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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2018

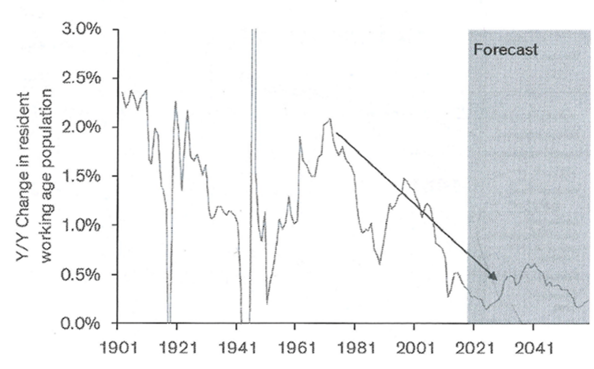
The FMI Small Cap portfolios returned approximately 3.2% in the September quarter compared to 3.58% for the Russell 2000 Index. Growth stocks continued to outperform value stocks, although not to the same degree as recent quarters or years. Equities of money-losing companies continued to outpace the moneymakers. As of September 25, 2018, of the top 50 performers (year-to-date) in the Russell 2000 benchmark, not a single one would pass our quality or valuation criteria. 35 of the top 50 Russell 2000 performers lost money over the past twelve months. These 50 companies, on a median basis, trade at 9.6 times revenue. The benchmark trades at or near record-high multiples of just about any valuation characteristic one can conjure. Given the heavy flows toward passive index investing, including the Russell 2000, it's not an exaggeration to say that investors simply don't seem to care what they are buying. They believe the Russell 2000 is a proxy for small cap or growth stock investing, and that's about the extent of it. The median Russell 2000 stock has significantly lagged the Index, suggesting performance has been driven by the higher-valued and heavier-weighted stocks. Interestingly, $1 invested at the beginning of 2009 (roughly coinciding with the start of this bull market) would be worth $2.38 for the median Russell 2000 stock, and $3.88 for the Russell 2000 Index. In a down market, it is likely that the movie will play in reverse, with the benchmark underperforming the median. Sectors that contributed positively to FMI Small Cap performance results in the quarter included Producer Manufacturing, Finance, and Commercial Services. On the negative side of the ledger were the Health Technology, Technology Services and Consumer Non-Durable sectors. Cash continued to be a drag. Carlisle Companies, Armstrong World Industries and W.R. Berkeley were positive performers, while FirstCash, Hain Celestial Group and ViaSat detracted.

> ***The seeds of any bust are inherent in the 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.***
> ***– J. Paul Getty***

The bull market stretched into uncharted territory in the third calendar quarter, reaching its longest duration and one of its strongest up-cycle performances on record. Investors continued to focus on the good news--the U.S. economy, Wall Street's version of earnings and rising stock prices…while ignoring danger signals--overconfidence (as reflected in valuations), rising rates and inflation, unbridled debt accumulation, a burgeoning trade war and perhaps some signs of fatigue in the economy. Faith in index funds and exchange-traded funds (ETFs) continued unabated, despite the "crowded trade" nature of many of these products. High confidence in technology shares harkens back to the 1990s, with exceptionally optimistic valuations for both established and startup companies. Private equity transactions, in all but a small minority of cases, are taking place at record-high valuations and debt leverage. So-called "covenant-lite" conditions have returned to the high yield arena. Across the board there appears to be little regard for safety and downside protection.

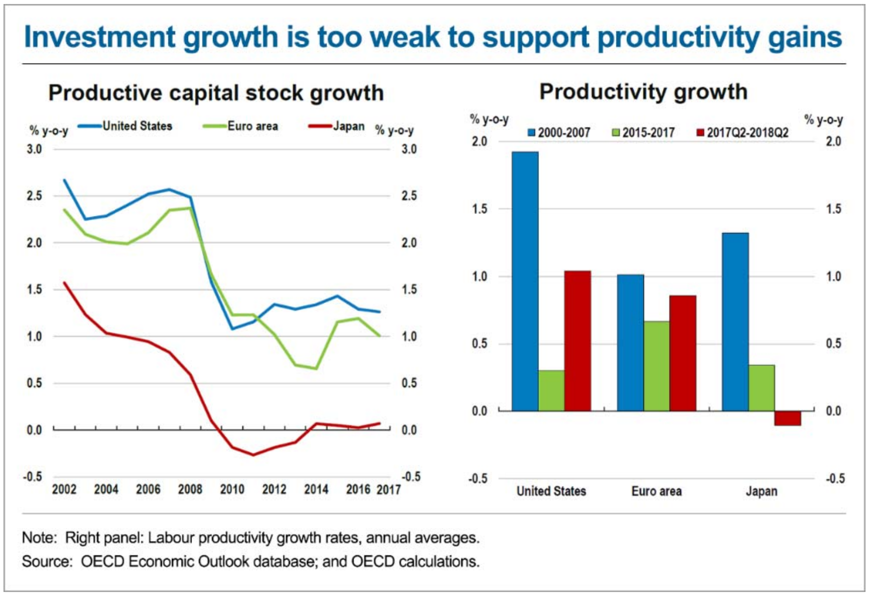
According to Bloomberg's weekly survey, U.S. real GDP grew at an estimated rate of 3.0% in Q3 and is predicted to grow 2.8% in the December quarter. While the unemployment rate is low, the work force participation rate of 62.7% remained well below its 67% peak, and today, hovers near a 40-year low. Working age population growth continued to be soft (see chart) and unless birth rates or immigration pick up, will be a source of future weakness.

Sharp slowdown in working-age population growth puts a severe constraint on potential growth



Source: U.S. Census and Bernstein U.S. Economics Analysis

The large number of working-age people who lost jobs in the last recession and were supposed to be returning to the labor force this cycle appear to be mostly idle. The evidence of this is rising wage rates (recently exceeding 3% according to the Atlanta Fed). With wages being the largest cost for most companies, margins may be at risk. Productivity gains, which have been meaningfully below long-term averages (see charts to the right) may not provide the offset to wage pressures unless there is a sustained increase in business improvement spending.



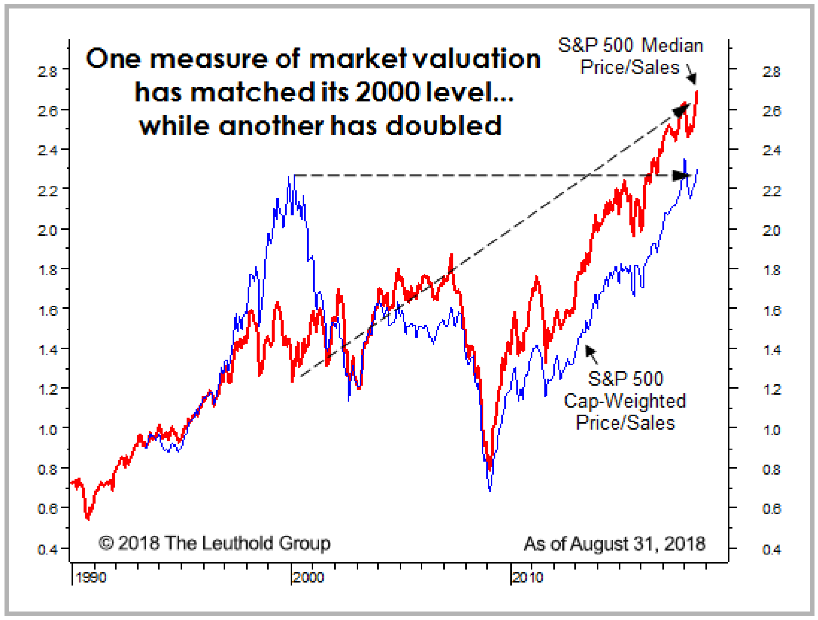
Note: Right panel: Labour productivity growth rates, annual averages.
Source: OECD Economic Outlook database; and OECD calculations.

The benefit from lower tax rates and fewer regulations is a positive, although the lack of fiscal discipline threatens long-term prosperity. The market seems unconcerned with the potential of an economic downturn. While we are not economists, we do recognize that recessions often come out of the blue. A yield curve that is near inversion doesn't bolster confidence that fair weather is a foregone conclusion. The CRB Metals Index is off over 15% from its recent peak. Pending home sales declined for the eighth straight month in August, down 2.3% from last year. Auto sales, at a recently annualized rate of 16.6 million, are down nearly 1.9 million units from the peak. Many technology companies are seeing inventories grow much faster than sales. Overseas economies, buyers of U.S. products, have softened, particularly in the emerging markets. Currency weakness in many of these countries is of particular concern, given high levels of dollar-denominated debt.

Across the globe, debt levels are rising significantly. The sovereign debt load has approximately doubled, and debt of all kinds is up 75% over the past decade, even though excessive debt was at the root of the last crisis. Worldwide debt-to-GDP is at a record 318%. The U.S. annual budget deficit as a percent of GDP is running at a 4.2% rate...the kind of figure one would normally see in the throes of a recession. Interestingly, it wasn't that long ago that U.S. leaders chastised Eurozone countries for exceeding the 3% deficit-to-GDP mandate. It is highly unusual for debt ratios to be rising at this point in the economic cycle. The U.S. national debt is $21.5 trillion, an astonishing figure relative to our $20.5 trillion economy and unprecedented in non-war times (see accompanying chart from Bernstein). Unfunded welfare benefits are a multiple of our debt obligations.

Source: CBO and Bernstein U.S. Economics Analysis

Much has been made of the strong earnings performance in recent quarters. Everyone's skepticism meter ought to be blinking yellow when Wall Street says earnings growth is 20% while the economy is growing 5% nominally and sales growth is in the single digits. We are, of course, experiencing a one-time positive year-over-year benefit from lower corporate tax rates but once those lap, long-term earnings growth rates will likely fall significantly. Wall Street, with an assist from corporate managements, has embraced the concept of "adjusted earnings," as discussed in previous letters. The abuse of this measurement has reached alarming levels. Based partly on our inquiry, the Leuthold Group studied actual GAAP (generally accepted accounting principles) reported, operating and "adjusted" S&P 500 earnings over a long-term (30-year) time frame. The spread between these figures has become wide. Even excluding the credit crisis quarters, the spread between reported GAAP earnings and Wall Street earnings is 23.6% (Wall Street's version is *always* higher). Proponents of adjusted earnings presentation say that amortization of intangibles, stock compensation and other one-time items justify this measure. Leuthold, among other findings, determined that more than 40% of the amount companies spent on mergers & acquisitions activity ended up in the scrap heap (written off). Additionally, many companies that claim "one-time" charges often have these write-offs with great frequency. Excluding the real cost of stock options seems dubious. There may be some justification for adding back a portion of amortization to GAAP earnings, but it seems managements and Wall Street have overplayed this hand.



Using the long-term, oft-cited valuation data provided by Leuthold, stocks today are in the 9th decile on a median basis (10th being the most expensive). We regularly review 46 different valuation series, including several price-to-earnings (P/E) data sets. It would be odd, to say the least, to have most of these measures registering in the 9th or 10th deciles, while at the same time having Wall Street's version of P/E ratios be "reasonable" or even "attractive," as proponents like to tout. Somebody is wrong. Using a much harder-to-manipulate series, price-to-sales, tells a different story. Leuthold recently called the chart above "the scariest chart in the world." Of course, investor sentiment usually reflects the current trajectory of stock prices. "Markets make opinions," as the old bromide goes.

Ten years after the last financial and stock market crisis, the media has engaged in a lengthy rehash and post mortem of what transpired. It's ironic and quite surprising to us at least, given how fresh the crisis still is in our minds, that many of the same mistakes are being repeated by investors today. A decade ago most investors scoffed at the notion that home prices could fall. A house was a surefire investment, and the proof of that was the willingness of banks to loan 95% or more against it. Investors believed in Wall Street's products (credit default options, mortgage-backed securities, collateralized loan obligations, etc.) and high-yield bonds. The economy was seemingly healthy, and the market saw little reason to worry about high valuations. They believed in central bankers. Today, investors have the same lofty confidence in high-flying social media, technology and med-tech shares. Many of the same aforementioned derivative investment vehicles are back in vogue, along with a cornucopia of ETFs and index products. Many mistakenly believe that these products carry not only low fees, but low risk. Do investors in the iShares U.S. Energy ETF, iShares Technology ETF or iShares Telecom ETF, for example, know that far from investing in diversified portfolios, they are putting over half their money behind just five stocks? A little over a year ago we discussed the potential liquidity issues facing many of the most popular ETFs. With turnover in many of these ETFs vastly greater than even the most liquid underlying constituent stocks, trading activity could be very interesting when markets get shaky. Junk bond spreads recently hit 315 basis points over treasuries--half the level of two years ago and a figure not seen since 2007, according to economist David Rosenberg. The faith in central bankers seems unshaken. Finally, just like a decade ago, perception that the economy is strong appears to be overriding any concern about high valuations or other potential troublesome developments.

What we have seen as excessive and unsustainable has persisted far longer than we thought possible. On one level that makes us "wrong," but of course that doesn't change the reality of the aforementioned conditions. We would rather give up some of the upside than to be remorseful in hindsight. Greed usually ends in regret. That means being more cautious with our investments and expectations today. Is there a way around another crisis and lousy stock market? Anything is possible when it comes to markets and human behavior. Earnings...the good and sustainable kind...could advance at a healthy rate and inflation could stay within earshot of 2%. The big one, interest rates, though significantly higher than two years ago, could stay well below normal for an extended period. Wages and other escalating costs could recede. The political crisis between the left and right could ameliorate. The nascent trade war with China could resolve. Externalities such as terrorism, wars, natural disasters, etc., could be benign. In other words, a lot must go right and not much can go wrong given today's valuations. We continue to hunt for attractive investments but acknowledge the environment is far from ideal. We are working diligently, with a focus on the long term. Additionally, we have our own money invested right alongside yours. Our confidence in achieving good full cycle returns remains high.

Below we highlight a couple of investments:

Argo Group International Holdings Ltd. (ARGO)

(Analyst: Matthew Goetzinger)

Description

Argo Group International is a diversified specialty insurance company focusing on small-to-mid-sized commercial risks. Specialty Excess and Surplus lines (35% of gross written premiums), niche Commercial Specialty (30%), and International Specialty (15%) together constitute Argo's property and casualty business. Argo's Lloyd's franchise, Syndicate 1200, comprises the remaining mix of premiums written. Reinsurance accounts for 12% of the premium mix. Argo is A rated by A.M. Best.

Good Business

- Argo is a durable, differentiated, and diversified specialty insurer with an attractive small-to-middle market account focus.
- The company has significant scarcity value as one of the few remaining independent scale players in the specialty market with a top five market share.
- Property and casualty insurance is a necessary coverage. This non-discretionary attribute, along with the company's emphasis on high service levels, results in strong customer retention and predictable revenues.
- Argo's focus on safety and good risk-adjusted returns leads the company to maintain conservative customer exposures and excess reserves. Management targets 10% annual growth in book value of equity per share.
- The company is managed with conservative leverage parameters.
- Argo is A rated by A.M. Best and Standard & Poor's, with a risk-based capital ratio of 200%.

Valuation

- Argo trades at just over 1 times estimated year-end book value per share.
- The 20-year industry average property & casualty insurance book value multiple is 1.2 times, with speciality insurers typically trading at a strong valuation premium to the group.
- Recent private market values for strong specialty insurers have been north of 1.7 times book value.

Management

- Mark Watson was named Argo's Chief Executive Officer in January of 2000. He previously had a leadership role at a smaller niche insurer who ultimately sold to the USF&G Corp.
- As a group, Argo's executive management team and corporate board own 4.9% of the company's shares outstanding. CEO Mark Watson individually holds approximately 3.3% of the shares.
- The company's incentive compensation plans appropriately target growth in book value per share as a key metric.
- During the past several years Argo has capitalized on industry changes and hired key talent from larger firms like AIG and Travelers.

Investment Thesis

Argo is a durable, differentiated specialty insurer with an attractive small-to-middle market account focus. Capitalizing on a continuation of the company's strong underwriting track record, incremental improvements to overhead costs, and steady investment performance should result in Argo achieving a 10% return on equity, and a higher level once interest rates normalize. The stock trades at an attractive valuation.

Graham Holdings Co. (GHC)

(Analyst: Dan Sievers)

Description

Graham Holdings, formerly the Washington Post Company, is a decentralized family-controlled holding company, and the owner of Kaplan International, Test Prep, and Professional education businesses (55% of second quarter 2018 revenue); seven broadcast television stations (17% of revenues); a manufacturing division (19% of revenues); a home healthcare division (6% of revenues); a digital marketing firm called Social Code (2% of revenues); and other assets (1% of revenues).

Good Business

- Following an almost decade-long restructuring, Kaplan no longer owns or operates a for-profit college. We believe that Kaplan's education services business (International, Test Prep, and Professional/Schweser) will be able to grow over time, and we should see potential for margin improvement.
- Graham Holdings' seven broadcast television stations continue to exhibit durability and good profitability, adding value through local news programming while benefiting from growth in retransmission fees and political advertising in even-numbered years.
- For Graham's Kaplan, broadcast, home healthcare, and Social Code divisions, we believe incremental growth can be achieved with very limited incremental capital investment, leading to attractive returns on invested capital and free cash flow that can be utilized opportunistically by the corporate office to repurchase undervalued shares, or for reasonably-priced acquisitions.
- Graham Holdings is conservatively capitalized with over $400 million in net balance sheet cash. In addition, its pension plans are overfunded by $1 billion. The value of this pension surplus to shareholders is certainly limited but may still be quite significant.

Valuation

- The company is not covered by any sell-side analysts, but based on our estimates for 2018, the company trades at a modest 6.0 times enterprise value-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) multiple.
- Based on these same near-term 2018 estimates, we estimate a sum-of-the-parts value that offers over 35% upside. We note that Graham has an exemplary long-term record of repurchasing its shares aggressively [only] when the shares trade at a wide discount to their estimate of net asset value.

Management

- CEO Tim O'Shaughnessy (age 36) has, in his 4 years at Graham, exhibited financial conservatism and a long-term focus. In August of 2018, he made a $2 million open-market purchase of Graham shares at $550. Mr. O'Shaughnessy is the son-in-law to controlling shareholder and Chairman Donald Graham (age 73), who has more than 18% economic ownership in the company.
- We note the presence (and influence) of reputable value-focused investors such as Chris Davis and Tom Gayner on the board of directors.

Investment Thesis

Graham Holdings is covered by zero sell-side analysts and has been largely ignored by investors during a nearly decade-long restructuring at Kaplan and a period of difficult--but necessary--divestiture decisions, including the 2013 sale of The Washington Post, the spin-off of the very valuable Cable One (CABO) division, and the recent March 2018 divestiture of Kaplan University (now part of Purdue University Global). Today, we believe the restructuring at Kaplan is largely complete, and that the remaining set of Kaplan businesses are attractive. We believe results from this new, stronger and simpler Kaplan are likely to lead some investors to rediscover the stock in due course. In the meantime, the company is run with a long-term focus and has a fortress-like balance sheet, which provides optionality to either repurchase shares at an attractive valuation or wait for moderately-priced acquisition opportunities to present themselves.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2006 - 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 %
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%
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.