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INVESTMENT STRATEGY OUTLOOK - LARGE CAP VALUE

Quarter Ended December 31, 2004

The Fiduciary Management Inc. large cap portfolios performed well in the December quarter and calendar year. For 2004, portfolio returns generally exceeded the Standard & Poor's 500 return of 10.9% by about 800 basis points. Our large cap portfolios have now outperformed the S&P each of the four years since the inception of this offering, and the annual compounded returns for these portfolios is about 13% compared to a negative .55% for the S&P. While this is very gratifying, the question in this business is always "What's next?"

These returns were higher than we had envisioned in early 2004, given the strong 2003 market and the elevated valuation levels starting the year. The year played out in three parts. The first half of the March quarter saw a continuation of the growth stock and "low quality" rally that characterized 2003. A series of worries, including Iraq, commodity prices, earnings growth, and political rhetoric set the stage for value stocks to outperform in the back half of the March quarter through most of the third quarter. This reversed again in the December quarter, with strong advances in some of the higher multiple sectors such as technology, biotechnology and telecom, along with good gains in industrials and financials. Our negative slant on technology and financials was outlined in our ISO letter for the quarter ending March 31, 2004.

> ***To continue good economic expansion from here, both employment and wages will likely have to grow significantly, as other sources of growth appear to have been exhausted.***

The holiday mood and the gratifying gains of 2004 do not shake us from our conviction that stock prices in general remain well above historical averages, and in many respects are significantly overvalued. Depending on which valuation metric is used, it appears that more stocks are overvalued today than were overvalued in the technology bubble of five years ago. The value of the median stock today exceeds that of five years ago. Later in this letter we will present supporting data. But first, as is our custom, we will make some general comments about the economy and corporate earnings.

The Economy

If the fourth quarter estimates come in as expected, real Gross Domestic Product (GDP) growth in 2004 should be approximately 4%. The economy has recovered nicely from very slow-to negative growth post-09/11/01. Employment continues an uneven, but positive recovery. Manufacturing activity has increased and consumer spending remains fairly robust. While real income growth advanced 3-4% in 2004, after a couple of years of virtually no growth, consumers continued to spend more than they make. Thus, consumer debt levels remain near an all time high and the personal savings rate hit the second lowest level on record (.2% in October). Mortgage debt is also at a record level and has undoubtedly provided a significant amount of fuel for consumer spending in recent years. To continue good economic expansion from here, both employment and wages will likely have to grow significantly as other sources of growth appear to have been exhausted.

The topic of the day in the financial and popular press is the current account (trade) deficit. The annual trade deficit is currently over 5% of GDP and is approaching $600 billion (see chart). Foreigners are not only selling Americans a lot of goods relative to what they are buying in return, they are plowing the dollars they receive back into U.S. Treasuries and stocks. The worry is that foreigners will lose their appetite for holding dollars, which have been depreciating lately, and thus, interest rates will have to rise to induce others to fund our trade deficit. Some notable commentators, including Warren Buffett and Stephen Roach (the Morgan Stanley economist), believe the trade imbalance will continue to impact the dollar. They believe the dollar will continue to fall, making U.S. exports cheaper, and imports more expensive. Clearly, this scenario has negative implications for inflation, as low import prices have kept consumer prices low.

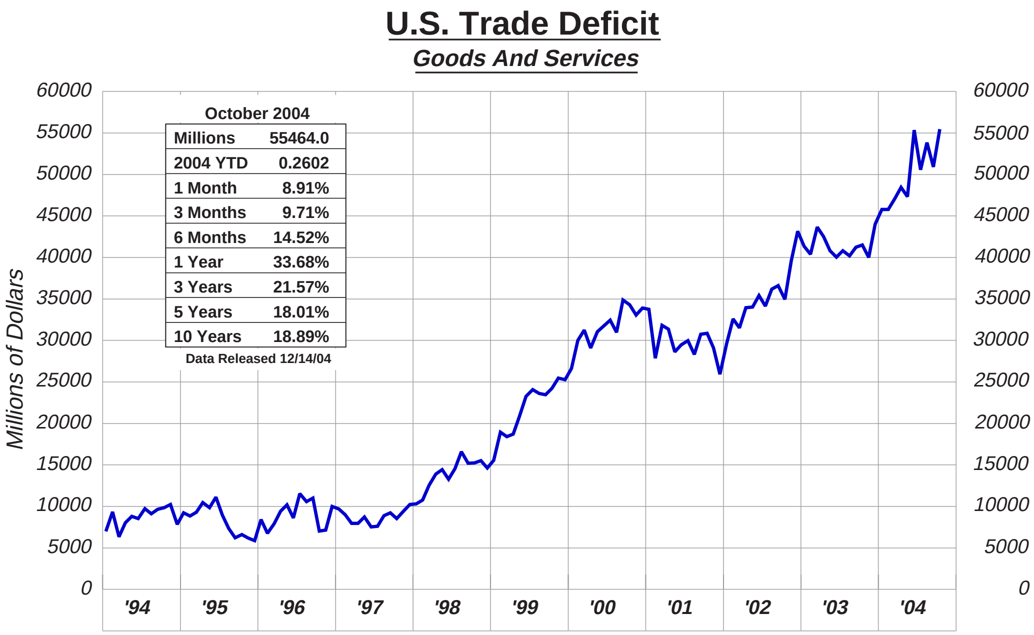

Table: Includes latest level and percentage changes for indicated periods.• Periods over 1 year are annualized.
Sources: Bureau of the Census; Copyright © 2005 Crandall, Pierce & Company

The government budget deficit, which is expected to be approximately $400 billion and around 4.1% of GDP, is also quite high by historical standards. Other economies throughout history that have run large deficits have tended to struggle with inflationary pressures. Most of the inflation that we have seen in recent quarters has been mainly in raw materials such as oil and other commodities. We are seeing some companies have success in passing on these price increases. Historically, rising labor costs have been a much more important inflationary factor. We haven't seen strong evidence of this as yet. Any significant increase in inflation will likely have a negative impact on interest rates and stock market valuations. In summary, we would say the status of the economy is better than it was a few years ago, but still remains on fairly shaky ground.

Corporate Earnings

Many times in these letters we have stated that over long periods of time, corporate earnings basically track corporate sales and nominal GDP. The growth rate of these three measures averages about 6%. Over shorter periods, earnings can dramatically lag or exceed corporate revenue growth and GDP. For instance there was a dramatic decrease in earnings in 2001-

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2002, as S&P 500 operating earnings declined more than 30% (50% on a reported basis) on only a modest decline in revenue and a flattish GDP growth rate. A rapid rebound in earnings occurred in 2003-2004, again, with only a modest increase in revenue and GDP growth. This past third quarter, corporate earnings slowed to 8% and that rate is about what is expected in the fourth quarter. It is also worth noting that corporate profit margins are at a 50 year high. With higher raw material prices and perhaps some wage pressures, it is unlikely that profit margins will expand significantly in the next year or two. We would actually not be surprised if margins dipped. Optimistically, we would say profits could track revenue growth, which would likely be in line with GDP growth. Thus, a mid-single-digit growth rate seems reasonable.

Valuation

At the end of 1999, the market reflected the enormous overvaluation of the technology and telecom sectors. In the years leading up to the peak in March of 2000, there were good, solid companies available at reasonable prices even while the aforementioned sectors of the market were at extreme valuation levels. Indeed, in the ensuing five years, most of the value indices did quite well while the S&P 500 was actually down approximately 10%.

It is perhaps natural to think that since the benchmarks have lagged over the past five years, they must now be attractive. We couldn't disagree more. While there are certainly fewer egregiously overvalued stocks today, there may be more companies that we would deem overvalued using traditional valuation yardsticks. One of the most consistent and dependable valuation yardsticks is the price-to-sales ratio (PSR). This is simply the total market value of the stock divided by the company's annual revenues. We analyzed PSRs, as well as some other valuation metrics, for the Russell 3000, which is the combination of the Russell 2000 (small caps) and the Russell 1000 (large caps) and constitutes over 95% of the market. The median PSR of this benchmark at the end of 1999 was 1.5; today it is 1.8. The multi-decade average for this ratio is approximately 1.0.

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At the end of 1999, the median price-to-earnings (P/E) ratio for the Russell 3000 was 16.6. Today it is 21.7. We hasten to add a caveat to these numbers. For simplicity's sake, we have chosen to ignore all the companies with negative P/E ratios. Thus, while there are a substantial number of these in the Index today, there were probably more five years ago. Ignoring the negative P/E ratios in this exercise may artificially lower the historical median P/E relative to today, since some of the money-losing companies were undoubtedly highflying technology stocks with no earnings. Still, we do not think it alters the conclusion that the median stock is at least as expensive, and perhaps more expensive than it was five years ago at the height of the stock market bubble.

The large cap portfolio was initiated four years ago, and was modestly more expensive than today. Four years ago, the portfolio P/E ratio on estimated 2000 earnings was 14.2. Today, the corresponding figure for 2004 is 17.2. The P/E ratio relative to the Index, however, remains attractive. Based on the midpoint between operating and reported earnings estimates by Goldman Sachs, the 2004 median P/E ratio for the S&P 500 is approximately 20.0. Thus, the portfolio still trades at a significant discount to the Index. On a PSR basis, the portfolio today trades at 1.5; four years ago this figure was 1.2. By way of comparison, the S&P 500's median PSR is 2.1. On a weighted average basis, the S&P 500's PSR is 2.9. Again, our portfolio appears to enjoy a significant relative advantage with respect to valuation.

Anecdotally, we have witnessed some signs of excess that are reminiscent of the late 1990s. Sirius Satellite Radio, for example, trades at 200 times revenue and sports a market capitalization of nearly $10 billion. Travelzoo carries a $1.6 billion market cap on revenue of just $28 million. Yahoo trades at a PSR of 15 and about 100 times earnings. Google's market value is now $53 billion on sales of $2.7 billion and has a P/E ratio in excess of 100. We screened all the publicly traded companies over $100 million in market value (roughly 5500 companies) and found over 750 that traded in excess of five times revenue.

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Given our concerns about overall market valuations, we are being even more vigilant about the quality of the business franchises in the portfolio. We have our portfolios more defensively postured today than at any time in the past five years. In tough times, investors will question everything. However, we continue to believe that lower quality businesses, "story" stocks and weaker balance sheets tend to get hit the worst in a stock market downdraft. Furthermore, we remain underweight in the most aggressive sectors of the market, particularly technology and biotechnology. Despite being wrong in recent months, we also remain steadfast in our conviction that financials should be underweighted.

We appreciate your confidence in Fiduciary Management, Inc.