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INVESTMENT STRATEGY OUTLOOK – SMALL CAP EQUITY

March 31, 2016

The FMI Small Cap portfolios returned approximately 5.8% in the March quarter, compared to the benchmark Russell 2000 Index return of -1.52%. Sectors that outperformed the benchmark included Health Technology, Distribution Services and Process Industries. On the negative side of the ledger, Utilities, Health Services and Electronic Technology hurt relative performance. MSC Industrial, Broadridge Financial Solutions and H.B. Fuller all contributed positively to the quarter, while Esterline Technologies, Allscripts Healthcare Solutions and TriMas lagged. Oil and a number of other commodities, whose prices have been collapsing over most of the past eighteen months, rebounded to varying degrees in the second half of the quarter. Growth stocks, which led the market advance over the past seven years, took a breather in the quarter; value stocks, including FMI portfolios, generally outperformed. Valuations started to become more interesting in January as markets came under pressure, but central banker's sugar once again lifted stocks in February and March. Unfortunately, fundamentals, as measured by revenue and earnings growth, remain quite weak. Standard & Poor's 500 Index (S&P 500) median GAAP[1] sales and earnings growth rates in 2015 were 0.8% and minus 0.8%, respectively. Goldman Sachs calculated final 2015 S&P 500 adjusted sales and earnings per share (EPS) growth, excluding financials and utilities, of minus 3.8% and minus 11.0%, respectively. Small cap sales and earnings growth data from the Leuthold Group show sales growth slightly higher than the S&P 500, and earnings growth lower.

As measured by the Dow Jones Industrial Average, the current bull market, lasting over seven years without a 20% decline, is the third longest on record (see chart to the right). This market was starting to break apart last year and into January of this year, with energy, commodity and industrial-related stocks moving into bear territory. Smaller capitalization stocks, and even some of the big winners over the past cycle such as health care and biotech, were slipping. An intra-quarter drop of nearly 30% in the Nasdaq Biotech Index, as well as high profile stock declines from the likes of Valeant, Micron, LinkedIn and

Bull Markets In The Dow Jones Industrials: Distribution Of Gains By Year

Bear Market Low	Annual Bull Market Price Gain (%) 1 Yr.	2 Yrs.	3 Yrs.	4 Yrs.	5 Yrs.	6 Yrs.	7 Yrs.	8 Yrs.	Total Gain (%)
September 24, 1900	**Bull market lasted less than one year**								47.8
November 9, 1903	59.1	21.6							144.3
November 15, 1907	66.2	12.7							89.6
September 25, 1911	28.0								29.1
July 30, 1914*	84.5								110.5
December 19, 1917	24.9								81.4
August 24, 1921	56.0	-7.8	12.6	37.9	13.1	16.5	24.3	60.7	495.2
July 8, 1932	155.1	-7.6	26.1	27.5					371.6
March 31, 1938	**Bull market lasted less than one year**								60.1
April 28, 1942	44.4	1.5	51.3						128.7
June 13, 1949	40.1	10.4	7.4	-1.0	21.2	36.7			222.4
October 22, 1957	29.2	15.4	-7.7	22.2					75.1
June 26, 1962	32.3	17.2	2.8						85.7
October 7, 1966	24.8	3.0							32.4
May 26, 1970	43.6	7.2							66.6
December 6, 1974	41.8								75.7
February 28, 1978	9.0	5.6							38.0
August 12, 1982	52.2	3.0	7.9	39.7	45.4				250.4
October 19, 1987	22.9	25.5							72.5
October 11, 1990	26.2	5.1	14.6	7.9	22.1	26.1	34.8		294.8
August 31, 1998	43.6								55.5
October 9, 2002	32.9	3.9	2.4	15.2	19.5				94.4
March 9, 2009**	61.4	15.6	5.7	11.7	14.2	9.4	-5.5		*158.1*
# Observations	21	16	10	8	6	4	2	1	23
Median	41.8	6.4	7.7	18.7	20.4	21.3	24.3	60.7	85.7
Average	46.6	8.3	12.3	20.1	22.6	22.2	17.9	60.7	133.9

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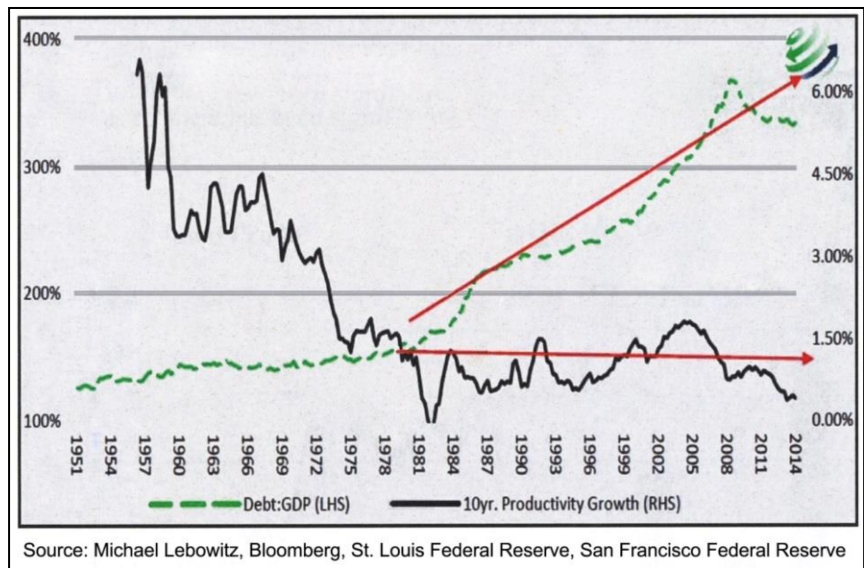
*Adjusted for closing of NYSE in second half of 1914.

**Year 7 gain is through March 4, 2016 (...assuming bull market is still intact).

[1] Generally accepted accounting principles

Twitter, seemed to indicate the bear was upon us, but soothing comments from the Fed and the European Central Bank (including negative interest rates) have, at least for now, put the bull back in charge.

We would like to embrace easy monetary and fiscal policies, except for the small issue that they don't seem to work. How many years of well-below-par growth, despite unprecedented stimulus, do we need to reach this conclusion? Apparently a decade is not long enough. In a recent market commentary from Dr. Marc Faber, noted value investor and long-time Barron's round table participant, he used the chart to the right, which depicts the rising line, debt-to-GDP,[2] juxtaposed to the declining line, 10-year productivity growth, to show that we are pushing on a string.



Source: Michael Lebowitz, Bloomberg, St. Louis Federal Reserve, San Francisco Federal Reserve

Debt levels go up, growth comes down. GDP remains largely locked in a 0-2% channel. The textbooks say it's not supposed to happen, but rather than explore why this is so, our leaders come back year after year and say "We haven't done enough." Dr. Faber infers the psychological parallel between the academics running the Fed and college professors, by quoting the famous writer and German statesman Johan von Goethe (1749-1832), in a book by Johannes Eckermann (published in 1836), on why professors ignore alternative theories:

> *This is not to be wondered at; such people continue to error because they are indebted to it for their existence. They would have to learn everything over again, and that would be very inconvenient […] They do not prove the truth, nor is such the intention; the only point with these professors is to prove their own opinion.*

One alternative theory to the prevailing conventional wisdom is that unnaturally low interest rates distort economic agents' behavior. Companies, for example, buy back stock and engage in dubious merger and acquisition activity rather than expand their capital investments, research and development spending and hiring. Suppressed interest rates may thus retard, rather than enhance, economic growth. Governments generally believe spending generates economic expansion, but they fail to measure the true cost of this effort, which inevitably appears to exceed the headline benefit. Data across a large number of countries seems to support the notion that government spending is generally beneficial up to the level at which such spending constitutes roughly 15-18% of GDP. Spending on infrastructure, protection, and other public goods enhances overall economic growth up to a point, and then additional outlays appear to restrain growth as the bureaucracy expands. All government spending, including federal, state and local, has grown dramatically over the past fifteen years and is approximately 38% of GDP in the U.S. today. We have discussed these issues at length in previous letters so we won't dwell on them here, other than to observe that nobody is doing much to reduce the size of the government.

[2] Gross Domestic Product

The fact that we have low growth is about the only thing on which most people can agree. The rising level of angst and the emergence of populist firebrand politicians are not emblematic of an economy that is satisfying the masses. Unfortunately, this pattern is all too common around the world as global economic growth estimates continue to wane. It is particularly interesting to observe how the Chinese are handling a lack of growth in their economy. How are they keeping the masses from stirring? Like Putin's Russia, there is an old fashioned crackdown on dissent and a nationalistic surge. Additionally, the Chinese are plying stimulus maneuvers again, but the level of debt in that economy is already alarmingly high (190-340% of GDP, depending who is doing the measuring). The government tacitly admitted they have a problem as regulators tried recently to foster debt for equity swaps out of some $200 billion in bad bank debt. It is widely recognized that China's banking system is at least $34 trillion in size (up from approximately $3 trillion ten years ago) and it continues to grow rapidly ($525 billion in January) despite increasing bad debts and a slowing economy. Kyle Bass, a highly regarded hedge fund investor, believes that in the current cycle China will experience losses of $3.5 trillion, or roughly 10% of assets and 30% of GDP, which happens to be the same loss rate experienced in the 1998-2001 credit cycle. To put this into context, U.S. banks lost about $650 billion in the great financial crisis of 2007-2009.

It's no coincidence that the dramatic economic slowing China has experienced in the past eighteen months has had a significant drag on U.S. industrial and commodity businesses. Even though we saw the China problems coming, it affected some of our companies more than we thought. It's a further reminder of the degree to which global economies are intertwined. Unfortunately, and despite the recent sharp stock market rally, China may not have hit bottom yet, if Mr. Bass is correct. Until valuations are more attractive, we will stay cautious about having a significant percentage of investments in businesses exposed to the producer side of the Chinese economy. Longer-term, we remain optimistic about consumer growth, but we would not be surprised if even that side of the Chinese economy takes a breather.

Before turning to a couple of individual investments, we'd like to revisit the word *optimism*. We sometimes get chided for not being optimistic enough. From one perspective, however, it is irrelevant. How we feel isn't going to change what actually happens to individual stocks, the market or anything else. From another perspective, optimism, if already reflected in the stock price or the market, is actually a dangerous thing. For many, if not most stocks, that is the issue today. Generally speaking, we are going to be more optimistic if valuations are lower. If pro-growth fiscal and sensible monetary policies are increasing in prevalence, we will be more optimistic. That is not happening today. Finally, optimism is far less important in the investment business than realism or common sense. We have recently seen investors who have been highly optimistic about various stocks back up this sentiment by taking truly outsized positions that have subsequently collapsed. Our modus operandi has always been to take prudent risks, and be highly sensitive to what can go wrong before dreaming about what can go right.

ePlus, Inc. (PLUS)

(Analyst: Matt Sullivan)

Description

ePlus is a leading value added reseller of information technology solutions in the United States. The company designs and implements an array of solutions from over 1,000 leading information technology (IT) vendors for more than 3,000 enterprise and mid-market customers across a diverse set of end markets. They are primarily focused on cloud, data center, security, infrastructure, and collaboration solutions, which are some of the fastest growing areas within IT. The company was founded in 1990 and is headquartered in Herndon, Virginia.

Good Business

- As a reseller of technology solutions, ePlus benefits from global growth in technology without being exposed to the same obsolescence risk as technology manufacturers.
- The company supplies necessary products and services from leading technology vendors to a broad set of customers and end markets.
- ePlus focuses on selling its products and services as integrated solutions, which helps drive better margins and returns relative to those of more basic IT distributors.
- The company specializes in some of the fastest growing areas within IT.
- ePlus has averaged a mid-teen return on invested capital (ROIC) over the past several years, which is well in excess of its cost of capital.
- The company has a strong balance sheet.
- This is a simple business that's easy to understand.

Valuation

- ePlus is valued at 0.47 times sales relative to a 6.4% operating margin. Margins should expand over the long term as the company's business mix continues to shift more towards software and services.
- The stock trades at 11.7 times the next fiscal year's EPS estimate, which is a significant discount to the Russell 2000. This is despite the fact that the company has above-average growth prospects and better-than-average returns on invested capital.
- ePlus trades at a large discount to other public value-added resale and IT consulting businesses such as CDW and Accenture.
- The company trades at 1.85 times book value.

Management

- Phillip Norton joined the company in March of 1993, and has since served as Chairman of the Board and Chief Executive Officer. Mr. Norton is a 1966 graduate of the U.S. Naval Academy with a B.S. in engineering, and served in the U.S. Navy from 1966-1970 as a Lieutenant in the Supply Corps.
- Mark Marron joined ePlus in 2005 as Senior Vice President of Sales. Mr. Marron was appointed as Chief Operating Officer of ePlus in 2010.
- Elaine Marion joined ePlus in 1998. Ms. Marion became Chief Financial Officer on September 1, 2008. Ms. Marion had served as Vice President of Accounting since 2004, and as Controller from 1998 to 2004.

Investment Thesis

ePlus is a simple business with solid returns on capital, serving a growing North American IT industry. As a reseller of IT solutions, the company gives investors exposure to technology growth without subjecting them to short product cycles, cutthroat competition, and poor capital allocation decisions that are typically inherent in technology investments. We believe the company has strong long-term growth prospects, and that it will continue to expand its margins over time by bundling more product sales with its services and software offerings. Given the growth potential and the company's ROIC profile, we view the current valuation as attractive.

Kirby Corporation (KEX)

(Analyst: Andy Ramer)

Description

Kirby has two business segments: Marine Transportation (77% of 2015 revenue) and Diesel Engine Services (23% of 2015 revenue). The Marine Transportation business operates the largest inland and coastal tank barge fleets in the United States. Diesel Engine Services is a nationwide service provider and distributor of diesel engines, transmissions, parts, and oilfield service equipment.

Good Business

- With approximately 25% of the inland and coastal tank barge markets, the resultant economies of scale position the company as a low-cost operator, and therefore raise the barriers to entry -- as does the Jones Act, which shields the business from foreign competition.
- The inland waterway system plays a vital role in the U.S. economy. Barges offer an efficient mode of transport for a wide range of cargoes.
- The company earns its cost of capital through a cycle.
- This is an easy business to understand.
- The balance sheet is solid, and Kirby generates a significant amount of cash.

Valuation

- The stock trades near the low end of its 10-year average valuation range on a price-to-earnings, price-to-book, price-to-sales, and price-to-cash flow basis.
- Kirby is valued at about a 30% discount to the replacement value of its fleet.

Management

- Chairman Joseph Pyne has been with Kirby for 38 years.
- David Grzebinksi has served as President and Chief Executive Officer since April of 2014, and prior to that was Kirby's Chief Financial Officer.
- Investment decisions are driven by return on capital. Compensation is based, in part, on the achievement of a return on total capital target.

Investment Thesis

Kirby has come under pressure due to the collapse in oil prices. This has resulted in barges that used to ship crude being converted to transport other products like petrochemicals, and has also led to a significant contraction in fracking equipment build and repair work. The percentage of industrywide inland barge capacity dedicated to crude, however, has fallen from 15% at the peak in mid-2014 to less than 5% today, and the industry has slowed new building activity and accelerated retirements, in an effort to balance supply with demand. Management has also restructured Diesel Engine Services such that the business is currently operating near break-even levels, which provides opportunity from here. Longer-term, the feedstock position of the U.S. should put the company's customers in a competitively advantaged situation globally. Kirby is poised to benefit from more than $100 billion of planned domestic petrochemical investments.

Thank you for your confidence in Fiduciary Management, Inc.

Fiduciary Management Inc.
Small Cap Equity Composite
12/31/2005 - 12/31/2015

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 %
2006	18.46	17.56	18.37	147	0.73	n/a	n/a	$ 1,606.8	$ 3,589.4	44.77%
2007	-0.92	-1.72	-1.57	161	0.85	n/a	n/a	$ 1,520.2	$ 3,960.4	38.39%
2008	-21.06	-21.69	-33.79	145	1.16	n/a	n/a	$ 1,212.4	$ 4,062.5	29.84%
2009	35.72	34.56	27.17	165	0.97	n/a	n/a	$ 2,004.6	$ 7,008.9	28.60%
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%

*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 - 12/31/2015. 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 -12/31/2015. 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 $21.0 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	0.90%
$25,000,001-$50,000,000	0.85%
$50,000,001-$100,000,000	0.75%
$100,000,001 and above	0.65%

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.