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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

June 30, 2019

The FMI Small Cap portfolios gained approximately 5.3% in the June quarter compared to 2.10% for the Russell 2000 Index. Sectors aiding relative returns included Producer Manufacturing, Finance, and Commercial Services. Detracting sectors included Distribution Services, Electronic Technology, and Technology Services. Notable stocks having positive relative impact were Armstrong World Industries, Woodward, and FirstCash. On the flipside, ePlus, MSC Industrial Direct, and Ryder System lagged. The modest correction late in 2018 is like a distant memory. Stocks have been on fire since then, and valuations are back near record levels. Market participants have seemingly abandoned valuation concerns. Mergers and acquisitions (M&A) activity is feverish, with mind-bending deal prices barely warranting a yawn any more. An unprecedented number of money-losing initial public offerings (IPOs) have hit the market this year and the bullpen of profitless companies looking to go public is deep. Growth stocks have significantly outperformed value stocks year-to-date, although interestingly, the so-called FAANG stocks have cooled in recent quarters. The New York Stock Exchange FANG Plus Index (Facebook, Apple, Alphabet, Amazon, Netflix, Tesla, NVIDIA, Alibaba, Baidu, and Twitter) declined 11.3% over the past twelve months. Some of the more defensive, slow-growing sectors such as Utilities and Consumer Non-Durables did remarkably well over both the last twelve months and in the June quarter, which is interesting and reassuring. FMI's performance compared to the Russell 2000 Value Index is also encouraging; as of 6/30/19 we have outperformed over 1, 3, 5, 10, 15, 20-year, and since inception periods -- while on most valuation measures, we have a cheaper portfolio.

> **I think it's essential to remember that just about everything is cyclical. There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.**
>
> - Howard Marks, *The Most Important Thing*

Howard Marks, the highly acclaimed co-founder of OakTree Capital Management, developed the cycle concept more fully in his recent book, *Mastering the Market Cycle.* He pointed out four things about cycles:

1. Cycles are inevitable.
2. Cycles' clout is heightened by the inability of investors to remember the past.
3. Cycles are self-correcting.
4. Cycles are often viewed as less symmetrical than they are.

Marks reminds us that even when cycles go in one direction for an exceptionally long time and people say, "it's different this time," it rarely is. Given how damaging bear markets can be, financial memories are surprisingly short. For example, investors seemed to have already forgotten the dangers of excessive debt, which was at the root of the financial crisis a decade ago. Additionally, investors believe today's methods of valuing hot technology stocks are novel, yet it is not much different than what occurred in the overheated technology arena two decades ago. That cycles are self-correcting should also not come as news, but the key point is that the seeds of any cycle's reversal are sown in the prior cycle phase. Hubris and overconfidence are the seeds of the eventual downcycle; despair and fear are the opposite. In prior letters we have discussed the "pillar of faith" concept. Every cycle has one or two pillars that are widely believed to be true but end up not being so in the fullness of time. In the early 1970s the pillar of faith was that investors had to own the Nifty Fifty stocks, sometimes referred to as the "one-decision" stocks such as Polaroid, Xerox and Sears. These stocks were soon crushed. The pillar of faith in the late 1990s was the infallibility of tech and telecom, and that no price was too dear for the leading players such as Cisco, Applied Materials, Dell and Intel. The 2000-2001 market devastated these stocks. "Home prices never fall" was the dictum of the mid 2000s, which, of course, became spectacularly untrue at the end of that cycle, taking AIG, Washington Mutual and Lehman Brothers down. Later in the letter we will address two pillars of faith in today's market, but first a brief comment on Marks' fourth point on cycles. Market pundits refer to negative price fluctuations as "volatility," while positive moves are called "profit." Capitulation is almost always associated with bottoms of markets but can be equally applied to tops ("melt-ups"). The symmetry in the stock market cycle is that prices have generally gained at roughly 5-6% over the entire period of recorded stock market history. Market moves significantly higher or lower than that over time have faced a cycle reckoning!

Table 1 shows a sample of today's unicorns (over $1 billion in implied value). Nearly all are unprofitable and in many cases the business models, in our opinion, will struggle to ever make money. Investors seem to value top line growth, regardless of the cost to achieve it. WeWork, which provides short-term office leases, is the poster child of this era. Given the price of recent capital raises, its imputed market cap is an astonishing $47 billion. WeWork operates a business with few barriers to entry, and in essence, runs a mismatched loan book, where they sign long-term leases for properties that they, in turn, subdivide and lease out on a short-term basis. In 2018, they managed to lose more money ($1.9 billion) than they earned in revenue ($1.8 billion). What happens when there is a downturn and many of the start-up and fledgling tenants either walk away from, or fail to re-up their leases? The spirit of today's environment is captured by the following quote from Robert Reffkin, the co-founder of Compass, a 2012 startup trying to disrupt the residential real estate brokerage business while sporting a $4.4 billon value and bleeding cash: "Short-term profitability is something that many of the more modern companies are not as focused on." Added the COO: "We're not yet at a stage where I have a very clear monetization strategy because we haven't really talked about it."[1]

Top 10 U.S. Unicorn Companies - January 2019

Company	Estimated Revenue ($Billions)	Projected Valuation ($Billions)	Estimated Revenue Multiple	Industry
JUUL Labs	$1.0	$50	50.0x	Vaping
WeWork	$1.8	$47	26.1x	Shared Workspaces
Airbnb	$2.6	$29	11.2x	Travel
Stripe	$1.5	$23	15.3x	Fintech
SpaceX	$2.0	$19	9.5x	Rocket Launches
Epic Games	$4.0	$15	3.8x	Video Games (Fortnite)
DoorDash	$1.0	$13	13.0x	Delivery
Samumed	$0.0	$12	n/a	Anti-Aging Drugs
Palantir Technologies	$1.0	$11	11.0x	Data Management & Analytics
Infor	$3.1	$10	3.2x	Cloud Data Management

TABLE 1 — Valuation Source: CB Insights

Top 10 U.S. IPOs of 2019

Company	2018 Net Income ($Millions)	2019 Projected Net Income ($Millions)	6/30/19 Market Cap ($Billions)	6/30/19 IPO Return	Industry
Uber Technologies Inc.	-$2,900	-$3,700	$78.6	3%	Ridesharing
Zoom Video Comm.	-$4	$8	$24.2	147%	Cloud Service
Lyft Inc.	-$911	-$1,427	$19.1	-9%	Ridesharing
Slack Technologies	-$181	-$139	$18.9	44%	Software
Pinterest Inc.	-$63	-$52	$14.8	43%	Social Networking
Chewy	-$338	-$268	$14.2	59%	Pet Retailer
CrowdStrike Holdings	-$141	-$140	$13.6	101%	Software
Avantor Inc.	-$261	$367	$10.8	36%	Life Science Equipment
Beyond Meat Inc.	-$29	-$15	$9.7	543%	Plant-Based Protein Products
Tradeweb Markets Inc.	$160	$205	$9.7	63%	Financial Marketplaces

TABLE 2 — Source: Bloomberg

Table 2 is a partial list of 2019 IPOs with some pertinent data. We haven't seen this many money-losing IPOs since the 1990s. It's difficult to see how a large percentage of these companies will ever make money. Many are probably better viewed as lottery tickets. We keep several good-sized boxes of late 1990s IPO prospectuses in our storeroom for new analysts to review. All were promising upstarts; nearly all failed. It's a poignant history lesson. The parallels with today's crop are eerily similar.

Top 10 U.S. Mergers & Acquisitions of 2019

Acquirer	Target	Estimated Value ($Billions)	Target Value/EBIT
United Technologies	Raytheon	$90.0	19.5x
Bristol-Myers Squibb	Celgene	$88.8	17.1x
AbbVie	Allergan	$83.8	11.5x
Occidental Petroleum	Anadarko Petroleum	$55.2	22.7x
Fidelity National Info.	Worldpay	$41.0	121.0x
Fiserv	First Data	$38.2	20.1x
BB&T	SunTrust Banks	$27.9	8.4x
Eldorado Resorts	Caesers	$26.7	31.3x
Global Payments	Total System Services	$25.0	29.2x
Multiple	Zayo Group	$14.1	28.7x

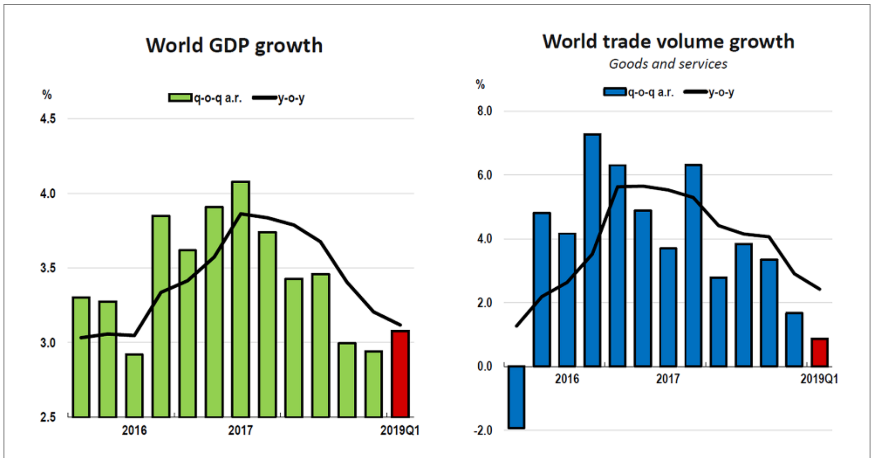
TABLE 3 — Source: Bloomberg

Table 3 depicts some of the bigger deals of 2019. When the ROICs of many recent M&A deals are calculated, the result is likely to be a remarkably low figure, and nowhere near a normalized cost of capital. Low borrowing rates and

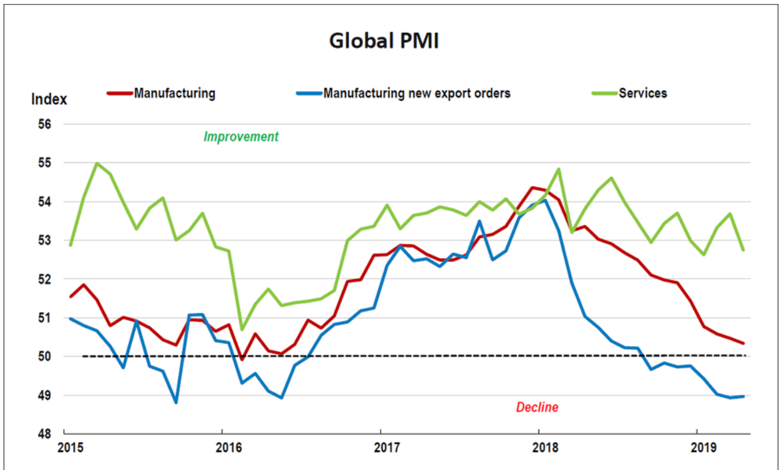
[1] *Grant's Interest Rate Observer*, May 17, 2019.

expectations of an eventual positive spread drive these deals under the banner of "accretive to earnings by year three," or something to that effect. Last quarter's letter touched on this subject in more detail, particularly as it relates to pharmaceutical M&A, so we won't belabor the point. Suffice it to say that we have never seen buy-out multiples as high as those of today.

Abnormally low rates are driving highly speculative M&A, and for the most part, a booming stock market. Returning to the pillar of faith notion, investors' belief in the Fed rivals any market "truth" we have seen. The mantra is that as long as the Fed is accommodative, rates will remain low and little can go wrong. It has been a green light for corporations and governments to lever their balance sheets to the hilt; they appear to not appreciate credit or stock market cycles. Over the years we've tried to note good "contrarian indicators," and this recent quote from National Economic Council Director Larry Kudlow is one for the ages: "I don't think rates will rise in the foreseeable future, maybe never again in my lifetime." The faith will crumble either *slowly*, as people realize that the continuation of decade-long emergency interest rate policies does not drive good sustainable organic economic growth, and in fact, carries unappreciated negatives… or *rapidly*, as a recession or an externality shakes the economy and investor confidence.

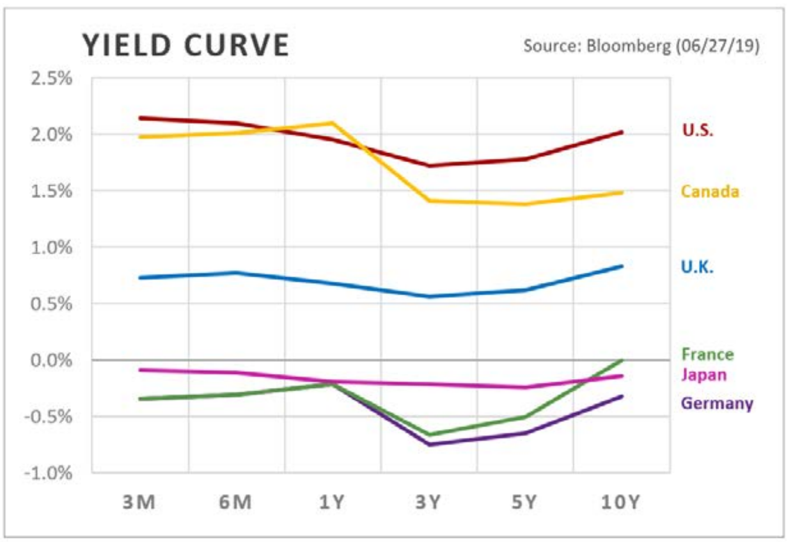


Source: OECD Economic Outlook Presentation, May 21, 2019



Source: OECD Economic Outlook Presentation, May 21, 2019

Regarding the economy, we are more wary than usual. Some smart people, including David Rosenberg at Gluskin Sheff, believe a recession may be unfolding now. He cites significant slowdowns in trade, manufacturing, housing and personal income, along with an inverted yield curve. Some of these elements are also at play globally, as depicted in the three accompanying charts.



The second pillar of faith in today's market is the powerful belief in passive investing and indexing. As we articulated in last December's letter, for investors who are honestly looking at a multi-decade investment time horizon and are truly unconcerned about large draw-downs, perhaps a S&P 500 index fund makes some sense. Today's index investors, however, seem to view the passive path as somehow less risky -- and in our opinion, nothing could be further from the truth. Late in bull markets, index funds get very heavy with the most popular and overvalued constituents. If someone offered you a stock trading at 28.9 times the last 12 months' earnings, 4.5 times revenue and 17.0 times EBITDA,[2] that has averaged less than 3% sales growth over the past decade, and with prospects of even lower growth in the near term, you'd run for the hills. Yet that is the asset (S&P 500[3]) that people can't get enough of today. We think this pillar will erode significantly in the back half of the current cycle. Using the same methodology, the analogous figures for the iShares Russell 2000 ETF are 34.2 times earnings, 5.2 times revenue and 21.2 times EBITDA, all extraordinarily expensive from a long-term historical perspective.

We are well aware that despite a few interludes, our message has remained essentially the same for some time. When cycles last more than a few years, people no longer view them as cycles. They speak of a new paradigm. Unfortunately, this talk has always proven to be dangerous. It is a shame that there are precious few truly cheap assets to buy. All we can do is own solid businesses that are relatively cheap. We are committed to trying to protect against the downside as much as possible, while still giving our investors with long-term time horizons a chance to participate in a portfolio of promising stocks.

Thank you for your confidence in Fiduciary Management, Inc.

[2] Earnings before interest, taxes, depreciation and amortization.
[3] Valuations are FMI's weighted average estimates for the iShares Core S&P 500 ETF (a proxy for the S&P 500).

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 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 %
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.