INVESTMENT STRATEGY OUTLOOK
LARGE CAP VALUE
July 2003

The large cap value portfolio experienced a strong absolute return in the June quarter, roughly in line with that of the benchmark Standard & Poor's 500. Normally, in a strongly advancing market, the portfolio would lag the performance of the benchmark. In the rally of the June quarter, the most speculative and high valuation stocks performed the best. Nonetheless, we benefited from unusually strong moves in Echostar and Dollar General. Echostar subsequently was eliminated from the portfolio and the proceeds have been redeployed in News Corporation.

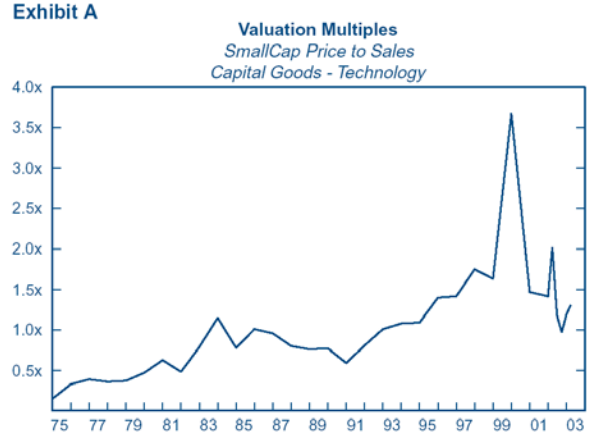
It is always a little unnerving when the investment chatter is of one mind. As the stock market rallied through various "resistance levels" following its October 2002 low (and particularly since March), the number of people saying "this time it's for real" seems to have reached a fevered pitch. The Wall Street gurus, many of whom were completely discredited in the aftermath of the nineties boom, are back in the press extolling the case for higher equity prices. It is eerily reminiscent of the bubble days in that stock behavior seems completely disconnected from the underlying company fundamentals. We readily recognize that the stock market is a discounting mechanism, one that typically moves well ahead of the fundamentals. Still, our best assessment is that from a big picture standpoint, the growth expectations embedded in current valuations are far too optimistic.

Since the bubble burst in March of 2000, the S&P 500 has rallied at least 10% seven times (four times over 20%), only to subsequently fall back to the starting level or lower. In virtually every case there were plenty of so-called experts who thought the rally would hold. Nearly all of these experts can be broadly characterized as "technicians." Technicians are those who look at price, volume and trading behavior rather than fundamentals to assess stocks and the market. Over short periods of time stocks often behave in a seemingly random fashion and technical analysis is probably as good as anything in trying to describe or predict these moves. The reason these rallies failed and the reason the technicians didn't get it right is because a basic problem remained: the underlying fundamentals were far out of balance with prevailing valuations.

The latest rally seems "real" because at 30% up from the October low (as of July 7), the S&P 500's move has been considerably more powerful than previous ones. The rallies in technology stocks have been both more numerous and of greater magnitude. The latest gain has been quite dramatic, with the Nasdaq Composite (a proxy for tech stocks) up 55% from the October 2002 low. Yet, as we will articulate shortly, the underlying fundamentals don't appear to have improved measurably. In fact, by most measures, the most speculative and highest multiple stocks have seen the biggest moves. In the S&P 500, for example, stocks that started the year with highest price-to-sales ratios significantly outperformed the lower valuation stocks. The gain for the highest quartile price-to-sales stocks was significantly higher than the lower quartiles.

Perhaps several positive investment factors – low interest rates, fiscal stimulus, a weaker dollar, and tax cuts – are in place to eventually deliver better fundamentals. The Fed and the Administration are pulling out all the stops to try and ignite the economy. Yet with current equity valuations above nearly every prior peak except the late 1990's, we would have to experience extraordinary economic and corporate growth to justify current valuations.

Exhibit A



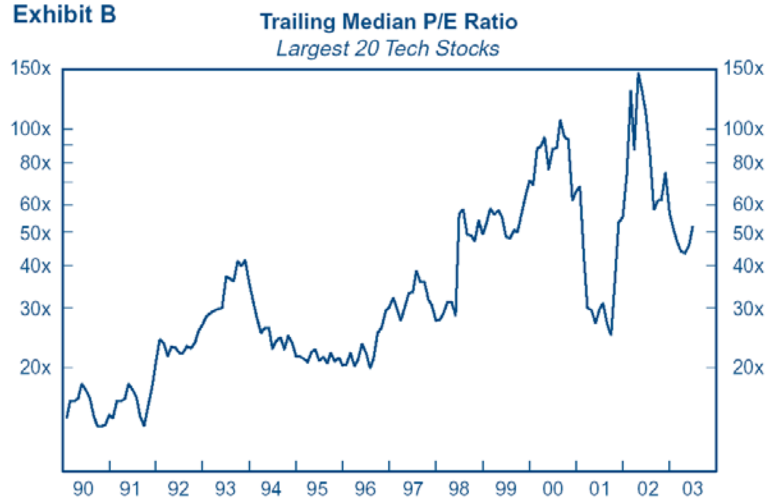
Source: Merrill Lynch Small Cap Research

Technology

Technology stocks are often the most interesting stocks to observe (but not necessarily own), because they are like the laboratory rats of the stock market. Everything about them happens quickly, from product life cycles to stock market gyrations. Investment managers "play" these stocks when they feel the market is in an up phase because the betas (how a stock moves relative to the market) are so high. In down markets they scramble out of them for the same reason. In fact, stock market mavens refer to managers seeking tech exposure as "beta chasers." In 2003 both small and large technology (and biotech) stocks have been the place to be. How little this has to do with fundamentals can be shown by the accompanying graphs and table. In Exhibit A, the price-to-sales ratio of small cap technology stocks is shown. The series goes back to the stock market trough in 1974. As can be readily seen, the May multiple of 1.31 (it is actually higher as of June) is higher than every other peak except the late 1990's bubble. It is startling to think previous peaks included the flowering of mini-computers, PC's, disk drives, spreadsheets, Windows and wireless communication.

High valuations are not confined to the small technology stocks. Exhibit B takes the largest twenty technology stocks and looks at P/E ratios. Although this chart only goes back to 1990, it tells a similar tale. The P/E ratio is 52 through June on what is arguably a mature group of companies. Finally, Exhibit C is a table of major semiconductor related stocks showing historical P/E and price to sales ratio data. This table shows current valuation measures versus the average of the 10 years ending 1998. While valuations during the 1989-1998 period were high relative to the 1980's, they seem downright cheap in comparison to today's valuations. The current P/E ratio of 62 is over three times the level seen in 1989-1998, while the price-to-sales ratio is more than double.

Exhibit B



Source: The Leuthold Group

These expensive valuations must be juxtaposed against the reality of what is happening to the fundamentals. In recent weeks we have seen significant sales and earnings shortfalls from a wide variety of technology companies (Motorola, AMD, Texas Instruments, Tech Data, Ciena, ADC Telecom, Nortel, Sprint, Solectron, etc.). We would estimate that for every one company reporting respectable results, seven are saying business is uneven or weak. It is very clear that capacity abounds, pricing is tough and volumes are coming up short. The outlook for the second half of 2003 is not particularly encouraging. While there are some pockets of strength in corporate IT

Exhibit C

SOXIndex Components	6/3 Price	Market Value ($US Billions)	P/E Ratio (Trailing)	2003 P/E Ratio (Estimate)	Historical 10-Year P/E (1989-1998)	Price/Sales Ratio (Trailing)	2003 P/S Ratio (Estimate)	Historical 10-Year P/S (1989-1998)
Advanced Micro Devices, Inc.	6.94	2.4	N/A	N/A	10.9	1.0	0.8	1.1
Altera Corp.	18.55	7.1	71	52	26	10.0	8.7	4.4
Applied Materials, Inc.	15.83	26.2	83	122	17	5.0	5.8	2.0
Broadcom Corp.	24.55	6.9	N/A	65	N/A	5.7	4.6	N/A
Intel Corp.	21.10	137.9	44	35	14	5.0	4.9	3.2
KLA-Tencor Corp.	47.36	9.0	57	72	22	6.2	6.9	3.1
Lattice Semiconductor	9.20	1.0	46	84	16	4.4	4.3	3.1
Linear Technlogy Corp.	35.99	11.3	50	49	22	18.8	18.6	7.2
LSI Logic Corp.	6.43	2.4	N/A	N/A	25	1.3	1.4	1.7
Maxim Integrated Products	39.02	12.7	44	43	23	10.8	10.6	4.9
Micron Technology, Inc.	11.39	6.9	N/A	N/A	14	2.3	2.3	2.1
Motorola, Inc.	8.49	19.7	39	27	21	0.8	0.7	1.1
National Semiconductor Corp.	23.58	4.3	590	236	26	2.6	2.5	1.0
Novellus Systems, Inc.	35.58	5.3	94	137	19	5.6	5.7	2.7
Teradyne, Inc.	16.88	3.1	N/A	N/A	21	2.4	2.2	1.5
Texas Instruments	20.62	35.7	74	52	19	4.0	3.8	1.1
Xilinx, Inc.	29.54	10.0	80	43	25	8.5	7.7	4.1
Averages/Totals		**301.9**	**62***	**65***	**20**	**5.6**	**5.3**	**2.6**

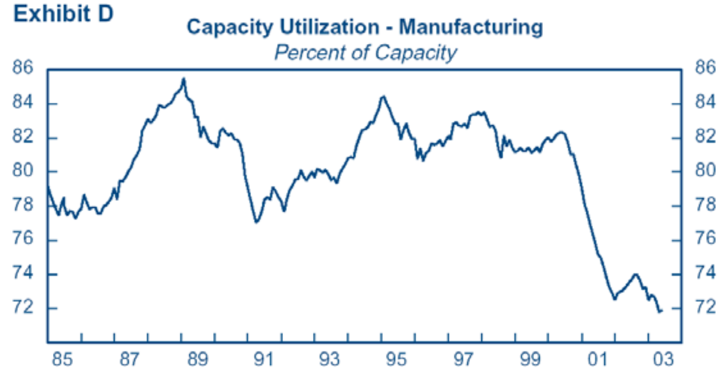
* Excluding National Semiconductor
Table courtesy of Fred Hickey/The High-Tech Strategist

spending, most of our observations lead to the opinion that an extended period of adjustment is still ahead. Suffice it to say that we believe technology stocks in general are unappealing, and from a valuation perspective, miles away from being interesting.

The Economy

There has been no discernable improvement in the economy this year. The June ISM number was again below 50, the fourth month in a row showing a contracting manufacturing sector. Capacity utilization, now in the low seventies (see Exhibit D), is at a 20-year low. Employment trends have been weak, particularly in manufacturing (see Exhibit E). June recorded the 35th straight month of decline in manufacturing jobs. The June unemployment rate rose to 6.4%, the highest in over nine years. Consumer and corporate balance sheets remained highly levered (see Exhibit F).

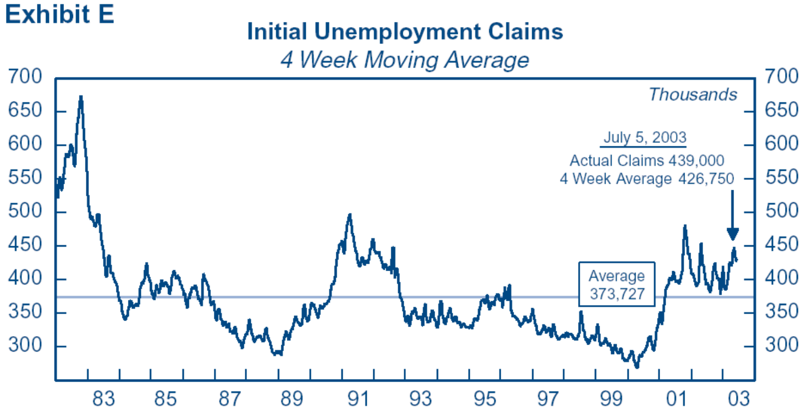
Exhibit D



Source: Federal Reserve Board

The curiosity about today's environment is that normally during recessions or times of weakness, consumers and corporations "get religion." Weakened balance sheets are repaired, helping to set the stage for an economic rebound. Instead, this cycle shows a consumer who has become even more levered with installment and mortgage debt. They have borrowed for cars (0% financing) and pulled the equity out of their homes ($700 billion last year). Normally the recovery of these two big-ticket items help drive a classic economic recovery. It will be difficult for housing and cars to provide much of a push from here. Business investment remains muted due to overcapacity. It will likely take a significant and sustained improvement in demand before capital spending improves. Therefore, strong GDP growth is hard to envision in the near term.

Exhibit E



Source: Bureau of Labor Statistics

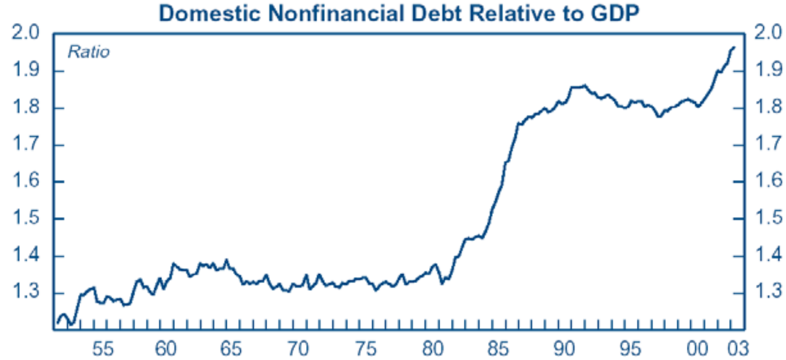
Sources: Federal Reserve Board; Copyright (C) 2003 Crandall, Pierce & Company. All rights reserved. Last Observations May 2003. All data is seasonally adjusted.

Good economic growth in the U.S. may require a significant pick-up in worldwide economies. The U.S. needs vibrant places to sell goods and services, something lacking in recent years. At a minimum, increased foreign demand takes some of the pressure off U.S. labor, as foreign labor is put to work satisfying domestic markets rather than becoming a cheap alternative to U.S. supply. Increased confidence will spur business executives to update outmoded productive capacity.

Despite a less than rosy look to the current economy, long term investors and followers of FMI know that we don't spend our days contemplating macroeconomics or "the stock market." Twice per year we attempt to give a fair assessment of the environment. Despite the tone of the letter heretofore, there are several positives worth mentioning. First, operating leverage is quite high. Companies have aggressively cut costs and have indeed become more productive. Incremental revenue is likely to be highly profitable. This bodes well for corporate earnings once demand accelerates. The outlook for profit margins in a recovery is enormously positive. Second, low interest rates will certainly help contain debt service costs. Third, lower tax rates should spur increased economic activity. Finally, there has been significant progress on the corporate governance front, which bodes well for the long-term health of the stock market.

It is also easy to neglect one of the big side benefits of excess supply, particularly in technology, and that is lower prices. Ever decreasing prices expand the potential applications of technology in ways that have very real benefits to society. Whole new industries develop around cheap technology and biotech (Wi Fi, proteomics, etc.), which increases economic activity, employment and wealth. Despite the slow economy over the past three years, the entrepreneurial spirit of this country appears to be intact and that always bodes well for the future.

Exhibit F



Source: Federal Reserve Board

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Outlook

We do not see the ingredients for a strong economy in the near term. Stocks have moved significantly in advance of expected improvement and this may be premature. It is doubtful whether the fundamentals can support the prevailing valuations in technology, biotech and perhaps the market in general. The good news is that portfolio is underexposed to the most overvalued sectors; its holdings are broadly diversified and balance sheets are well above average. The current and expected return on invested capital for the portfolio holdings are above average and the valuation level is reasonable. On an enterprise value-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio basis, the portfolio trades at a 30% discount to the S&P 500. The attentiveness to low relative valuation has served long-term investors well and we don't expect the future to be any different.

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