FIDUCIARY MANAGEMENT, INC.
Investment Counsel

INVESTMENT STRATEGY OUTLOOK
LARGE CAP VALUE
January 2003

For the calendar year ended December 31, 2002, the Standard & Poor's 500 Index fell 22.1% – its worst year since 1974. It was the third down year in a row for the S&P 500 and the other major stock market indices, and our portfolio declined as well, although not as dramatically. Technology stocks dropped precipitously in 2002 in both the S&P 500 and our portfolio, although our portfolio technology stock performance was somewhat better than the market. Other weak areas include retail and pharmaceutical, offset partially by strength in the entertainment sector.

If the major indices are down for a fourth consecutive year, it will match only one other period in the United States in the 20th Century (1929-1932), and one other in the 19th Century (1836-1839). Naturally, we cannot predict the market, but as we pointed out in last quarter's letter, the magnitude of this bear market is about average and the duration is already significantly longer than average compared to the nineteen major declines of the past century. Coming off the biggest bull market of all time in the 1990's, it wouldn't surprise us if it took a little longer to cleanse the excesses, but there are some interesting positives that may mitigate further damage. These will be discussed below.

The Economy

Nominal GDP growth for 2002 is expected to be approximately 3.5% – decent, but less than 40% of the average gain in recoveries from 1950-1980. As is usually the case, there are a number of countervailing factors that have to be considered as we assess the economic prospects for 2003 and beyond. On the negative side there remains a great deal of excess capacity in a number of industries, particularly technology and telecommunications. Capacity utilization rates are still near record lows at roughly 75% (see Exhibit A). Factory orders in November were down 0.8%, the third drop in the last four months. There remain only a handful of industries with any pricing power. Many U.S. labor markets remain uncompetitive when juxtaposed against China, India and several other countries. With skyrocketing health care costs, insurance and legal expenses (asbestos, mold, etc.), it's hard to fathom a strong U.S. employment gain, even in the next economic upturn. Housing is unlikely to be a driver of growth over the next few years. Record low mortgage rates and record high home ownership rates are possibly in the journal of irreproducible results. Mortgage default rates, though declining slightly in the third quarter, are still high and companies like Home Depot are missing numbers.

Exhibit A

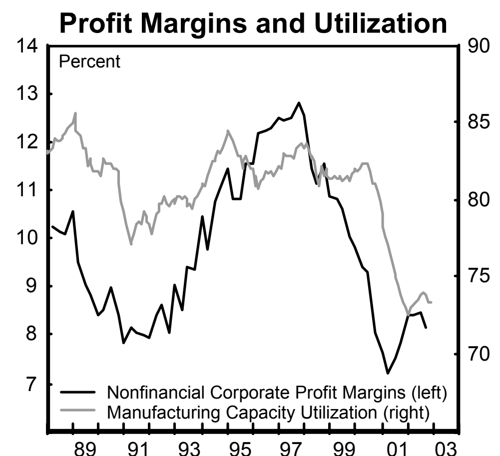
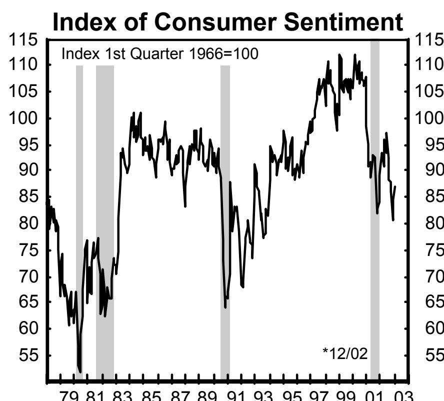


Exhibit B



Policy makers must also grapple with Medicare and a prescription drug benefit. Congressional Republicans have tagged the drug benefit at $310 billion, while the Democrats want a $500 billion plan. Even the former becomes problematic in the face of runaway Medicare expenditures. The U.S. already spends 14% of its GDP on health care, over 50% higher than other major industrial countries. We have already started to see a push back on the consumer, in the form of higher deductibles, and in some cases, the elimination of benefits completely. Anecdotally, General Electric may see its first strike in thirty years as workers react to a proposed increase in health care deductibles.

On the positive side there has been significant monetary and fiscal stimulus. Notwithstanding the $670 billion tax and spend package announced by President Bush on January 7, there have already been twelve rate cuts and significant deficit spending. Consumers are slowly repairing their balance sheets, as evidenced by an increase in the savings rate from a negative number in 2001 to plus 4% recently. Consumer sentiment, as depicted in Exhibit B, hit a 9-year low this past October, but has seen a decent uptick in November and December. The President's tax cut proposal, if enacted, will help consumers to keep spending at a healthy clip while continuing to save. Despite the populist rhetoric, lower taxes almost always eventually lead to higher tax revenues. An elimination of the double tax on dividends would be an enormous positive. Not only will this directly benefit Americans (as over 50% of them own stock), it is also likely to result in a more productive allocation of capital. With dividends a more attractive alternative, corporate boards will be more likely to choose this path rather than making acquisitions, which most often destroy value.

In a nutshell, the economy is being aided by a very accommodating Federal Reserve, the potential of a large fiscal stimulus, and the prospect of a very positive capital allocation policy (elimination of the double tax on dividends).

Earning and Market Outlook

U.S. industry appears to be operating with little excess inventory or labor. Inventory levels are near record lows and companies have continued to reduce employment levels. The industrial side of the economy has been weak for nearly five years and companies have consolidated. The dollar has also fallen substantially over the past nine months. The pieces are in place for strong earnings growth in the event of a classic economic rebound. As can also be seen in Exhibit A, corporate profit margins have declined dramatically in the last couple of years. Because of the high operating leverage, it did not take much of a revenue shortfall to cause a large margin reduction. The flip side of this will also be true; i.e. a modest uptick in sales should result in a large margin improvement.

Standard & Poor's 500 Earnings and Valuations Exhibit

	2001 EPS	2002E EPS	% Change From 2001	2002E P/E	2003E EPS	% Change From 2002E	2003I P/E
Reported	$24.69	$31.50	28%	29.3x	$40.00	27%	23.1›
Operating	$38.85	$47.00	21%	19.7x	$58.00	23%	15.9›
Core	$16.76	$23.00	37%	40.2x	$35.00	52%	26.4›

Profits already appear to be on the rise, as shown in Exhibit C. We can see that this pattern is quite typical in the first year of an economic recovery, and we expect the same to occur this time. Our main issue with regard to profits is the quality of the earnings. "Core" earnings were introduced by Standard and Poor's in 2002, in an effort to address a number of shortcomings in the generally accepted accounting principles "reported" figures and the sanitized "operating" numbers. Exhibit C illustrates the vast discrepancy between these three measures of earnings. We think that the so-called core earnings are closer to representing actual corporate profitability than operating and reported earnings, which leave out restructuring charges and everything else managements deem to be extraneous to the ongoing business. Core earnings take into account non-operating factors such as pension fund gains and stock option expenses to name a few. The 2002 gap between operating earnings and reported earnings, as shown in Exhibit C, is as wide as we have ever experienced, and is no doubt due to the significant writeoffs and "coming clean" mentality currently permeating managements and corporate board rooms. It is worth noting that analysts who come up with these estimates see significant growth in 2003 in all measures of earnings, from a 23% increase at the low end for operating earnings to a 52% increase for core earnings. We hope they are not as wrong as they were last year! Most Wall Street seers use operating earnings as their guide to valuations. On that basis, a P/E ratio of 15.9x on 2003 estimates seems reasonable. We would argue the true P/E multiple is probably over 20x. So despite the significant three-year decline in the S&P 500 and Nasdaq, stocks in general are not particularly cheap. Nevertheless, we think the major downside risk is over and we see better times ahead. The gains will have to come from growing earnings rather than growing multiples.

Summary

It is almost certain that at any given period of time, the performance for our portfolio will not accurately reflect the change in economic values of our underlying companies. While 2002 was a difficult year for most corporations – and in fact, the earnings growth of our portfolio companies was below that which we forecasted coming into 2002 – our companies still made significant progress overall in improving market positions and growth prospects. With the addition of some strong business franchises at reasonable multiples, we remain optimistic about the prospects for the large cap value portfolio. Based upon 2003 estimates, the portfolio's P/E multiple is approximately 15 – significantly lower than that of the S&P 500.

Thank you for your continued support of Fiduciary Management, Inc.