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# INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

March 31, 2020

The FMI Small Cap portfolios fell approximately 28.4% in the first quarter compared to the benchmark Russell 2000 Index decline of 30.61%. Sectors adding to relative performance included Producer Manufacturing, Process Industries and Consumer Services. Detracting sectors included Health Technology, Electronic Technology, and Commercial Services. Houlihan Lokey, FirstCash and Phibro Animal Health held up reasonably well on a relative basis. Howard Hughes, Ryder System, Woodward and many others declined sharply. Fears about COVID-19 and reactions to this pandemic caused a sharp and widespread drop in stock prices over a very short 30-day span, followed by a remarkable bounce over three days. In addition to this turmoil, a price war broke out in oil, with Saudi Arabia apparently making the decision to punish Russia for not cooperating with an OPEC supply cut, but more likely intending to cripple the U.S. shale (frack oil) market. World economies were already slowing prior to COVID-19. The severe response both here and abroad, with "shelter in place" orders and temporary suspensions of many activities and business closures, will send most economies into a deep recession. In the last week of March, Goldman Sachs projected a 34% (annualized rate) decline in second quarter U.S. GDP. The market slide was largely indiscriminate, with most equities precipitously falling. Stocks related to travel, hospitality, financials and industrials were some of the worst hit. Many of these sectors were on the value side of the investment spectrum, resulting in underperformance of value-oriented strategies versus growth ones during the quarter. The Russell 2000 Value Index underperformed the Russell 2000 Growth Index by 9.90% in the March quarter, continuing a multi-year pattern. For the first time in a long time, however, we no longer have to sing the "relative value" song. Good absolute values have emerged and today we are more enthusiastic about future long-term equity returns. We increased our personal investments in the FMI Small Cap portfolio during the quarter.

By the time this letter is read we will have a much greater understanding of COVID-19, so it is hazardous to make too many definitive statements now. On the optimistic front, it appears that the ultimate mortality rate is likely to be lower than some of the figures bandied about in early March. With antibody testing just beginning as of the date of this writing (March 31), authorities will start to gain a better understanding in a few weeks of how prevalent the infection is and how to structure a more optimal treatment and quarantine regimen. It is hard to keep calm in the midst of these unsettling events. Deaths are heartbreaking, and images of turmoil in emergency departments are frightening. If the latest mortality projections from the Administration's point person ("up to 240,000 U.S. deaths") prove accurate, it will be a very deadly disease. It is important, however, to keep perspective on COVID-19. Assuming the 240,000 figure ends up being accurate and all the people who die from this virus would not have passed from other comorbidities (highly unlikely), it would represent 8.6% of the approximately 2.8 million people who die every year in the United States. The point is, the disease is awful and seems overwhelming, but it is manageable.

What has been most unusual in this crisis is the response. We have not seen anything quite like it in peacetime. Implementing shelter-in-place orders and shutting down large swaths of the economy may very well be the best approach, but it is not the only option, and it is not shared by all highly-respected experts or countries. It forces a set of trade-offs that perhaps people have not fully considered. This is not the place to debate something that has already been decided and is unlikely to be reversed. Investors must deal in realities. What we know for sure is that the response to this crisis has put the economy in a deep hole with massive unemployment. Leaders are trying to cushion the blow with $2.2 trillion of programs, loans and grants, with all of it coming from additional borrowing. Recall that prior to the outbreak, the economy wasn't robust. Growth was uneven and fairly slow, and the budget deficit had already surged to $1 trillion. With CARES, the deficit will soon exceed $3 trillion, juxtaposed to the Federal budget of $4.9 trillion, collections of approximately $3.9 trillion (pre-COVID-19), and an existing total Federal debt load of over $22 trillion. Given how sharply GDP will plunge, it is conceivable that the deficit will exceed Federal collections. All this debt (as well as increased corporate borrowings) will be a headwind to long-term growth. Combining the fiscal picture with an activist Fed, who gained new powers from the CARES Act, poses significant long-term challenges. But this reckoning is down the road…

In the meantime, there is the short and intermediate term to consider. What will an economic "restart" actually look like? Will people act normally? We have already seen cancellations of many things into August. Will governors even allow certain activities like ballgames, concerts, conferences, etc.? We think it will take some time. Earnings for the most affected industries such as hospitality, airlines, restaurants, and many cyclicals have declined dramatically and are unlikely to recover quickly. We believe most of these concerns are already in the stocks. Predicting people's fears and behaviors, however, is difficult. Second-order effects will be widespread, hurting earnings across a very broad spectrum of sectors. Few companies will be spared. The Fed made its predictable move, lowering its benchmark interest rate to near zero percent, which has hurt the financial sector. For the first time in memory, short-term interest rates ticked negative late in the quarter. Balance sheet strength will be critical throughout the intermediate term, even with government assistance. More than a few of the popular growth stocks rely on equity financing, which can turn fickle when fear arises. Companies like Airbnb, Uber and Lyft may be in deep trouble if risk appetites go dormant. Even Tesla, which has been remarkably resilient, could face a rougher future if the demand for big ticket luxuries weakens and financing needs remain high. Corporate borrowing spreads, particularly in the sub-investment-grade area, have blown out over the past several weeks. The cost of capital has changed dramatically over the past month.

This type of environment should work in our favor. The FMI Small Cap strategy has a portfolio of financially-strong enterprises. We are confident in their ability to weather a longer-than-expected recession. We think value stocks should regain their multiples as the economy stabilizes. The Small Cap portfolio trades at a large discount to the Russell 2000 (depicted in the table below) and the Russell 2000 Value on most valuation metrics. As a rule of thumb, we are using 2019 earnings as a peak which we think most companies will return to by roughly 2023, give or take a year. Some firms will recover more quickly, but our experience is that recoveries generally take longer than expected. Still, we think valuations largely incorporate these worries. Volatility is extreme, however, so investors must focus a few years out and not on the day-to-day.

| March 31, 2020<br>Weighted Average Valuations* | FMI<br>Small Cap | iShares<br>Russell 2000 | Discount to<br>the Benchmark |
|---|---|---|---|
| P/E (1 Year Trailing) | 16.1x | 30.7x | 48% |
| FY1 P/E (1 Year Forward) | 16.3x | 27.7x | 41% |
| P/S | 1.3x | 5.3x | 75% |
| EV/EBITDA | 8.7x | 20.5x | 58% |
| Average Valuation Discount | | | 56% |

** Estimated valuations for FMI and the iShares are weighted average valuation calculations, not reweighted to exclude cash, and financial companies are excluded from the EV/EBITDA calculation. Valuations for both the portfolio and the ETF are modified based on criteria identified by FMI. For more detailed information regarding these valuations, please contact FMI.*

Below, in a shortened presentation format, we highlight several of our attractive stocks.

***A.O. Smith Corp. (AOS) — Analyst: Benjamin Karek***

A.O. Smith is a leading manufacturer of water heaters, boilers and purification systems. Effectively all of the company's current operating profit comes from North America, and ~80% of that business is replacement demand for water heaters and boilers. These are necessary products that are typically replaced within 24-48 hours of breaking, making this a steady, high return-on-invested capital (ROIC) business. A.O. Smith is suffering from challenges in China, but at today's valuation we are only paying a nominal amount for the Chinese business. In North America, 85% of the company's distribution is exclusive, and we believe the stickiness of this network will help insulate it from competitive pressures. Additionally, by 2025 we will have lapped the replacement cycle headwind in 2022/2023 and investors will be staring at a decade-long increase in replacement volumes. A.O. Smith has net cash on the balance sheet and good liquidity and trades at a discount to its historical valuation.

***Avery Dennison Corp. (AVY) — Analyst: Benjamin Karek***

Avery has a consistent long-term record of success as a leading blue-chip manufacturer of pressure-sensitive labels and a variety of tickets, tags, labels and other converted products. Most of Avery's products are sold into fast-moving markets including food, beverages, household products, apparel, e-commerce boxes, healthcare bandages, etc. Given this, we believe the business is fairly stable. Avery manages its operations to optimize economic value add and earns a 20% ROIC. The balance sheet has 1.7 times net debt-to-EBITDA[1] with no near-term maturities and ample liquidity. Avery is trading at an attractive mid-teens earnings multiple.

***Dentsply Sirona Inc. (XRAY) — Analyst: Daniel Sievers***

Dentsply is #1 or #2 in a variety of dental specialty products, and Sirona is #1 in digital dentistry. Typically, Dentsply sales are driven mostly by the predictable cadence of dental visits, although COVID-19 is requiring many dentists around the world to defer elective procedures. This caused the company's share price to decline precipitously, creating an attractive entry point. We have little doubt that once societies regain some semblance of normalcy, demand for Dentsply's products will rebound. The company targets long-term revenue growth of 3-4% and we expect margins to eventually expand to at least 20%. The balance sheet is strong at 1.3 times net debt-to-EBITDA and operating cash flow has been improving as they begin to put restructuring and integration behind them. Dentsply normally trades at a significant premium to the market, and now we can buy this quality franchise at a discount.

***FirstCash Inc. (FCFS) — Analyst: Matthew Sullivan***

FirstCash is the world's largest operator of pawn stores. The company has 1,056 stores located in the United States, and 1,623 in Latin America. 60% of the company's EBITDA comes from the U.S. segment, and 40% comes from the Latin American segment. The pawn business is steady, countercyclical, and generates attractive returns on capital. We expect FirstCash to hold up well in a recession. FirstCash also has the ability to grow its store base significantly over the next decade. The company's balance sheet is in good shape, with a net debt-to-EBITDA ratio of 1.9 times and no near-term maturities. In addition to a discounted valuation, it is appealing considering its countercyclical nature.

***Houlihan Lokey Inc. (HLI) — Analyst: Benjamin Karek***

Houlihan Lokey's advantageous positions in middle-market advisory and financial restructuring make it a durable franchise in what is otherwise not a very durable industry. The company's advantages include a diverse customer and employee base, middle-market focus (which is less cyclical), deep relationships with private equity sponsors, and a countercyclical restructuring business. Houlihan's financial restructuring business, the largest such practice by employee count and revenue, allows them to thrive regardless of the economy. As the global shutdown impacts revenues in almost every industry, liquidity and solvency concerns have quickly come into view. Given this, activity in Houlihan's restructuring franchise is accelerating, and we expect growth here will largely offset declines in their mergers and acquisitions advisory business, albeit with a lag. With net cash and no financial debt, combined with a highly variable cost structure, we think Houlihan is set up to perform well in most economic environments. This stock is trading at an attractive mid-teens earnings multiple.

***Kennedy-Wilson Holdings Inc. (KW) — Analyst: Jordan Teschendorf***

Kennedy-Wilson is an integrated real estate investment company which acquires, manages, and sells real estate properties and related investments. The company invests predominantly in multifamily (46% of net operating income [NOI]), and commercial properties (47%), and to a lesser extent, hotel & industrial (7%), with a focus on growing in the Western United States (51% NOI), the United Kingdom (24%) and Ireland (21%). The company has generated an impressive investment record across multiple geographies and economic environments, often providing liquidity when it has been scarce. In recent years, the company has been a net seller of assets, building its liquidity position to record levels, deploying capital to internal NOI growth initiatives, and growing its fee income. Notwithstanding potential near-term issues related to COVID-19, we think the company will continue to capitalize on market volatility and grow its

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

recurring property NOI. Kennedy-Wilson's balance sheet is healthy, with strong liquidity. We conservatively estimate the net asset value to be more than double the current stock price, with growth opportunities aplenty.

***Robert Half International Inc. (RHI)* — Analyst: Robert Helf**

Robert Half is the market share and innovative leader in professional staffing to small and medium-sized businesses. The company has a very strong franchise in the field of accounting (Accountemps) and finance, while its Protiviti professional consultancy has grown nicely over the last decade. The temporary staffing business is cyclical, and the company will experience profit contraction during the COVID-19-induced recession. The company has the balance sheet to withstand a deep recession. Historically, the time to buy Robert Half is when the near-term outlook is bleak. Once the economy recovers, earnings should snap back quickly. Additionally, the business generates significant cash from working capital during the early periods of contraction. Robert Half has $200 million of net cash on the balance sheet. The enterprise value-to-sales ratio is about half of its 20-year average.

***Zions Bancorporation (ZION)* — Analyst: Dain Tofson**

Zions is a mid-sized bank operating under seven brands, although most of its net interest income is from three: Zions (Utah), Amegy (Texas), and California Bank & Trust (California). The bank caters to small businesses and has a relatively large exposure to the energy industry, at 4.8% of the loan portfolio. As such, Zions is in the eye of the COVID-19 and oil price storms, causing the stock to decline substantially this year. Management has improved the balance sheet since the financial crisis, increasing the CET1 (Common Equity Tier 1) ratio to >10% from <6%, improving the loan-to-deposit ratio to the mid-to-high 80s from >100%, and implemented a more robust risk management infrastructure. Given the changes, we believe the balance sheet can weather this environment. The valuation is very compelling, trading at a significant discount to tangible book value. Longer-term, Zions' strong position in growing markets, large non-interest deposit franchise, and improving efficiency ratio are appealing to us.

Thank you for your confidence in Fiduciary Management, Inc.

# Fiduciary Management Inc.
## Small Cap Equity Composite
## 12/31/2009 - 12/31/2019

| 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 % |
|---|---|---|---|---|---|---|---|---|---|---|
| 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% |
| 2019 | 27.14 | 26.17 | 25.53 | 119 | 1.83 | 12.44% | 15.71% | $ 2,415.0 | $ 22,609.8 | 10.68% |

*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 - 12/31/2019. 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 -12/31/2019. 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 $22.6 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.