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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

December 31, 2018

The FMI Small Cap portfolios declined approximately 12.0% in the December quarter compared to minus 20.20% for the benchmark Russell 2000 Index. Sectors that boosted returns included Producer Manufacturing, Consumer Services and Commercial Services. Sectors that hurt included Technology Services, Consumer Non-Durables, and Electronic Technology. Graham Holdings, Woodward and Argo Group added to relative performance while Allscripts Healthcare Solutions, Ryder System and Hain Celestial Group detracted. The abnormally low volatility of the last several years appears to be over. Markets are moving dramatically in both directions, although mostly downward since September. It was a tough quarter for stocks, and it pulled the year into negative territory. Value-oriented strategies such as ours outperformed growth-focused strategies and the benchmark in the quarter. Perhaps this is the end of an astonishing run for growth stocks… the longest on record of outperforming value. Nearly a decade ago (March 9, 2009) marked the bottom of the last stock market cycle, and approximately the nadir of the economy as well. The Fed has had an outsized role in financial and economic matters ever since the Greenspan era, but the last decade has seen an unprecedented level of Fed intervention, driving interest rates to roughly zero and essentially conjuring $4.5 trillion out of thin air. These central bank policies, copied the world over, helped inflate assets -- especially the more aggressive growth stocks, private companies, bonds, real estate and art. Naturally, Fed defenders will point to the long economic expansion as justification for their policies, but it has been the slowest recovery on record, and has left the government buried in debt. A large number of people simply dropped out of the workforce, and the economy and society are now left to deal with the aftermath of a misallocation of resources brought about by artificially low rates. We applaud the normalization of rates and hope the Powell Fed recognizes the age-old axiom: “There is no such thing as a free lunch.”

The severe decline in the December quarter may have woken the complacent, reminding them that stocks go both ways. It remains to be seen whether the speculative excesses of the last cycle will be wrung out in classic bear market fashion or if this is just another pause that refreshes (“buy the dip!”). It’s too early to say whether the strong rebound on December 26th (roughly 5% in the S&P 500) is another win for the “buy the dip” crowd. Since we believe our investments are more conservative, we hope that the newfound volatility means we have entered a more discerning era where balance sheets and *bona fide* earnings rule the roost, rather than profitless growth and made-for-Wall Street earnings. While a sizable number of stocks have declined significantly, most of the higher-quality equities have yet to reach an attractive zone from a valuation standpoint. In fact, overall valuations remain well above historical norms. Nevertheless, the rapid change in sentiment, save December 26, has put many more interesting ideas into view, and the research team is excited for the first time in a while. Additionally, while it might seem a bit unsporting, it is gratifying to see some of the rankly speculative stocks get crushed. Many of these high-wire acts were performing without a net, so to speak. In a rough market, burning cash and losing money are not comforting words to investors, many of whom are tasting fear for the first time. The muscle memory of a 10-year growth-driven bull market doesn’t change in one quarter, however, so we expect sharp growth stock rallies within the context of a return to normal in valuations. Our working thesis is that investors will capitalize the good growth companies at lower multiples and abandon the rickety companies, both of which should work in our favor.

Rather than the typical narrative, below we have addressed the most common questions we have been getting over the past twelve months.

The changing nature of our economy, with more technology companies, favors growth stocks. Why do you think value will outperform growth?

Human nature is unlikely to change. People like to feel smart, and owning the most popular stocks and the hippest companies makes them think they are. What they pay (valuation) for this luxury becomes an afterthought. Cognitive dissonance (the state of having inconsistent thoughts, beliefs, or attitudes), prevents investors from embracing the notion that these stocks are speculative, risky and possibly poor investments. Each year they “win” gives them more confidence and allows them to embrace a range of explanations and justifications for their positions. Thus, revenue growth or customer count trumps profit, adjusted earnings trumps real earnings, and momentum trumps balance sheets. Value investors basically work away from the tendencies of the growth stock investors. They take advantage of the madness of crowds and understand that high growth is rarely sustainable. Most importantly, value investors understand that hitting for average is more important than socking an occasional home run. Growth stock investors typically rely on home runs to counter the higher number of big losers in their riskier portfolios; however, institutional constraints usually prevent investors from owning huge percentages of their portfolio in just a few stocks, thus negating some of the benefits of owning big winners, and of growth stock investing relative to value investing.

Why is the P/E ratio for the market that I hear on CNBC, Bloomberg or FactSet so much different than FMI's?

The price-to-earning (P/E) ratio used by the popular press and data providers are most often an estimate of the following year's earnings, adjusted for amortization of intangibles, restructuring charges, one-time items, and other non-cash items such as stock compensation. It is not based on generally accepted accounting principles (GAAP). As we have articulated in the past, the difference between adjusted earnings and GAAP earnings has grown enormously as the bull market has lengthened, and today is at least 30% higher. Moreover, the way Standard & Poor's calculates the P/E ratio is (approximately) the summed market values of the companies divided by the summed float-adjusted earnings. When an investor buys an index fund, however, what they are really buying is the P/E ratios of each individual constituent times its weighting in the index, with the sum of these weighted P/E's being the P/E ratio for the index. When the largest market caps are also the most expensive, the S&P method can understate the actual P/E ratio. The following simplified example shows how the S&P method could yield a P/E ratio approximately 30% lower than the weighted average P/E method. This phenomenon would be reversed if the bigger market caps had the lower P/E ratios.

Stock	Market Value	Weight	Earnings	P/E	Weighted Average P/E	Approximate S&P Method (MV/Earnings)
A	600	60%	10	60	36.0	
B	300	30%	12	25	7.5	
C	100	10%	10	10	1.0	
	1,000	100%	32		**44.5**	**31.3**

Looking at the U.S. Russell indices, they have calculated index P/E's using an interquartile range to exclude outliers. This appears to ignore the money-losing companies, most of which are speculative and deserving of a high P/E ratio. In the iShares Russell 2000 ETF (essentially an identical proxy), for example, as of 12/31/18 there are over 700 companies losing money! This methodology also eliminates a meaningful number of the highest P/E ratio companies. Based on a weighted average methodology that we have used for years using actual earnings (capping over-100 P/E stocks at 100, and money-losing companies at 40) the weighted average P/E ratio of the iShares Russell 2000 ETF is 30.8x as of December 31, with a median of 31.3x. For the S&P 500, the weighted average P/E using our methodology is 31.3x, with a median of 20.2x.

Even if we acknowledge that valuations are high, they've been high for many years and we've made a lot of money. Why do you think they are poised to fall?

Stock returns are a combination of earnings performance, multiple change and dividend yield. If multiples did not change, stocks would rise at the underlying earnings growth rate. Over long periods of time, this has been approximately 6%. Recently, this rate has been slightly higher than the underlying growth rate of the economy, in nominal terms. Over the past ten years, despite starting from a trough (and having no recessions, and benefiting from lower tax rates, low interest rates and share repurchases), the S&P 500 has grown earnings at a median rate of just 5.7%.[1] Yields have slipped from approximately 3.3% to 2% over the past decade. Thus, the approximate 13% compound return of the index over the past decade has benefited from approximately 4.8% annualized growth in the multiple. The multiple expansion is even more extreme in the Russell 2000. As previously mentioned, valuations are still quite high by historical standards. If growth struggles to reach 6% when aided by lower rates and share repurchases, how will the next several years look on this front, with higher interest rates, perhaps higher tax rates, and maybe even a recession? We have just witnessed in the December quarter how sentiment can change rapidly. Will investors shrug off illogical valuations as they have for half a decade? Time will tell.

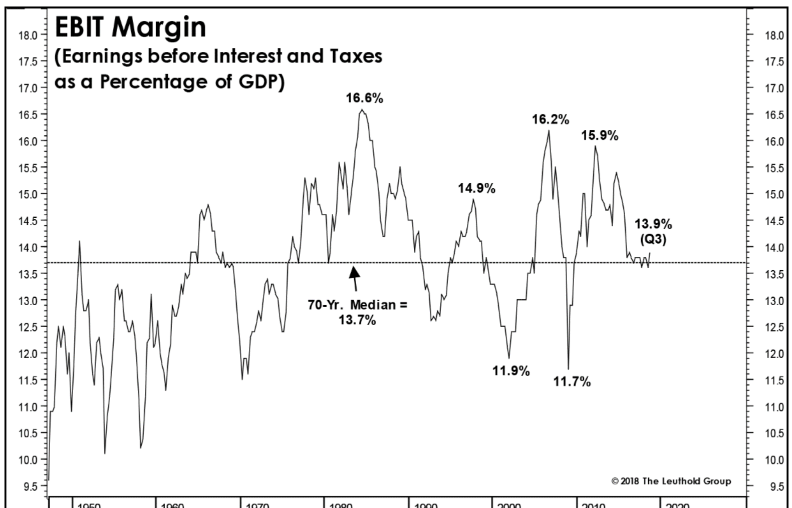
[1] Ten years ending November 2, 2018.

Why would stocks be declining when the economy appears strong?

We'll start with the fact that the current growth rate is not actually strong by historical standards. Nevertheless, the market may be anticipating a tougher economic environment. There are numerous signs of worry, including several regional Purchasing Managers' Indices (PMI) falling, oil and industrial commodities dropping, World Bank and Atlanta Fed estimates of GDP growth slowing, core capital expenditure orders retreating, and auto and housing-related industries weakening. Maybe the market is starting to wise up to some shenanigans, including most companies' presentation of adjusted earnings -- or just plain aggressive accounting, as exhibited by companies such as GE. In an October issue of *Grant's Interest Rate Observer,* Francine McKenna, a trained accountant and reporter for Dow Jones' *MarketWatch*, was quoted bemoaning the quality of today's earnings: "Companies are deliberately misleading investors in terms of their actual results, using these alternative metrics because they gave up trying to do it via GAAP. It is much easier to just make stuff up." The SEC is undoubtedly going to be more heavily scrutinizing adjusted earnings in coming years. Perhaps investors are beginning to consider that they were on borrowed time, betting on money-losing companies and momentum stocks. Some investors are chart readers who see a technical breakdown and are simply hitting the sell button. Others are part of ETFs, index funds and other program trading. As *The Wall Street Journal* said recently, "Roughly 85% of all trading is on autopilot—controlled by machines, models or passive investing formulas, creating an unprecedented trading herd that moves in unison and is blazingly fast." Maybe geopolitical tensions have become too intense to support high multiples. Finally, as we have documented in previous letters, economic growth and stock market performance are often not correlated in the short-to-intermediate term.

Profit margins are excellent and there doesn't seem to be any reason to believe they will be falling. Why do you feel differently?

This is an easy one. Margins have already dropped significantly. After-tax margins are still near a peak but that includes lower interest expenses and lower taxes, which may be in the journal of irreproducible results. According to The Leuthold Group, earnings before interest and taxes (EBIT) as a percentage of GDP peaked about five years ago, and margins are already down roughly 200 basis points. The new year will lap the tax law change. Higher wage inflation will make for a more difficult margin story, whether using EBIT or net income. The end result could be earnings growth that may actually trail sales growth, with both rates in a mid-single-digit growth range… barring a recession.



From National Income and Product Accounts (NIPA).
Profits are after tax and Include inventory valuation allowance and capital consumption adjustment.

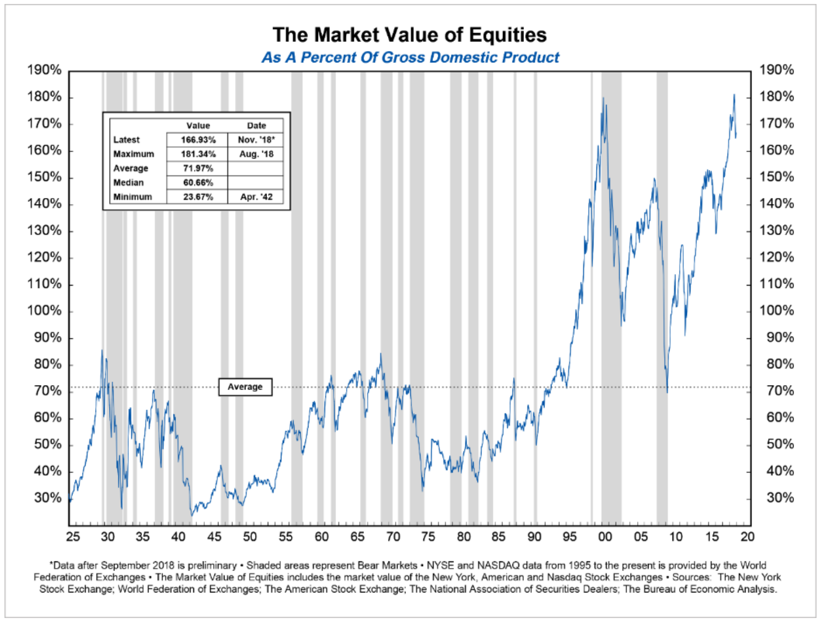
Why do you seem so concerned about debt levels when few else seem to be?

Debt as a percentage of GDP is at a 50-year high. The level is virtually unprecedented in non-wartime. Interest expense is 6.6% of the federal budget, and expected deficits (approaching $1 trillion) and the debt (over $20 trillion) are escalating rapidly. Astonishingly, the Office of Management and Budget (OMB) expects interest expense to rise to 12% by 2023. This poses significant crowding-out effects and social costs, not to mention P/E multiple risk.

At the individual company level, high debt lowers the margin of error. According to Moody's, "Since 2009, the level of global nonfinancial companies rated as speculative, or junk, has surged by 58 percent, to the highest proportion ever." The capital markets might not always be receptive to rolling over one's debt. Few things match the fear that comes from a debt market that seizes up. Higher interest expense clearly dents earnings. Companies with levered balance sheets often see their stocks fall much harder when ill economic winds blow. Further, raising debt to buy back equity, the favored method of earnings growth in recent years, is simply much more difficult given today's balance sheets.

Why will active management outperform index funds?

One of the great mysteries of recent years is Warren Buffett's advice to all investors: buy the S&P 500 Index Fund. On one level, the S&P 500 is perhaps a good thing to buy in the aftermath of a bear market when almost all stocks are discounted. Obviously, that doesn't apply today, at least at the very moment we pen this! The S&P 500 is probably the best index fund to own of all the various index funds and ETFs one could purchase. There appear to be higher-quality companies and balance sheets in this index than in the others, especially the popular ones tracking the Russell 2000 and Nasdaq. Perhaps Buffett is thinking in very broad, long strokes… as in fifteen or twenty years. Considering how the typical investor deploys money (chasing performance and earning a return that is less than half of the market's return over the last 30 years, according to DALBAR), it may not be bad advice even from today's relatively high valuation levels, as long as the holding period is sufficiently long. Perhaps Buffett recognizes that the average investor doesn't live in Lake Wobegon (where "all the children are above average"), so rather than recommend some type of active management over others, he defaults to recommending the index. Still, for someone who generally looks forward rather than backward, and who made his career in active management, it's a bit curious, especially with the market (using Buffett's favorite valuation yardstick, market cap-to-GDP) recently touching the highest level ever, in August.



Buffett's compatriot-in-arms is Jack Bogle, the long-time leader of Vanguard and index fund espouser extraordinaire. Mr. Bogle has been a proponent of index fund investing regardless of valuations. In early 2000 the S&P 500 stood at approximately 1530. Thirteen years later it was also 1530, with an intermediate stop at 673. One clipped a small dividend for the trouble but that was a pretty paltry return compared to many active managers, particularly of the value persuasion. The setup looks eerily similar today, or at least it did a few months ago. As in the early 2000s, speculative juices were (and probably still are) unsustainably high. When the most popular companies come under pressure, it is likely to have a disproportionate impact on the index funds. The Russell 2000 and other small cap-focused index funds, where speculation and shaky balance sheets are the most rampant, will likely see astonishing declines. We win by having far fewer of these names than the index. The question really should be, "Why will some active managers beat the index?" Careful, discerning, value-oriented investors should beat an index that has heretofore benefited from years of nonfundamental money flow, causing it to be top-heavy with expensive stocks. We are confident that when the full story plays out over the long run, we should comfortably outperform.

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		Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
						Composite	*Benchmark			
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.