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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

March 31, 2019

The FMI Small Cap portfolios returned approximately 15.9% in the March quarter compared to 14.58% for the Russell 2000 Index. From a sector perspective, Producer Manufacturing, Finance and Commercial Services helped during the quarter, while Technology Services, Health Technology and Consumer Services lagged. Armstrong World Industries, Ryder System and Woodward added to results while Interpublic Group, MSC Industrial Direct and Cars.com were also positive contributors, but underperformed in relative terms. After strong relative performance but difficult absolute results in the December quarter, stocks roared ahead in calendar quarter one. Fears that Fed Chief Powell would be different than former chairs Yellen and Bernanke proved ill-placed. Investors have been treated to more candy, i.e. easy money, or in this case, additional delays in returning to "normal rate policy" after more than a decade of "emergency rate actions." Stocks and most other financial assets rebounded dramatically from only moderately depressed fourth quarter levels, leaving valuations back near all-time highs. Market participants have learned not to bet against central banks, regardless of the underlying fundamentals. Investors, after a one-quarter respite, have returned to growth stocks, continuing a decade-long love affair they believe will never end. Since 1900 (using the Dow Jones Industrial Average), there have been 21 bull markets, and excluding the present one, the median duration was 2.6 years and the cumulative price gain was 94.2%. The current bull market is 10 years old and has gained 296% on the same basis. Oddly, fundamental growth over this period has been below-average. As value-oriented investors, we often modestly lag growth stock-fueled markets, and this bull market has been no different. The real measure of performance, however, comes after a full market cycle, which few see coming but history says is inevitable. Since 1900, there have been 21 bear markets with a median duration of 1.43 years and a price return of -37.2%. As investors increasingly abandon risk-sensitive investments chasing growth and index products, we remain steadfast in our belief that in the end, fundamentals win -- not momentum or popularity.

Unemployment and inflation rates are low. Personal and corporate income tax rates have been cut. Stocks are higher. What's not to like about today's environment? While we are gratified to be near the government's definition of full employment, we wonder why so many people are not working. The Federal Reserve Bank of St. Louis reports that in February of 2019, the employed-to-population ratio was 60.7%, compared to 64.6% in February of 2000. The labor participation rate is significantly lower than a decade ago. Ten years past the last recession, the number of people on SNAP, the Supplemental Nutrition Assistance Program ("food stamps"), remains approximately 38 million, which is significantly higher than the last recession. Additionally, 10 million individuals are categorized as disabled (almost double from 20 years ago).

Despite a return to fiscal stimulus and a dramatic rise in the budget deficit, the data suggests the United States economy has slowed considerably in recent months, and many economies around the globe are experiencing the same thing. At the beginning of the year, the Blue Chip consensus for first quarter U.S. GDP growth was over 2%. The estimate is less than 1.5% as of late March, while the Atlanta Fed's GDPNow forecast (as of 3/10/19) for the first calendar quarter had fallen to just 0.4%. The yield spread between the 3-Month Treasury Bill and the 10-Year Treasury Bond recently inverted, which is often a precursor to recession. The Organisation for Economic Co-operation and Development (OECD) world growth estimate for first quarter real GDP is now 3.3%, down from 3.6% last year. Germany and China's economies have experienced notable weakening, with Germany's GDP growth barely above recession levels. The German 10-year bond yield is negative as of March 26th. China's growth is expected to slow to 6.2% from 6.5%, according to the World Bank. While Chinese data is notoriously unreliable (a recent Brookings Institute study suggests China's economy is 12% smaller than the official figures), anecdotal information such as electricity usage, equipment orders, and the resumption of stimulative monetary and fiscal actions suggest significant slowing. Early this March, just three months after ending the long-term quantitative easing program, the European Central Bank said it would hold interest rates at subzero levels at least through the end of 2019 and provide capital [from where?] to boost bank lending. Does anyone ever stop to wonder why, after years of artificially low interest rates and extraordinarily accommodative fiscal policies, economic growth is not higher?

At some point, people will begin to understand that economic growth is a function of labor hours and productivity (Figure 1). With U.S. productivity growth, population growth, and labor hours growth relatively low from a historical perspective, it is not surprising that GDP growth has been significantly less than long-term averages. The Eurozone is in even tougher shape, as population growth and productivity growth are lower than in the United States, as the accompanying chart from the *Financial Times* attests (Figure 2).

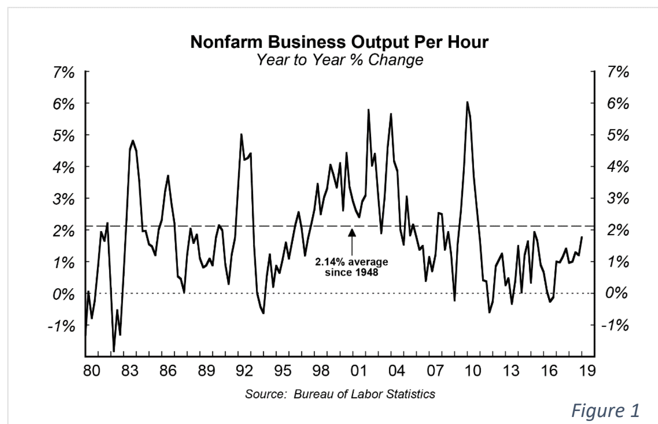

Figure 1

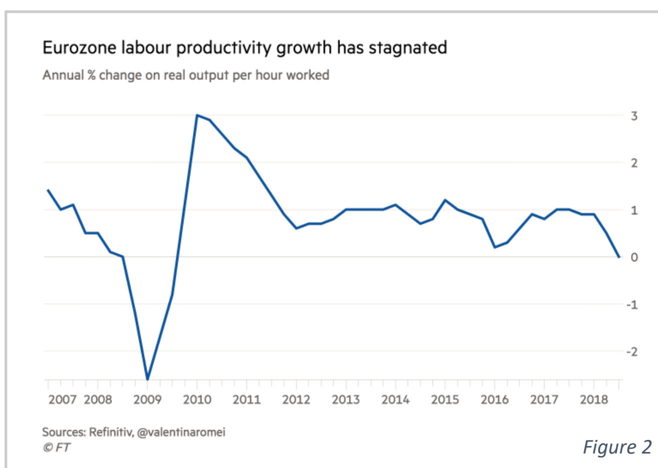

Figure 2

In previous letters we have shown that over long periods of time, corporate sales and earnings growth essentially mirrors nominal GDP growth. Corporate performance is, in a sense, a proxy for GDP (most economic activity involves buying products and services from companies). Historically, growth in sales, earnings, and GDP has clustered around 5%, although recently it has been less than this. In March, The Leuthold Group published the sales and earnings growth of the Standard & Poor's 500 Index from the 2007 cycle peak through March of 2019. *The S&P 500 sales per share advanced at a 2.6% rate, and earnings per share grew at a 3.8% clip* -- both figures benefitting from strong stock repurchases. Most analysts find these figures shockingly low, especially juxtaposed to the earnings growth rates bandied about on CNBC or Bloomberg. The disconnect from the actual figures and "excellent earnings growth" one constantly hears from the media comes back to the phenomenon we have illuminated in recent missives: "adjusted earnings." The massive write-offs at Kraft Heinz, General Electric, Teva and many others, along with the multitude of smaller, ever-recurring write-downs most companies are reporting, are really a true-up of formerly inflated earnings. And there is simply no explaining away 2.6% sales growth. We live in a slow-growth world, yet stocks seem to live on a different planet; in bull markets, realism is in short supply.

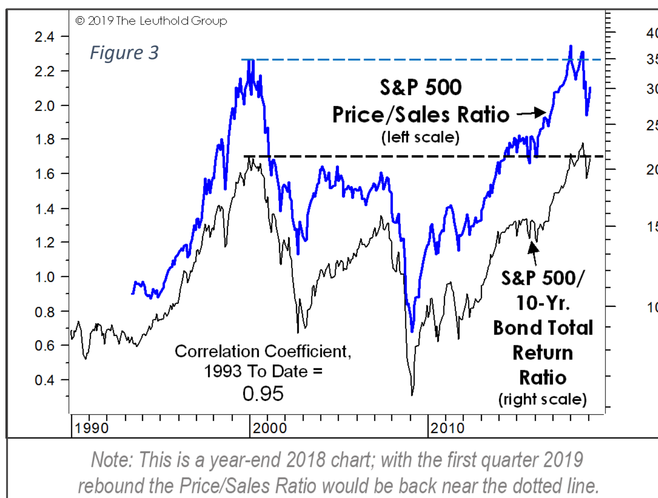

Figure 3

Note: This is a year-end 2018 chart; with the first quarter 2019 rebound the Price/Sales Ratio would be back near the dotted line.

With equities advancing faster than underlying earnings, adjusted or otherwise, it leaves valuations back near historical highs (Figure 3). The late 2018 swoon was quickly wiped away by the "Powell Put" further ingraining in investors' minds that there is no real or lasting risk to owning financial assets. The length and magnitude of this stock market cycle seems to have dulled the senses of investors. They want the performance of growth stocks, or at least the index, regardless of the underlying fundamentals or valuations (Figure 4). Although Wall Street-adjusted earnings growth estimates (not to mention GAAP[1] estimates) for the S&P 500 have slowed to zero or lower for the March quarter, it doesn't seem to affect stock prices. Neither does a budget deficit again exceeding $1 trillion, federal debt surpassing $22 trillion, total debt-to-GDP of 250% (Figure 5), a venomous political climate, or a majority of young people -- and even some high-profile politicians -- favoring socialism over capitalism.

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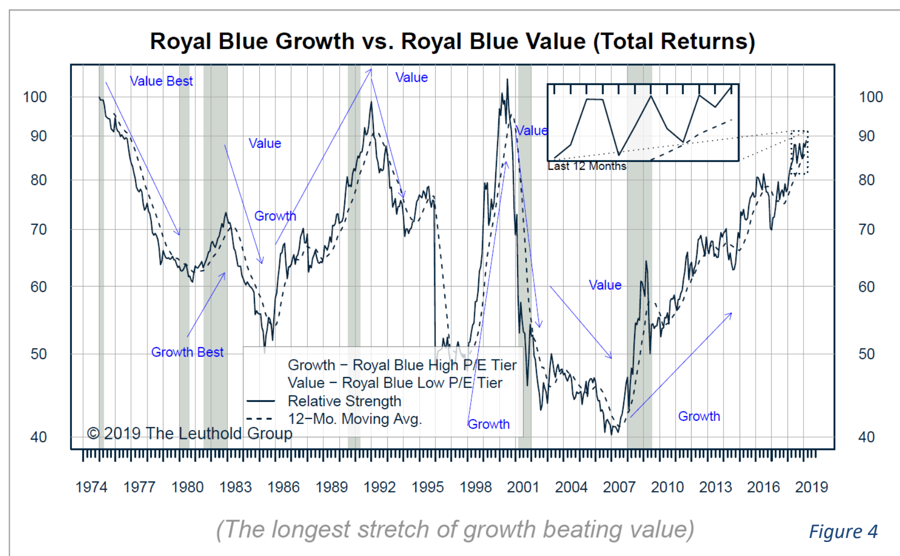
[1] Generally Accepted Accounting Principles.

We are actually quite optimistic that the U.S. and the world will overcome most of the aforementioned negatives; there is a long history of problems being fixed. High valuations and the depth of some of the challenges, however, influence our opinion of what to expect out of stocks in the near-to-intermediate term, as well as the style that will win in the long run. Historically, value stocks have provided better protection on the downside, and have typically outperformed over a full market cycle; unless a hundred years of market history are no longer valid, we stand firm in this belief.



(The longest stretch of growth beating value)

Figure 4

Before discussing a couple of investments that epitomize our approach, we'd like to take a moment to review the portfolio's sector weightings, with specific emphasis on areas we are avoiding.

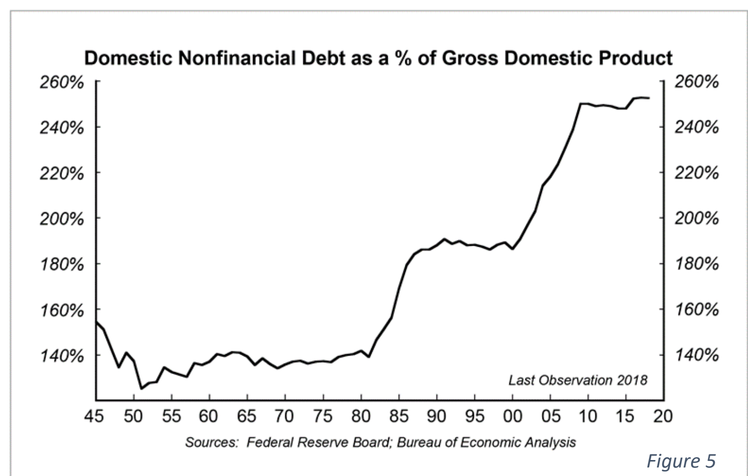


Figure 5

Since inception, the strategy has usually been underweight most technology-related sectors due to a few factors. First, the reward-to-risk ratio is not high enough; though there are periodic big winners in the Technology sector, there are also many losers. In portfolios where diversification doesn't matter, one could let a winning stock overcome the bad ones; however, in professionally-managed portfolios or mutual funds, wherein there are either regulatory or self-imposed position size limits, the winning stock must usually be trimmed, mitigating some of the ability to cover the decliners. Next, when we study the return on invested capital (ROIC) for various Technology sectors, we don't find the spread over the rest of the universe great enough to justify a large exposure. Finally, we are underweight Technology because the time required to stay on top of fast-moving and knowledge-intensive industries is tremendous; it is counterproductive to spend a disproportionate amount of time on something that won't deliver a commensurate reward. So, in high-tech we tend to focus on service companies and downstream technology stocks, where the customer base is stickier and the information paper chase is less time-consuming.

The Utilities and the Energy sectors, specifically Exploration & Production (E&P), are two additional areas wherein we are perennially underweight. Even when multiples are cheap (which they are not), we generally find utilities unattractive. It is questionable whether most utility companies even earn their true cost of capital, but, being charitable, let's just say that it is a very low return business; additionally, growth is almost non-existent or negative in many regions. Finally, utility companies are generally very levered businesses. The E&P space is also a low-returning sector over a full cycle. Discipline is in short supply, and illogical capital flows tend to ruin the economics of this business; E&P has wonderful "trading" moves from time to time, but it is a difficult place for long-term buy-and-hold type investors.

The last area where we have little exposure today is in Pharmaceuticals and Biotechnology. Since 2010, Deloitte has tracked the research and development (R&D) productivity for the top twelve global publicly-listed pharmaceutical companies: Amgen, AstraZeneca, Bristol-Myers Squibb, Eli Lilly, GlaxoSmithKline, Johnson & Johnson, Merck & Co.,

Novartis, Pfizer, Roche, Sanofi, and Takeda.[2] R&D returns for the cohort have plunged, falling from 10.1% in 2010 to just 1.9% in 2018. The smaller cap biotechnology arena is even more bleak as the vast majority of companies lose money.

The reason that pharmaceutical investment returns have deteriorated is twofold: costs are rising rapidly and forecast revenue is falling – a toxic combination. The cost to bring a compound to market has increased by over 80% the past eight years, from $1.188 billion in 2010 to $2.168 billion in 2018. At the same time, forecasted peak sales per compound have more than halved since 2010, falling from $816 million to $407 million. Even with record-low interest rates, it's very difficult to make the case that pharmaceutical companies have been earning the cost of incremental capital deployed. For years, the bigger pharmaceutical companies have seen the writing on the wall and have opted to shoot their way out with expensive mergers and acquisitions (M&A). *Informa Pharma Intelligence* estimates that in 2018, biopharma M&A activity reached an astounding ~$265 billion, up 26% versus 2017. Takeda's $64 billion acquisition of Shire led the charge. In early 2019, Bristol Myers Squibb announced a ~$95 billion acquisition of Celgene, in the largest pharmaceutical deal on record. While it might be easier to buy growth than to build it, acquisitions often fail to earn their cost of capital, especially at today's lofty valuations. Trying to pick the next lottery ticket for a takeout is not our bailiwick.

Studying the long-term fundamentals of the largest pharmaceutical companies is instructive. For the cohort, total ROIC peaked at 29.8% in 2000. ROIC has since collapsed, averaging just 11.4% over the last 5 years, down by over 60%. To make matters worse, the 5-year average is overstated, as it fails to capture the tens of billions of dollars of impairments and write-downs that are ignored by Wall Street but help to inflate the ROIC calculation (i.e., lower invested capital, depreciation, and amortization in subsequent years). We think the structural challenges are far deeper than commonly perceived.

The Small Cap portfolio typically does not have any major sectors that are always overweight. Today, some of our overweight contingent includes Producer Manufacturing, Commercial Services, Process Industries and Distribution Services. Our focus is on individual securities and the diversity each company brings in terms of sales, earnings and geographic exposure. We strive for broadly diversified portfolios but not at the expense of participating in overvalued segments.

Today, the strategy is positioned relatively defensively. In the difficult fourth quarter of 2018, the portfolios outperformed, and that has historically been the pattern in difficult markets. In the current environment we remain cautious and are prudently deploying capital to deliver both good absolute and risk-adjusted returns.

Below we highlight two Small Cap investments.

Genpact Limited (G)

(Analyst: Jordan Teschendorf)

Description:

Genpact is a global leader in business process outsourcing (BPO) and information technology outsourcing (ITO) services; in 2017, BPO contributed 84% of sales, and ITO, 16%. The company executes its strategy according to its proprietary Smart Enterprise Processes (SEP) and Lean Digital frameworks. Genpact was spun off from General Electric (GE) in 2007 and continues to operate with an intense focus on Lean and Six Sigma business streamlining methodologies. The company has broad exposure across a number of industry verticals, employs over 77,000 professionals around the globe, delivers services to more than 700 clients from a network of more than 70 delivery centers, and competes in 16 countries, while supporting more than 30 languages.

Good Business:

- Genpact derives a majority of its revenues from Fortune 1000 companies.
- The company believes that more than 80% of its revenues can be considered recurring in nature, with average deal length around three years and annual client retention in the high-90% range.

[2] "Unlocking R&D productivity: Measuring the return from pharmaceutical innovation 2018." Published electronically by Deloitte.

- Over the trailing 3, 5, and 10-year periods, Genpact's organic growth has averaged 7%, 7%, and 9%, respectively. The company expects growth to be approximately 10% over the next several years, with two thirds of sales growth expected to come from existing clients.
- Genpact's solutions provide customers with a tangible return on investment and the company is gaining share in a secularly growing BPO market. We think the addressable market opportunity is approximately $500 billion, which is expected to grow 20% by the end of 2021.
- Over the trailing 5 and 10-year periods, the company's ROIC has averaged approximately 12%, which exceeds its cost of capital.
- Genpact carries a prudent amount of debt. Its net debt-to-EBITDA[3] and interest coverage ratios are 1.9 times and 6.5 times, respectively.

Valuation:

- The stock has underperformed the S&P 500 by 13% over the last 3 years, despite generating superior growth.
- Genpact's forward price-to-earnings multiple is 16.8 times, which is consistent with its trailing 5 and 10-year averages of 16.7 times, and a substantial discount to both the Russell 2000 and S&P 500 indices.
- Consistently declining customer concentration (e.g., GE accounted for 9% of sales in 2018 compared to 20% in 2014 and 30% in 2011) and our expectation for accelerating organic growth and margin expansion over the next several years supports a valuation multiple above the company's historical average.

Management:

- Current CEO, N.V. "Tiger" Tyagarajan (57) has led the company since June 2011. He is considered a pioneer of the BPO industry and has a deep knowledge of Lean and Six Sigma. Mr. Tyagarajan beneficially owned 2.373 million shares as of the latest proxy filing (April 2018).
- Bain Capital has approximately $1.1 billion invested in the company, which represents 17% of the outstanding shares. Further, representatives of Bain occupy two seats on Genpact's board of directors. We believe this significant ownership interest will help to drive future shareholder value creation.

Investment Thesis:

Over the last several years, areas within Genpact's legacy information technology (IT) service and GE business lines have been a drag on the company's top-line and earnings growth. Concurrently, management has invested significantly in the BPO franchise to add vertical expertise, enhance its brand image, and accelerate future top-line growth and margin potential. As a result, Genpact is increasingly being viewed as a partner in revenue generation rather than solely a provider of cost arbitrage. As these investments continue to mature and the headwinds abate, we see above-average return potential with a below-average risk profile driven by Genpact's relatively high-growth business, with a sticky customer base and strong balance sheet.

Ryder System, Inc. (R)

(Analyst: Jordan Teschendorf)

Description:

Ryder System, Inc., a Florida corporation founded in 1933, is a global leader in transportation and supply chain management solutions. Ryder generated $8.4 billion of revenue in 2018 and its business is divided into three operating segments. Fleet Management Solutions (FMS) contributed 62% of 2017 earnings before tax (EBT), and provides full service leasing, contract maintenance, contract-related maintenance, and commercial rental of trucks, tractors and trailers to over 14,000 customers in a diverse set of industries in North America. Supply Chain Solutions (SCS), with 26% of 2017 EBT, provides comprehensive supply chain solutions including distribution, transportation, and IT solutions to over 500 customers throughout North America and Asia/Pacific. Dedicated Transportation Solutions (DTS), with 12% of 2017 EBT, provides vehicles and drivers as part of a dedicated transportation solution to over 200 customers throughout North America.

[3] Earnings before interest, tax, depreciation and amortization.

Good Business:

- The company benefits from a reasonably high level of recurring revenue. We estimate that over 70% of total revenue is generated through multi-year contract agreements.
- Ryder is one of only two nationwide full-service truck leasing companies, with roughly 20% market share. As one of the largest buyers of commercial trucks, and fleet maintenance, with its network of over 800 maintenance locations, the company benefits from economies of scale in purchasing.
- Ryder is a beneficiary of secular trends favoring transportation outsourcing, including increasing cost and complexity of equipment ownership, driver recruitment and retention challenges, and regulatory pressures.
- Despite headwinds from weak used vehicle pricing, Ryder has a good track record of earning a positive return on capital spread above its cost of capital, averaging over 50 basis points per annum over the last five years. The company is targeting an increase in the spread to a range of 100-150 basis points over the next several years.
- The balance sheet is adequately capitalized, with net debt outstanding of $6.6 billion and a total debt-to-equity ratio of 2.28 times as of the fourth quarter of 2018. Ryder's long-term corporate credit rating is investment grade by Standard & Poor's (BBB+), Moody's (Baa1), and Fitch (A-).

Valuation:

- Ryder is cyclical and out of favor, so the stock has badly lagged the Russell 2000 and S&P 500 indices over the past several years. With a positive ROIC spread relative to its cost of capital, we believe it has been treated too harshly.
- Over the past five years, Ryder's earnings per share (EPS) has averaged $5.48. The stock trades for 10.9 times this number.
- The stock trades at 9.5 times forward EPS, and 24% and 30% below its 5 and 10-year averages of 12.6 times and 13.5 times, respectively.
- We expect Ryder's EPS to grow 10% over the long term without any meaningful tailwind from an improvement in used vehicle pricing.

Management:

- Bob Sanchez has been Chairman and CEO of Ryder since January 2013 and May 2013, respectively. He previously served as President and COO, CFO, President of FMS, CIO, and in other executive roles since joining the company over 25 years ago.
- Management's compensation has a meaningful performance-based component and long-term incentives are directly tied to return on capital.

Investment Thesis:

The market is fixated on the prospects for near-term improvement in used vehicle pricing, which has been a headwind to Ryder's profit growth over the last two to three years. Meanwhile, Ryder's contractual businesses (~85% of sales) have delivered mid-single-digit organic growth at value-creating returns over this period. In fact, the company is seeing record demand in its core full service leasing product, which is the largest contributor to the company's cash flow. We believe Ryder is nearing an inflection point where the core contractual business can generate double-digit consolidated earnings growth going forward, even considering incremental used vehicle sales headwinds (rental will be a key swing factor). The secular outsourcing trend to leasing appears to be accelerating, notwithstanding higher lease pricing (and lower residual risk for Ryder), which should set the stage for a reversal of used vehicle EPS headwinds at some point over the next few years, and an improvement in sentiment.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2008 - 12/31/2018

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			
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%
2018	-8.10	-8.83	-11.01	160	0.74	11.73%	15.79%	$ 2,220.4	$ 19,833.6	11.20%

*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 - 12/31/2018. 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 - 12/31/2018. 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 $19.8 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	0.85%
$25,000,001-$50,000,000	0.80%
$50,000,001-$100,000,000	0.70%
$100,000,001 and above	0.60%

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.