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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2019

The FMI Small Cap portfolios retreated approximately 0.8% in the September quarter compared to a decline of 2.40% for the Russell 2000 Index. Health Technology (underweight), Producer Manufacturing, and Energy Minerals (underweight) drove sector performance on the positive side this quarter. On the flipside, Electronic Technology (underweight), Commercial Services and Finance all hurt. Stocks boosting quarterly performance included W.R. Berkley, Carlisle Companies and Valmont Industries. Cars.com, ManpowerGroup and Phibro Animal Health detracted from performance in the period. Two stocks were sold in the quarter: Cars.com for fundamental reasons, and Cable One due to valuation. The Russell 2000 Value Index outperformed the Russell 2000 Growth Index in the quarter, but still lagged year-to-date and over a 5-year perspective. Value-oriented investors have been on the outside looking in for quite a while, but we are optimistic that this will change. The charm of today's market was captured by Jim Grant, in a recent edition of *Grant's Interest Rate Observer:* "The quest for value comes instinctively to shoppers but only cyclically to investors. The same individual who trundles home grocery bags filled with store-brand bargains may think nothing of logging on to Charles Schwab to buy shares of Netflix."

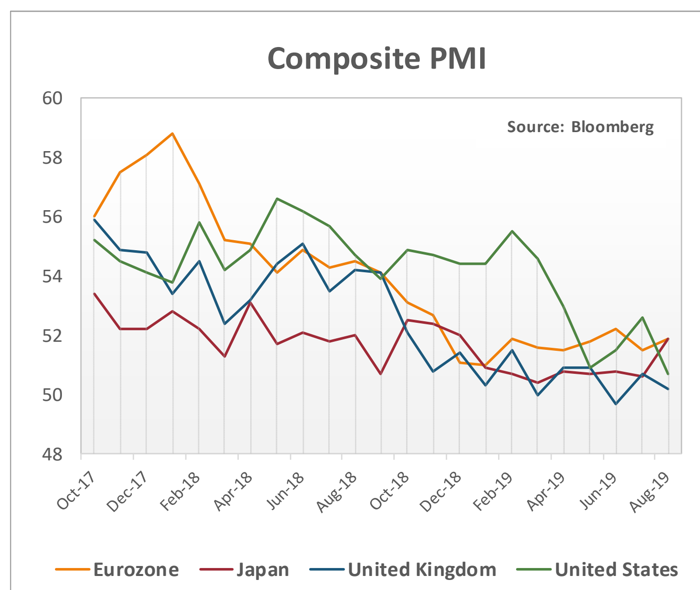
From an investment landscape perspective, not much has changed over the past three months. Stocks remain near the high end of historical valuation ranges. The long list of valuation statistics compiled by The Leuthold Group, which we frequently reference, reveals that the median valuation metric returned to the most expensive decile (10), which is not surprising considering the strong market move this year. Nearby is a chart of the cap-weighted average price-to-sales ratio of the S&P 500, showing a ratio that is near the tech bubble highs of early 2000. What seems to get little airtime is the fact that earnings growth has been flat-to-negative this year!

For most of the year, stocks perceived as safe have done well, despite very high valuations. Deep cyclicals have underperformed, setting up a difficult investor decision: hold on to overvalued but historically defensive names, or take a chance with relatively more attractive deep cyclicals that may already be discounting a recession. We find ourselves leaning toward the latter, but do so with some trepidation. The pullback in the fourth quarter of last year favored traditional defensive names, despite their high valuations. At some point the valuation spread will be too wide, but of course a gnome isn't going to magically appear to steer our Bloombergs. It is a judgment call whose correctness will only be apparent in the fullness of time. Mergers and acquisitions (M&A) activity continues unabated, apparently driven by a belief that low interest rates are here to stay, along with the idea that *this* deal is going to work out better than the prior ones! While just a guess, we'd estimate that the typical CEO spends twice as much of their time on deals versus 25 years ago. This would include evaluating, consummating, integrating, fixing or selling prior acquisitions. Return on invested capital (ROIC) is hardly more than a talking point for many CEOs. Instead, "proforma adjusted EBITDA[1]" three years in the future, which typically depends on speculative growth assumptions, is seemingly what drives

[1] Earnings before interest, taxes, depreciation and amortization

many transactions today. We admit to some cynicism regarding today's deal culture, but numerous academic and consultancy studies show that most acquisitions are value-destructive to the buyer.

Despite significant weakening in many Purchasing Managers Index (PMI) figures and other recession indicators, economic growth has continued at around a 2% rate (the Atlanta Fed's GDPNow third quarter estimate is 1.9% as of September 25th). We have been stuck in a low-growth world for nearly twelve years (U.S. real GDP growth since the end of 2007 has averaged just 1.6%), and continued tepid growth seems to be the consensus opinion for the future. We are more optimistic about future growth, as long as people begin to realize that rate suppression, high government borrowing, and unbridled M&A are not pathways to prosperity. Academics and economists have promulgated these policies for a very long time with the same results (low growth and dangerously levered balance sheets). As Friedrich Hegel famously said, "The only thing we learn from history is that we learn nothing from history."



Growth-friendly conditions, in our opinion, involve having a normal risk premium reflected in interest rates, engendering organic rather than inorganic investment, having free and fair trade, growing our population and reducing government borrowing, leaving more money for private investment. Profit-seeking enterprises are almost always better asset allocators than governments, although in recent years corporations have been levering up to do deals and to buy back stock. The Federal Reserve reports that corporate debt has grown by approximately $1.2 trillion in the last two years alone and now is nearly $10 trillion, which is a record high percentage of GDP (47%), according to *The Wall Street Journal*. Ginning up debt to such a high level doesn't have a great historical track record of success. Morgan Stanley recently documented a notable drop in the price of loans within collateralized loan obligations. While corporate credit problems remain mostly anecdotal at this point, we will be closely monitoring the situation.

Before our customary discussion of two portfolio holdings, we want to briefly review our background and philosophy. Fiduciary Management, Inc. (FMI) is independently owned and has managed money for over 39 years in the same disciplined, fundamentally-driven and value-oriented way. FMI operates from a single office in Milwaukee, Wisconsin, away from the bustle and groupthink sometimes prevalent in big cities. We are not a "product shop"; we have one investment team, one philosophy and one process. We do not manage any hedge funds. We're not like many large investment managers who constantly open new funds and strategies, and close underperforming ones. Approximately 5,300 mutual funds have been closed or merged since 2009; it certainly makes peer group statistics suspect! Instead, we stick to our knitting, and our team invests right alongside our shareholders and clients. FMI has a focused approach to investing, with high active share. We are the antithesis of an index fund. While not popular today, this approach has been both a winning one, and a less volatile one, over the long run. As the small print always says, past results may not repeat but rest assured, we have not changed our stripes.

FMI's investment philosophy can be summarized as follows:

- We seek undervalued stocks. That typically occurs when there is a cloud over the business.
- We make our research count by focusing on a limited number of companies for the portfolio.
- We invest in businesses that are likely to earn above their cost of capital over the business cycle.

- We invest in management teams who we believe will act like shareholders.
- We are highly attuned to avoiding value traps, i.e., secularly challenged businesses.
- We want to minimize financial risk by sticking to companies with good balance sheets.
- We focus on the downside risk before the upside opportunity.

In addition, all of our investments have to pass a common-sense test. Recall, last quarter we expressed astonishment with a number of so-called unicorns, including WeWork (recently changed to The We Company). It had a valuation of $47 billion. In three short months that value has collapsed to an estimated $10 billion and the initial public offering is currently on ice. As we said in the June letter, the business has few barriers to entry and operates what is essentially a mismatched loan book. Corporate governance was a disaster, although the board is now scrambling to improve it. The We Company cleverly tried to pass themselves off as a technology company and it worked for a while, but to us, it never passed the common-sense test. Similarly, Uber and Lyft also seem to fail a common-sense test. Their respective business models depend on drivers underestimating the true cost of operating automobiles. These companies can't charge enough to make money and grow rapidly. They whipped investors into a frenzy by underpricing their service to drive rapid top line growth. Economies of scale have yet to surface, as evidenced by the escalating losses, even as the revenues grow. Ride-sharing economics will be further damaged if regulatory bodies treat independent drivers as employees. Perhaps as a premium service they will thrive; meanwhile, they are eating capital like crazy. These kinds of stories play poorly when markets are risk-averse. The common-sense litmus test applies to all our investments, as well as company strategies and acquisitions.

Today it is more important than ever to have an experienced and steady team behind your investments. Using the Dow Jones Industrial Average as a proxy, the current cycle (through September 30th) has returned approximately three times (438%) the bull market average since 1900 (145%) and has also lasted three times longer (roughly 126 months versus 42 months). Characterizing this phase of the market cycle as *long in the tooth* would be an understatement. Anecdotally, it seems many of today's investors implicitly believe at least two things: one, that stock market returns will continue to be much higher than underlying economic or earnings growth; and two, that investing in index funds is a risk-mitigating maneuver. We simply don't believe the first, since there is little historical evidence of it over long periods of time, and regarding the second, we recognize that fund flows have driven outperformance in many index products, but those who think an index fund is less risky than a carefully-constructed and risk-sensitive approach may be in for a rude awakening.
Below we discuss two portfolio holdings.

Kennedy-Wilson Holdings Inc. (KW)

(Analyst: Jordan Teschendorf)

Description

Kennedy-Wilson is an integrated real estate investment company employing 336 professionals and operating out of 16 global offices. Its core business is sourcing, acquiring, managing, and disposing of real estate properties and related investments. The company invests predominantly in multifamily and commercial properties, as well as loans backed by real estate, with a focus on the Western U.S., the UK and Ireland. At the end of June 2019, the carrying value of Kennedy-Wilson's real estate was $5.8 billion with the portfolio generating $410 million of annual estimated net operating income (NOI) split as follows: Western U.S. (48%), UK (24%), Ireland (23%), and Italy & Spain (5%).

Good Business

- Kennedy-Wilson has generated impressive returns from its real estate investments, realizing over a 25% gross internal rate of return on its U.S. investments since 1999.
- Many of the company's investment properties are located in markets with above-average employment growth rates and prospects (i.e., the Pacific Northwest) -- a dynamic we expect to benefit the rental rate growth.

- The company's integrated acquisition, asset management, and disposal functions generate superior investment performance relative to public real estate investment trusts (REITs), evident in its multifamily same property revenue and NOI growth.
- The assets are simple to understand and most of them generate predictable cash flow.
- Kennedy-Wilson continues to increase its recurring revenue through the growth of third-party assets it manages, and through its ownership interest in expanding property level income.
- The balance sheet is in good health, with $854 million of liquidity ($404 million of cash), a weighted average interest rate on debt of 3.9%, and a weighted average maturity of 5.3 years. 94% of total debt has a fixed rate, or is hedged against rising interest rates.

Valuation

- The stock trades at a meaningful discount to our net asset value per share (NAV) estimate, a value which assigns zero value to the company's development and re-development projects (which we believe could conservatively contribute an additional 40% in NAV through 2023).
- The company is underfollowed by the sell-side, contributing to its undervaluation.
- Kennedy-Wilson pays an annual dividend yielding 3.8%.

Management

- Management and directors own nearly 15% of the company, aligning their interests with ours.
- William McMorrow has been Chairman and Chief Executive Officer since 1988 and as of the latest proxy, owned 9.3% (13.2 million shares) of the company.
- Mary Ricks was named President in August 2018. She served as CEO of Kennedy Wilson Europe starting in 2011, and has been an important contributor to the International investment platform. She's been with the organization since 1990 and owns over 2.1 million shares.

Investment Thesis

Kennedy-Wilson has produced an impressive track record of investment returns across multiple geographies and investment environments, often providing liquidity when it has been scarce. In the current environment, the company has been a net seller of assets, preferring to deploy capital to internal NOI growth initiatives and opportunistic share repurchases. As a result of significant development and redevelopment projects underway, along with its strong record of investment performance and capital raising, the company should be able to capitalize on market volatility and continue to grow its recurring property NOI and services cash flow. We feel that the downside is well-protected by the stock's discount to NAV and the company's strong internal growth prospects.

Trinity Industries Inc. (TRN)

(Analyst: Andy Ramer)

Description

Trinity Industries is a leading provider of rail transportation products and services in North America, servicing its customers through an integrated rail platform. Trinity's rail platform combines railcar leasing and management services (about 80% of 2018 economic profit) and railcar manufacturing (about 20%) to provide customers with a single source for comprehensive rail transportation solutions.

Good Business

- Trinity has leading positions in the railcar market, which plays a key role in the economy as 25% of U.S. freight ton miles is moved via rail (essential-use equipment). The company is the largest manufacturer (40% share) and fifth largest lessor (12% share) of railcars in North America.
- Although railcar manufacturing is cyclical, the operations generate substantial earnings over a business cycle. The company has also tripled the size of its high-quality portfolio of leased railcars during the past

decade, which has built a base of stable, recurring revenues through long-term leases (high utilization throughout rail cycles).
- Trinity aspires to mid-teens return on equity for the leasing business, and a similar return on capital for the manufacturing business over the railcar cycle.
- The company is conservatively financed. The balance sheet is under-levered versus peers and the leasing business is capitalized through non-recourse debt.

Valuation

- At the current share price, we are getting the leasing business for approximately book value, and the manufacturing business for free. Both the public and private markets are valuing railcar leasing businesses at 1.5-2.0 times book value. Trinity's railcar manufacturing business should generate north of $250 million in mid-cycle EBITDA.
- At 1.5 times book value and 10 times mid-cycle EBITDA, the stock would be valued at nearly two times the current share price.

Management

- With the recent corporate transformation (non-rail manufacturing businesses were spun-off in November 2018) and ValueAct partner Brandon Boze joining the board, the company is working to unlock significant earnings potential for the business. After having recently bought additional shares on the open market, ValueAct is Trinity's largest shareholder, with an ownership stake of 17.6%.
- The company has taken advantage of the attractive valuation and aggressively repurchased stock. The share count is down in excess of 12% year over year, and Trinity is also returning capital to shareholders though an upsized dividend that currently yields 3.5%.

Investment Thesis

The market is undervaluing Trinity due to fears about the economy and because its integrated leasing and manufacturing business model is perceived to be complex; however, the company is taking steps to improve the investment community's understanding of the business. The combination of operational improvement potential, organic and inorganic growth opportunities for the fleet, and improving fundamentals in rail equipment demand, sets up well for both near- and long-term value creation. Railcars have the added benefit of serving as an inflationary hedge, given their positive yield relationship to inflation.

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.