FIDUCIARY MANAGEMENT, INC.
Investment Counsel

100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545
www.fmimgt.com

INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

December 31, 2020

The FMI Small Cap portfolios gained approximately 24.8% in the fourth quarter compared to 31.37% for the Russell 2000 Index, and 33.36% for the Russell 2000 Value Index. Compared to the Russell 2000, sectors that helped during the quarter included Utilities, Consumer Durables, and Retail Trade. Ryder System Inc., Zions Bancorporation, and HD Supply Holdings Inc. gained considerably in the period. HD Supply was acquired by Home Depot, a transaction that closed in late December. Sectors that hurt the strategy relative to the Russell 2000 included Commercial Services, Electronic Technology, and Health Technology. Residual cash was also a drag in the December period. Genpact Ltd., FTI Consulting Inc., and W.R. Berkley Corp. detracted from relative performance in the December quarter. For the calendar year, the portfolio underperformed the growth stock driven Russell 2000 and outperformed the Russell 2000 Value.

Value strategies rebounded in the fourth quarter, but results were uneven. The intermediate to longer-term outlook for value looks promising, at least on a relative basis. Vaccine deployment and the natural course of COVID-19 (down dramatically) in areas that have been hit hard are encouraging. Bernstein models, which have been good so far, show the virus essentially disappearing by summer. Dr. Fauci and other experts' estimates are a few months later. As the virus recedes, confidence should improve, and demand is likely to recover. Higher GDP growth, higher employment, and greater loan demand could change the locus for interest rates, inflation, and value-oriented shares. Growth stocks have been the prime beneficiary of low inflation, unprecedented interest rates, and coronavirus lockdowns, not to mention massive speculation. If history is any guide, there will be some comeuppance in overpriced shares. This bodes well for the value trade, though it remains to be seen whether it will be an absolute or relative win.

Over-exuberance eventually gets punished in capital markets. The fact that it hasn't in recent years doesn't mean that it won't. Riding the winners and buying the dips has worked very well, but there is no historical precedent for the "winners" to continue to win year-after-year. Any asset, no matter how exciting, can become overvalued. Today, it seems as if many investors don't draw the connection between fundamental results and stock prices. To them, stocks are simply pieces of paper that go higher. The crazier the action in stocks like Tesla, Inc., the more likely the fever will break, ushering in a period of value outperformance. Tesla was up 743% on the year and 64% for the quarter. When a barely profitable company competing in a cut throat industry with nearly all competitors gearing up their electric vehicles trades at approximately 21 times sales (the very best players trade at roughly one times) and garners over a $650 billion market value, you know investors may have lost touch with reason. *But it's a technology company, dummy!* Indeed. It is also noteworthy, and equally remarkable, that a SPAC (special purpose acquisition corporation) recently acquired a promising solid-state battery technology company with no revenue (and none expected until 2025). According to *Barron's,* in December, this company, QuantumScape Corp., had a $59 billion market value, which was bigger than that of both Ford Motor Company and General Motors Company. Recent IPOs DoorDash Inc., Airbnb Inc., and Snowflake Inc., gained 86%, 113%, and 112%, respectively, on their first trading day. These stocks lose money, of course, but unlike 1999 – when most exciting tech names typically came public with a few billion dollars in market cap – today's crop is truly gargantuan. Tesla is the sixth largest market cap company in the S&P 500. DoorDash, Airbnb, and Snowflake had market values of $72 billion, $129 billion, and $153 billion, respectively. Snowflake's price-to-sales ratio looks like a good bowling score.

The pressure to perform is so great that we are seeing things that are certainly remarkable, if not surreal. One well-known value investor, who even wrote a book on the subject, has firm-level holdings where the top six positions are Apple Inc., Facebook Inc., Amazon.com Inc., Oracle Corp., Alphabet Inc., and Microsoft Corp. Another notable value shop shows 9/30/20 top ten holdings (with a 50% weighting) in their U.S. Value Fund to be Amazon, Microsoft, Alphabet, Facebook, Apple, PayPal Holdings Inc., Salesforce.com Inc., Visa Inc., MasterCard Inc., and Alibaba Group

Holding Ltd. In 2020, the widely-followed domestic growth indices have outpaced the value indices by over 30%. Perhaps the humorous meme to the right, sent to us recently, captures the sentiment of the day.

The incredible gain in the largest S&P 500 stocks, particularly the technology-related issues, has already been well-documented. The speculative move in the small cap universe in the December 2020 quarter (after a COVID-19 rebound in the second and third quarters), however, was equally breathtaking. Using the iShares ETF for comparative purposes, there were 185 companies in the Russell 2000 that were up over 75% in the quarter. Of this, nearly 80% were money-losers. It appears that fourth quarter performance in small caps was mainly driven by lower-quality COVID-19 rebound beneficiaries (weak retailers like Macy's Inc., now a small cap, was up 97% in the quarter) along with "lottery ticket" biotech stocks. Twenty-nine Health Technology companies in the index gained over 100% in the quarter, including Solid Biosciences Inc., which gained 273%. Approximately 88% of the Health Technology sector companies lose money. FOMO (fear of missing out) was on full display. On a weighted average basis, the iShares Russell 2000 trades at an astronomical 27 times enterprise value-to-EBITDA (EV/EBITDA),[1] 7.5 times price-to-sales (P/S) and a 39.8 times price-to-earnings (P/E) ratio on 2020 estimated earnings.[2] Both small and large cap valuations may be the highest we have ever experienced.

Bitcoin USD gained 305% in 2020, including a 171% move in the fourth quarter. We had to chuckle reading a recent quip by David Rosenberg, one of our favorite economists and market commentators, about Bitcoin:

> *I did a small experiment yesterday and tweeted that Bitcoin is in a bubble - the reaction was visceral (you should view the troller comments – I may need a bodyguard!). It reminded me of how the intelligentsia responded to the calls of "tech bubble" in 1999 and "housing bubble" in 2006. When investment debates become personal and emotional, you know you are in a huge bubble. […] Bitcoin - wow! It's become somewhere between a cult and religion.*

We don't yet have a house opinion on Bitcoin, although we would lean toward gold when it comes to an enduring, sound currency (Bitcoin earrings also leave a lot to be desired!). There currently appear to be approximately 6,700 crypto currencies in existence, up from roughly 2,000 at the start of 2020. The total market value has exploded from under $200 billon at the start of the year to roughly $646 billion in late December. The last time Bitcoin spiked like this (late 2017), it fell approximately 80% the following year. It certainly has the characteristics of a bubble, but the boom isn't happening in a vacuum. Central bankers printing money at a harried rate has historically spelled debasement and inflation. Storing wealth outside of the traditional fiat money framework is understandable.

The bond market has a similar "suspension of reality" feel to it. Approximately $18 trillion of debt is trading with a negative yield. That is roughly 26% of all investment grade debt, according to Bloomberg. Imagine paying Portugal, Spain, and Italy to borrow money! Central banks printing money and fiscal authorities borrowing at unheard of levels, with little consideration for the potential long-term consequences, are mind-blowing. Modern Monetary Theory is misnamed – it isn't a theory anymore. Investors quite clearly don't expect to ever have to pay the piper.

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[1] EBITDA is earnings before interest, taxes, depreciation, and amortization.

[2] Valuations are estimates based on the following scrubbing criteria: money losing companies are ascribed a 40 P/E ratio to them (which is probably conservative) and those with P/E ratios greater than 100 are capped at 100. For P/S, those with greater than a 30 multiple are capped at 30x. We assign the same multiple for no sales. The EV/EBITDA calculation excludes financials, and uses a cap of a 200 multiple, while those with a negative EV/EBITDA receive a 20 multiple in the calculation.

Moreover, economic growth has been weak wherever negative real rates have prevailed (for decades in Japan), calling into question the whole premise on whether monetary accommodation works.

Despite the madness of the financial markets, we want to emphasize the notion that directionally, the stock market may be signaling a positive progression in the economy. Ironically, that could be the undoing of the growth stock surge, as weak macro conditions in recent years – particularly in 2020 due to the coronavirus fallout – have created a perfect storm for markets to reward the relatively few companies with good growth. We think the probability is high that the virus will be largely in the rearview mirror within two to three quarters. Pent-up demand across multiple sectors will be addressed, and the financial wherewithal to fund this demand and capital investments is abundant. Employment should improve. It is hard to imagine, in such an environment, that interest rates and inflation won't begin to normalize. Trillions of dollars of Fed credit will be multiplied many times over as it is deployed in the commercial banking system. The probability of a pick-up in inflation is nontrivial, though with a few notable exceptions, few believe it will happen. Our best guess is that many areas of the economy that have been weak will improve. This should play into value stocks outperforming. A bigger element in value winning will be rates. Growth stocks have been winning primarily because growth rate expectations have been high and the discount rate for far-into-the-future earnings has been low. A meaningful rise in rates could be devastating for long-duration growth stocks. The inevitable slowing of earnings growth for the vaunted names will also play a role. Many of these companies are so large now that truly extraordinary things must happen to move the needle. Apple needs to find $28 billion of new business to grow 10%. Amazon needs to grow $38 billion to show a similar growth rate. That is equivalent to adding an entire Nike Inc. in one year! Any sustained loss in momentum on the part of the growth stocks could trigger fund flows to slow and even reverse, helping the relative performance of the more neglected stocks.

The timing for the start of a much better economy really depends on how people muddle through the next several months. The latest COVID-19 surge may buckle the economy in the short run if policy responses remain severe. The logistics of administering tens of millions of inoculations could be a short-term problem, and a surprising number of people are saying they will not get a vaccine. Eventually all of this will get sorted out and the economy should rebound smartly. The cost of capital simply cannot stay at ground-hugging levels forever. Investors, private equity managers, corporate mergers & acquisitions teams, and borrowers have all gotten fat on a condition that is more than two standard deviations from the mean. Even a modest normalization of rates, and a recognition that equities are risky, will change the cost of capital significantly, setting up the conditions for a great value run. Our philosophy and strategy had a remarkable half-decade run after the tech bubble burst in early 2000. As the small print says, past performance is no guarantee of future performance, but we are confident that a commonsense value approach will win over the long term.

Our sincere thanks for your support of 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.