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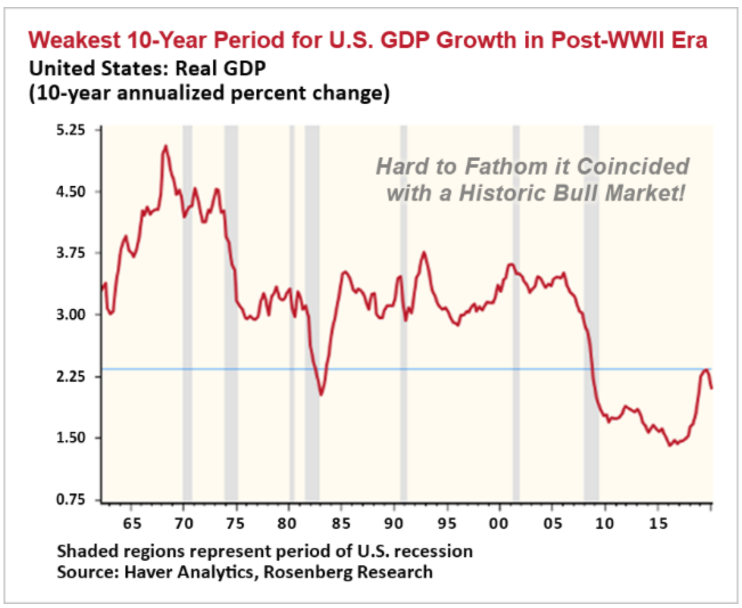
INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

September 30, 2020

The FMI Small Cap portfolios returned approximately 1.9% in the quarter compared to 4.93% for the Russell 2000 Index, and 2.56% for the Russell 2000 Value Index. While not changing much in the most recent quarter, the spread between value-oriented strategies like FMI's and growth stock-dominated indices like the Russell 2000 or Russell 2000 Growth Index has widened significantly in recent years. The year-to-date gap between the Russell 2000 Value and Russell 2000 Growth Indices was 25.42%. The portfolios have handily outperformed the value benchmarks and most of its value peers over 3, 5, and 10-year time frames. With much of the investing world capitulating to the siren song of growth stocks, FMI remains steadfast in our belief that ultimately, fundamentals and good values will trump high valuations and unsustainable growth expectations. We are starting to see some investors call "timeout" on the mad dash to growth stocks, hedging against the idea that the most popular names and the best-looking stock charts can continue to beat value equities. In the quarter, sectors that helped FMI's Small Cap relative performance included Process Industries, Technology Services, and the absence of meaningful exposure to Energy Minerals. Sectors detracting included Producer Manufacturing, Finance, and Commercial Services. Avery Dennison Corp., Insight Enterprises Inc., and Arrow Electronics Inc. were positive relative contributors, while Armstrong World Industries Inc., Zions Bancorporation, and White Mountains Insurance Group Ltd. hurt.

Over several missives prior to the pandemic, we articulated the strange juxtaposition of relative weak U.S. corporate sales and earnings growth compared to high valuations. The S&P 500 (iShares Core S&P 500 ETF as a proxy), grew revenue and operating earnings at 3.4% and 3.6%, respectively, over the 10-year period ending 2019; this includes acquisitions and a record increase in balance sheet leverage. With the S&P 500 constituting such a large swath of the U.S. economy, it is perhaps not surprising that the last ten years has been the slowest decade of economic growth since WWII (see chart to the right). GDP growth had been so weak pundits began talking about using a different measurement for gauging economic well-being.



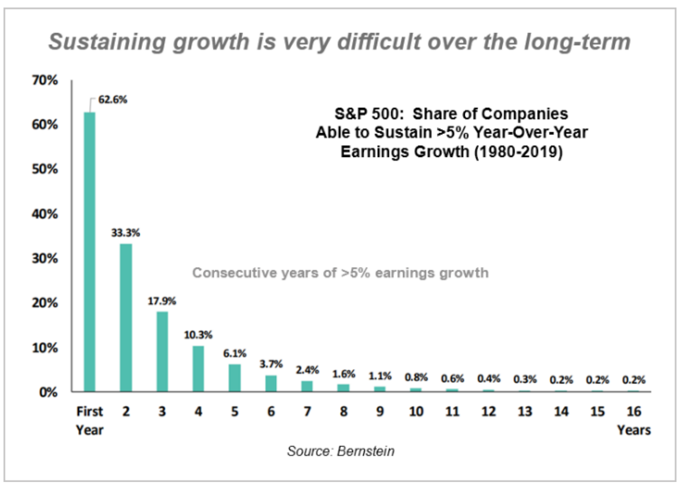
The onset of COVID-19 sent the 2020 fundamentals for the economy and most companies down further, yet the market endured just a very short 23 trading days of trouble before resurging to an all-time high. Growth stocks, including most highly speculative ventures, have continued to dominate the landscape, creating the widest performance spread to value stocks in memory. Although the popular and financial media doesn't describe it as such, it is truly a mania for many equities. Investors have seemingly thrown caution to the wind in their effort to participate. Despite a few short market contractions, to include the fourth quarter of 2018 (66 trading days) and earlier this year, the bull market that began in March of 2009 has the illusion of permanency. Many feel we are in a new, higher-growth paradigm, driven mostly by technology. If that were the case, why is economic growth so slow? Why is productivity over the past decade so weak? It doesn't add up. Perhaps it is merely the belief that a few companies will have secular growth and the remaining "old economy" companies will struggle. While acknowledging the superior growth of some of the big cap tech names, we think any stock can get too expensive and any trade can be overcrowded. Every frothy market in history has its earmarks; following are a few recent observations:

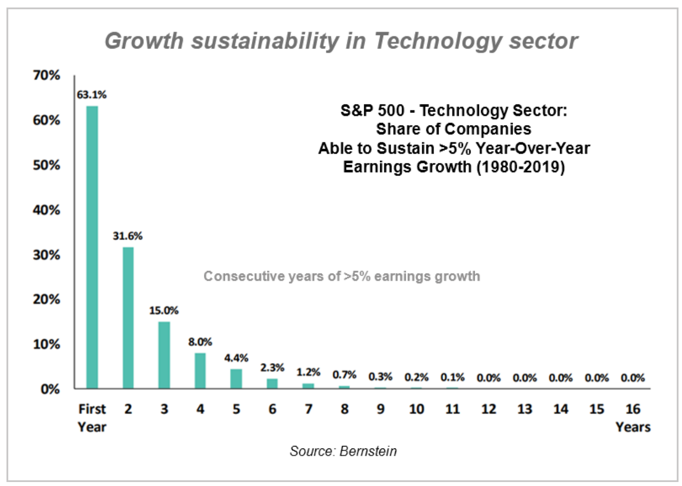
- The total market value of the NASDAQ Composite stocks recently became larger than the combined value of the developed world stock markets, ex-U.S. (MSCI World ex USA Index).
- Four tech names – Apple Inc., Amazon.com Inc., Microsoft Corp., and Alphabet Inc. -- became bigger than the entire Japanese market, as well as the combined China/Hong Kong stock market.
- Tesla Inc., barely profitable after 17 years and competing in a highly competitive industry, saw its market cap go up over tenfold (from $38 billion to over $400 billion) in the 12 months ending 8/26/20, including a 75% gain in the three weeks following the 8/10/20 stock split announcement, which has zero fundamental meaning.
- Apple, whose operating earnings peaked five years ago at $71.2 billion, saw its market capitalization go from about $600 billion five years ago to over $2 trillion recently, including a 40% gain in a little over a month after their stock split was announced on 7/30/20.
- In Q3 2020, Apple's market cap became larger than the entire Russell 2000 Index, and also overtook the FTSE 100 Index for the first time.
- The IPO market is likely to set a record in 2020, and recently Snowflake Inc., a company that had $264 million in sales and lost over $350 million in fiscal 2020, came public with a $33 billion value. On the first day of trading the market value reached $89 billion, larger than Autodesk Inc. and Cerner Corp. combined, which together have approximately $9 billion of highly recurring software revenue. Palantir Technologies Inc., a secretive big data company that has been rumored as an IPO for years, finally pulled the trigger on the last day of the September quarter. This company was founded in 2003 and as far as we can tell, has never turned a profit. In 2019, the company had $742 million in revenue and lost about $580 million. Its market cap on day one stretched to $18 billion. Asana Inc., one of many emerging software-as-a-service companies, also came public on the last day of the quarter and traded to $4.6 billion. It was valued at $1.5 billion in December of 2018; it had fiscal 2020 revenue of approximately $143 million and lost about $119 million.
- Nikola Corp., a development-stage hydrogen truck company with no revenue, reached a $27 billion market cap this summer before a short seller exposed potential serious flaws.
- Workhorse Group Inc., a company that for years has been trying to develop electric vehicles, has never made money, and managed to garner less than a half million dollars in 2019 sales, recently sported a market cap of over $3 billion.
- Gilead Sciences Inc. announced the $21 billion acquisition of Immunomedics Inc., an emerging biotech company with minimal sales and over $300 million of losses last year. Illumina Inc. announced they were buying Grail Inc., a development stage company, for a valuation of $7.1 billion and a 12-year earn-out. Johnson & Johnson announced the purchase of Momenta Pharmaceuticals Inc. for roughly $6.5 billion. It has $30 million in sales for the trailing 12 months ending 6/30/20.
- As of 9/30/20 there were 415 Health Technology sector stocks in the iShares Russell 2000, and 371 were money-losing. In nearly all cases the companies have never made money. They have been some of the best performing stocks in 2020.
- Mirati Therapeutics Inc., a company with $3.3 million in revenue and losing over $200 million, has an approximate market value of $7.4 billion and was up 1,319% over the past three years. The CEO makes more than two times the annual revenue of the company. For over 20 years this company has been on the verge of hitting it big!
- Special Purpose Acquisition Companies (SPAC), empty shell corporations set up to buy companies, have received over $50 billion so far this year. SPAC managers typically get 20% of the SPAC shares. Billy Beane (of Oakland Athletics and *Moneyball* fame) and Paul Ryan (former congressman from Wisconsin) are in on the action.
- *The High-Tech Strategist* reported in September that the top five holdings of Vanguard's Total Stock Market ETF and SPDR S&P 500 ETF were Apple Inc., Microsoft Corp., Amazon.com Inc., Alphabet Inc., and Facebook Inc. These same five stocks were the largest holdings of the iShares Russell 1000 ETF, iShares Russell 3000 ETF and Vanguard Growth ETF. While this is not surprising, one of Vanguard's largest international ETFs, the Vanguard

Total World Stock ETF, had the same top five holdings. Ditto for the Vanguard ESG U.S. Stock ETF. As of 8/31/20, the Fidelity Magellan Fund had these same five in their top six holdings, along with Visa Inc. (trading at nearly 20 times revenue). Same for the Fidelity Independence Equity Fund. The Fidelity Trend Fund had the same five plus Mastercard Inc. (21 times revenue). Fidelity Growth Discovery Fund had the same five, as did the Fidelity Disciplined Equity Fund. We surmise many of the largest fund families look similar.

- The S&P 500 is more concentrated in the top names than at the peak of the 2000 market.
- In June, Deutsche Bank estimated that roughly 19% of U.S. companies are "zombie" companies, i.e., their debt servicing costs are greater than their earnings.
- Since 1947, the median number of hours of work required to purchase one unit of the S&P 500 was 30. As of early July, it is over 140 hours.
- According to The Leuthold Group, as of 7/10/20, stocks were in the highest decile (10^{th}) of valuations based on the median decile of approximately 50 different valuation measures.
- Robinhood Financial LLC has added over 3 million customers since the beginning of the year. Measures of retail investor speculation are near their highest ever, including small-sized option trading that now exceeds the trading volume of individual stocks.

We are not ignorant to the excitement and promise of some of the emerging software companies, and other concepts that essentially defer profits on the income statement in order to grow the top line rapidly and lock in a future stream of profit. Establishing what is perceived to be an unassailable position in the market is easier in the digital world compared to the physical world. Many companies will win with this strategy. Many more will try and fail. Our issue is that most of these companies are being priced as the eventual winners. They can't all win! Sustaining even 5% growth for more than a few years is difficult (even for the Technology sector), as evidenced by the following charts. The stocks that have captured the imagination of investors depend on sustained success over a very long time horizon. Valuations leave little room for error.





Growth stocks in particular are sensitive to discount rate changes. This is because so much of the present value depends on compounding higher earnings well into the future. Following is a table from Credit Suisse HOLT, outlining possible return outcomes in different classes of stocks as a result of changes in sector discount rates. This table reveals some interesting scenarios. For example, if sector discount rates went back to just the 3-year median, U.S. Hyper Growth stocks would fall 32% and U.S. cyclical value stocks would decline 7%. If rates went back to their 20-year median, U.S. Tech Large Cap would fall 44% and U.S. Financials would gain 46%. Realize, these are just mathematical calculations, but they inform the possibilities. Our portfolios are far less dependent on the maintenance of historically low interest rates. We are finding excellent values in the cyclicals, such as Flowserve Corp. and Applied Industrial Technologies Inc., and in financials, particularly Ryder System Inc., Kennedy-Wilson Holdings Inc., and Howard Hughes Corp.

Probability-weighted valuation upside/downsides for various HOLT Styles, regions and sectors based on observed discount rates in a given economic regime

	Warranted Valuation Upside/Downside %														
Scenario per Fig 4 (probability weighting)	US Hyper Growth	US Tech Large Cap	US Quality Defensives	US Quality Growth	US	Europe Ex-UK	UK	Developing Countries	US Cyclical Value	Top 25% Value Developed Markets	Developed Energy Large Cap	Developing Financials	UK Financials	Europe Financials	US Financials
Goldilocks (35%): discount rate@20-year min	6%	23%	4%	11%	4%	0%	7%	13%	19%	18%	43%	72%	96%	90%	84%
Normalization (35%): discount rate@3-year median	-32%	-38%	-17%	-21%	-10%	-7%	-10%	-8%	-7%	-5%	15%	14%	8%	20%	28%
Status Quo (27%): no change in discount rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Stagflation (3%): discount rate @ 20-yr median	-83%	-44%	-43%	-36%	-19%	-27%	-18%	-13%	-8%	-4%	21%	21%	38%	35%	46%
Weighted Upside/Downside	-12%	-7%	-6%	-4%	-3%	-3%	-2%	1%	4%	4%	21%	31%	38%	40%	41%

Source: Credit Suisse HOLT®, HOLT Global Viewpoint, September 28, 2020

Two additional investments we highlight this quarter are Plexus Corp. and TriMas Corp.

Plexus Corp. (PLXS)

(Analyst: Julia Jensen)

Description

Plexus provides electronic manufacturing services (EMS). The firm partners with companies to transform concepts into branded products and delivers them to the market. It operates in four different market sectors: Healthcare and Life Sciences (39% of revenues), Industrial and Commercial (37%), Communications (8%), and Aerospace and Defense (16%). Plexus' focus is on winning contracts in niche markets that involve high-complexity/low-volume products. The company operates mainly in Malaysia and the U.S., but also in China, Mexico, Scotland, Germany, and Romania.

Good Business

- We consider Plexus to be best-in-class due to its superior margins and returns relative to peers, which have been driven by shifting product mix from low-complexity/high-volume products to high-complexity/low-volume products.
- Plexus has differentiated itself from peers with its top-notch design team and regulatory expertise. Much of this differentiation is within the Healthcare/Life Sciences sector, where projects with high engineering involvement and regulatory barriers predominate.
- The company's business model has a more defensive business mix relative to peers, which has been proven by its relative outperformance in the Great Financial Crisis and the current pandemic-related recession.
- Plexus is regarded as having higher service levels relative to peers, and has a net promoter score of 84%, which is high relative to the industry benchmark of ~56%.
- Management is organically focused and does not believe in mergers and acquisitions. We expect 9-12% annual revenue growth for the next five years now that management is largely finished with pruning its networking and communications portfolio.
- The company has a strong balance sheet with a net debt-to-EBITDA[1] ratio of 0.4 times and $650 million of liquidity.

Valuation

- Plexus trades at a forward price-to-earnings multiple (P/E) of 16.2 times and a trailing P/E of 17.9 times, which are approximately 50% lower than the weighted average Russell 3000 P/E multiples.

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

- Despite performing much better fundamentally throughout the pandemic than the average U.S. business, the shares are still down ~20% from their pre-pandemic high, while the U.S. stock market in aggregate is almost on par with pre-pandemic highs.

Management

- Plexus' management team is regarded as one of the best in the industry. The team takes a disciplined approach when selecting new projects, only taking on those that fit their strategy.
- CEO Todd Kelsey and COO Steven Frisch have been with the company for over 25 years and have held their positions since 2016. All other executives have held their positions for over five years.
- Management is well-aligned with shareholder interests and focused on growing return on invested capital (ROIC), which comprises 40% of incentive-based compensation. The other compensation is based on revenue growth (40%) and individual goals (20%). Notably, this compensation plan runs deep in the organization and includes all managers.

Investment Thesis

The EMS industry has historically been a tough one; it has been earmarked by little differentiation and low returns. However, Plexus has been an exception to this characterization due to its disciplined, niche strategy. Over the past decade, management has had an emphasis on shifting to a high-complexity/low-volume product mix. This has transitioned the company's high-complexity product mix to 93% of the business from 47% in 2008. This change has brought superior design team capabilities, sticky relationships, advanced regulatory knowledge, lower cyclicality, and higher returns. We particularly like that roughly 40% of the business now comes from Healthcare/Life Sciences, given its defensiveness and long product lifecycles. The protective nature of the business mix has been demonstrated throughout the pandemic. We expect continued strong demand for Plexus' services because recessions tend to drive manufacturing outsourcing, as many businesses lack the capital to manufacture in-house. We think the company will achieve strong growth over the long run, and it is an attractive relative value with a mid-teens earnings multiple.

TriMas Corp. (TRS)

(Analyst: Matt Sullivan)

Description

TriMas is a global designer, manufacturer and distributor of engineered products for commercial, industrial, and consumer markets. The company operates in three business segments: Packaging (58% of sales), Aerospace (26%), and Specialty Products (16%). The Packaging business makes specialty closures and dispensers for consumer and industrial products that are sold to a variety of end markets. The Aerospace business is a leading supplier of highly engineered fasteners to the aerospace industry. The Specialty Products business manufactures high and low-pressure steel cylinders, natural gas-powered wellhead engines and compressors, as well as other products. In total, approximately 82% of the company's consolidated sales come from the U.S., 12% from Europe, 5% from Asia-Pacific, and 1% from Latin America.

Good Business

- We estimate that TriMas' ROIC is approximately 12%, which exceeds the company's cost of capital.
- TriMas' products typically constitute a small portion of a customer's total production costs, but are critically important to the end product.
- The company's businesses have relatively high barriers to entry. Each business segment exhibits one or more of the following characteristics: the products are highly engineered, patent-protected, sold into industries with stringent regulatory requirements, sold under long-term contracts, have well established and highly regarded brands, and/or the businesses have longstanding relationships with customers.
- The Packaging and Aerospace businesses are defensive, have the highest barriers to entry, contribute the vast majority of the company's earnings, and should drive earnings growth going forward.
- The Packaging business' dispensers and closures are mainly used in consumer non-durable products, and the Aerospace business sells its products to customers under long-term contracts.
- The company has a strong balance sheet and is easy to understand.

Valuation

- The stock trades at 15.0 times our next 12-months earnings per share (EPS) estimate, which is below the company's 5-year average and is a significant discount to the Russell 2000 as well as other comparable companies serving similar end markets.
- The stock is trading at 1.6 times enterprise value-to-sales, which is below the company's 5-year average of 1.7 times.

Management

- Tom Amato became President and CEO in July 2016. He has more than 25 years of broad industrial experience, having served in several leadership positions at global, multi-billion-dollar businesses, and as a CEO for companies owned by notable private equity firms, including The Carlyle Group Inc. and American Securities LLC.
- CFO Bob Zalupski joined TriMas in 2002. He has more than 30 years of business and financial management experience. Prior to being named CFO in 2015, he was Vice President, Finance, Corporate Development and Treasurer.

Investment Thesis

TriMas is a collection of above-average businesses. COVID-19 has negatively impacted two of the company's three business segments, causing the stock to come under pressure. Offsetting these challenges, the Packaging business (dispensers and closures for cleaning and hygiene products) has experienced a strong increase in demand as a result of the pandemic. We believe the strength in the Packaging business will more than offset weakness in the company's other segments. Given the fairly resilient fundamental profile during this difficult time, we view the current valuation, at only 15 times the next 12-months EPS estimate, as attractive.

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	*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.