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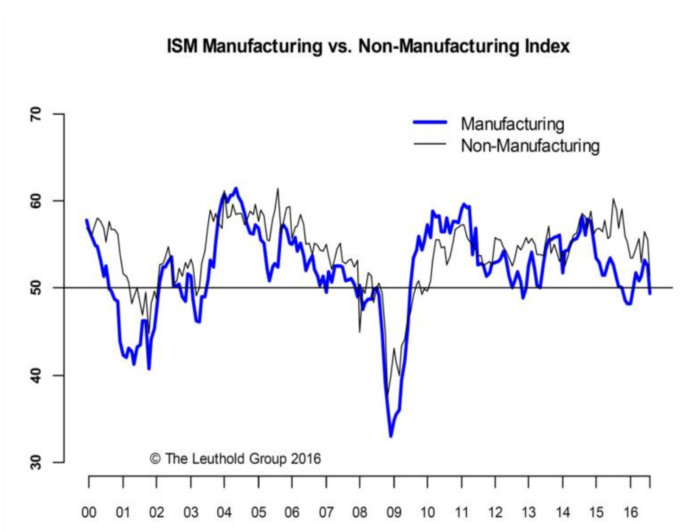
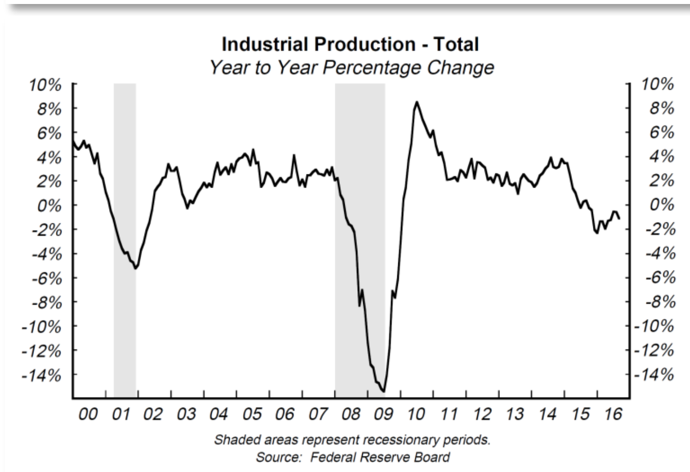
INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2016

The FMI Small Cap portfolios returned approximately 5.2% in the September quarter compared to 9.05% for the Russell 2000 Index. Sectors that aided performance included Retail Trade, Consumer Services and Health Services. Those that hurt performance included Commercial Services, Producer Manufacturing and Health Technology. Stocks that aided results included Penske Automotive, Anixter International and Zions Bancorporation. Underperformers included Genpact Limited, Interpublic Group and Valmont Industries. The market worries of January and February, which were bringing some sanity back to equity valuations, ameliorated through the second and the third calendar quarters, keeping the bull alive. The portfolio experienced a tough relative quarter, with some of the more economically sensitive stocks taking it on the chin and the elevated cash position hurting as well. Being underweighted Health Technology and Electronic Technology also hurt relative performance. Investors seemed more emboldened as the quarter unfolded. Health Technology and Electronic Technology sectors are both very expensive. Additionally, we are underweight Finance, which generally performs poorly in difficult markets. To give some color on the degree to which speculative fervor drove the Russell 2000 this quarter, nine of the top ten contributors to that index were biotech or technology companies. For example, Sarepta Therapeutics gained 222%, Exelixis advanced 64%, and Cepheid appreciated 71%; all three generate huge losses. Rumors that Twitter was in play caused its stock to surge over 35% in the quarter. Twitter carries a $17 billion market cap, has never turned a profit (and has lost over $400 million in the last twelve months), and trades for over five times revenue. Further evidence comes from a corner of the private equity world with the impending offering of Yeti (coolers, coffee mugs, etc.) rumored at a $5 billion valuation, which is over 10 times 2015 revenue, and 36 times 2015 earnings before interest, taxes, depreciation and amortization (EBITDA).





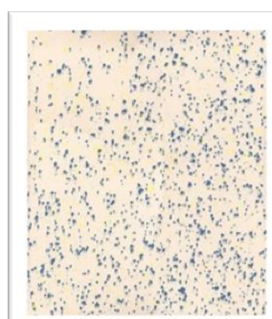
There is somewhat of a surreal nature to the economic and stock market dialogue today. If one listens to the administration, the economy is a well-oiled jobs machine that delivers steady growth without inflation. Janet Yellen and other Federal Reserve (Fed) board members tell us the economy is sound, and that interest rates will soon be normalized (although year after year goes by with little action). The bull market recently passed 7½ years, and people with financial assets -- essentially the top 5% -- seem pleased. It's hard to reconcile this against the backdrop of persistently weak real gross domestic product (GDP) growth of roughly 1.0-1.5%, and corporate sales and earnings growth that has been negative for five quarters (with a sixth decline expected in the September quarter). If the market reflected just the decline in earnings so far, according to David Rosenberg of Gluskin Sheff, the S&P 500 would be down 20%. The combined Manufacturing and Non-Manufacturing ISM Composite Index recently dropped to 51.2% (the weakest in over six years), industrial production remains soft, retail sales have sputtered, and the Fed's own broad Labor Market Conditions Index dropped 0.7% in August. The employment-to-population ratio for the U.S. remains mired below 60% and real incomes are lower today than a decade ago, although they rose last year for the first time in years. The average American is running in place, at best.

Consumer health care, rent/housing and educational expenses are swamping the small increases or declines in other consumer items. Perhaps someone should tell the Fed that the Consumer Price Index (excluding food and energy) was up 2.3% year-over-year in August. Health care and entitlement spending are out of control and are being funded with unsustainable increases in debt. Most people believe the real damage to balance sheets took place in 2008-09, yet over just the past five years the federal government has added $4.8 trillion of debt (bringing the total debt to $19.5 trillion), the Federal Reserve pumped up its balance sheet by $1.7 trillion to $4.5 trillion, and corporations have layered on an estimated $2.2 trillion of new borrowings. The most dangerous aspect is that debt is growing faster than GDP.

These stories, however, are old news. We've lost the ability to be surprised or moved by quarter after quarter of the same combination of runaway government spending, easy money and relatively weak economic growth. On the corporate side, financial engineering remains the go-to strategy, but this has proven to be no substitute for organic investment in people and projects. The Fed seems to think one more quarter, or one more year, of extremely low rates is all that is needed to jump-start the economy. If low rates induce capital formation, however, wouldn't we have seen explosive business investment after eight years of a nearly zero percent Fed Funds rate? Instead, it has been one of the weakest periods of fixed business investment on record.

Moreover, despite a curious but enduring belief in Keynesian economic theories, government spending doesn't seem likely to cure the growth problem. If deficit spending was the answer, wouldn't the economy be screaming after more than a decade of nonstop stimulus? It is astonishing that some pundits are calling for even more fiscal stimulus today. Few consider that there is a wide body of evidence showing that government debt accumulation (deficit spending) steals from overall economic growth. That government spending has a negative multiplier effect on the economy should not come as a startling revelation. Just look around and see where governments spend money and compare that to private capital projects and research and development expansion, and it is easy to see why the economy has underperformed.

Stocks remain elevated by just about all traditional valuation measures. Asset inflation and high valuations are also not confined to the equity markets. Bonds, private equity, real estate and other alternatives are all expensive by historical standards. Paul Singer, the highly regarded leader of Elliott Management, recently called long-term bonds the "biggest bond bubble in world history," although the 10-Year Treasury has recently backed up a bit. A relatively weak economy, negative earnings growth and high valuations wouldn't seem to be the ticket to higher stock prices. As we asked in our last letter, what are investors supposed to do? The best option is to take the long view and own quality franchises trading at relative discounts, and recognize that while nobody will be immune to a stock market downturn, this strategy offers the best chance to preserve, and eventually grow, capital. The public continues to pour money into index funds, which have beaten approximately 90% of active U.S. equity managers over the past five years. The money flows are a self-fulfilling feedback loop in the short run that will eventually collapse, as they have in the past. The last time index funds outperformed like this was in the five years ending in early 2000. The S&P 500 proceeded to drop nearly 50% and it took over seven years to recover to the prior peak.



While speculation is alive and well in the stock market, there may be a few markets beginning to crack. The high end of the Canadian and New York City real estate bubbles may be beginning to deflate. Additionally, recall our discussion in the June of 2014 letter of the tremendous excesses in the contemporary art market. In recent months the bottom has begun to fall out of this market, with a number of pieces dropping over 90% or failing to sell at auction. In a recent *Bloomberg* story, the author mentioned the work of one Lucien Smith: "Smith saw a painting he made while an undergraduate at New York's Cooper Union fetch $389,000 at Phillips in 2013, two years after it was purchased for $10,000. This week, estimates for three Smith pieces are as low as $7,000. One (to the right), from the series he made by spraying more than 200 canvases with paint from a fire extinguisher, is estimated at $12,000-18,000. A bigger spray work sold for $372,120 two years ago." To each his own, but we know some third graders with ball point pens who would take a dollar and an ice cream cone for similar work.

It takes fortitude to avoid playing someone else's game, i.e., chasing after what is currently working even though these investments may lack true value. Using professional golf as an analogy, the best players focus not on the results, but the process. They do everything in their power to choose the right club, envision the right shot shape and put themselves in a mental mindset that will deliver a positive swing. If they can execute the process consistently, most, but not all shots will come off well. If they let their minds race after a bad shot or a bad hole and fret about the results, they are likely to compound their difficulties. You can't wish the ball into the hole, but instead, must keep your discipline and process. It is strikingly similar with investing. Fortunately, our firm has a great culture that places a lot of faith in being intellectually honest and in staying true to the process. We can't control the fact that over the past few years, investors have been willing, for example, to buy utility stocks that barely earn their cost of capital, have little to no growth, are highly regulated, and are heavily indebted and expensive. Our process would not translate into a purchase decision in this sector even though, looking in the rear view mirror, it has been rewarding. We are highly confident that in the fullness of time, this group will reflect its underlying fundamentals. Over the years, we have seen this same dynamic in many popular stocks; with few exceptions, these equities ultimately reflected the intrinsic value of their respective businesses. As Ben Graham famously said over eighty years ago, "…the market is a voting machine [popularity contest] in the short run but a weighing machine in the long run."

Below are a couple of investments we think will eventually register well on the weighing machine.

Arrow Electronics, Inc. (ARW)

(Analyst: Matt Sullivan)

Description

Arrow Electronics is a leading global distributor of semiconductors, passive and other electronic components, and enterprise computing solutions. The company also offers a variety of value-added services including programming, system training and certification, solutions testing, and inventory and supply chain management. Arrow distributes these products and services to over 100,000 industrial and commercial customers spanning across 85 different countries.

Good Business

- As a distributor of electronics and technology systems, Arrow benefits from global growth in high technology without being exposed to the same obsolescence risk as technology manufacturers.
- Arrow is one of the world's largest global information technology distributors, and controls a large market share position in the industry. It has stood the test of time, having incorporated in 1946.
- The company has a diversified set of vendors, customers, and end markets. Arrow serves over 100,000 customers in 85 countries, including 12,000 value-added resellers. No single supplier accounts for more than 7% of overall revenues, and no single customer accounts for more than 2% of overall revenues.
- Arrow's size and expertise in its product offerings create a competitive advantage that translates into better margins than most of its smaller competitors.
- Over time, the company has proven its ability to consistently earn a return on capital that exceeds its cost of capital.
- The balance sheet is modestly levered with a debt-to-total capital ratio of approximately 37%.

Valuation

- Arrow is valued at 9.7 times the 2016 consensus earnings per share (EPS) estimate, and 0.34 times enterprise value-to-sales (EV/Sales). This is a significant discount to most market indices, including the Russell 2000.
- While Arrow has historically traded at a discount to most market indices, the valuation gap has widened significantly in recent years.
- Based on a sum-of-the-parts analysis, we believe Arrow should be trading at least 50% higher. Our confidence in this analysis grew recently when Arrow's closest competitor, Avnet, sold part of its business at an attractive multiple.

Management

- Michael Long is Chairman, President, and Chief Executive Officer. He has been CEO since 2009, and has been with the company since 1991. Prior to working at Arrow Electronics, Long worked at Schweber Electronics from 1983 until Schweber merged with Arrow in 1991.
- Management has become more focused on return on invested capital (ROIC) over time. ROIC is one of the key performance metrics used to evaluate and compensate management.

Investment Thesis

Arrow Electronics is one of the world's largest distributors of electronic components and enterprise computing solutions. As a distributor of electronics, the company is in the advantageous position of benefitting from global technology growth without being directly exposed to the short product cycles and cutthroat competition that exist for the innovators of technology. Arrow trades at a significant discount to most market indices, despite having a solid track record of earnings per share growth and an above-average ROIC profile. Concerns about Arrow's role as cloud computing grows have also impacted the multiple. We feel Arrow will continue to thrive in the environment we see existing over the next decade, which, for the vast majority of companies, will be a combination of pure cloud services, traditional networks and hybrid public/private deployments. The large discount in Arrow's multiple is unwarranted.

Robert Half International (RHI)

(Analyst: Rob Helf)

Description

Headquartered in Menlo Park, California, Robert Half is the world's largest specialized staffing company. Approximately 50% of the company's revenues are generated in the fields of accounting and finance (Accountemps), Robert Half Technology, Legal and Protiviti, a well-regarded business consulting and internal audit operation.

Good Business

- Robert Half is the world's largest specialized staffing company, with a particular strength in the field of finance/accounting. The company has successfully levered its powerful brand name into other specialty staffing services, including information technology.
- The increased regulatory burden on permanent employment provides a tailwind for the company.
- Robert Half has a diverse set of small to mid-size customers, which have traditionally been less price-sensitive and stickier than larger, national account clients.
- Flexible staffing has strong secular appeal, given the changes in how work is conducted.
- The company has been expanding its international presence.
- The company has generated a low double-digit ROIC, on average, over the last decade.
- Robert Half's balance sheet is in excellent shape with approximately $2 per share in net cash.
- The company has consistently generated strong free cash flow and has returned over 100% of this to shareholders via dividends and repurchases.
- The company currently pays a $0.88 annual dividend, yielding 2.4%.

Valuation

- On a cash-adjusted basis, Robert Half trades at 12.8 times EPS, 8.0 times earnings before interest and taxes (EBIT) and 0.85 times sales.
- Over the past ten years, the stock, on average, has traded for over 25 times EPS, 15 times EBIT and 1.1 times sales.
- The shares are approaching one standard deviation below its 10-year EV/Sales average.

Management

- Harold Messmer, 70, is Chairman and CEO; he has served in these roles for over 20 years. From 1985-2004, he served as President. Mr. Messmer beneficially owns more than 1.2 million shares at a value of $68 million.

- Keith Waddell, 59, is Vice Chairman (since 1999), President (since 2004) and Chief Financial Officer (since 1988). He owns over 1.3 million shares.
- Paul Gentzkow, 60, is President and Chief Operating Officer-Staffing Services.
- Management has created an enterprise that has among the highest margins and returns in the staffing industry, and they have been good capital allocators.

Investment Thesis

The shares of Robert Half have underperformed the overall market in 2016, as growth has slowed for this growing/cyclical leader in specialized staffing. In the most recent quarter, organic growth was a very healthy +8%, and this compared to 15% in the prior year. The shares are discounting an economic recession with an EV/Sales ratio approaching one standard deviation below their 10-year average in the context of an overall stock market that is just the opposite, trading near the upper end of its historical range. The stock appears to be largely discounting a recession and a severe earnings decline. We believe any additional decline in the stock will be temporary. The long-term outlook for Robert Half appears to be strong.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2005 - 06/30/2016

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 %
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%
2015	-5.72	-6.52	-4.41	171	0.34	11.18%	13.98%	$ 2,597.2	$ 21,042.9	12.34%
Q1 2016	5.77	5.55	-1.52	171	0.11	11.82%	15.13%	$ 2,587.8	$ 21,477.7	12.05%
Q2 2016	1.05	0.85	3.79	172	0.08	11.80%	15.02%	$ 2,396.4	$ 21,521.3	11.14%

*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 - 06/30/2016. 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 -06/30/2016. 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 $21.5 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.