is the one we are taking.

Thank you for your continued support of Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2001 - 09/30/2012

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 ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
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%
Q1 2012	10.40	10.20	12.44	180	0.18	18.53%	22.27%	$ 2,779.0	$ 14,145.3	19.65%
Q2 2012	-4.88	-5.08	-3.47	180	0.11	16.94%	21.57%	$ 2,583.9	$ 14,510.6	17.81%
Q3 2012	1.41	1.20	5.25	184	0.11	15.70%	20.99%	$ 2,603.5	$ 15,122.8	17.22%

*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 - 09/30/2012. 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 - 09/30/2012. 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 $15.1 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 equal weighted 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.