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INVESTMENT STRATEGY OUTLOOK - LARGE CAP VALUE

April 2004

Fiduciary Management, Inc. large cap portfolios gained more than 4% in the March quarter, compared to a gain of 1.6% for the Standard & Poor's 500. The quarter played out in two parts, a first half rally dominated by consumer growth stocks, followed by a decline and corresponding outperformance by more value-oriented issues. Midway through the quarter, investors seemed to question expected growth rates and valuations. Additional factors in this reversal were escalating terrorist activities, worse than expected employment numbers, the recognition of decelerating earnings growth in the back half of 2004, and the heating up of election year politics. To punctuate the seesaw nature of this market, it rallied again right at the end of the quarter and into early April, apparently in response to a better than expected March employment figure and an Institute for Supply Management (ISM) number of 62.5, which indicates stronger manufacturing activity.

In spite of some better economic news, we maintain our belief that overall stock market valuations remain too high relative to the long-term growth prospects for equities in general. We do not see fundamental growth rates over the next five years being above average. Areas of worry include poor consumer and government balance sheets, nascent inflation rumblings and a lack of meaningful job growth. In next quarter's letter, we will discuss these issues in more detail.

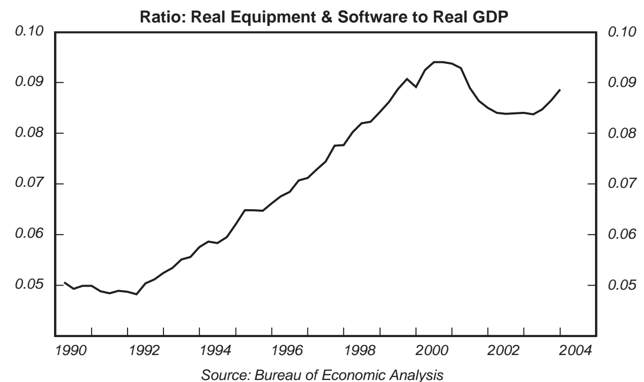
Our research department spends the great majority of its time analyzing individual securities and more specifically, their long-term fundamental prospects. Along with this bottom-up focus, we are also cognizant and careful about the portfolio's industry and economic sector exposure. We have never "managed to an index." We will, however, tilt our research effort toward the sectors that appear to have more value, while moving away from areas that look overvalued. We continue to believe that broadly speaking, technology remains overvalued and unattractive. The portfolio's technology weighting is approximately 5.4% versus the S&P 500's 17.2%. Our technology exposure continues to be of a "downstream" nature, i.e. users of technology rather than inventors of technology.

Financial services is another sector where the portfolios have been, and continued to be, underweighted. We believe the very favorable conditions that have existed for this group are, or will be, disappearing. The laundry list of difficulties this sector faces includes: excess capacity (mutual funds, banking, finance), an over levered consumer, an inflated housing market, credit derivatives, hedge fund accidents, and an unfavorable interest rate environment. Financial sector exposure is approximately 11.1%, but of course that includes Berkshire Hathaway, which is about 40% non-financial, so the actual financial weighting is roughly 8%. The S&P 500 financial weighting is 21.4%. By way of comparison, the S&P 500's financial weighting ten years ago was 10.9%.

As a check on our sanity, we theorize that sector weightings, in a broad stock market index, should roughly match their commensurate percentage of the gross domestic product (GDP) or real economy over time. Any weighting in excess of its position in the real economy suggests a growth premium. According to the Bureau of Economic Analysis, technology related industries are approximately 9% of GDP (see chart on the following page). Other studies suggest an even smaller number. The S&P 500's 17%+ weighting suggests a very sizeable growth premium. Similarly, financial services look to be approximately 15% of the real economy, yet over 21% of the index.

Our relatively light exposure to technology and financials will be a sizeable factor in whether or not the large cap portfolios outperform the benchmark over the next few years. Our contrarian bent and a sober look at the fundamentals gives us the confidence to stick with this position.

As is our custom for our April letter, we highlight a few of your holdings.



W.W. GRAINGER INC.

Description

Grainger, with 2003 sales of $4.7 billion, is the leading broad line supplier of facilities maintenance products in North America. Grainger serves customers through a network of nearly 600 branches, 17 distribution centers, and four Web sites. Revenue is broken out by the following end markets: heavy industry, 19%; commercial, 19%; government, 15%; contractors, 14%; light manufacturing, 12%; reseller, 8%; retail, 8%; and transportation, 5%. By product line: material handling and storage, 15%; safety, 14%; cleaning, 9%; pumps/fluid power, 9%; lighting, 8%; electrical, 7%; ventilation, 7%; hand tools, 6%; power tools, 6%; heating, ventilation and air conditioning (HVAC), 5%; metal working, 5%; motors, 4%; power trains, 3%; and plumbing, 2%.

Good Business

- The company is a leader in the distribution industry and has an established brand name.
- Relative to the end markets it serves, Grainger's sales are steady. The maintenance and repair business is less cyclical and capital intensive than that of an original equipment manufacturer (OEM).
- The return on invested capital (ROIC) has averaged 12-16% per annum over the past ten years. Near term ROIC will be on the low end as the company resets their asset base.
- The balance sheet is good and operating cash flow is approximately $4.00 per share.

Valuation

- On a price-to-earnings (P/E) basis, the stock is 19 times. The ten-year mean P/E range is 14-26. The book multiple is 2.4, in a ten year range of 2.2-3.7. The price-to-sales ratio is 0.9 in a ten-year range of 0.7-1.3.
- The relative valuation is near the bottom of its ten-year range.

Management

- Richard Keyser has been chairman and chief executive officer since 1997. Prior to this appointment he was president and chief operating officer, and before that worked at NL Industries and Cummins Engine. While book value and revenues have grown moderately on Keyser's watch, earnings growth has been spotty.
- Wesley M. Clark has been chief operating officer since 2001 and served in various capacities at Grainger prior to this. As the company restructures their branch network, his role will be especially visible.

Investment Thesis

Grainger is levered to a recovery in the manufacturing and commercial construction sectors. Additionally, the company is expanding its market to address a wider range of end markets with somewhat larger branch stores. Grainger is working through a large IT systems transition. These internal issues, combined with weak end markets, have hurt the stock. While the secular outlook for U.S. manufacturing doesn't appear to be bright, we need just a modest cyclical rebound to provide the backdrop for better Grainger earnings. Historically, the market has awarded the company with P/E ratio of 20. Based on earnings per share (EPS), which should exceed $3.00 within a few years, there is significant appreciation potential in the stock.

DIAGEO PLC

Description

Diageo is the world's largest branded premium spirits business. Its portfolio includes premium international brands like Smirnoff, Johnnie Walker, Guinness, Baileys, J&B, Captain Morgan, and Tanqueray. Diageo was formed from the merger of Grand Met and Guinness in December 1997. The combined company subsequently embarked on a strategy to focus exclusively on premium drinks, selling Pillsbury in October 2001, acquiring part of Seagram's portfolio in December 2001, and divesting Burger King in December 2002.

Good Business

- The company possesses many highly valued brand names and extensive sales and marketing expertise.
- Alcohol beverages exhibit broad appeal, as price points are low; and strong recurring revenue, as they are consumed.
- Diageo generates an above average ROIC in the mid- to upper-teens that should increase in the coming years, driven by margin expansion and stable capital expenditure requirements.
- This is an easy business to understand.
- Diageo's balance sheet is rated A+ by S&P.

Valuation

- Diageo trades at a discount to other global beverage companies. On a P/E basis, the stock trades at 16.1x the fiscal 2004 (June) estimate, which compares to 18.9x for Anheuser-Busch and 22.7x for PepsiCo. On an enterprise value-to-sales (EV/sales) basis, the stock trades at a 2.91 multiple (operating margin = 21.5%), which compares to 3.51 (operating margin = 22.6%) for Anheuser-Busch and 3.31x (operating margin = 19.5%) for PepsiCo. Backing out the value of Diageo's 21% stake in General Mills, the EV/sales multiple drops to 2.68.
- The stock also trades at a 20% discount to the market on a P/E basis (16.1 versus 20.3) despite generating a ROIC (17.4%) that is approximately double that of the market.

Management

- Management has focused the company on growth through organic means rather than acquisitions, with the excess cash flow going to dividends and share buybacks. While the company is open to acquisitions, management believes that the opportunities are limited as it employs a stringent ROIC test to acquisitions.

Investment Thesis

The major attraction to Diageo is its defensive characteristics. The company's steady, modest top-line growth, in combination with margin expansion, share buybacks, and the 3.2% dividend yield, offers

double-digit total return potential in an overvalued stock market. The stock should furthermore be supported by an improving ROIC profile.

NEWELL RUBBERMAID, INC.

Description
Newell manufactures and markets name-brand consumer products such as housewares, hardware, and office supplies sold primarily to large retailers, including discount, hardware and home improvement stores. The company's brands are well known, including Rubbermaid, Sharpie, Parker, Calphalon, Little Tikes, Graco and Levolor. Over 70% of Newell's revenue is generated in the United States.

Good Business

- The company is a leader in its consumer product categories and has established brand names.
- Newell sells modestly priced consumer products with a reasonable amount of predictability.
- The ROIC is approximately 10-11%, which is down from its previous range of 12-14% in the early-to-mid 1990s. Management's strategy includes improving profitability to historic ranges.
- The business is easy to understand.
- The balance sheet is reasonably levered, with an earnings before interest, taxes, depreciation, and amortization to interest (EBITDA/interest) ratio of 7x. Newell pays a $0.84 per share dividend, which equates to a 3.5% yield.

Valuation

- On a P/E basis, the stock is 16.0 times. The ten-year mean P/E range is 17-25. The price-to-sales ratio is 0.85 with a ten-year average range of 1.1-2.0.
- The relative valuation is near the bottom of its ten-year range.

Management

- Joe Galli has been president and chief executive officer of Newell since January 2001. Prior to Newell, Mr. Galli was president and chief executive officer of VerticalNet, and president and chief operating officer of Amazon.com. Mr. Galli previously held a number of positions with Black and Decker, including president of the Worldwide Power Tools Group.
- This past June, Pat Robinson was named chief financial officer, after two years as controller of the company.

Investment Thesis
The general thesis for an investment in Newell is based upon two important company initiatives that are being orchestrated by a fairly new management team. First, management has outlined a program to lower costs, including consolidating manufacturing facilities, rationalizing unprofitable lines, sourcing more product from lower cost nations and reducing the supplier base by 50%. Second, management is driven to grow the business through more aggressive product introductions and leveraging its strong brands. In the next two years, we should see EPS increase to over $2.00 and the multiple return to 18-20x. The current dividend of $0.84 per share is safe and offers good support for the share price.

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