Madison FUNDS®

MADISON SMALL CAP FUND

4Q 2022 Investment Strategy Letter

Tickers: BVAOX | MSCIX | MASMX | MSCRX

PORTFOLIO REVIEW

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Industry since 1999

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After three difficult quarters, the Russell 2000 was up 6.23% in the fourth quarter while the Russell 2500 was up 7.43%. Our performance in the quarter trailed the benchmark, with the Madison Small Cap Fund (Class Y) returning 5.66%. Bright spots in performance came via Healthcare, Materials, and Financials, not enough to overcome poor stock selection in Industrials, Consumer Discretionary, and Technology stocks. As it has all year, our lack of investments in Energy continued to drag our performance, though to a lesser extent in the fourth quarter. Another trend that continued in the fourth quarter was the outperformance of value stocks over growth stocks. Although we are core investors with a blended portfolio of both growth and value stocks, over the last three years, our portfolio has tilted to growth stocks, which has weighed on our performance in 2022.

Coming on the heels of two very strong years, the Fund underperformed the benchmark in 2022, returning -24.64%, compared to the Russell 2000 Index return of -20.44% and the Russell 2500 Index return of -18.37%. The only sector that returned positive absolute returns for the Russell 2000 was Energy, delivering a staggering 50% positive return in aggregate. The next-best performing sector was Utilities, with a negative 1% return. The fact that the second-best performing sector, defensive Utilities, was down for the year in absolute terms is a testament to how challenging the market has been. And our zero exposure to these top two sectors significantly detracted from the Fund's relative performance. We have long avoided these two areas as they seldom fit our 5-pillar process.[1] We fundamentally do not believe that Energy and Utility companies are durable, franchise-style businesses that compound growth and create excess returns over the long run. We've historically relied on our stock selection abilities to overcome the ephemeral periods when Energy, for example, is in favor. This year, stock selection was our weakness – something we are unused to. In the following paragraphs, we'll discuss what worked, what didn't work, and what we learned from this challenging year.

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1 Madison's 5-Pillar Process is a fundamental research framework in which a stock must pass a rigorous analysis of five quantitative and qualitative factors to be included for consideration and/or remain in the portfolio. The five pillars include: discount to private market value, quality, durability, growth, and corporate stewardship.

SWIMMING UPSTREAM

The Fed and the economy surprised everyone in 2023

Few anticipated the Federal Reserve's higher longer stance, nor did many anticipate the resiliency of the economy to this hawkish posture. Even if we had, we do not invest based on our views of the Fed or the economy. Our discipline is to invest in durable, franchise-style businesses that can compound growth over many years, as dictated by our 5-pillar process. And so, as we discuss the backdrop, we do so to provide perspective on why our stocks fared as they did.

Until 2023, the Federal Reserve – and its current chairman, Jay Powell, in particular – has governed under a general dovish regime, meaning they've chosen to maintain a relatively easy monetary policy stance that favors economic growth and employment versus inflation. Of course, this position has been buttressed by 40 years of disinflation. However, as the supply chain shocks from the pandemic and the War in Ukraine met head-on with the strong demand of an economic reopening and fiscal stimulus, the Fed was forced to abruptly turn radically hawkish to fight inflation. The fed has not embarked on a string of rate hikes this rapidly and this aggressively for 40 years. Not only were we surprised by this "higher for longer" posture by the Fed, but we were also surprised by the economic impact. So far, the economy has absorbed this aggressive tightening with very little impact on employment or consumer demand. The housing market, on the other hand, is in full recession, in our opinion. Despite recent compelling evidence that inflation has peaked, the Fed has maintained its aggressive posture, and the economy has remained largely resilient. The impact on the stock market, however, has been severe. The stocks most devastated by rate increases have been technology stocks. Investors aggressively sold tech stocks, which were some of the most expensive stocks in the market. The most battered, of course, were profitless tech stocks. While our overweight in Technology did not help our performance, our stock selection in this sector held up well, as we have historically focused on profitable, high-margin, high-ROIC (return on invested capital) companies with attractive valuations.

Our Defense Failed

Where our overweight in Tech was a drag on performance, our overweight in defensive Consumer Staples should have provided a counterweight. Most Consumer Staples stocks did outperform the market. The Russell 2000 Consumer Staples sector was down just 6% compared to the 20% decline for the entire index. Stock selection was the poorest for us in this sector. Two stocks in particular – Hain Celestial (HAIN) and Scott's Miracle-Gro (SMG) – while big winners for us in 2020 and 2021, hurt the portfolio in 2022.

While both companies were so-called COVID beneficiaries (businesses that benefited from consumers staying home and spending on their homes during COVID), we felt they possessed certain additional drivers that would maintain their fundamentals into 2022 and beyond. Hain, for example, has a strong portfolio of organic health and wellness brands that target a higher-end demographic. As strong as their brands are, there is ample room for growth. Put simply, there are channels of distribution like Costco and Walgreens that their brands don't currently serve, but we believe eventually will. Furthermore, we believed HAIN's portfolio had pricing power to pull them through this inflationary period.

While we were largely correct on both counts, we underestimated the challenges they faced in their European business (40% of revenue), which overshadowed their success in North America. Entering 2022, HAIN's stock had just hit a 5-year high of $45. However, the good times were short-lived as Russia invaded Ukraine early in 2022, sending energy prices materially higher in Europe. Although HAIN has a #1 or #2 market share in their brand categories, they could not withstand the economic shock from the war. The pressures on Hain's European business came from multiple fronts: Rising energy prices skyrocketed their manufacturing and transportation costs. Essential ingredients for their products, like sunflower oil, became scarce as Ukraine is a key exporter of grains. The pressure on energy prices exacerbated an already weakened U.K. consumer due to BREXIT. And finally, the structure of the grocery market in the U.K. led to a delay in price increases. All of these factors weighed heavily on earnings and cash flow. Although we reduced our position size in the early summer, the stock took considerable punishment. As we enter the new year, HAIN's European business has stabilized considerably. Natural Gas prices have meaningfully corrected, bringing relief not just to their costs but to the U.K. consumer.

Scott's Miracle-Gro is arguably one of the great American franchises. The brand is synonymous with lawn care and pest control, has a dominant market share (~60%) with historically-impressive ~30% cash flow margins, and has the country's largest Cannabis supply business. Scotts' core business saw a significant windfall during COVID lockdowns. Lawn and garden care is not a growth business, and SMG dominance does not allow for much incremental gain in market share. However, our thesis was that even in a reopening scenario where lawn and garden businesses would revert to the mean, the cannabis market was poised for years of growth as more states legalized recreational use.

What we missed was the highly inefficient structure of the U.S. cannabis market. Currently, California, Colorado, and Michigan have the biggest and most mature markets. However, over the course of the last few years, several very large states and regions have voted to legalize recreational use, including New York, New Jersey, and Connecticut. The fly in the ointment has been Oklahoma, which is a medical marijuana state. Although recreational use is still prohibited, licenses to grow the crop were granted in Laissez Faire fashion to anyone willing to buy one. Oklahoma began to grow and cultivate the crop far in excess of their medical marijuana demand. That excess supply bled into grey markets across the country, devastating pricing for growers in other states. This glut put a near complete stop to capital spending on grow operations. With no new or incremental facilities coming on, Scotts' Hawthorne business was cut in half from its peak in F21. This, of course, had a devastating effect on the stock.

2023 OUTLOOK

As we look out to the next year, three key questions come to mind:

1. How will Small Caps fare on a relative basis in 2023?
2. Will value beat growth again – and will the technology/energy stories continue?
3. Will inflation worries give way to the economy and thus earnings? And, importantly, will markets care?

The small cap market has undergone a significant correction. Valuations on both an absolute and relative basis have not been this attractive in over a decade and are already reflective of a recession. As the macro analyst at Renaissance Macro said recently, "The broader story remains that the discussion of an economic slowdown is very much a forecast, not a present-day reality." In our humble opinion, should a recession play out in 2023, there's a meaningful probability that the market will look through the weakness.

This is, of course, dependent on the severity of any downturn we may or may not see. If we do slip into recession, it could quite possibly be the most anticipated and most predicted recession in modern times. But opportunities are not everywhere. The most distressed stocks are in technology, but again, selectivity is key. Although the sell-off in 2022 was most acute in technology, we had several tech stocks experience positive returns. But what if rates stay higher for longer? Will Technology still be a rewarding investment pool? We believe so. As Technology companies shift from aggressive growth to capital discipline, our 5-pillar process should help us identify the most durable growth compounders.

Over the last few months, energy stocks have decoupled from the commodity. As oil has meaningfully corrected, energy equities have held up. This is highly unusual. Should the economy hold up, we may see a recovery in the commodity, especially if the long-anticipated reopening of China drives demand for commodities. In this scenario, energy and value stocks could continue to outperform.

Despite the challenging environment, nothing has changed with our philosophy and process. We will stay disciplined in our search for enduring franchises that outperform over time. The coming economic volatility will provide ample opportunity to invest for the future. While 2022 was disappointing, we believe our portfolio of companies is well positioned for 2023 and beyond.

Faraz Farzam *Aaron Garcia*

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The Russell 2500 Index combines a portion of midcap stocks with small cap stocks – forming a "SMID" (small/mid) cap segment of stocks from the Russell 3000®.

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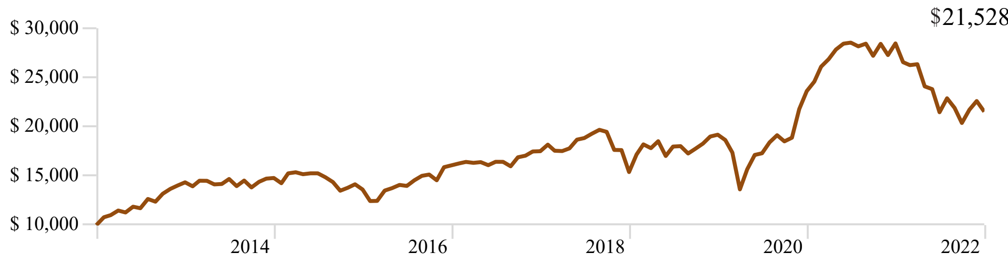
MADISON SMALL CAP FUND

December 31, 2022

Growth of $10,000 Class Y Shares, Trailing 10 Years[1,3]



Average Annual Total Returns[2,3] (%)

		Three Months	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception
Class I		5.53	-24.36	-24.36	-	-	-	-9.85
Class R6		5.53	-	-	-	-	-	-17.91
Class Y		5.66	-24.36	-24.36	3.91	4.22	7.97	12.32
Class A	without sales charge	5.38	-24.64	-24.64	3.67	-	-	6.54
	with sales charge	-0.70	-28.98	-28.98	1.63	-	-	4.67
Russell 2000® Index		6.23	-20.44	-20.44	3.10	4.13	9.01	-
Russell 2500® Index		7.43	-18.37	-18.37	5.00	5.89	10.03	-

Calendar Year Returns[2,3] (%)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Class Y	43.48	3.06	-7.90	18.04	8.90	-12.09	24.67	23.09	20.52	-24.36
Russell 2000®	38.82	4.89	-4.41	21.31	14.65	-11.01	25.52	19.96	14.82	-20.44
Russell 2500®	36.80	7.07	-2.90	17.59	16.81	-10.00	27.77	19.99	18.18	-18.37

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Characteristics

Median Market Cap (billions)	$3.4
EPS Growth Rate (3-5 year)	14.2%
P/E (trailing 12 months)	18.0x
P/E (forward 12 months)	17.7x

5-Yr Risk Measure (%)

Class Y vs. Russell 2000® Index

Standard Deviation	22.15
Downside Capture	92.17
Upside Capture	93.10

Experienced Management

Faraz Farzam, CFA
Portfolio Manager
Industry since 1999

Aaron Garcia, CFA
Portfolio Manager
Industry since 2002

Fund Features

- Seeks long-term capital appreciation
- Generally 50-90 holdings
- Seeks to purchase companies at a perceived discount compared to potential future earnings

Class	Ticker	Inception Date	Exp. Ratio
A	MASMX	8/31/19	1.35%
Y	BVAOX	12/16/96	1.10%
I	MSCIX	2/26/21	1.00%
R6	MSCRX	2/28/22	0.92%

Expense ratios are based on the fund's most recent prospectus.

Distribution Frequency - Annual

1. Growth of $10,000 is calculated at NAV and assumes all dividends and capital gain distributions were reinvested. It does not take into account sales charges (see Note 2) or the effect of taxes.

2. Average annual total returns and calendar year returns assume all distributions are reinvested and reflect applicable fees and expenses. Class A share returns without sales charge would be lower if sales charge were included. Class A share returns with sales charge reflect the deduction of the maximum applicable sales charge of 5.75%. Class Y shares do not impose an up-front sales charge or a contingent deferred sales charge ("CDSC"). Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

3. The performance shown for the Small Cap Fund (the "Fund") for periods prior to August 31, 2019, for the Class Y shares are based on the performance of the Broadview Opportunity Fund (the "Predecessor Fund") which was the accounting survivor and reorganized into the Class Y shares of the Fund after market close on August 30, 2019 (the "Reorganization"). Periods prior to November 29, 2013 represents the performance of the FMI Focus Fund (the 'FMI Fund') which merged with and into the Predecessor Fund on November 29, 2013. Prior to November 29, 2013, the Adviser of the Predecessor Fund served as sub-adviser to the FMI Fund.

Performance results prior to August 30, 2019 for the Class Y shares are based on the performance of the Predecessor Fund, which was reorganized into the Class Y shares of the Fund on August 30, 2019. Performance for Class A shares was deemed to be new effective August 31, 2019 as a result of the reorganization. Madison waived 0.04% of the Fund's annual services fee from August 31, 2019 through February 27, 2021. Investment returns reflect this fee waiver, without which returns would have been lower.

Madison lists the performance of the Predecessor Fund and accounting survivor of the Reorganization for the following reasons:

- Continuity of Fund portfolio managers through the Reorganization;
- Substantially the same investment objective and investment strategies between the Fund and the Predecessor Fund;
- Substantially similar investment policies between the Fund and the Predecessor Fund;
- A similar expense ratio (excluding acquired fund fees and expenses).

Madison FUNDS®

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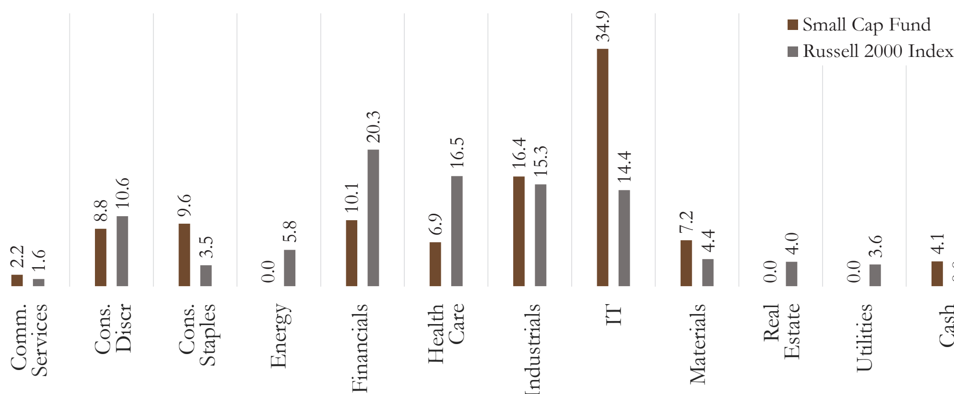
Sector Diversification (%)

Figures are rounded to the nearest 0.1%.



Total Net Assets

$175.7 Million

Total Number of Holdings

45

Portfolio Turnover

41%

Top Ten Holdings (%)

Holding	%
WILLSCOT MOBILE MINI HOLDING	4.8
BOX INC CLASS A	4.1
ENCOMPASS HEALTH CORP	4.0
AXIS CAPITAL HOLDINGS LTD	3.2
MODEL N INC	3.1
PTC INC	3.1
GLOBUS MEDICAL INC A	2.9
PRIMO WATER CORP	2.8
TEXAS CAPITAL BANCSHARES INC	2.7
SIMPLY GOOD FOODS CO/THE	2.6

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An investment in the fund is subject to risk and there can be no assurance that the fund will achieve its investment objective. The risks associated with an investment in the fund can increase during times of significant market volatility. The principal risks of investing in the fund include: equity risk, small cap price volatility risk, small cap illiquidity risk, value investing risk, ETF risk, capital gain realization risks to taxpaying shareholders, and foreign security and emerging market risk. Investing in small, mid-size or emerging growth companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity. More detailed information regarding these risks can be found in the fund's prospectus.

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