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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

June 30, 2014

The FMI Small Cap portfolios gained approximately 5.3% in the quarter compared to the 2.05% total return of the benchmark Russell 2000 Index. Sectors aiding performance in the period included Finance, Commercial Services and Technology Services. Distribution Services, Electronic Technology, Health Services and cash detracted from results in the June quarter. Protective Life, Dun & Bradstreet and Broadridge Financial Solutions were noteworthy positive contributors, while Patterson Companies, FLIR Systems and Hanger lagged. We sold our positions in long-time holdings Arthur J. Gallagher, Protective Life, and Family Dollar. Protective Life was sold after the announcement Dia-ichi Life was acquiring them. A.J. Gallagher and Family Dollar were sold because we could no longer justify the valuations. Lastly, World Fuel Services was sold due to a growing lack of confidence in management's strategy. We also initiated a few small positions in the quarter, including Progress Software, Hanger, Interpublic Group, UniFirst, and Dresser-Rand. We will have more to say about these companies in future letters. Generally speaking, we are pleased with how we've performed over the last five-plus years of nearly uninterrupted stock market gains. Markets that go essentially straight up for this long are highly unusual from a historical perspective and we do not expect it to continue, although we can't possibly say when it will end.

We learn from history that we learn nothing from history.

– George Bernard Shaw

Don't be afraid of being scared. To be afraid is a sign of common sense.
Only complete idiots are not afraid of anything.

– Carlos Ruiz Zafón

Days, weeks, months, quarters and years… each period we continue to see central bankers ply the same trade… an endless monetary experiment involving complete guesswork. The results sputter and their response is, "We need to do more." It fails again, and again, and again, and still the reaction is, "It's not enough." While it is clear that the maestros care little for their experiments' short-term implications, which include ravaging the income of risk-averse savers ($100 billion per year for the past five years in lost bank deposit income, according to *Moneyrates.com*), it is also apparent that they do not care about, or fail to recognize, the long-term ramifications of manipulating money rates. This gross misallocation of resources has already caused or at least contributed greatly to two and perhaps three bubbles, if one includes the current period. Today, most Wall Street and private equity players cheer the stimuli. Forget about investing in the business. Why not lever up to buy one's stock? It's accretive to EPS (earnings per share). Investors love it and management, whose compensation is often tied to EPS growth, makes a fortune. Corporations can avert investors' eyes from their meager internal growth rates by doing deals. Each quarter the deals get larger and more fanciful. We met with Tyson's management in August of 2012 and they expressed no interest in Hillshire at 7 times EBITDA[1] because it was "too expensive" and yet recently agreed to pay over 16 times! Today's private equity shops can do practically any deal in a world of ground-hugging interest rates. Forget about buying a cheap, undermanaged company and improving it. Artificially low rates have fueled private equity deals at

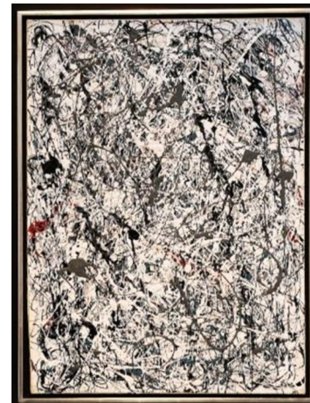
[1] Earnings Before Interest, Taxes, Depreciation and Amortization.

unheard of EV/EBITDA[2] multiples. Many then load the acquired companies with even more debt post-acquisition in order to pay themselves a "dividend," leaving some of these businesses in precarious financial shape. The longer this goes on, the more emboldened the participants become. Fear is for wimps and history is for textbooks.

Over the past few years we have discussed why central bank stimulus has not resulted in acceptable economic growth. Patrick Barron, writing recently for the *Mises Daily*, and reprinted in *The Wall Street Journal*, made this argument more eloquently than we have. He makes the point that central bankers are following Keynesian dogma—attempting to increase aggregate demand through monetary stimulus which will supposedly increase employment and production. Mr. Barron reminds us of Say's Law, also known as the Law of Markets, which states that money is the conduit for facilitating the exchange of goods and services of real value. Thus, he points out, the farmer does not buy his car with dollars but with corn, wheat, beef, etc. The baker buys shoes with his bread and so forth. They could not purchase these items without producing something others valued. Barron states:

> *The value placed on the farmer's agricultural products and baker's bread is determined by the market. If the farmer's crops failed or the baker's bread failed to rise, they would not be able to consume because they had nothing that others valued with which to obtain money first. But Keynes tried to prove that production followed demand and not the other way around. He famously stated that governments should pay people to dig holes and fill them back up in order to put money into the hands of the unemployed, who then would spend it and stimulate production. But notice that the hole diggers did not produce a good or service that was demanded by the market. Keynesian aggregate demand theory is nothing more than a justification for counterfeiting.*

Central bank credit expansion is the best example of the Keynesian disregard for the inevitable consequences of violating Say's Law. Money certificates are cheap to produce… so, receivers of money get something for nothing. The consequence of this violation of Say's Law is capital malinvestment, the opposite of the central bank's goal of economic stimulus.

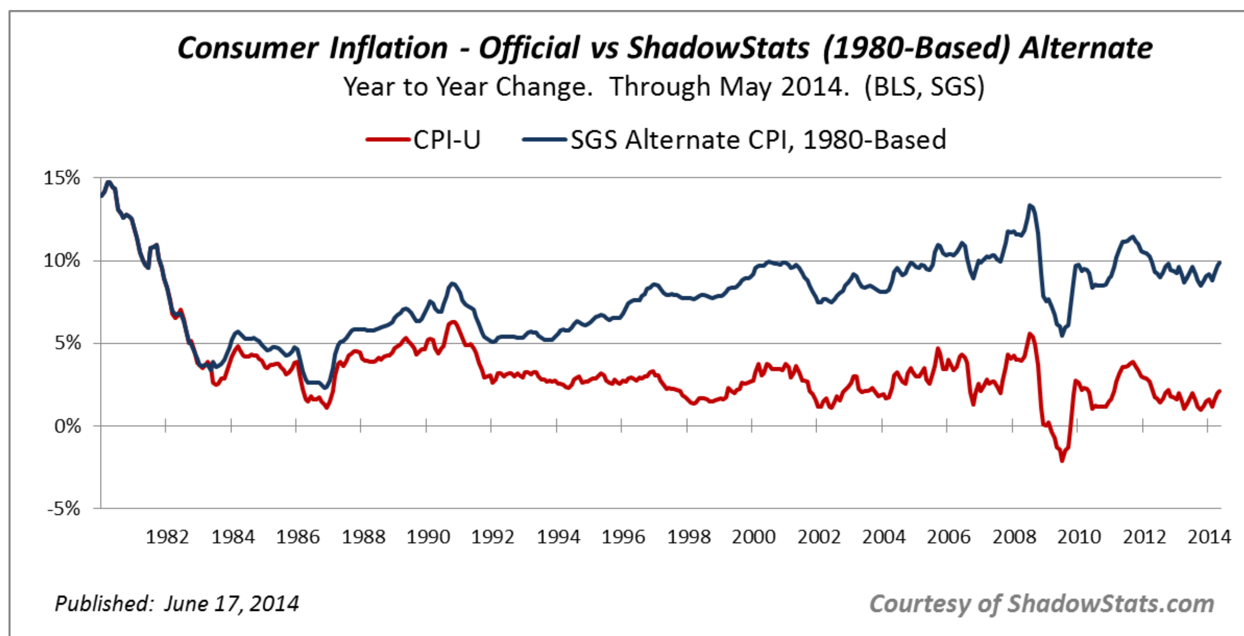


Barron goes on to describe how capital is destroyed by this malinvestment. Think of the aftermath of the tech and real estate bubbles. Phony market conditions induce economic agents to do the wrong things. Today we have the precursor to the same eventualities taking place in biotechnology, social media, Chinese real estate, private equity and contemporary art, to name just a few. In normal times what would easily be seen as uneconomic becomes acceptable. The longer these bubbles last, the more unwise the projects and deals get. It's only in the fullness of time that the truly uneconomic mergers and acquisitions, real estate projects, or biotech companies unravel and the damage is left on bank balance sheets, brokerage statements and art auctions. Given the hugely negative cash burn of the vast majority of biotechnology companies, how long would they last if equity markets became fearful? How much would the nearby painting sell for if art markets were normal? Probably not $58 million!

Another interesting aspect of the central banker's narrative is how they view inflation. Across the board it is virtually the same: non-existent. In fact, Mario Draghi, the head of the European Central Bank, recently lowered a key interest rate to below zero to stave off deflation, or so went his argument. Where is this deflation? Prices are inflating at a 0.7% rate in Europe. In the US, Yellen and company want more inflation. How much more? When the stated CPI (Consumer Price Index) was 1% they said 2% would be ideal. Now that it is 2.1% what will be the acceptable level? And while we're on the subject, who really believes true inflation is only 2%? Groceries, gasoline, tuition, health care, taxi-cabs, cable bills, theme park tickets, concerts, rent… these items are certainly inflating at a rate faster than 2%. Putting aside the inflation in stocks, real estate, bonds, oil, art, etcetera, real world experience, as well as knowledge of how the CPI construction methodology has changed over the years, convinces us that prices

[2] Enterprise Value divided by EBITDA.

are rising much faster than the official figures. In the 1980s, hedonic quality adjustments began to be applied to items in the CPI basket. Rather than measuring true out-of-pocket expenditures for a computer, for example, the Bureau of Labor Statistics, the government agency in charge of calculating the CPI, adjusted the price for "quality." Simplistically, if a laptop was 25% more powerful and cost the same out-of-pocket, the CPI figure for laptops would show a 25% decline. These hedonic adjustments take place across a wide variety of goods. Of course, the geniuses at the Bureau of Labor Statistics don't consider the fact that products have been improving in quality since the dawn of modern mankind 50,000 years ago. Additionally, beginning in the 1990s, the government gradually began using a substitution-based model in calculating CPI. If steak inflated faster than chicken, for example, chicken was substituted in the calculation. This brought a whole new opportunity to game true inflation. You have seen us cite the work of John Williams' Shadow Government Statistics in previous letters *(www.shadowstats.com)*. John's group has gone back to 1980 and calculated CPI using the same formula that existed at that time, and brought it forward to today. The following chart shows this data. Intelligent people can argue about what rate at which prices are truly inflating, but it certainly is not 2%.



While the role of the central bank remains the dominant feature on the investment and economic landscape, there are a few other notable elements that warrant comment, although these things remain essentially the same as we have described over the past few years. Real investment, i.e. capital investment used to start and grow a business, remains soft but has nascent signs of improvement. Employment levels are also improving slightly but remain disappointing both in the rate of recovery and in the nature of the jobs being created (lower paying). Overall employment has recently been touted for regaining the level of seven years ago. What isn't mentioned is that the population has grown; there are 15 million more people of working age that are not working, thus, the labor participation rate is near a 35-year low. The true unemployment/underemployment rates are multiples of the much cited 6.1% unemployment figure. Government (tax payer) dependency is at an all-time high. The GDP (Gross Domestic Product) growth rate has been up and down (and even negative in the first quarter of 2014), but overall has been running at less than half of its long-term average. If the aforementioned adjustments to the official CPI calculation are even half correct, inflation is running significantly higher than GDP growth, implying falling real incomes. Policies that would promote long-term investment and sustainable organic growth are absent.

Financial engineering, however, is at record levels. The value of global mergers and acquisitions hit $1.75 trillion in the first half of the year, up 75% from the same period last year. Mergers and acquisitions activity is frenetic and deal valuations are higher than we have ever seen. Medtronic announced they are buying Covidien in a $46 billion

transaction at 17 times EBITDA. Valeant is going after Allergan in a $54 billion deal at 26 times EBITDA. Suntory is buying Jim Beam at 20.1 times EBITDA. Actavis bought Forest Labs for roughly 5.8 times sales in a $21 billion deal. Dozens of sizeable private equity transactions have taken place this year at over 10 times EBITDA. Over most of the past 40 years, 5-6 times EBITDA would be considered typical. High valuations have induced some companies to use stock rather than cheap credit. Facebook paid $18 billion for WhatsApp, a company with just a few hundred million in revenue. Regarding stock repurchases, $159 billion worth of stock was repurchased in the first quarter in the Standard & Poor's 500 Index, up 59% year-over-year. In the last twelve months, these companies repurchased $534.9 billion of stock, up 29% from the prior period. It's hard not to be cynical about the timing (paying premium valuations with other people's money) of these repurchases compared to five years ago when stocks were cheap. Public stock valuations remain highly elevated from a long-term historical perspective.

The current bull market recently surpassed 63 months, the third longest of the 16 bull markets since 1929, and 20 months longer than the median prior to this cycle. The S&P 500's price gain in this cycle (since March 9, 2009) of 190% is 129% greater than the 83.1% median return of prior bull markets. The party continues and we're trying to smile and pretend we are having fun. We don't even comment any more when the talking heads expound on the merits of owning a Facebook or a *Salesforce.com* at nosebleed multiples. It's better to keep silent than to rain on their parade. The longer cycles last, the more confident the cycle's beneficiaries become and the more one sees new investment theories and spreadsheet gymnastics to justify current valuations. We are not going to fall into that trap. Our team continues to work very hard to find good businesses at reasonable valuations (cheap valuations are a pipe dream for now). The portfolio, as you might imagine, is structured relatively defensively and cash levels are elevated. We are maintaining a bullpen of terrific businesses that we would love to own at the right price. How will we know when that is? Our best gauge is when valuations become more reasonable, complacency and smugness disappears, and investors become more afraid.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2003 - 03/31/2014

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation		Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
						Composite	*Benchmark			
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%
2012	11.34	10.43	16.35	182	0.40	15.46%	20.20%	$ 2,609.5	$ 15,253.5	17.11%
2013	33.43	32.33	38.82	180	1.04	12.51%	16.45%	$ 2,801.8	$ 19,705.3	14.22%
Q1 2014	2.21	1.99	1.12	180	0.16	12.85%	16.55%	$ 2,900.3	$ 19,764.3	14.67%

*Benchmark: Russell 2000 Index®

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 - 03/31/2014. 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 -03/31/2014. The verification and performance examination reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

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 $19.7 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.