FIDUCIARY MANAGEMENT, INC.
Investment Counsel

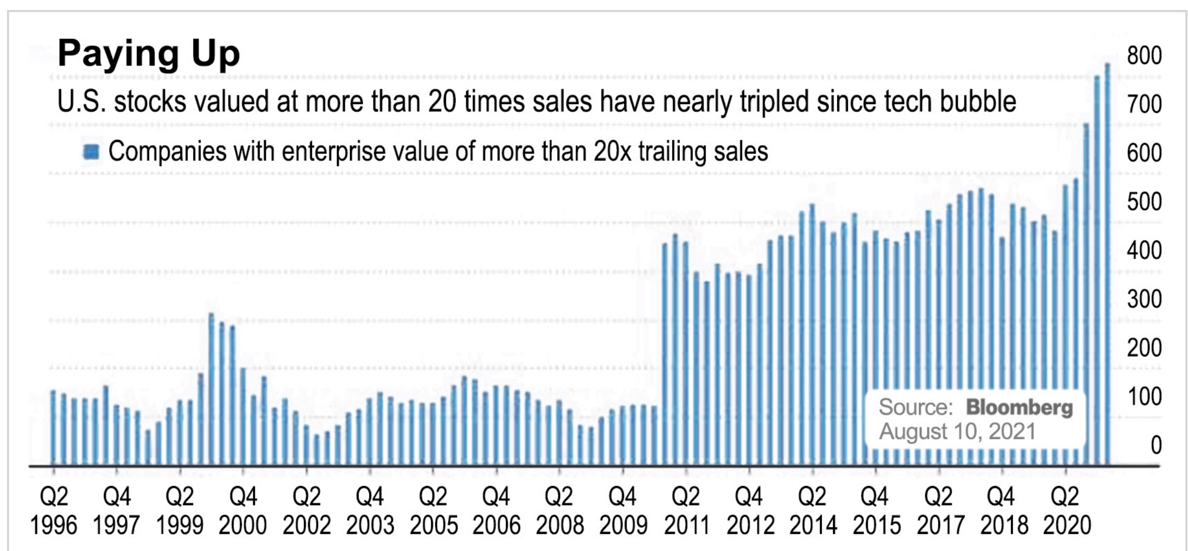
100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545
www.fmimgt.com

September 30, 2021

INVESTMENT STRATEGY OUTLOOK - SMALL CAP EQUITY

The FMI Small Cap portfolios gained approximately 0.6% in the September quarter compared to declines of 4.36% for the Russell 2000 Index and 2.98% for the Russell 2000 Value Index. Energy Minerals, Transportation, and Industrial Services detracted from relative performance versus the Russell 2000. From a stock perspective, Donaldson Co. Inc., Herbalife Nutrition Ltd., and Insight Enterprises Inc. all declined in the period. On the positive side, Commercial Services, Retail Trade, and Producer Manufacturing all added to relative performance. Interpublic Group Cos. Inc., FirstCash Inc., and Carlisle Cos. Inc. outperformed from an individual stock perspective. Year-to-date the portfolio has outperformed the Russell 2000 by a wide margin, but has modestly underperformed the Russell 2000 Value. We believe the quality of the companies we own are superior to both indices, and most valuation measures are lower. We are confident that this is a winning combination longer-term and have recently increased our own investments in the portfolio.

Worries about the Delta variant and its effect on the economy turned investors toward the same forces that have prevailed since early 2020, when COVID first surfaced. The S&P 500, driven mostly by higher-multiple growth stocks, has performed strongly since the start of the pandemic (+37.3% from February 1, 2020 through September 30, 2021). Curiously, in a time of uncertainty and difficulty, many of the most speculative stocks have done even better. Bitcoin-sensitive stocks were up 274.9%, and the most liquid shorted stocks, popular with the Reddit/Robinhood crowd, were up 172.6%. Non-profitable technology stocks were up 157.7%. In fixed income, speculative grade issues have lapped Treasuries. New issues of money-losing companies are at a record level, and ones that trade for greater than 20 times sales remain commonplace. Currently there are over 800 companies with an enterprise value-to-sales multiple greater than 20 (see the following chart), compared to approximately 300 at the peak of the 2000 market. This measures only companies with sales, so it excludes a significant number of development-stage biopharmaceutical companies with sizeable market values. Historically, the 5-year forward relative return for stocks with a price-to-sales ratio in excess of 15 has been -28%[1]. Will this be a new era?



Bob Farrell, a dean of Wall Street thinkers from the mid-1960s through the early 2000s, published his "Ten Market Rules to Remember" in 1998 (see Appendix), the third of which was, "There are no new eras," meaning that change, technological breakthroughs, and progress are always part of the landscape. Innovation, by its nature, is unique, but its impact within the stock market does not last forever. We haven't entered a new era for growth. One "proof" of that is the rate of economic growth over recent decades. Despite fantastic innovations in technology, health care, and entertainment, real GDP growth has been relatively steady over each of the past three decades. In fact, even with all the new marvelous technology, productivity growth has actually lagged historical rates over the past ten years. There is no new era to justify today's extraordinarily high valuations. In the decade ending 2020, the S&P 500 (iShares S&P 500 ETF as a surrogate) revenue and earnings growth were roughly 4.5% and 8.2%, respectively. If eight stocks are removed (Facebook Inc., Apple Inc., Amazon.com Inc., Alphabet Inc. (Google), Microsoft Corp., NVIDIA Corp., Netflix Inc., and Tesla Inc.), the revenue and earnings growth for the remaining companies were approximately -1.5%. Ending 12/31/20, the median stock return of the iShares S&P 500 over the past decade was 11.2%. Multiple expansion is clearly responsible for a large share of the market's return. Since 2020 was a depressed endpoint, we analyzed the five years ending December 31, 2019. During that period, S&P 500 sales grew at a compound rate of about 5.0%, and earnings advanced at around a 10.6% clip. Without the aforementioned eight names, we estimate that revenue grew just 0.1% and earnings gained

[1] Eric Savitz. "Pricey Tech Stocks Still Carry Big Risks, Bernstein Analyst Cautions." *Barron's*, March 22, 2021.

5.2%, compounded. The desire to hold the S&P 500 has been a self-fulfilling prophesy in recent times, but we contend that it won't always be this way. Investors seem immune to the notion that the reverse can happen, and yet history tells us that this occurs with great regularity. It just hasn't happened recently!

2000 Market Versus Today

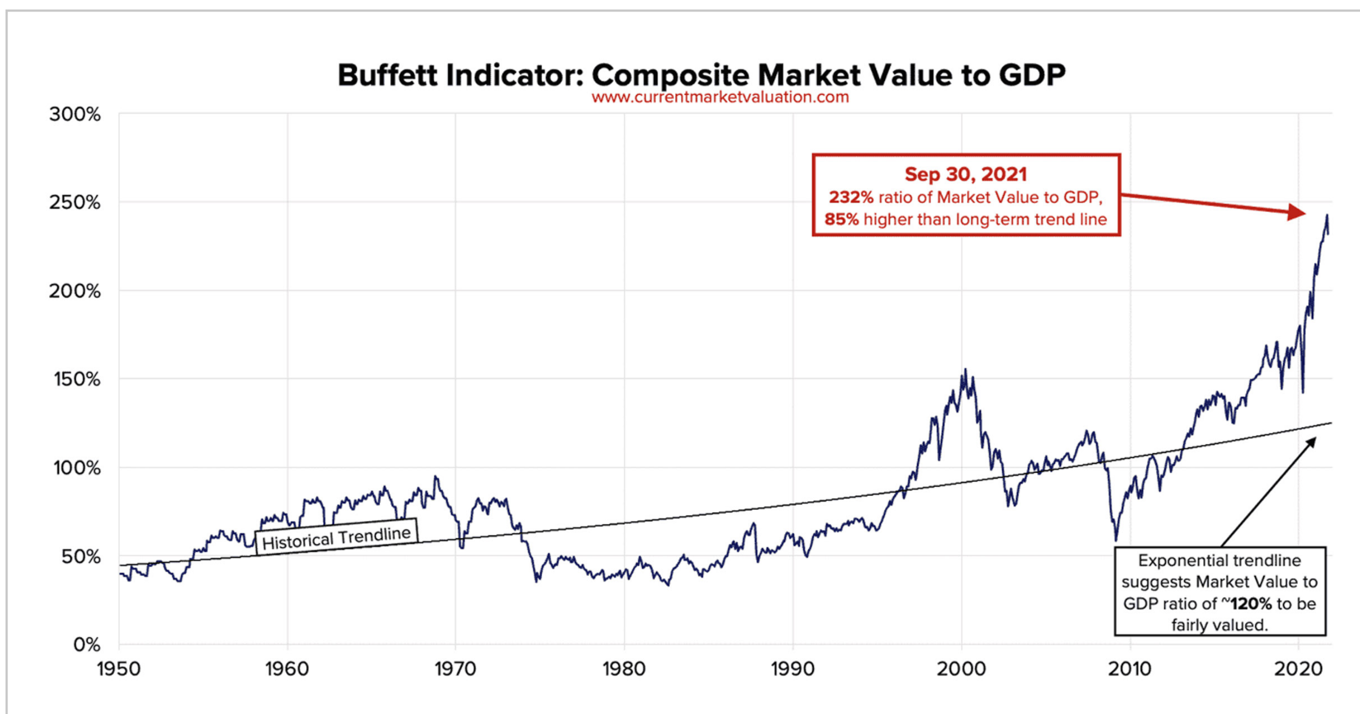
Today we have a market picture that is very reminiscent of the 2000 period. Information Technology and Communication Services stocks constituted 39.9% of the market at the end of 1999. Information Technology (to include social media and Amazon) and Communication Services were 42.8% of the S&P 500 as of September 30. Technology's weighting in the stock market is roughly five times its weighting in the real economy. Valuations were extreme in 2000, and are, on many measures, even more so today. The market capitalization-to-GDP ratio is the highest ever (see chart below). Investor sentiment is very bullish. "Retail" involvement in the market was high in 2000, but with the dawn of free stock trading, has recently expanded dramatically. Margin debt is also near a record high.

There are, however, some important differences. Many companies are "investing" through the income statement rather than the balance sheet. By this we mean that they are expensing customer acquisition or network development expenses on the profit and loss statement, rather than through capital investments made on the balance sheet, and this depresses current earnings. Notable companies like Amazon and Netflix have done this. These successful "deferral" models have been copied by hundreds of companies. Today there is an obsession with top-line growth almost to the total exclusion of profits. It seems that for emerging companies, showing profit is a sign of weakness, because it means one is not driving (spending) hard enough on revenue generation. Some deferral models will work, but many will not. Underpricing a product or service to drive sales growth may, in the end, just turn out to be an unprofitable endeavor. Another big difference between 21 years ago and today is that the cone of overvaluation was fairly confined to a few sectors then, whereas extended valuations permeate most sectors today. At the beginning of 2000, if one avoided tech and telecom, it was possible to build a portfolio of excellent companies with price-to-earnings multiples in the low-to-mid-teens. Buying a portfolio of roughly the same quality today, while avoiding the extremely high multiple ideas, would cost closer to 20 times earnings. Finally, from a macro standpoint, there are several major differences to highlight. Inflation is on the rise today, and was going the other way in the early 2000s. This may eventually influence interest rates, which have been ground-hugging for over a decade. Companies are running hot with leverage up dramatically. The government seems to be on a nonstop spending spree; government debt exceeds $28 trillion and the deficit/GDP is as high as it has been since WWII.

Economic Growth Generally Positive

Despite these concerns, however, we remain generally optimistic about economic growth. A huge contingent of workers remain on the sidelines due to COVID-19. There are roughly 8 million officially unemployed, and perhaps as many as 10 million more who are no longer counted, because they are not actively seeking work. Incentives to forgo work must lessen. It seems like nearly all sectors are complaining about worker shortages: restaurants, hotels, technicians, nurses, tradesmen, and teachers, to name just a few. There are officially an incredible 10.9 million job openings. Wages are rising, which may bring people back into the workforce. As people return to work, economic growth will accelerate, creating even more employment opportunities. Additionally, one of our greatest competitive advantages as a nation is access to immigrant labor. Countries we compete with have low birth rates and highly restrictive immigration. We need comprehensive laws and clarity in this area, but potentially, this is a huge long-range positive.

Another important aspect to growth that has been improving lately is capital formation. Orders for durable goods, excluding defense, are up 26.6% year-to-date through August, which is an easy comparison due to COVID, but they are also up 2.2% com-



pared to 2019. According to S&P Global Ratings, global capital expenditures are projected to jump 13% this year. We've waited a long time for this, and although it is too early to call it a trend, the signs are encouraging.

Inflation

The inflation we have been warning about over the past few years is here. The Fed claims it is a blip and will soon disappear, i.e., return to 2% (which for some reason is considered good), and in the short run, the Delta variant's impact could slow the economy and lessen inflation. Additionally, as the most acute supply chain bottlenecks ameliorate, prices are likely to settle down, but the conditions for secularly higher rates of inflation appear to be in place. Wages are very sticky on the downside and constitute a sizeable percentage of most companies' costs. In nearly every industry we analyze, wages are rising at rates that haven't been seen in years. Prices for many consumer products, including food and energy, are rising, and prices for nearly every service one could think of are increasing as well. It is beginning to feel more like the 1970s every day. Producer prices have escalated dramatically. The Producer Price Index was up 8.3% for the 12 months ended August, after having gained steadily all year. Inflation psychology seems to have changed, too. People now expect to see higher prices, surcharges, special fees, etc. Moreover, one of the greatest dampeners of inflation over the past 20 years has been China. As more manufacturing moved or threatened to move to China, it suppressed domestic wages and inflation. Cheap imports from China also depressed U.S. product prices. The great migration of hundreds of millions of rural folks moving to Chinese cities has largely played out. Today, China's working-age population is starting to fall. Wages are rising significantly and import prices are rising. Add to this the massive amount of quantitative easing. Nearly everything that worked to lower inflation for many years is now going in reverse.

Interest Rates

How will rates respond to inflation, and to all the newly created money that is likely to get deployed in coming quarters and years? How will they react to the long-awaited Fed tapering? How will huge deficit spending programs impact rates? How sustainable are deeply negative (~-5% today) real returns on cash and short-term investments? Will a decade-plus of extremely low and unprecedented rates give way to something more normal in the future? We think the answer is yes, although of course, we cannot predict the timing. We envision a different environment than the one that has prevailed in recent years. Buying growth and so-called story stocks and ignoring valuations and balance sheets has been a winning formula for quite some time. We are content to own sound companies with durable business franchises and reasonable valuations, knowing that long-term, this has worked. Below we have highlighted a couple of portfolio companies.

LGI Homes Inc. (LGIH)

(Analyst: Julia Jensen)

Description

LGI Homes engages in the design, construction, marketing, and sale of new single-family homes in the U.S. It participates in 34 markets across 18 states, with 9,339 closings per year as of 2020. It is the tenth largest residential homebuilder in the U.S., and focuses on building affordable, entry-level spec homes that are move-in ready. The company primarily markets its homes to renters in order to convert them into homeowners. It operates through the following segments: Central (39% of closings, 36% of revenues), Southeast (26% of closings, 24% of revenues), Florida (13% of closings, 12% of revenues), West (11% of closings, 12% of revenues), and Northwest (11% of closings, 16% of revenues). The company was founded in 2003, completed its IPO in 2013, and is headquartered in The Woodlands, Texas.

Good Business

- The company has a unique selling culture with a simple and differentiated business model that is easy to understand and consistently applied across every LGI Homes community in the U.S.
- Its homes are built quicker and more efficiently than a typical spec home because LGI uses even-flow production, allows for no customization by the buyer, and builds in sets of 3-4 homes simultaneously.
- LGI uses a highly successful direct-to-consumer sales model and is not reliant on realtors to bring potential buyers to its communities, like most peers. This makes the company less sensitive to underlying demand for housing than the average homebuilder.
- LGI has been profitable every year since its inception in 2003, even throughout the Great Financial Crisis.
- It has the highest monthly absorptions (homes closed per community per month) among other homebuilders, at seven homes per community, and has the highest gross margin out of its peers.
- LGI Homes' communities are primarily located in southern geographies with favorable migration patterns.
- LGI is one of the only homebuilders that has earned returns above its cost of capital over the past decade. It has averaged a return on invested capital of ~14% over the past five years.
- The company's balance sheet is in good shape, with a net debt-to-total capital ratio of 31% and a net debt-to-EBITDA[2] of 0.9 times.

---

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

Valuation

- The stock is trading at 8.3 times its trailing enterprise value-to-EBIT,[3] which is over a standard deviation below the company's 5-year average of 11.0 times.
- It trades at a forward price-to-earnings multiple (P/E) of 8.9 times, half a standard deviation below its 5-year average of 9.6 times.

Management

- LGI management and directors own nearly 12% of the company, aligning their interests with shareholders, and all named executive officers have long tenures. The management team members are regarded as some of the best operators in the industry.
- CEO Eric Lipar is one of the founders of the company and owns over 9% of the shares.
- CFO Charles Merdian has been with the company for 17 years, and in his current position for 11.
- President and COO Michael Snider has also been with LGI for 17 years, and in his current position for 12 years.

Investment Thesis

LGI Homes operates quite differently than most peers. What really sets the company apart is its unique, systematic approach in marketing to renters, training its sales staff, and identifying optimal locations to build communities. In contrast to many homebuilders that depend on realtors to bring buyers to their communities, LGI uses a direct-to-consumer approach to actively search for renters and convert them into homeowners. This model has proven extremely effective, as the company has sustainably higher monthly absorption (closing) rates, double its peers. This sales model has also proven to be a more durable and consistent way to sell homes, and better able to withstand a tougher economic environment. Additionally, LGI Homes is well-positioned to benefit from strong economic and secular trends in the industry, such as low U.S. home inventory, low interest rates, migration patterns to the south, strong demand for more affordable single-family housing, urban flight, and increased working from home. LGI should continue to outpace peers while generating good returns as it follows its superior sales model and expands into new communities.

Beacon Roofing Supply Inc. (BECN)

(Analyst: Dan Sievers)

Description

Beacon is the largest publicly traded (#2 overall) distributor of roofing materials and complementary building products in the U.S. and Canada. Beacon serves greater than 90,000 customers and offers 140,000 SKUs from over 400 branches throughout all 50 states (97% of sales) and 6 Canadian provinces (3% of sales). Beacon makes 1.7 million annual deliveries (within a two-hour radius) using its fleet of specialized trucks. Since the sale of the non-core Interiors division (2021), their run-rate sales have been 53% Residential Roofing; 25% Commercial Roofing; and 22% Complementary Building Products (siding, windows, specialty exterior building products, insulation, and waterproofing systems).

Good Business

- Manufacturers and distributors operate in a rational and consolidated market, with the top three distributors accounting for 54% of a $28 billion industry (almost two times what they had ten years ago).
- The industry is led by ABC Supply Co. Inc. (24% share), Beacon Roofing (20% share), and SRS (10% share), with the remaining 46% held by 1,500 smaller distributors.
- It is estimated that roughly 80% of roofing sales are replacement, and that the U.S. housing stock is now over 40 years old on average. Ninety-four percent of U.S. re-roofing demand is thought to be non-discretionary.
- With management's focus on organic growth and maintaining discipline, rising returns should follow.
- Aided by the Interiors divestiture, the fiscal third quarter 2021 net debt-to-EBITDA ratio dropped to 2.4 times, providing financial flexibility and likely the ability to buy back stock and issue dividends.
- Beacon is a simple scale business, and roofing distribution is unlikely to undergo major change.

Valuation

- Despite newfound financial health and flexibility, and strong fundamentals, Beacon's shares have receded from $60 in May to $50 in August (-17%), and the stock trades at a discount to its 10-year average for the next twelve months P/E (11 times), enterprise value-to-EBITDA (9 times), and enterprise value-to-sales (0.85 times). With steady execution, we think there is scope for Beacon to trade at a premium to 10-year averages and north of 1 times EV/Sales.
- If Beacon were to grow 4.5% and reach the low end of their EBITDA margin target by fiscal year 2026 (9%-11%) and were ascribed a 15 P/E ratio, the compound return would be approximately 15%.

---

[3] Earnings before interest and taxes

Management

- New CEO Julian Francis has refocused the company on its core Roofing/Exteriors business (divesting Interiors and substantially de-risking the balance sheet), and inward on branch productivity, margin improvement, organic growth, and realizing the benefits of scale.
- Frank Lonegro, CFO, recently joined Beacon from CSX Corporation, where he was the CFO and Executive VP.

Investment Thesis

Beacon is a simple business driven by largely non-cyclical, non-discretionary demand. While Beacon has achieved scale in an industry that has consolidated substantially over the last decade, under prior management they were saddled with (1) a challenging and costly integration (2) substantial debt and interest costs, and (3) a separate Interiors business. Under their new CEO they sold Interiors, and are progressing on strategic initiatives. Strong industry fundamentals have led to rapid restoration of financial flexibility and Beacon's future now looks solid. While expecting a sequential slowdown in growth (in part due to lower y/y storm activity) and a decline in margin, we think enhanced focus on organic growth and structural margin improvement should help reaccelerate future earnings, particularly as replacement demand will likely benefit from the strong build period from 2000-2006.

Thank you for your confidence in Fiduciary Management, Inc.

____

Appendix:

Bob Farrell's Ten Market Rules to Remember

1. Markets tend to return to the mean over time.
2. Excesses in one direction will lead to an opposite excess in the other direction.
3. There are no new eras — excesses are never permanent.
4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.
5. The public buys the most at the top and the least at the bottom.
6. Fear and greed are stronger than long-term resolve.
7. Markets are strongest when they are broad and weakest when the narrow to a handful of blue-chip names.
8. Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend.
9. When all the experts and forecasts agree — something else is going to happen.
10. Bull markets are more fun than bear markets.

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		Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
						Composite	*Benchmark			
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.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.