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

June 30, 2021

The FMI Small Cap portfolios returned approximately 6.9% in the June quarter compared to 4.29% for the Russell 2000 Index and 4.56% for the Russell 2000 Value Index. Relative to the Russell 2000, Process Industries, Finance and Commercial Services sectors outperformed, while Technology Services, Consumer Services and Distribution Services lagged. Avery Dennison Corp., Houlihan Lokey, Inc. Cl A, and FirstCash, Inc. gained ground in the quarter. Avery, a long-time holding, was sold due to valuation. CDK Global, Inc., Trinity Industries, Inc., and Applied Industrial Technologies, Inc. modestly hurt performance.

A multi-year period of growth stock outperformance was interrupted last fall by a value stock surge. In the back half of the quarter just ended, performance ping-ponged back in favor of growth stocks. We all fall victim to characterizing the market in this fashion, e.g., growth versus value. The truth is a bit more complex. In the fourth quarter of 2020 and first quarter of 2021, deeper value names, including many low-earning or money-losing cyclicals in energy and commodity areas, roared. A number of very cyclical, and in some cases secularly-challenged retailers (mall-based), who were further depressed by COVID-19, rebounded dramatically. Heavily-shorted stocks, most of suspect quality but categorized as value stocks, were among the strongest performers, and that continued through the June quarter. "Meme" stocks, e.g., AMC Entertainment Holdings Inc. and GameStop Corp., have also seen spectacular moves. Year-to-date, some of the strongest-performing stocks were those whose debt is rated "junk" (below investment grade). Summarizing the market in recent quarters, we'd say it is like a teeter-totter, oscillating between growth and deep value, with both quality growth and quality value near the fulcrum and lagging modestly. Transcending this teeter-totter analogy are groups of stocks where risk consideration seems minimal and investor behavior is stupefying. We are comfortable sitting in the quality value camp, with a bevy of durable businesses, good balance sheets, and discount-to-the-market valuations.

<u>What we know</u>

It is possible that companies losing a lot of money today will become cash-generating machines down the road. It is also possible that industries that haven't earned their cost of capital in decades can turn around and be money-makers. Our experience tells us that most of today's money-losers will not be big winners, and the majority of industries that face destructive competition and/or dependence on volatile commodities will be tough places to make money. Of course, there will always be exceptions. We try to avoid unknowable or hard-to-predict outcomes, particularly in situations where the company has little control over its destiny. Trying to forecast markets is even more difficult as they fall into the art rather than the science world. For example, if an omniscient being had said at the end of 2010 that the companies in the S&P 500 would grow earnings (generously defined) over the next decade at 4.2%, how many would have predicted a 13.9% compound annual return for the index? Yet that happened. What about today? To paraphrase a former Secretary of Defense, what are the "things that we *know* we know… the *known* knowns?"

1.) Stocks are incredibly expensive when compared to history. The table in Figure 1, from The Leuthold Group, says it all. We are in the tenth decile (most expensive) on a median basis across a spectrum of valuation measures.

2.) Some investors are investing in a manic fashion, taking enormous risks on speculative, and in some cases, arguably ridiculous ideas. Many investors have abandoned fundamental underwriting, and instead, trade stocks in buckets or themes… and these themes can change daily. Ironically, it seems some hedge funds are now following the "retail" crowd. The renewed surge in speculative names (Figure 2) since mid-May caused noted historian Jeremy Grantham to say, "[This is] the biggest U.S. fantasy trip of all time." Margin debt at the end of May was $862 billion, up 56% from a year ago.

3.) Interest rates remain extremely low from a historical perspective, and it is abundantly clear that most investors believe rates will stay low indefinitely. Consider the financial repression that exists today; a risk-averse investor holding short-term government instruments is underwater each year on an inflation- adjusted basis by nearly 5%!

4.) Companies, both public and private, have loaded their balance sheets with debt. High-yield spreads (Figure 3) are extremely narrow, suggesting that most investors are unconcerned about leverage.

5.) Systemically, government debt levels (Figure 4) and central bank balance sheets have exploded. *Thirty trillion dollars of fiscal and monetary "stimulus" has been incurred over the past 18 months across the globe.* The U.S. government has borrowed more relative to our ability to repay it (debt-to-GDP) than at any time since World War II.

6.) Perceptions of future equity returns seem wildly out of touch unless market valuations go to almost unimaginable levels. Real GDP growth and corporate earnings growth over the last decade have been less than 2% and approximately 4%, respectively. As mentioned, stocks have returned multiples of underlying growth due to valuation expansion. How much further can this go?

7.) Inflation has officially spiked to 5% recently. Unofficially, the inflation rate could be even higher using 1990 methodology, as revealed in the chart in Figure 5.

Figure 1

Equity Valuations are Expensive
1st Decile = Cheap / 10th Decile = Expensive

Quarterly Summary - Leuthold Valuation Deciles (ex-Duplicative)	Q1 2000	Q1 2021
Average Decile	9.41	9.52
Median Decile	10.00	10.00

Individual Valuation Metrics	Peak Q1 2000	Today Q1 2021
S&P 500: P/E Ratios...Normalized (5 Year Average Earnings) 1926-Date	10	10
S&P 500: P/E Ratios...Normalized (10 Year Average Earnings) 1935-Date	10	10
S&P Industrials: P/E Ratios...Normalized (5 Year Average) 1926-Date	10	10
DJIA: P/E Ratios...Normalized (5 Year Average) 1926-Date	10	10
S&P 500: Operating Earnings P/E Ratios Trailing 12 Month Operating Earnings 1926-Date	10	10
S&P 500: P/E Ratios Trailing 12 Month Reported Earnings 1926-Date	10	10
S&P Industrials Normalized P/E (5 Year Average Return on Sales) 1956-Date	10	10
S&P Industrials: P/E Ratios Normalized (5 Year Return on Equity) 1930-Date	10	10
Median Normalized P/E Ratios (Monthly) For Largest 3000 Stocks 1986-Date	7	10
Median P/E Ratios (Monthly) 12 Month Trailing Earnings For Largest 3000 Stocks 1986-Date	7	10
S&P 500 P/E Ratio: National Income & Products Account Earnings (NIPA) 1957-Date	10	10
S&P 500: Yields 1926-Date	10	10
S&P Industrials: Yields 1926-Date	10	10
DJIA: Yields 1926-Date	10	10
"Real" Dividend Yield S&P 500 1957-Date	7	6
S&P 500: Dividend Payout Ratio (Based on Reported Earnings) 1946-Date	9	2
S&P Industrials: Book Value Ratio 1926-Date	10	10
DJIA: Book Value Ratio 1926-Date	10	10
S&P Industrials Book Payout Ratio 1926-Date	3	9
S&P Industrials: Cash Flow Ratio 1946-Date	10	10
S&P Industrials: Price/Sales Ratio 1956-Date	10	10
Total US Equity Capitalization as a Percentage of GDP 1926-Date	10	10
Total US Equity Capitalization as a Percentage of GAG (GDP after Government) 1957-Date	10	10
S&P 500 Index as a Percentage of GDP 1957-Date	10	10
S&P 500 Index as a Percentage of GAG (GDP after Government) 1957-Date	10	10
Median Existing Home Prices Divided by S&P 500 1968-Date	10	10
Ratio of S&P 500/Gold Prices 1926-Date	10	9
Number of Hours of Work Required to Purchase One S&P 500 Unit 1947-Date	10	10
S&P 500 Dividied by the Price of Oil 1945-Date	10	10

Source: The Leuthold Group. Data is as of 4/9/2021. Decile rankings reflect up to 95 years of history.

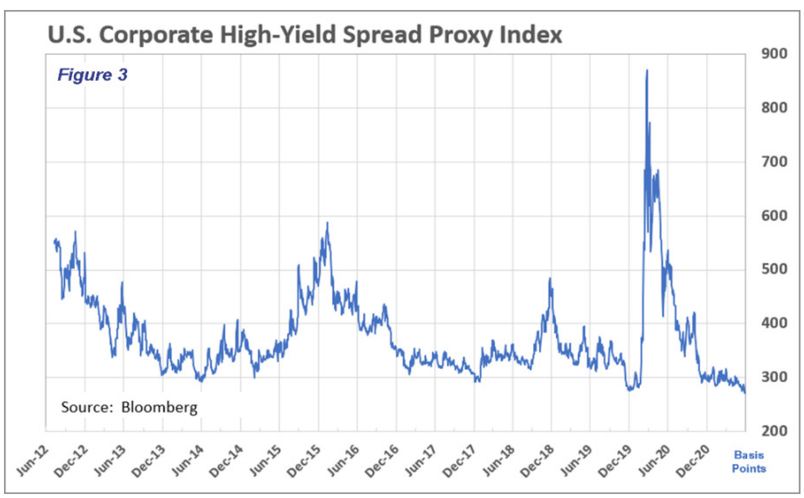
Figure 2

Back on the speculative stocks since May 10

High Retail Sentiment		Non-profitable Tech	
AMC Entertainment	481.9%	Li Auto	105.4%
Virgin Galactic	156.3%	Appian Corp.	58.0%
Clover Health	61.3%	NIO	55.0%
BlackBerry	50.3%	Cloudflare	53.7%
GameStop	49.5%	Beyond Meat	46.9%
Palantir Tech.	42.7%	MongoDB	42.1%
NVIDIA	40.3%	Fastly	41.2%
Canoo	40.2%	LendingClub	40.7%
Zoom Video	34.2%	Farfetch	22.8%
Sundial Growers	29.6%	PROS Holdings	18.9%
Clean Energy Fuels	15.6%		

From May 10 through June 30, 2021, the Russell 1000 Growth outpaced the Russell 1000 Value by 9.5%
From May 10 through June 30, 2021, the Russell 2000 Growth outpaced the Russell 2000 Value by 6.9%

Source: Bloomberg



What we think we know

We see the U.S. economy continuing to rebound from the depths of the last year's COVID lockdowns. Other countries are following this general pattern depending on how quickly vaccinations roll out and normal business activity resumes. As of June 25, the Federal Reserve Bank of Atlanta's model shows that the estimate for second quarter real GDP growth is 8.3%, which, if it comes to fruition, would be one of the strongest on record. Corporate earnings have rebounded sharply over the past few quarters and current estimates suggest at least a 40% rebound for 2021, although in many cases, earnings will still be below 2019 levels. If there are no major changes in the trajectory of GDP, 2022 growth should remain above-average. Long-term, we view increasing capital and research & development (R&D) expenditures as critical to achieving higher growth. The chart in Figure 6 is encouraging.

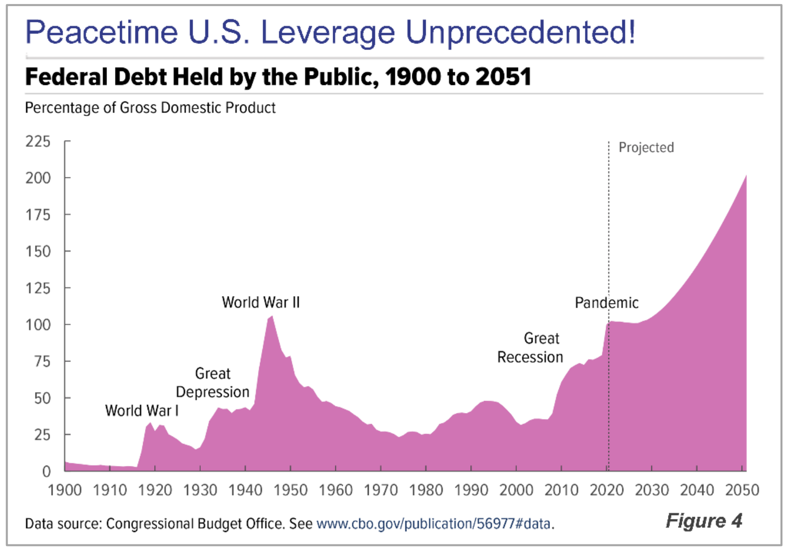


Figure 4

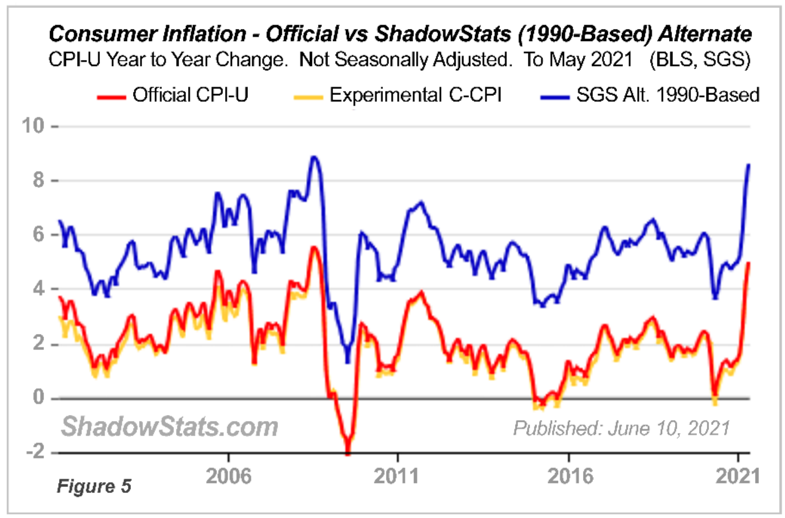


Figure 5

The byproducts of potentially stronger economic growth will likely have a heavy influence on the stock market. Today, supply chain problems and labor shortages are impacting inflation. Surplus money, in the form of stimulus checks, may also be spiking prices. Most of the companies we follow are implementing higher wages; it is rare to see wages fall. With stronger economic growth and permanent increases in labor costs, higher secular inflation may be on the horizon. As millions of workers reintegrate into the workforce, income and demand will also rise. Inflation could thus be influenced by both varieties: cost push and demand pull. Ultimately, we think this impacts the holy grail of the investment landscape -- interest rates.

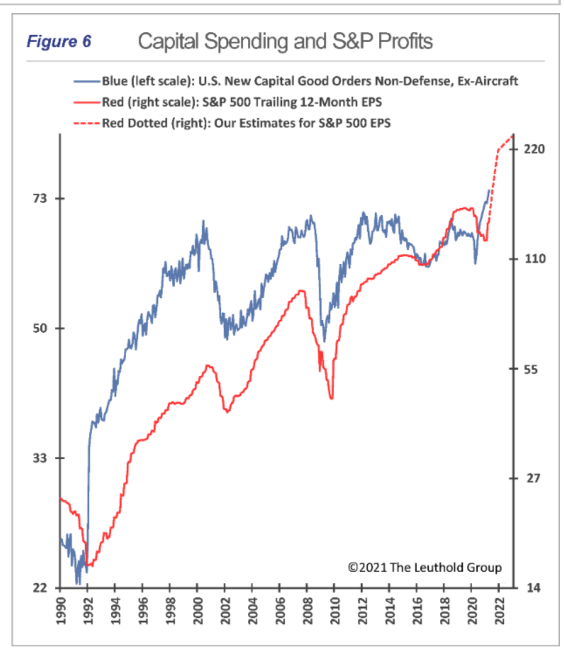
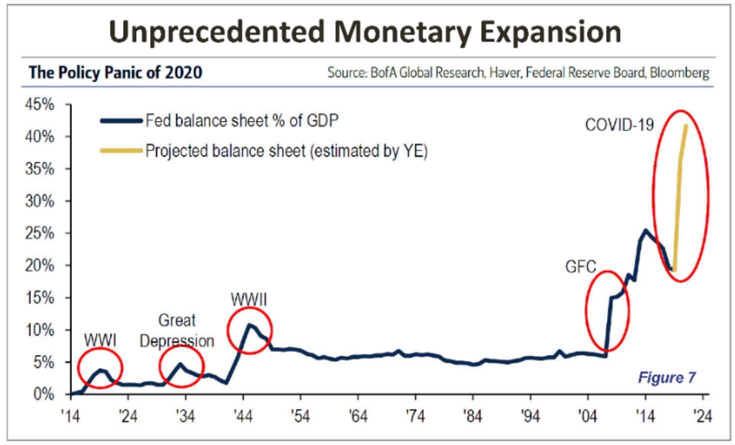


Figure 6 Capital Spending and S&P Profits

Monetary expansion is on a tear (Figure 7). The market bet in a nutshell can be summarized by this question: Do you believe a government can indefinitely engage in quantitative easing at a level that is substantially in excess of the underlying growth of the economy without inflation and interest rates taking flight? If you believe it can, and it becomes reality, then growth stocks will likely outpace value stocks. If you don't, thinking that the combination of unbridled monetary and fiscal expansion might just finally do the trick on interest rates, then value-oriented stocks -- particularly of the higher quality ilk -- should win. Regardless of the overall sentiment of the market, we would expect the most speculative and reckless stocks and cryptocurrencies to get their comeuppance, as was the case recently with Iron Finance TITAN tokens, which went down over 99%.



Higher market rates mean higher discount rates, hurting the stocks of companies that depend on far-into-the-future earnings being discounted at historically unprecedented levels, and on a relative basis, seemingly helping stocks of businesses where the earnings are more immediate. That describes our portfolio of companies. Rate fears may also severely damage the companies running hot with debt. A flight to quality should help us on a relative basis.

Previously, we have pointed out that economic growth is driven by more hours of work and/or higher productivity. Reemploying the roughly nine million officially unemployed workers, the millions not even looking for work (and therefore not counted), and putting in place a sensible immigration program, would give the U.S. an enormous leg up on countries and regions with shrinking working age populations -- particularly China, Southeast Asia, Europe, and Russia. Efficient capital deployment and R&D would help make labor more productive. Additionally, according to a recent report from the National Bureau of Economic Research, new business formations have grown rapidly, setting the stage for future economic expansion. These are the main factors we “think we know” that will set the course for better long-term economic growth, perhaps at the expense of inflation and higher interest rates. Ironically, better fundamental growth might not be the best for absolute stock performance, but should be good for the relative performance of the FMI Small Cap portfolios.

Thank you for your support of Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2010 - 12/31/2020

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 %
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	$ 22,609.9	10.68%
2020	4.40	3.60	19.96	104	1.49	21.15%	25.27%	$ 2,079.2	$ 16,284.2	12.77%

*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. claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Fiduciary Management, Inc. has been independently verified for the periods 12/31/1993 - 12/31/2020. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The Small Cap Equity Composite has had a performance examination for the periods 12/31/1993 - 12/31/2020. The verification and performance examination reports are available upon request.

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 $16.2 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 and incepted 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®. FMI uses gross returns to calculate these.

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 and FMI distributed mutal funds are 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.