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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

March 31, 2018

The FMI Small Cap portfolios returned approximately 0.0% in the March quarter compared to -0.08% for the Russell 2000 Index. Finance, Utilities, and Consumer Services were three notable positive sector contributors, while Technology Services, Health Technology and Producer Manufacturing detracted. Our zero exposure to the Utilities sector explained the positive relative performance, while our intentional lack of exposure to high flying, and almost entirely money losing biotechnology shares caused substantial relative underperformance. Stocks that helped during the period included FirstCash, Interpublic Group, and Broadridge Financial Solutions. On the flipside, Allscripts Healthcare Solutions, Carlisle Companies and ManpowerGroup all lagged.

There were a few new elements to contend with in the investment world this quarter that we haven't seen in a while. An almost complete lack of volatility over recent years was interrupted for twenty trading days, beginning January 27th. Over nine sessions, the S&P 500 dropped 10.10%, followed immediately by a gain of 7.84% during eleven trading days, leaving it down just 3.05% for this period. Interestingly, the average of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google [Alphabet]) actually outperformed in the down-and-up part of this mini-cycle, reinforcing both the "buy-the-dip" and the "value doesn't matter" notions. It is going to take more than a few bad days to shake people's faith in these exceedingly expensive stocks. Amazon and Netflix were up 23.8% and 53.9%, respectively, *in the quarter*, and trade at multiples that would make the big cap tech darlings of 1999 blush. Amazon and Netflix both have trailing GAAP (Generally Accepted Accounting Principles) price-to-earnings ratios north of 180. Facebook, a phenomenal stock over the past five years, did wobble a bit in March, marking this as an unusual occurrence. Stocks suffered a rare few bad days near the end of the quarter, with most pundits tying this to tariff concerns. The last few sessions also saw more volatility in the FAANG group, Tesla and a few other tech high fliers. Perhaps change is on the horizon. Additional wrinkles from the quarter include the 3-month Libor (London Interbank Offered Rate, a key number tied to $200 trillion in financial contracts) gaining roughly 60 basis points to 2.3% -- a level not seen since 2008 -- and an inflation rate hitting 2.2% in February, which, if it holds for the year, would be the highest annual figure since 2011. For the first time in years, companies were talking about higher raw material and transportation costs pinching margins. Oddly, given the widespread view that lower taxes were expected to propel the economy into overdrive, real GDP forecasts for the first quarter from the Atlanta Fed (GDPNow) have dropped from 5% in early February to 2.4% at the end of March. We find corporate revenue growth to be a more reliable indicator and it still appears solid, but the precipitous drop in GDPNow is noteworthy. One more significant change in today's investment landscape was the defenestration of the price of Bitcoin, as foreshadowed in our last letter. It was down 52.7% in the quarter and is off 72.4% from its peak on December 18th of 2017.

Most things about this market, however, haven't changed much over the past several years. March 9th marked the ninth year without a bear market in the large cap indices, making this the longest bull market (using the Dow Jones Industrial Average) in measured history and the third most powerful (see table).

Bull Markets In The DJIA, 1900 To Date

Dates	Gain (%)	Duration (Mos.)
August 24, 1921 - August 30, 1929	495.2 %	96
July 8, 1932 - March 10, 1937	371.6	56
March 9, 2009 - January 26, 2018	**306.5**	**107**
October 11, 1990 - July 17, 1998	294.8	93
August 12, 1982 - August 25, 1987	250.4	60
June 13, 1949 - April 6, 1956	222.4	82
November 9, 1903 - January 19, 1906	144.3	26
April 28, 1942 - May 29, 1946	128.7	49
July 30, 1914 - November 21, 1916	110.5	28
October 9, 2002 - October 9, 2007	94.4	60
November 15, 1907 - November 19, 1909	89.6	24
June 26, 1962 - February 9, 1966	85.7	44
December 19, 1917 - November 3, 1919	81.4	22
December 6, 1974 - September 21, 1976	75.7	21
October 22, 1957 - December 13, 1961	75.1	52
October 19, 1987 - July 16, 1990	72.5	33
May 26, 1970 - January 11, 1973	66.6	32
March 31, 1938 - November 12, 1938	60.1	7
August 31, 1998 - January 14, 2000	55.5	16
September 24, 1900 - June 17, 1901	47.8	9
February 28, 1978 - April 27, 1981	38.0	38
October 7, 1966 - December 3, 1968	32.4	26
September 25, 1911 - September 30, 1912	29.1	12
AVERAGE	**140.4 %**	**43**
MEDIAN	**85.7 %**	**33**

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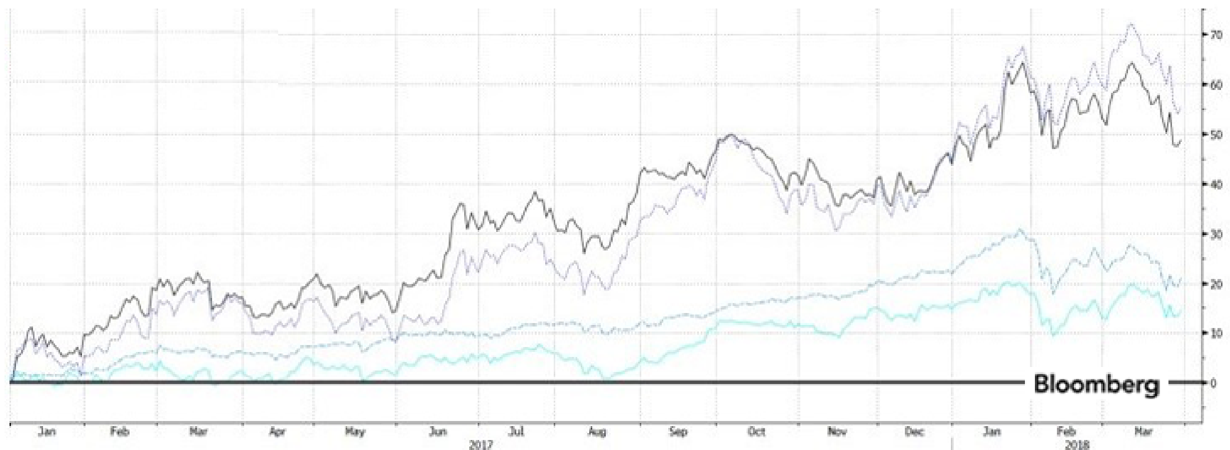
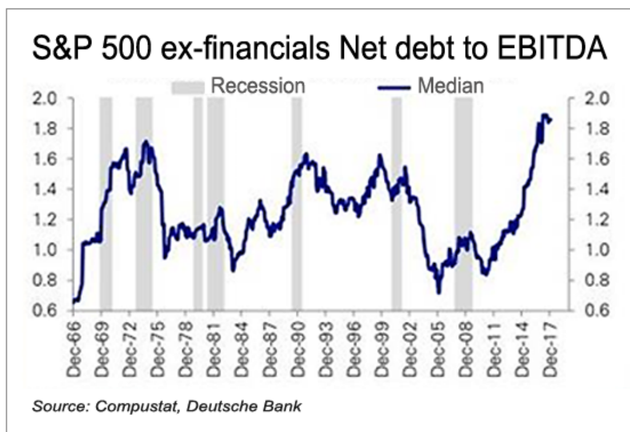
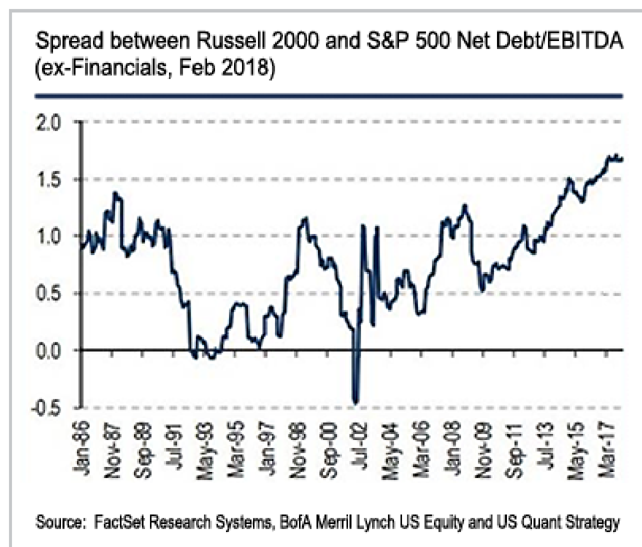
We aren't going to conduct a lengthy rehash of what we have been articulating for some time. Despite a slightly improved valuation environment from the December quarter, stocks, on a median basis, remain near the most expensive we have ever experienced or studied. Many stock indices have become quite narrow again, reflecting a strong funneling effect from passive flows to the most popular names. The median stock once more underperformed the S&P 500 Index in the March quarter. Speculative biotech stocks have again been on a roll, as seen in the chart below showing performance compared to the benchmarks since the beginning of last year. Like some of the popular tech names, however, they also had a few tough days right at the end of March.



Range: 12/30/2016 - 03/29/2018

Security	Name	Price Change	Total Return	Annual
XBI	SPDR S&P Biotech ETF	48.22%	48.71%	37.58%
SPX	S&P 500 Index	17.96%	20.90%	16.48%
BIOSC	Wells Fargo Biotechnology Small Cap Index	54.81%	55.41%	42.54%
RTY	Russell 2000 Index	12.70%	14.54%	11.53%





Investor confidence, which was near record-high territory three months ago, has started to fall. Still, there appears to be widespread belief that the S&P 500 is a safe investment over any time horizon. The losses that S&P 500 Index investors sustained in the past two bear markets (47.4% in 2000-2002 and 55.3% in 2007-2009) apparently are forgotten. People have been conditioned not to fear, yet ironically, risk elements are on the rise. Debt continues to pile up, as we have noted numerous times previously. The S&P 500's debt-to-earnings before interest, taxes, depreciation and amortization (EBITDA) is at a 50-year high. (See chart, above left).

Smaller capitalization companies are even more extreme, as can be seen in the chart (above right).

Growth stocks have bested value stocks over the last ten years, causing investors to question the premise that value beats growth over long time frames. More recently, since the beginning of 2017, growth stocks have seemingly gone into overdrive, as shown in the table to the right.

Total Returns 12/30/16 - 3/31/18

MSCI World Value Index	13.3%
MSCI World Growth Index	28.7%
Value performance	***-15.4%***
Russell 1000 Value Index	10.4%
Russell 1000 Growth Index	32.1%
Value performance	***-21.7%***
Russell 2000 Value Index	5.0%
Russell 2000 Growth Index	25.0%
Value performance	***-20.0%***

Source: Bloomberg

Despite the great outperformance of growth compared to value during most of the past decade, over longer periods, value has still significantly outperformed growth. Using the Russell 2000 growth and value indices as far back as the Bloomberg data goes (12/31/1979-12/31/2017), value has outperformed growth (9,048% versus 2,577% -- or 12.6% versus 9.0% compounded annually). We are confident value will win in the long run because it takes advantage of human nature and behavior. People tend to be overly optimistic in bull markets, paying up for projected growth. When reality strikes and stocks fall, some panic. In a true bear market, many lose faith, become overly pessimistic, and sometimes even vacate the market completely. These investors typically do not come back until "the situation stabilizes," which is usually well into the next up cycle. Since 1994, DALBAR, Inc. has published studies of the "Quantitative Analysis of Investor Behavior," where they attempt to measure the "effects of investor decisions to buy, sell and switch into and out of mutual funds over short and long-term timeframes." Not surprisingly, "The results consistently show that the average investor earns less – in many cases, much less – than mutual fund performance reports would suggest."[1] For example, in their 2016 study, over the last 30 years, DALBAR estimates that the average equity investor generated an annual return of 3.98% versus the S&P 500 at 10.16%.[2] Buying near the top and selling near the bottom are all too common. Similarly, in Spencer Jakab's book, *Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor*, he examines the track record of Fidelity Magellan's renowned portfolio manager Peter Lynch: "During his tenure Lynch trounced the market overall and beat it in most years, racking up a 29 percent annualized return. But Lynch himself pointed out a fly in the ointment. He calculated that the average investor in his fund made only around 7 percent during the same period. When he would have a setback, for example, the money would flow out of the fund through redemptions. Then when he got back on track it would flow back in, having missed the recovery."[3]

In our view, human nature will never change. Emotion, fear, and greed will continue to play a role in investor behavior. In its simplest form, value investing looks to appraise the value of a business, invest when the business is undervalued by the market (out of favor), and sell when the discount has narrowed. It is inherently contrarian in nature – buying when the masses are running for the exits, and selling during periods of irrational exuberance. Conversely, growth, momentum, and technical investing are far more speculative in nature. A disciplined value-oriented approach is well-positioned to outperform over the long run, as it is rooted in fundamental analysis with valuation as its guidepost. We firmly believe that value investing's recent lull is the exception, not the rule. A confluence of factors -- including large-scale central bank asset purchases, suppressed interest rates (i.e., negative yields), a lack of volatility, a disconnect from valuation, and a massive shift from active to passive investing -- have obscured markets since the great financial crisis of 2008-09. Today, high-quality, well-run businesses often trade at one or two standard deviations above their historical averages. It's likely just a matter of time before history repeats itself, fear rears its head, and value investing returns to the top.

Following, we highlight a couple of investments.

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[1] "DALBAR's 22nd Annual Quantitative Analysis of Investor Behavior: Period Ended 12/31/15." www.dalbar.com.

[2] "DALBAR 2017: Investors Suck At Investing & Tips For Advisors," by Lance Roberts. Realinvestmentadvice.com. September 25, 2017. Performance period ending December 30, 2016.

[3] Spencer Jakab. "Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor." July 12, 2016.

Carlisle Companies, Inc. (CSL)

(Analyst: Ben Karek)

Description

Carlisle is a diversified manufacturer of a broad range of products selling into industries such as commercial roofing, aerospace, construction, transports, heavy equipment and general industrial. Carlisle operates in four segments: Carlisle Construction Materials (CCM -- 62% of sales, and 79% of earnings before interest and taxes [EBIT]), Carlisle Interconnect Technologies (CIT -- 22%, and 17%), Carlisle Fluid Technologies (CFT -- 8%, and 3%), and Carlisle Brake and Friction (CBF -- 8%, and 1%). Carlisle's operating companies are given significant autonomy and responsibility for the performance of their businesses. This instills an entrepreneurial spirit that is central to the Carlisle Operating System, a LEAN/six sigma program.

Good Business

- The majority of Carlisle's sales are in markets where they maintain a #1 or #2 position.
- Carlisle's largest segment, CCM, derives 70% of its sales from the aftermarket. Commercial roofs are replaced roughly every 25 years.
- The company's products are specialized, highly engineered and recurring in nature.
- Carlisle's businesses are necessary and easy to understand.
- The company is conservatively financed at 1.7 times net debt/EBITDA.
- Carlisle's business is cash generative, with free cash flow averaging greater than 100% of net income.
- Return on invested capital (ROIC) has averaged 12% over the last 5 years.

Valuation

- The stock trades at a reasonable 17 times 2018 estimates, which approximates its 10-year average.
- Carlisle's enterprise value-to-sales multiple is 1.8 times, as compared to a long-term margin target of 20%.

Management

- The company has a strong track record of value creation. Carlisle's ROIC is above its cost of capital in spite of completing numerous small and mid-size acquisitions.
- Chris Koch, who took over from former CEO and current Chairman Dave Roberts in 2016, has demonstrated a continuity with the Carlisle model and a willingness to shrink the portfolio of businesses if doing so creates value.
- Carlisle's variable compensation includes metrics on EBIT margin, ROIC, and working capital.

Investment Thesis

Carlisle's shares have recently come under pressure due to raw material-driven margin compression in its largest segment, Carlisle Construction Materials. Carlisle has historically proven the ability to pass through raw material inflation, albeit on a lag, as evidenced by the decade-long margin expansion that this segment has experienced through multiple cycles. The company has increasingly exited low margin, less differentiated businesses while re-investing in their better businesses both organically and through tuck-in acquisitions. We believe Carlisle continues to be a best-in-class operator, and this hiccup has given us a chance to own the shares at a discounted valuation relative to an expensive small cap market.

The Howard Hughes Corporation (HHC)

(Analyst: Andy Ramer)

Description

Howard Hughes specializes in the development of master planned communities (MPCs); in the ownership, management, and redevelopment of revenue-generating real estate assets (Operating Assets); and in the development of other real estate assets in the form of entitled and unentitled land and residential condominium

developments (Strategic Developments). Howard Hughes emerged as a public company in November of 2010 following its spinoff from General Growth Properties.

Good Business

- The company owns attractive real estate in some of the country's best markets.
- Howard Hughes is growing its sources of recurring revenue.
- Since inception, the company has completed $1.6 billion of development that is expected to deliver a 9.9% yield on cost, or a 29.7% return on the $283 million of cash equity invested, assuming a 5.5% cost of debt.
- Howard Hughes owns all the development rights to its land, and is therefore able to control supply, and thus pricing, in markets with high barriers to entry.
- The company maintains a conservatively funded balance sheet. The net debt-to-capital ratio is 38.5%, and a majority of the debt is non-recourse to the parent.

Valuation

- Howard Hughes is underfollowed and misunderstood due to its relative complexity and lack of current profitability.
- At the 3/15/18 closing share price of $136.54, the company traded at a 9% discount to our conservative Net Asset Value estimate of $150.00 per share. Howard Hughes repurchased stock at $120.33 per share on 2/21/18 because this represented a meaningful discount to their estimate of NAV ($165+).
- Short interest is only 2.5% of the float and passive strategies own just 13.0% of the shares.

Management

- There is strong alignment between insiders and shareholders as the board of directors and management have a combined ownership in the company of approximately 20%.
- There is an average of 25 years of commercial real estate experience throughout the company's senior management and board.
- In September of 2017, CEO David Weinreb entered into a 10-year employment agreement and purchased a new warrant for $50 million at market value.
- That same month, President Grant Herlitz also entered into an employment agreement through 2027 and purchased a new warrant for $2 million. CFO David O'Reilly acquired a warrant for $1 million upon joining the company in October of 2016.

Investment Thesis

Howard Hughes is on the cusp of transitioning from a real estate company with dormant assets and lack of cash flow to one that is producing cash flow from difficult-to-replicate assets. The company has a presence in markets that have prospects for above-average growth – Houston; Las Vegas; and Columbia, Maryland – and owns unique irreplaceable land in Manhattan and Honolulu. Howard Hughes is managed by owner-operators who have demonstrated their ability to deploy capital and earn attractive returns.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2007 - 12/31/2017

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 %
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%
2016	21.65	20.65	21.31	171	0.46	12.02%	15.77%	$ 2,596.0	$ 22,626.7	11.47%
2017	15.42	14.49	14.65	171	0.84	11.12%	13.91%	$ 2,774.0	$ 25,322.0	10.96%

*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 - 12/31/2017. 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 - 12/31/2017. 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 $25.3 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.