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INVESTMENT STRATEGY OUTLOOK

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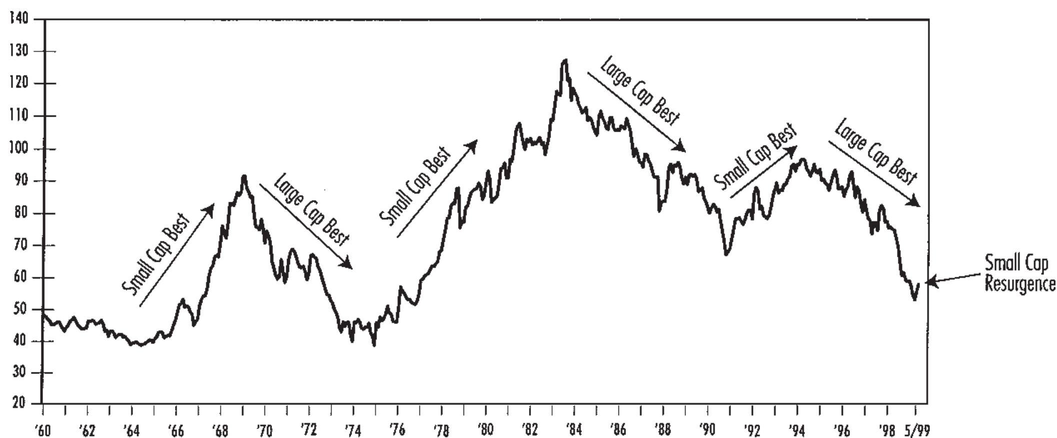
The market environment for mid- to small-capitalization companies improved dramatically in the second quarter, and your portfolio participated accordingly. For the quarter ended June 30, 1999, your equity returns exceeded 20%, versus a return of 6.9% for the S&P 500, and 15.5% for the Russell 2000 Index. Year-to-date, through June 30, 1999, your double-digit equity returns compare favorably to 12.3% for the S&P 500, and 8.5% for the Russell 2000.

As we had stated in our past communications, we were somewhat puzzled as to why our companies had not performed better, given their strong earnings gains in the past year, relative to the S&P 500 and the Russell 2000. Specifically, while S&P 500 operating earnings were nonexistent in 1998, your companies grew at about 9% and accelerated to 10% in the first quarter of this year, while the S&P 500 operating earnings for the first quarter grew 3.7%. Your companies were enjoying strong relative earnings growth, while at the end of the first quarter, the portfolio sold at a 55% discount to the S&P 500's price/earnings ratio; that conundrum, however, was resolved with a resounding vote of confidence for your companies in the second quarter. Even with this strong absolute and relative performance in the second quarter, your portfolio today still sells at a 44% discount. The environment for corporate profitability has picked up, for both the broad economy as well as your portfolio. We envision the growth in our companies approaching 12-14%, which is still ahead of the earnings growth that most of Wall Street's pundits forecast for the S&P.

One of the contributing factors to our strong second quarter performance was the acquisition of some of your portfolio companies. We would expect that this phenomenon may well continue, with the valuation disparity that still exists between large and small companies. It certainly makes sense for the S&P 500 type of companies to continue to expand via acquisitions, when these acquisitions can be done accretively.

From a longer term perspective, as can be seen from the following table which graphs the performance of large versus small capitalization companies over the past 40 years, Wall Street will, at times, view one sector more favorably than the other. With the exception of the 1991-1993 period, when small capitalization companies outperformed their large cap brethren, it has been an environment, since the end of 1983, where larger companies have performed better. At the end of the first quarter of this year, we were almost at relative valuation levels not seen since 1974, which led to a protracted period of almost ten years of outperformance for smaller capitalization companies. Given the significant valuation discrepancies we've discussed in favor of small cap companies, we think we may be at a period of small cap resurgence which may well persist for some time to come.



Source: The Leuthold Group; as of 5/29/99

We are heartened by the strong showing in the second quarter, and believe that the performance we have achieved thus far, though not sustainable at this rate of growth, will still be well in excess of the returns one will be able to achieve in the popular indices in the next two to three years.

Portfolio Commentary

We have often discussed how "bottom-up" fundamental analysis drives the research process. While it would be foolish to ignore the macroeconomic environment, we have always felt that picking good businesses at bargain prices and having a diversified portfolio was the best way to handle whatever "top-down" forces were presented. This approach does not exclude consideration of larger "themes," but simply tries to capture a desired theme without taking undue risk. In the following paragraphs we will address the diversification issue, and why we feel your portfolio is well positioned for the future.

In the following table, we have outlined the approximate weightings of your portfolio as well as that of the S&P 500. We use the S&P 500 because the constituent data is more readily available than it is for the Russell 2000, our standard benchmark.

Market Sector	FMI	S&P 500
Technology	20.3%	26.5%
Consumer Staples	13.5%	19.6%
Consumer Cyclicals	8.8%	6.0%
Consumer Services	9.9%	5.7%
Basic Industries	12.7%	3.4%
Industrial	8.7%	6.7%
Financial Services	10.0%	16.2%
Utilities	0.0%	6.8%
Energy	5.5%	6.9%
Transportation	0.0%	1.1%
Building Cyclicals	0.0%	1.3%
Misc. Business Services	5.1%	0.0%

As you will see shortly, we are certainly not an index fund. Of course in hindsight, shadowing the S&P 500 would have been the smart thing to do the past few years, as massive fund flows found their way to the very largest market cap companies that have driven the performance of the S&P 500. If the second quarter is a harbinger of things to come, this phenomenon should be reversed, allowing the more neglected stocks to shine. At FMI, there are sectors that are heavily overweighted, and others with no exposure at all. If the companies within a sector do not have the characteristics or valuation that we like, we avoid that area. *Utilities* would be a good example of this. Conversely, sometimes companies with attractive long-term business fundamentals fall into a sector that is out-of-favor. We may have a double or triple weighting in this sector. Because of "Y2K" worries, *technology services* (a subset of *technology*) such as Modis, Romac and Keane are examples of this, even though our overall *technology* weighting is less than the S&P 500. The interesting feature of our approach is that a 40-45 stock portfolio of largely niche companies is still diversified and exposed to the main economic growth sectors that comprise GDP.

In the *technology* sector, the composition of our portfolios is vastly different than the S&P 500. The S&P *technology* weighting is concentrated in a group of very high valuation, mega-capitalization stocks such as Microsoft, Lucent, AOL, Cisco and Dell. Your technology stocks are predominantly service-oriented, and distributors. Companies such as Sungard and National Data have business models characterized by recurring revenue and high return on capital, yet sell at reasonable multiples. The electronic distributors are long term proxies for the semiconductor and computer industries, yet do not carry the "innovation" risk of these industries. These companies typically have lower margins but higher returns on capital employed. As a general rule, we prefer **users** as opposed to **inventors** of technology. Where we do have exposure to a leading edge technology inventor, such as Methode, the risk is quite manageable. Methode's optical connector and switch business is experiencing explosive growth driven by the internet and broadband buildout; yet the company has a highly profitable and relatively predictable automobile electronics business that provides a base level of earnings growth. We believe this approach provides above-average risk adjusted returns.

The underweighted position in the *consumer staples* category largely reflects the massive move in a few S&P 500 stocks within the *drug, household products* and *soft drink* sectors (all part of *consumer staples*).

These were the large cap growth stock “winners” (i.e Coca-Cola at a price/earnings ratio of 45; Gillette at 46 times earnings; and Pfizer, at 42 times) over the last several years, currently experiencing slowing profit growth, yet still trading at what we feel are extraordinary multiples. While our overall *health care* (also part of *consumer staples*) exposure is slightly higher than the S&P 500 (12.6% vs. 11.3%), the constituents are again quite different. Valuations keep us away from the drug stocks currently, but we are participating in the underlying growth of the industry through Covance and Cambrex. As big pharmaceutical companies face profit margin pressure, they are outsourcing research (Covance) and manufacturing (Cambrex). Both these companies are leaders in these areas and should continue to benefit from this trend. Our other health care investments are strong niche players with high levels of recurring revenue. For example, Dentsply is the leading worldwide manufacturer of dental consumables and equipment. They are number one or two in virtually all of their product lines and carry an estimated 40-45% overall market share. As a general rule, our health care investments try to minimize the risks associated with government reimbursement issues. From this standpoint, we feel the portfolios are much better positioned than the S&P 500 going forward.

One area that has struggled recently for us is *retail* (within the *consumer cyclical* category), where we have also been modestly overweight. This is an area where we have had good historical success and the franchises that we own have solid long-term records. Nonetheless, the recent performance has been unacceptable. We have recently intensified our research effort in this area and some changes may be forthcoming.

Our 12.7% weighting in *basic industries* doesn’t reflect investments in commodity chemical, fertilizer or paper companies, where the lion’s share of the S&P weighting is. The largest investment is Cambrex, which has both a health care and specialty chemical product mix. The other investments in this sector are unique companies producing products in metal-based derivatives (OM Group), polymer additives and specialty chemicals (Great Lakes Chemical), esoteric research chemicals (Sigma-Aldrich), and precipitated calcium carbonate (Minerals Technologies). All of these companies have above average profitability and growth.

Our underweight position in *financial services* reflects the growing commoditization of the banking sector and our view that margins will be squeezed here over the next several years. Our lack of participation in the large multi-line insurance companies also explains the lower weighting. The six companies we own have established niches, solid profitability, and in aggregate, are growing at about twice the S&P 500.

The overweighted position in the *industrial* category does not reflect investments in heavy machinery, trucks, etc. Most of our exposure is in the relatively predictable, high-margin waste services industry; i.e. Republic Services, Casella Waste, and Superior Services, which is in the process of being acquired.

Finally, underweight positions in *utilities, energy, transportation*, and *building cyclicals* reflect the inability to find our kinds of companies at the right price.

If you have any questions about our strategy, the companies in your portfolio, or your current performance, please call us at (414) 226-4545, or toll free, at (800) 264-7684.

Thank you for your continued confidence in Fiduciary Management, Inc.