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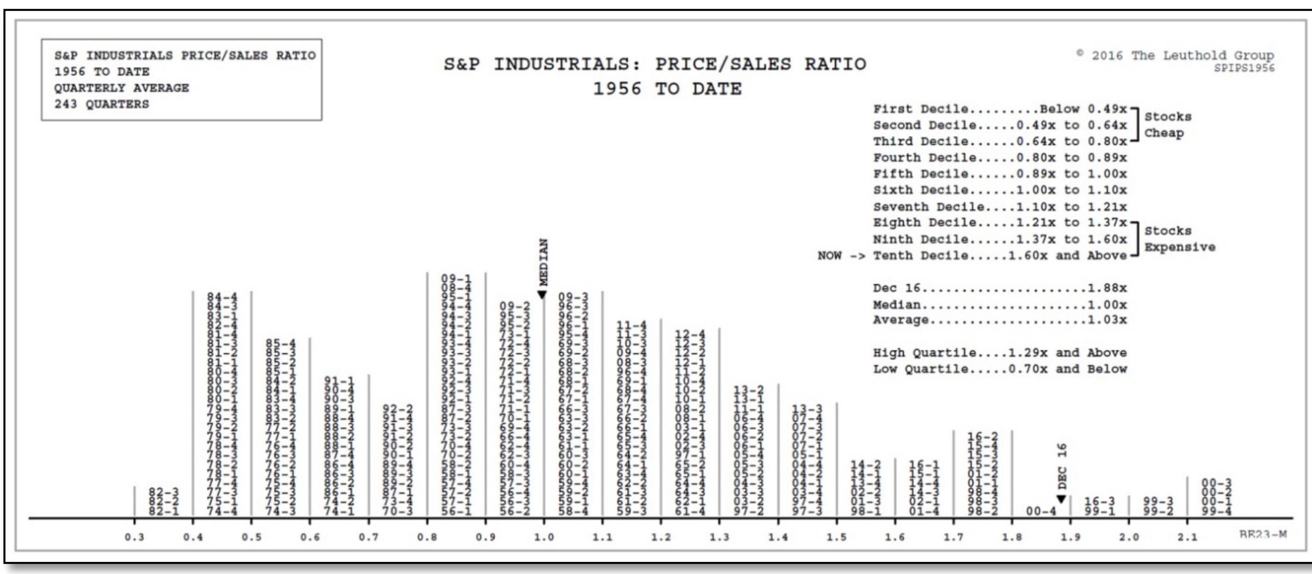
INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

December 31, 2016

The FMI Small Cap portfolios advanced approximately 8.2% and 21.6% in the December quarter and calendar year, respectively. The benchmark Russell 2000 Index gained 8.83% and 21.31% in the corresponding periods. Sectors that helped performance in the quarter included Distribution Services, Technology Services and Commercial Services, while Finance, Process Industries and Consumer Services detracted. A number of stocks appreciated sharply in the quarter, including Applied Industrial Technologies, Progress Software and Robert Half International. On the flipside, Allscripts, Avery Dennison and Kennedy-Wilson Holdings lagged. Three stocks were sold in the period: FLIR Systems, ScanSource and Donaldson. The sale of FLIR was due to an elevated valuation and disappointing growth. We sold ScanSource because of maturing end markets and an ineffective acquisition effort. Donaldson was sold due to valuation. A couple of new ideas were on the threshold but the strong rally took them above our comfort level. Additional trimming of stocks that had reached outsized positions brought cash levels to a fairly high level. Attractive replacements are hard to find right now. The market has appreciated dramatically both in the near term and over the past nearly eight years, despite relatively mediocre fundamentals, and that has resulted in valuations that are near the highest we have ever seen. Following is a histogram of the price-to-sales ratio of the S&P Industrials for every quarter since the beginning of 1956. We like price-to-sales since sales are far less manipulated than earnings. Today's figure of nearly 1.9 is in the highest (most expensive) decile.



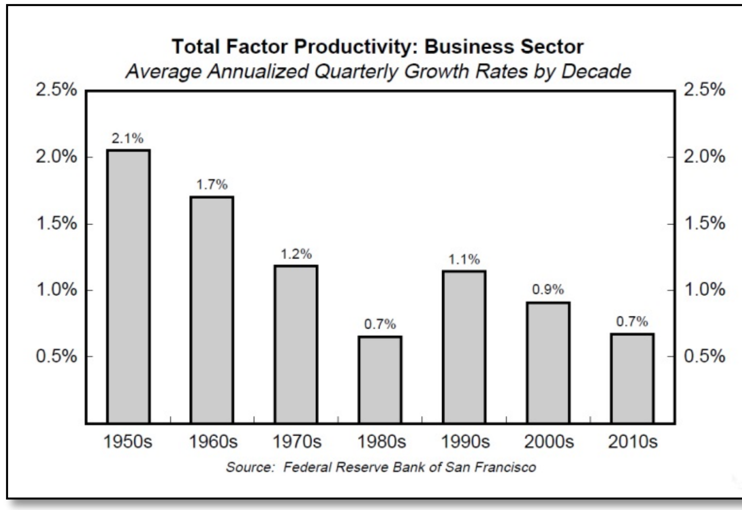
Investing is an odd business. In very few other businesses do emotions and psychology play such large roles. In 1990 we bought stock in a company called Sungard Data Systems. It was a financial software and services company with approximately 80% recurring revenue, reasonable growth prospects and a solid balance sheet. We paid approximately six times earnings before interest, taxes, depreciation and amortization (EBITDA) and mid-teens times earnings. It was trading well below its historical valuation range. It turned out to be a wonderful stock. Fiserv, a similar company (and one we do not own), trades today at over 15 times EBITDA and 26 times earnings. Fiserv trades at approximately two standard deviations above its long-term valuation mean (based on enterprise value-to-EBITDA). Fiserv is a microcosm of today's stock market: very expensive, little organic growth, mergers and acquisitions (M&A) focused, and in possession of just an average balance sheet. In 1990 inflation was running about 6% and the 10-year Treasury yielded around 8.4%, compared to today's figures of 1.7% on the Consumer Price Index and 2.56% on the 10-year note. Some will say today's low inflation and interest rates explain the dichotomy between these two stocks, or these two markets, but why do investors think this way? Hundreds of years of history tell us that prevailing conditions always change, yet investors invariably extrapolate recent trends into the future. The late iconoclastic basketball coach Al McGuire once said, "Life is what you allow yourself not to see." Why are investors willing to pay nosebleed prices today for ho-hum fundamentals? One reason is that change can happen over a different time frame than most people are accustomed to. Most investors are used to thinking in short-term time segments, but in the investment world, sometimes five years can be too short to see a full cycle transpire. The longer an environment remains essentially constant, the more investors believe it will persist. History shows that this belief is 100% misplaced. Great investors tend to shy away from popular themes as they gather momentum, but most investors do the opposite. What looks smart in the short run almost always becomes spectacularly wrong in the end. One proof of this is the consistent long-term results from the Dalbar studies, which show that mutual fund investors achieve only about a half of the market's return. We are highly confident that the rush into index funds in recent years will end with the same result: poor returns. Money was flowing out eight years ago when stocks were cheap; today the flood is the other way. Why investors think the ultimate trajectory of a passive asset (e.g. the S&P 500) is somehow going to be different than every other asset that has become overvalued since the beginning of time is a curious psychological or behavioral oddity, to say the least.

The current bull market (with just one near-20% correction in the large cap universe) is very long in the tooth, having started in March of 2009. The S&P 500 is up 290%, which is more than double the average bull market return, and the third greatest move since 1929. Confidence is high that the party will continue. In fact, the recent elections have emboldened investors even more, despite the fact that the stock market's valuation at the beginning of an administration is a much greater determinant of future stock returns than who is president. Make no mistake, we would be thrilled to see a renaissance in economic growth and a balanced budget, but there is an old saying in the stock market: "Buy on the rumor, sell on the news." This is often seen with "story" stocks. Emerging companies, before they have established an earnings track record, can sometimes trade at ridiculous prices as investors buy into the "story." The sky is the limit when imagination is your guide. Some story stocks flame out before ever establishing earnings, but often, even the companies that make money will see their stocks fall. Once investors start to measure results on hard facts and more traditional valuation measures rather than hype, the stocks often disappoint. We think this same phenomenon will play out over the next few years with respect to the market and the new administration. Expectations seem to be far ahead of the likely fundamentals. Getting things done is a lot harder than promising that things will get done. When Ronald Reagan ran for president in 1980 he vowed to eliminate the Education, Commerce and Energy Departments and he was zero for three on that one. Barack Obama lambasted George Bush for running up the debt from $5.7 trillion to $10.6 trillion and vowed to bring it under control. He will leave office with debt of approximately $20 trillion.

Somehow Mr. Trump is going to spend a trillion dollars on infrastructure without increasing the debt load. Somehow America is going to sell more of its goods overseas even while we bash our trade partners, threaten to erect additional tariffs, and cope with a very strong dollar. Somehow we are going to roll back the regulatory burden and make government agencies more accountable, even though most presidents have been saying this for generations and the government just gets bigger. Somehow we are going to reform the tax code, making it fairer for more people and more attractive for risk-takers and business owners while balancing the budget. Somehow we are going to fix the health care system, eliminate perverse incentives and make it much more cost-effective without diminishing access. We are not mocking these goals. We are simply saying that the proverbial devil is in the details. The last two presidents had many of the same goals and reality fell well short. Frustrated and ideological presidents turn to executive orders. It's easy to forget that when you live by the sword you die by the sword. The next president can reverse executive orders by issuing his own. True and lasting reform involves Congress making laws that usually have some bipartisan input. These brokered solutions stand a far greater chance of working long-term than highly partisan pieces of legislation or executive orders.

It's doubtful the new Congress is going to be bullied by Mr. Trump. Perhaps in partial recognition of this he has already backtracked on a number of Trump-the-Candidate positions even though the ink is still wet on the ballots. He has yet to flip on the most damaging of his positions, protectionism, and has made a very unsettling appointment to the newly created "White House National Trade Council." Perhaps someone can inform him that there is a 4,000-year track record of protectionism failing. Regarding tax rates, we would relish the broader, simpler and lower kind, while eliminating deductions. A tax code of 74,000 pages is an abomination, however, with three Wall Street veterans having been recently named either to cabinet level or advisory positions, our hopes have already taken a hit. Obamacare is a nightmare from a moral hazard and cost standpoint. Installing something better, however, will be difficult and time consuming. People seem to think Paul Ryan will wave a magic wand and we'll have cost effective health care. Where will this stock market rally be if a new health care bill takes 18-24 months to pass? Or tax reform stalls? Regarding the so-called fourth branch of government, recall that Reagan had a mandate and yet could barely slow the government regulatory juggernaut. Trump will find the same tough sledding and he is handicapped by a short attention span. Real reform of all of these elements will largely take place on Congress' time table, not the president's -- and probably not Wall Street's either. How patient will investors be if reforms are slow to develop and the economy continues its lethargic performance?

Regarding the economy, it looks like the final tally for 2016 nominal GDP is going to be approximately 2.8%. Inflation-adjusted growth remains meager. The past decade's growth has been equally unimpressive at a 3.3% nominal rate, compared to an average of 4.5% over the past 25 years, and 6.6% over the past 50 years. We have a growth problem and the culprit appears to be a combination of too many workers on the sidelines, low fixed business investment, insufficient research & development expenditure, and weak productivity growth (which is partly related to the latter two).



If you want to question the wisdom of near-zero rates for eight years, you need to look no further than how corporations have been spending money. We've become a nation of financial engineers. Corporations and private equity firms take cheap money and buy other businesses. They write down assets and use a bastardized version of earnings to give the illusion of growth or "accretion." They drag Wall Street analysts around by the ear to do their bidding by ignoring or minimizing GAAP (generally accepted accounting principles) earnings and serial restructurings. According to Factset, over 90% of the S&P 500 use adjusted earnings, and these figures are as much as 30% higher than the legitimate kind. CEOs and Wall Street have a silent partnership to build the illusion that price-to-earnings ratios are more attractive than they actually are.

We could pick on a number of sectors in this vein but the pharmaceutical industry is one of the most egregious offenders. This industry's return structure has plummeted over the past decade. Organic revenue growth is very low (with most coming from price hikes) and nearly all of the companies engage in M&A that is so economically destructive that we can hardly believe investors stand for it. In a nutshell, new drug development has become so expensive and time consuming -- and the probability of success is so low -- that it is rapidly becoming an uneconomic endeavor. We would even venture to say that some companies' development pipelines have a negative net present value. For the industry, we believe the economic value-add of the pipelines, on a probability-weighted basis, is probably barely at the cost of capital and almost certainly below 10%. This compares to a return on invested capital 10-15 years ago of above 20%. Thus, one sees a veritable M&A feeding frenzy for late-stage development compounds. While this occasionally yields a home run, overall, the data suggests this strategy is a massive destroyer of capital. Despite these troubling fundamentals, most of the stocks trade at high valuations.

The title of a recent article in *The Wall Street Journal* was, "Are We Out of Big Ideas?" This piece suggests that despite the efforts in Silicon Valley and elsewhere with robots, artificial intelligence, gene therapy, big data, etc., we haven't been able to move the productivity needle. Our standard of living hasn't budged since 2000. Why? The authors believe it is partly due to the cost of regulation (think how difficult and costly it is getting a drug through the FDA process) and our aversion to risk. They claim innovation used to come through trial and error, and society has become less tolerant of failure or risk. As an aside, it's ironic that today the opposite is the case in the stock market… investors seem to love risk!

Necessity dictates that we must start seeing more of a payoff from innovation. We have to be more tolerant of failure, and perhaps tort reform could go a long way in making this a reality. Businesses, health care researchers and providers bearing the burden of unconscionable judgments struggle to deliver cost effective solutions. Additionally, if we are to achieve a more rapidly growing economy, society may have to redirect some of its innovation focus from social media and entertainment to pursuits that can drive better economic growth and job creation, while adding more lasting value to people's lives. There are some encouraging efforts in this regard, including autonomous driving, water purification, solar energy, exoskeletal enhancements for paralysis, nonlethal weapons, drones, 3D printing and many more.

Promises of better innovations, faster growth and more productive policies can't sustain stock prices unless these promises become reality. Perhaps it is all on the come, and our reticence will prove to be misplaced. With valuations in the upper reaches of long-established parameters, the market seems to believe that all these promises will be realized and there won't be anything significant that crops up on the negative side of the ledger, such as higher interest rates, inflation or any other externality. Today we see a stock market that is disconnected from the world around it; over the last almost eight years, it has not only rebounded from the financial crisis, but continued to appreciate to a level that gives investors little room for error. In the words of the famous industrialist and investor J. Paul Getty, "The seeds of any bust are inherent in any boom that outstrips the pace of whatever solid factors gave it its impetus in the first place. There are no safeguards that can protect the emotional investor from himself."

The good news is going to have to wait until true values resurface in the market. We have some hope that through rolling sector declines we can reload the portfolio with great values without a generalized bear market, but the odds are against this. All we can say for certain is that we think we have a portfolio of strong franchises that are cheaper than the market averages. Our hope is that these stocks will hold their value better than the market when rocky times come, which has been our historical pattern. As the small print always says, past performance is not a guarantee of future results.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2005 - 09/30/2016

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%
Q3 2016	5.16	4.94	9.05	170	0.19	11.07%	14.36%	$ 2,442.2	$ 22,087.2	11.06%

*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 - 09/30/2016. 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 -09/30/2016. 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 $22.0 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.