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INVESTMENT STRATEGY OUTLOOK
LARGE CAP PORTFOLIO

October 2003

FMI large cap portfolios exceeded the S&P 500's September quarter advance of 2.5%. The strong performance of the portfolios was driven by BHP Billiton Limited, Charles Schwab Corporation and VF Corporation. The stock market in general continued to be driven by the "high beta" stocks, which are typically more speculative. Our July letter addressed this phenomenon in some detail and there isn't much we can add to this commentary other than to remind our clients that stock prices and fundamentals can diverge widely in the short run but eventually come together. No one can predict the timing, but the notion that it is possible to ride a speculative wave and get off before the crash is dangerous. Richard Bernstein, Merrill Lynch's Chief Strategist, recently related the findings of Dr. Vernon Smith, the 2002 Nobel Prize winner in Economics. Dr. Smith is best known for his work in experimental economics related to investment bubbles. Even after experiencing a bubble (and crash) in the first round of trading, participants in his studies consistently produced another bubble (albeit smaller) and subsequent crash. When asked why they took part in the second bubble, their responses were uniform, in that they thought they could make money in the rally, yet get out in time to avoid the crash.

The economic and employment news continues to be very mixed. The bulls note improving GDP and consumer spending figures, and an increase in technology spending. The bears cite weak employment trends; high consumer, business and government debt levels; and relentless competition from Asia and elsewhere. Our view is that the economy is staging a very slow recovery that won't gather much force, due to high debt levels and international competition. Furthermore, we strongly believe that the valuations that prevail in the stock market cannot be supported by the fundamentals. That is not to say that individual stocks can't do well but the valuation wind will be in our face, particularly in certain sectors. The key to performance in coming quarters and years will be to avoid these overvalued sectors.

In the last quarter we eliminated the Dow Chemical position based on valuation and concern about the long-term outlook for natural gas prices. We added General Mills and Praxar, which are discussed below.

GENERAL MILLS, INC.

General Mills ("GIS") processes and markets branded food products such as cereals (Cheerios, Wheaties, Total, Chex) which comprise 23% of sales; baking, snack and yogurt products (Betty Crocker, Yoplait) with 29% of sales; meals (Hamburger Helper) with 15%, refrigerated dough (U.S. Pillsbury) with 10%; and international brands, with 10% of sales.

Good Business:

- Food products exhibit broad appeal as price points are low, and revenue is recurring.
- The company possesses many highly valued brand names and extensive sales and marketing expertise.
- The return on invested capital (ROIC) is above average and should expand significantly in coming years.
- General Mills sells necessities and the business is easy to understand.

Valuation:

- At 15.7 times current fiscal year estimates, the stock is toward the low end of its historical relative and absolute valuation range of 15-28.
- A period of elevated capital expenditures appears to be behind the company; free cash flow should build rapidly in coming years.

Management:

- Stephen Sanger, 57, has been Chairman and CEO since 1995 and has been with GIS since 1974. Historically, GIS was a high return, moderate grower. With the 2001 purchase of Pillsbury, it remains to be seen whether this team can capitalize on the purchase.
- James Lawrence, 50, has been the CFO since 1998. Prior to this he was the CFO at Northwest Airlines and was with Pepsico previous to that.

Investment Thesis:

General Mills has a strong lineup of branded consumer products and appears to be getting a better handle on the Pillsbury integration issues. It is unlikely the company will make any more large acquisitions (a positive) and instead will focus on driving earnings per share (EPS) and cash flow.

PRAXAIR, INC.

Praxair is the largest supplier of industrial gases in North and South America and the third largest worldwide. The gases are used in a variety of end markets, from metals and mining to medical. The industry is largely consolidated and is earmarked by economies of scale and broad distribution.

Good Business:

- Industrial gases are consumed and reordered, providing nice recurring revenue.
- Praxair provides on site service and fulfillment, typically under long-term contracts, which raises the barriers to entry.
- The concentrated industry structure generally provides healthy pricing.
- The ROIC is above average and should expand as industrial production expands.
- The business is a necessity and is easy to understand.

Valuation:

- At 18.3 times current fiscal year estimates, the stock is in the middle of its historical absolute valuation range of 13-25. Given the cyclically depressed condition of North and South America, this appears to be an attractive valuation.
- The free cash flow characteristics are attractive and much better than the average company. We feel the stock should sell at a premium.

Management:

- Dennis Reilley joined Praxair as Chairman and CEO in 2000. Since 1989 he had been at DuPont, most recently as Executive Vice President and Chief Operating Officer. His track record at Dupont appeared to be good and Praxair has done well in the industrial downturn of the last few years.
- James Sawyer became CFO in 2000 and was treasurer from 1992-2000. The company appears to be focused on ROIC.
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Investment Thesis:

A disciplined industry and a company focused on ROIC should yield a good stock, particularly in view of a worldwide economic rebound.

Thank you for your support and confidence in FMI. We value and appreciate your commitment.