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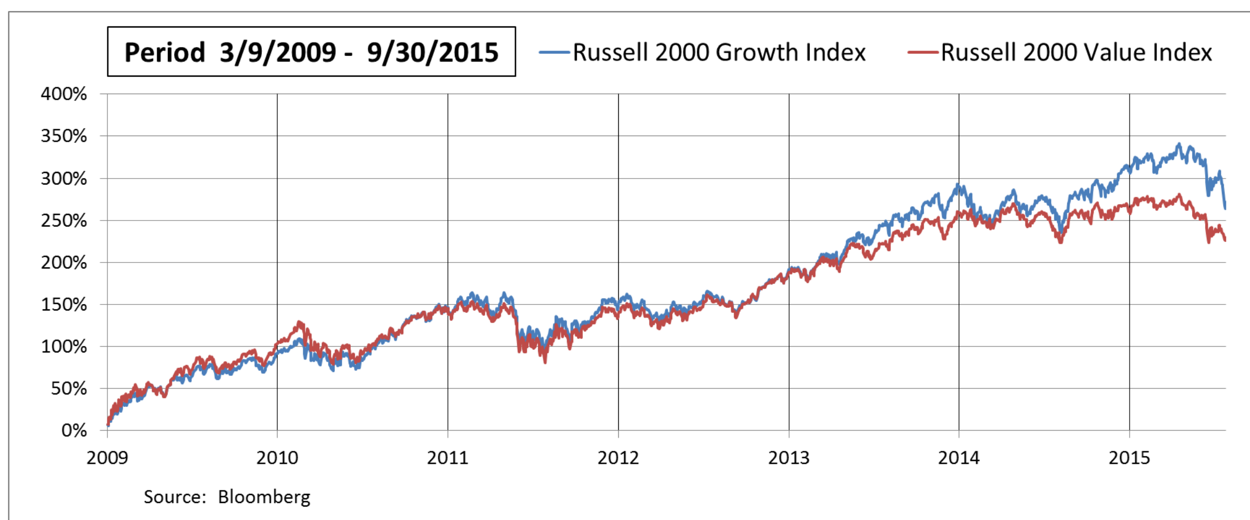
INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2015

The FMI Small Cap portfolios declined approximately 8.2% in the September quarter compared to a drop of 11.92% for the Russell 2000 Index. Sectors that outperformed included Commercial Services and Consumer Durables, while sectors that underperformed included Producer Manufacturing and Finance. Genpact Ltd. and NVR Inc. were relatively strong in the September quarter, while Woodward and Cullen/Frost meaningfully declined.

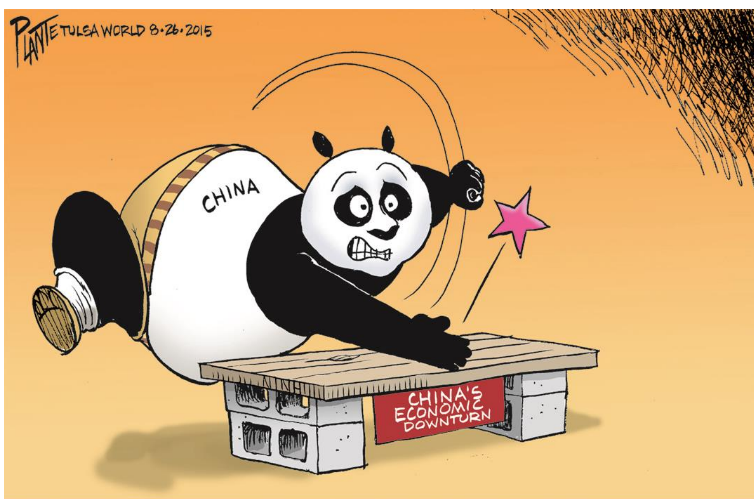
Worries about global growth, particularly in emerging markets, have dampened demand for most commodities and industrial machinery. Nearly all commodity-oriented stocks have been hit, with energy- and agriculture-related stocks both suffering significant losses. Many industrial stocks have also buckled as global GDP has slowed. The first market pullback, which began in late May and ended in late August for most stocks, was the third 10% correction the market has seen since March of 2009. It is interesting that some of the most speculative sectors like Health Care and Biotechnology, which have been huge winners over the past several years, declined less than the market during this downturn. A quick recovery of about half the decline seemed to put the market back into the same pattern of the past several years. There is an old stock market bromide that says, “In a real bear market they get them all.” We think Biotechnology is a good bellwether group for this market; unless and until this group gets its comeuppance, we probably haven’t broken the pattern. Biotechnology stocks did come under significant selling pressure when the market had a second rough spell beginning September 17 and continuing until the last day of the quarter. The action in Biotechnology and other highly speculative groups will be closely monitored for signs that the fever has finally broken. The relative cheapness of our stocks has yet to pay significant dividends in this cycle. The market has not been focused on valuations, and continues to favor so-called growth and momentum stocks relative to value-oriented equities. Below is a chart of the Russell 2000 Growth Index compared to the Russell 2000 Value Index since the bottom of the last bear market.



As we pointed out in a previous letter, over very long periods of time value has historically beaten growth by a significant margin, but it is obviously very cyclical and growth has been relatively strong for quite some time. We anticipate this dynamic to change but cannot predict the timing.

Poor fundamental and anecdotal data coming out of China, Brazil and Japan, including expected negative gross domestic product (GDP) in the latter two countries; an energy-wounded and increasingly belligerent Russia; an escalating Middle-East crisis creating approximately four million refugees; and a United States economy that quarterly bobs back and forth between poor and moderate growth, haven't delivered a nasty market in six and a half years, despite high valuations (the Leuthold statistics of roughly 50 different valuation measures that we cite frequently was in the ninth decile at the start of the September quarter). The Fed recently lapped the ninth year since rates have been raised and nearly seven years of essentially zero percent Fed Funds rates, continuing what we believe is a dangerous and destructive policy that misallocates investment and engenders low, rather than high growth. As long as the Fed sees the world through a single prism – that low growth, seemingly slack labor conditions and low investment means interest rates need to be suppressed — no one will know what normal policies could achieve.

Since China concerns seemed to be at the root of the recent market correction, it is important to both remind ourselves just how extended China has become, but also that these worries need to be kept in perspective. Yes, as we have discussed for the past several years in these letters, China has undergone a massive credit buildup on the order of $26 trillion over the previous fifteen years, and has overbuilt a number of areas including steel and cement. Yes, China has likely built infrastructure that is far in excess of what is needed. Yes, China has too many apartments and too many malls. Yes, the Chinese banking system is fraught with risk. Yes, it will be very painful as China retrenches. It is important to remember, however, that most of the infrastructure (roads, bridges, rails, airports, marine terminals, etc.) has a long useful life. It is also critical to realize that what we know loosely as the private sector in China (businesses other than the State Owned Enterprises, or SOEs) has grown much more rapidly than the SOEs, and today account for an estimated two-thirds of all economic output, according to *The Economist*. The Chinese, generally speaking, are highly entrepreneurial and the largely private firms that have been allowed to operate have generated hundreds of millions of jobs over the past few decades. Chinese companies are increasingly known for their innovation, and we've seen glimpses of that with companies such as Alibaba, Xiaomi and Huawei. There is little doubt that China's growth rate is less than the official number of 7% GDP growth, and there will likely be very significant digestion problems over the near term, including perhaps negative GDP growth. This will continue to have a deleterious impact on a number of companies across the globe, but longer term we remain optimistic about the growth in China and for many other emerging markets.



By permission Bruce Plante / Tulsa World

The producer side of the U.S. economy is clearly slowing, if not retracting. The strong dollar and the weakness in big economies like China, Brazil, Japan and Russia, along with the collateral damage from plunging commodity prices, is clearly affecting U.S. companies. Bellwether companies such as Grainger, Praxair and GE are seeing a broad-based industrial slowdown. However, some of the consumer facing industries such as retail, home and multi-family housing, automobiles and health care, are still growing significantly. Real personal spending on categories like food service, hotels, recreation and communications are all growing at a mid-single-digit rate. Overall real GDP growth in the first two quarters of 2015 was 0.6% and 3.9%,

respectively, and recently the Atlanta Federal Reserve Bank lowered their third quarter GDP estimate from 1.8% to 0.9%. Unfortunately, corporate sales and earnings growth, as measured by the S&P 500 and Russell 2000 Indices, respectively, continue to be mired in the minus 1% to plus 1% range.

So, in summary, we see an uneven domestic economy, generally difficult world economies, little corporate sales or earnings growth, and equity valuations that remain quite expensive from a historical perspective. They are particularly expensive in the so-called defensive sectors. Investors have a tough choice: own really expensive stocks in the sectors that are "holding up," or own less expensive stocks in the areas where fundamentals are deteriorating. The good news is that increased volatility is giving long-term investors at least a glimpse of better risk/rewards. Over the past few years as stocks have seemingly levitated at unattractive levels, the research team has been actively researching dozens and dozens of good businesses whose valuations are not quite acceptable. We are excited about the potential opportunities to deploy capital at more attractive levels and reorient the portfolio to even better values as the market is pressured. As is our custom in the September letter, below we have highlighted a few investments:

First Cash Financial Services, Inc. (FCFS) and Cash America International, Inc. (CSH)

(Analyst: Matt Sullivan)

Industry Description

First Cash Financial Services and Cash America are two of the largest pawn operators in North America. While we don't often buy two companies in the same industry, in this instance we felt it was appropriate. Generally speaking, we were attracted to the pawn industry because many states have adopted regulations that make it difficult to open new pawn stores, which insulates incumbent players from new competition. Further, other forms of lending to the pawn industry's core, low income customer base are under intense regulatory scrutiny, which we believe will create a tailwind for the pawn industry over the next several years. Finally, the pawn industry gives investors exposure to gold, as pawn store fundamentals improve when gold prices rise. Given the experimental monetary policies around the world, we believe this exposure is attractive. We also believe that pawn stores are a much better way to get exposure to gold than buying gold miners, which are notoriously bad businesses with dismal return on invested capital (ROIC) profiles.

The reason we decided to buy both companies is that First Cash derives over 50% of its business from Mexico, whereas Cash America only does business in the United States. The Mexico market has different demographics and growth prospects than the U.S. market; therefore, we felt that we were getting significantly different exposures from the two businesses, despite the fact that they are close competitors in the same industry.

First Cash Financial Services, Inc. (FCFS)

Description

First Cash Financial Services is one of the largest pawn operators in the world by market cap and by number of stores. The company operates a total of 1,011 stores, 686 of which are in Mexico (68%), and 325 of which are in the United States (32%). Stores are typically 5,000-6,000 square feet in size. Pawn services account for 93% of the company's net revenue, while uncollateralized consumer loan fees account for the other 7%. The company was founded in 1988 and is headquartered in Arlington, Texas.

Good Business

- First Cash's ROIC was 16.5% last year, and has averaged 22.2% and 20.2% over the past five and ten years, respectively, which greatly exceeds the company's cost of capital.
- Loans are typically based on need, making revenue relatively stable and providing some insulation from economic cycles.

- According to the company, a high percentage of customers are repeat customers. Customers redeem collateral for 70-75% of their loans and often use the same piece of collateral for multiple loans. This gives the business some recurring revenue characteristics.
- Loans are small in size and have short maturities, which helps to keep regulatory bodies out of the industry, and helps customers to repay loans frequently.
- All loans are collateralized by merchandise at attractive loan-to-value ratios. When a customer "defaults," First Cash is still able to earn a yield on the loan by selling the merchandise through its retail stores.
- Regulatory barriers to entry keep new competitors at bay.
- The company has worked to reduce uncollateralized consumer loans as a percentage of the overall business in order to decrease regulatory risk.
- The company has a strong balance sheet and solid free cash flow.
- This is a simple business that is easy to understand.

Valuation

- First Cash trades at an enterprise value-to-sales multiple of 1.8 times, which is well below the company's 5- and 10-year averages. The company's 5-year average earnings before interest and taxes (EBIT) margin is approximately 20%.
- The stock trades at 14 times the next 12-month earnings per share estimate, which is below the company's 5- and 10-year averages, and is a significant discount to small cap market indices such as the Russell 2000.

Management

- Rick Wessel has been with the company since 1992 and has served in a number of positions, including CEO since November 2006, and CFO from May 1992 to December 2002. He has also been Chairman of the Board since October 2010, and previously served as Vice Chairman of the Board from November 2004 to October 2010.
- Doug Orr joined the company in 2002, and became CFO in 2003.
- Management and executives own 4% of the company. Rick Wessel personally owns a $30 million dollar stake.

Investment Thesis

First Cash Financial Services is one of the leading pawn operators in the world. The company is known as the best operator in its industry, as their growth, margins, and returns are better than their peers. Over the past few years, declining gold prices and the depreciation of the Mexican peso relative to the U.S. dollar have caused the stock to meaningfully underperform. This has given us the opportunity to buy an industry leader with strong long-term growth and return prospects at an undemanding valuation. First Cash also gives investors exposure to gold, which we believe is a prudent hedge given the experimental monetary policies around the world.

Cash America International, Inc. (CSH)

Description

Cash America is the largest pawn operator in the United States by number of stores. The company operates 859 lending locations in 21 states. Pawn services account for approximately 90% of the company's net revenue. The company also offers other financial services such as uncollateralized consumer loan services, check cashing, and a few other ancillary financial services that account for the remaining 10% of the company's net revenue. Cash America was founded in 1983 and is headquartered in Fort Worth, Texas.

Good Business

- Returns on capital are adequate. Incremental returns on capital appear to be attractive. The company should be able to narrow the gap between their ROIC and that of their closest competitor, First Cash, over time.

- Loans are typically based on need, making revenue relatively stable and providing some insulation from economic cycles.
- According to the company, a high percentage of customers are repeat customers. Customers redeem collateral for 70%-75% of their loans and often use the same piece of collateral for multiple loans. This gives the business some recurring revenue characteristics.
- Loans are small in size and have short maturities, which helps to keep regulatory bodies out of the industry, and helps customers to repay loans frequently.
- All loans are collateralized by merchandise at attractive loan-to-value ratios. When a customer “defaults,” Cash America is still able to earn a yield on the loan by selling the merchandise through its retail stores.
- The business was recently simplified with the spinoff of Enova, an online unsecured lending business. The company is also working to reduce unsecured consumer lending in its retail outlets in order to decrease regulatory risk.
- Regulatory barriers to entry keep new competitors at bay.
- The company has a strong balance sheet and solid free cash flow.
- This is a simple business that is easy to understand.

Valuation

- Cash America trades at an adjusted enterprise-value-to-sales multiple of 0.8 times, relative to an 8% operating margin. Margins are significantly below the company’s closest peers. We believe Cash America should be able to improve margins and narrow the gap with peers over time.
- Cash America trades at 11.9 times this year’s cash earnings per share forecasts, which is a significant discount to its closest peer and to the broader small cap market indices.

Management

- CEO Dan Feehan has been with the company since 1988. Feehan is stepping down from the CEO position in October of this year, but will move into an Executive Chairman position. He has also agreed to remain on the company’s board through 2020 if shareholders approve his nomination each year.
- Brent Stuart was promoted to the CEO position. Stuart has been at Cash America since 2008, and most recently served as the company’s COO.
- CFO Tom Bessant has been with the company since 1993, and has been CFO since 1997.
- Each board member has been with the company for over nine years. Most have been with the company for 20 years or more.
- Executives and managers own 2.1% of the shares outstanding.

Investment Thesis

Cash America is a simple business that operates in a large, fragmented market with stable competitive dynamics. They provide necessary services to a growing number of people. Management recently simplified and de-risked the business by spinning off the online unsecured consumer loan business, and by reducing its storefront unsecured consumer loan revenue. The U.S. pawn business now contributes almost all of the company’s revenue and profits. We believe that the long-term outlook for the U.S. pawn industry is attractive, and that Cash America is undervalued relative to competitors and broader small cap market indices. Additionally, Cash America gives investors some exposure to gold, which we believe is a prudent hedge given the experimental monetary policies around the world.

Applied Industrial Technologies, Inc. (AIT)

(Analyst: Andy Ramer)

Description

Applied Industrial is a leading North American distributor of motion control technologies including bearings (29%), fluid power products (29%), and power transmission components (27%), which combined account for 85% of the portfolio. The company serves customers in virtually every industry.

Good Business

- Applied's scale, technical expertise, and longstanding relationships with both customers and suppliers support its competitive position.
- Distributors play a crucial role in connecting many suppliers and customers with one another, as it would be inefficient for the two parties to contract with each other directly.
- The aftermarket accounts for 75% of sales, where the company sells replacement parts to factories to fix machines on assembly lines when they break down.
- ROIC is 11.5% and has averaged 13.5% over the last five fiscal years; it has remained in the double digits during the most recent recession.
- This is an easy business to understand.
- The balance sheet is solid and cash flow generation has been strong.

Valuation

- At a price-to-fiscal 2016 (June) forecast earnings multiple of 13.8 times, the stock trades at a significant discount to the Russell 2000.
- Shares trade for 0.67 times trailing 12-month sales relative to an operating margin of 6.7%, or 10 times EBIT.
- At a price-to-book ratio of 2.11 times, the stock trades below its 5- and 10-year average multiples of 2.44 and 2.33 times, respectively.
- The dividend yields 2.8%.
- Only two of the eight Wall Street analysts who cover the stock have rated AIT a Buy.

Management

- Neil Schrimsher, 51, joined Applied as CEO in October 2011. He was previously Executive Vice President of Cooper Industries, where he led Cooper's Electrical Products Group, and also served as President of Cooper Lighting.
- Mark Eisele, 58, has been CFO since January 2004.
- The company successfully completed a multi-year phased-in implementation of a new enterprise resource planning (ERP) system to replace multiple legacy applications.
- Applied does not grant stock options, and compensation is, in part, tied to return on asset performance over a 3-year time horizon.

Investment Thesis

Applied has an opportunity to accelerate growth and boost profitability after having greatly enhanced its operating capabilities via the new ERP system, which standardizes and simplifies processes and enables continuous improvement throughout operations for years to come. The current weakness in the industrial sector has negatively impacted the stock and provided an opportunity for long-term investors.

Thank you for your support of Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2004 - 06/30/2015

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 %
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%
2014	7.99	7.06	4.89	178	0.39	9.65%	13.12%	$ 3,006.5	$ 21,001.1	14.32%
Q1 2015	2.68	2.46	4.32	181	0.17	10.08%	13.23%	$ 3,023.0	$ 21,939.0	13.78%
Q2 2015	-1.36	-1.56	0.42	178	0.12	9.08%	12.33%	$ 2,939.5	$ 22,136.3	13.28%

*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 - 06/30/2015. 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 -06/30/2015. 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 $22.1 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.