Rising Return on Capital

Investing is as much art as science. Short-term investors reward fast-growing companies with high multiple valuation but invariably this growth slows down, taking down the high-flying stocks with it. Finding companies with stable growth, strong market positions and rising return on capital takes analysis and conviction beyond reading financial statements. The team managing the FMI Large Cap Fund thrives in researching companies and stocks for these metrics.

Q: ***What's the investment philosophy of the fund?***

A: Our philosophy is to look at one company at a time. We consider ourselves investors in businesses first. There are three beliefs that form our core investment disciplines; we are looking for, 1) businesses that have recurring revenues, market leadership, and strong business franchises; 2) attractive valuation metrics; and 3) managements that act in shareholders' best interests.

Q: ***What are the key elements of your investment process?***

A: When we analyze companies we are not focused on reported earnings per share. The most important elements we look at are the balance sheet, the return on invested capital, and the valuation metrics. When we do our internal valuations, we go back 10-20 years and take a look at all the investment valuation data available. We'll make adjustments for write-offs to determine the fatal dollars invested in that business. True cash return on the investment is the most important valuation parameter. We want to have companies that are earning their cost of capital, increasing operating margins significantly and improving their return on invested capital. We're looking for businesses with high recurring revenues, offering products or services that we understand, and where we can fully grasp the company's market position and the potential for growth.

Then we focus on the strength of the balance sheet. If the balance sheet cannot support strong cash flows and is not able to weather a downturn in the cycle, we're not interested.

The next part of the process is valuation. It's different depending upon the industry. We look at price to sales,

FMI Large Cap Fund

Fund Facts

Symbol	FMIHX
Website	www.fmifunds.com
Address	FMI Funds c/o U.S. Bancorp Fund Services, LLC P.O. Box 701 Milwaukee, WI 53201-0701
Tel. No.	800-811-5311
Inception	12/31/01

Portfolio

Total Net Assets *	$ 119.6
Avg Mkt Cap ($ Weighted) *	$ 25,116.7
Average Price/Earnings Ratio	17.0x
Average Price/Book Ratio	2.8x
Turnover Ratio	28.98 %

Investment Information

New Investment	Open
Min Initial Investment	$ 1,000
Min Subsequent Investment	$ 50
Min Initial IRA Investment	$ 1,000

Risk (Against S&P 500 - 3 Years)

Alpha	0.50
Beta	0.81
R-Squared	0.69
Ann Std Deviation	7.49
Sharpe Ratio	1.85

Returns vs. S&P 500 Index

	FMIHX	Index
1 Year (Cum.)	12.50 %	8.63 %
3 Year (Ann.)	16.20 %	11.21 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.00 %

Portfolio Manager

Ted Kellner, CFA	12/31/01
Patrick English, CFA	12/31/01

** millions*

Russell & Fact Set Data through: 6/30/2006

Source: Company Documents; Factset, Russell

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price to book, EBITDA multiples (which metrics we use depends upon the specific company) and with each company we'll go back as far as we can to calculate our intrinsic value for the company. This value is benchmarked against where the stock has sold historically and in difficult market conditions.

By the time a company goes through our vetting process, there has been a tremendous amount of work done to understand what could go wrong. This is used to calculate the downside risk on the company. We do this by going back in time to look at the valuation of where the company has traded in the market at low points. There are always periods when there are "concerns" around almost any company. We go back to see what has happened in these periods and find what the low valuation was and how that compares with our worst-case scenario. We tend to buy companies in the lower quartiles of valuation over the last 10-20 years.

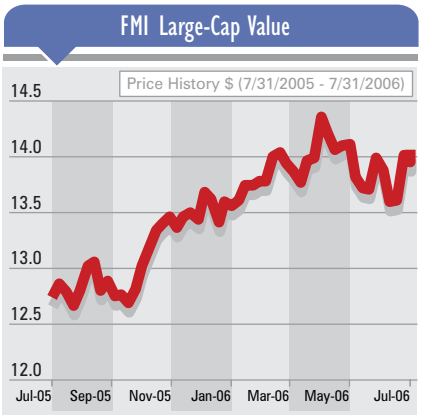
Q: *How do you view the management's role in a firm?*

A: We want them to think like owners.

For example, we almost never approve a management stock option plan. Stock options are asymmetrical in nature, and are always in favor of management. We prefer restrictive stock plans. If the company doesn't perform, management suffers right alongside the shareholders. We look at how management views stock option plans along with their view on acquisitions. We are suspect of acquisitions as most acquisitions are done with an eye towards accretive earnings, and that is not the way we look at the investment world.

Every week we screen the entire universe of companies with a market value of $5 billion and above. We often find that companies, when they hit our valuation screens, "some have issues" and concerns that have caused Wall Street to cast aspersions on the stock, and therefore there is a discount to our intrinsic value.

In our portfolio you can see companies like Waste Management, Willis, Kroger, Time Warner and Wal-Mart. These are extremely strong franchises, and are very defendable, but in each case there is an issue. Our job is to determine if these issues are permanently impairing that franchise or if they are temporary in nature. In these cases we've come to the conclusions that the management is doing a good job, the company has a strong



franchise, and the concerns that are "headline risks" can be dissipated in the course of time. It's not uncommon for clients to ask us why we are buying Wal-Mart as they have union issues, employment issues, health care issues. That's true, but the return on invested capital at Wal-Mart is north of 13%. With the strength of the balance sheet and free cash flow, at some point, as these lingering issues are resolved, we believe that we'll have an excellent investment for our clients.

Q: *You mentioned that it is important for you to have companies earn at least the cost of capital, otherwise in your experience these companies fall apart over a period of time. Why is that important that these companies have to earn a certain cost of capital? The cost of capital can change every 3 or 4 years.*

A: That's correct. It can change as the capital structure changes, and that's a number that we're continually looking at. What is the composition? You can rather easily calculate the cost on the debt. We ascribe a 10-12% cost of capital to the equity. But economically, you're not building wealth if you're not earning more than whatever that blended cost of capital is. Otherwise, you're destroying enterprise value and that ultimately shows up in earnings.

Q: *You gave a good example of Wal-Mart where the return capital and the other financial metrics look exemplary, yet the market is not rewarding them. But you wouldn't make a similar argument with Target which is a far smaller company and still has the same growth rate as Wal-Mart, so they can certainly keep growing like Wal-Mart for the next 15 or 20 years.*

A: I don't agree with that. Target's return on invested capital is on the decline but Wal-Mart's is rising. If I were a shareholder in Target and have read everything that Wal-Mart is doing (and that is, primarily, focusing on what has worked for Target) I would be concerned. In our opinion, Target is priced very expensively, while Wal-Mart sells at valuation levels at the low end of the past 15 years. In my view, Wal-Mart is going to be successful in the strategies they have going forward.

Q: *Wal-Mart is now largest grocer but has not been as successful as Kroger, and that obviously shows up in the Kroger results.*

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A: Correct and we own Kroger. Wal-Mart now is the largest grocer in America. They're taking share from the smaller companies that can't compete in quality and price but not from Kroger. At Kroger, eight years ago, the pricing gap of a blended basket of 100 products was about 15%. Today it's less than 7%. Kroger is gaining market share, and the return on invested capital is improving. Kroger has continued to compete effectively with Wal-Mart, and if you consider the major markets, they haven't lost market share to Wal-Mart.

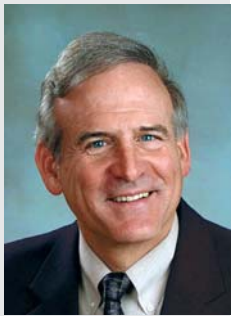
Q: ***It seems that at some point in time the tech companies go through a long phase of low capital return. Does that mean you generally look at tech companies with a more skeptical eye?***

A: Much more skeptical. If you go back in the history of our firm, the one time we were significantly overweighted (in the FMI Common Stock Fund) was in 1990. We owned companies like Applied Materials, Oracle and a few others.

We bought Oracle at 52% of sales. Oracle software at the time was a successful product but they had an accounting issue similar to Waste Management. The issue was not product-related, market position or industry-related, but the stock had been decimated. When we looked at the cash flow statements, we were comfortable with the company. The balance sheet remained healthy, but the accounting clouded the issue and we felt that the issue would eventually be resolved. We had Oracle, Applied Materials and SunGard, and I believe a total of seven companies with a market overweighting. Our companies in this sector did very well for 3-4 years.

Everybody says, "Look at Microsoft — how cheap it is compared to five years ago." I was looking at Microsoft with our research team; it's still selling at 5.5 times sales. As bad as it's been from a performance standpoint, it's not cheap. It's not even on our radar screen. Intel is the same story, the stock is still selling at over 3 times sales. Even with poor performance for 5 to 6 years, technology stocks still aren't cheap enough as a group, in our opinion.

"We believe that companies have to earn at least their cost of capital (10% and 12%). If a business cannot generate this return then the management is destroying rather than creating enterprise value."



about Ted Kellner, CFA

Ted Kellner is one of the co-founders of Fiduciary Management, Inc. and he is a member of the firm's investment policy committee. He is primarily responsible for equity research for a variety of industries and is involved in the client servicing of several of the firm's institutional relationships. Mr. Kellner began his career as an analyst for Brittingham, Inc. (1968-1972) and then served as a portfolio manager at Nicholas Company, Inc. (1973-1980). Mr. Kellner received a BBA degree from the University of Wisconsin and is a member and Past President of the Milwaukee Analysts Society. He has earned the right to use the AIMR® Chartered Financial Analyst designation.

Q: ***How does macroeconomics factor into your thinking?***

A: Minimally. In some sectors we're more sensitive than in others, but we are bottom-up investors and we are looking at individual stocks that meet our criteria, and that's 95% of what we do.

We are constantly looking at a company's fundamentals and current valuations. We are not benchmark huggers. We are willing to be in or out of a sector, overweighed or underweighted depending upon where we find attractive values.

Q: ***How do you go about building your portfolio?***

A: We have 21 companies, but really have 42 different industries represented in these 21 stocks. Today, Berkshire, at 7.9%, is the largest weighting. Berkshire, excluding the insurance operations, is the 19th largest company in America. It has a broad base of diversified industries. We're sensitive to portfolio diversification. The covariance of our portfolio is very low.

Q: ***What do you do to mitigate portfolio risk?***

A: The most important thing is the diligence with which we look at companies: What is the downside risk to our holding if we are wrong? Beyond that, we have stock an allocation limit of 8%, and an industry limit of 10%. Our portfolio is diversified by industry and by number of stocks, but the most important thing to us is the thoroughness of our investment research process.

Right now 70% of our retirement plan cash flow is flowing into this fund. Between the two funds, the fund management has $23 million of our own money invested with our fellow shareholders. ▮

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