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# INVESTMENT STRATEGY OUTLOOK

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To paraphrase our outgoing President, "It was the valuations, stupid!" Almost a year ago to the date, we commented in our letter to you that our 30+ years in the investment business have allowed us to witness, among other things, the conglomerate boom and bust of the late-1960s, the computer software and services debacle of 1970, the Nifty Fifty run-up and demise in the 1973-1974 market, the oil bubble of the early 1980s and the biotech bust in the early 1990s. We also stated, "*...But nothing in the last 100 years rivals the valuations placed on the technology, Internet, and telecommunications companies that we are experiencing in today's market. Suddenly, and for some yet unknown reason, a few of the investors will head toward the exits, then the rest of the investment wildebeests will charge for the door. Greed will turn to panic, and share prices ultimately crumble, and we will experience a significant destruction of wealth.*" During one of our client meetings early in 2000, after discussing the above commentary about what we believed would be the ultimate demise of the mania existing at that time, our client opined that things were "different" this time, with these new technologies, and that we were in a "new paradigm." In a sense, he was right. The declines in "the new economy" stocks are the worst ever, to wit:

| Company | Price 12/31/99 | 2000 High | Price 12/31/00 | % Change 12/31/99 to 12/31/00 | % Change 2000 High to 12/31/00 |
|---|---|---|---|---|---|
| Amazon.com | $76 | $92 | $16 | -80% | -83% |
| America Online | $76 | $83 | $35 | -54% | -58% |
| CMGI | $138 | $164 | $6 | -96% | -97% |
| E*Trade | $26 | $33 | $7 | -72% | -78% |
| EToys | $26 | $28 | <$0.50 | -99% | -99% |
| Priceline.com | $47 | $104 | $1 | -97% | -99% |
| Red Hat | $106 | $148 | $6 | -94% | -96% |
| Webvan | $17 | $19 | <$0.50 | -97% | -97% |
| Yahoo! | $216 | $250 | $30 | -86% | -88% |

As can be seen in the following table, the declines weren't only isolated in the Internet/technology/telecom spectrum in 2000. Some of the more visible big-name companies suffered as well.

| Company | Total Return 12/31/99 to 12/31/00 |
|---|---|
| Lucent | -80.9% |
| WorldCom | -79.6% |
| AT&T | -66.0% |
| Dell Computer | -65.8% |
| Microsoft | -61.8% |
| Motorola | -58.7% |
| Qualcomm | -49.3% |
| Cisco Systems | -28.6% |
| Intel | -24.7% |

In all of these cases, the scenario was, in many respects, the same. A slower growth rate (or perceived growth rate) for the Company, whether a dot.com company buying "eyeballs," in the case of Priceline, or a significant decline in earnings, as with WorldCom, coupled with an astronomical valuation, resulted in all cases in a swift and devastating market decline for the security. The 39.2% loss in the NASDAQ in 2000 was the greatest in its history, and in terms of major averages, trailed only the drops in the Dow and S&P 500 in 1931. For the full year, the Dow Jones Industrial Average declined 6.18%; the S&P 500, 10.14%; and

the Russell 2000, 4.2%. In environments like this, we find ourselves coming back to one of Warren Buffett's more notable quotes, *"The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs."* When others cast aside the concept of risk and embrace, rather, growth at any cost, it is a time for us to proceed with caution. The year 2000 was such a year.

Against that backdrop, our equity portfolios showed solid absolute returns, and 2000 was one of the best relative years ever at Fiduciary Management.

Over the years, we have discussed with you that our philosophy here at Fiduciary Management has always been to invest defensively. By that we mean that we constantly concern ourselves with what could possibly go wrong with our investments, and with the risk of losing money. In so doing, we think we've built into our model Ben Graham's "margin for error." Investing this way invariably leads us to make less when markets are reacting "irrationally," as they did in 1998 and 1999 — but to do very well in a year like 2000. It allows us, on a long-term basis, to build significant gains for our clients.

The question we are now being asked is whether stocks have fallen enough. The answer, of course, depends upon the individual stock. Even with the significant declines depicted above, Cisco, Yahoo!, Qualcomm and Oracle still sell at 61x, 77x, 60x, and 70x earnings, respectively -too rich for our blood! More egregious still are the valuations in some of the "new economy" technology stocks, such as Juniper Networks, which sports a price/earnings ratio of 400x; Broadcom, 178x; Seibel, 200x; Network Appliances, 270x; and Brocade Communications, 310x. Indices such as the NASDAQ, with a price/earnings ratio of nearly 100x, or the S&P 500, with its current 24x multiple, are normally not indicative of market bottoms. In reviewing the January 4 issue of the *Wall Street Journal*, the majority of Wall Street's chief market strategists were still extremely positive, and the Investors Intelligence Survey still shows 51% of all investment strategy newsletters to be bullish. It strikes us as though there is still a bit too much bullishness, and still too many individual stocks that are very expensively priced. There are, however, some individual companies that are starting to come in to view - even in the technology arena. We are firm believers that the market swings from one extreme to the other, and we have seen it happen time and time again. As technology stocks decline from the extreme levels of the past few years, it is quite possible they will "overshoot" fair value, thus becoming real bargains. This happened in 1990-1991, and we built a significant position in this sector. Many technology companies that have been discarded by Wall Street are now starting to look more reasonable to us, and we are beginning to do some significant research in this area. Don't be surprised if you begin to see some of these stocks in your portfolio in the next 12-18 months!

***Economic Commentary and Corporate Outlook***

At this point in our commentary, we were planning to predict an easing in the Fed Funds rate by the Federal Reserve, most likely to occur at the upcoming FOMC meeting on January 31. The Fed, however, took a preemptive strike with a 50 basis point reduction last week, which led to a sharp one-day rally in the markets. By the fourth quarter of 2000 it became increasingly evident that the economy was beginning a sharp slowdown. In December, the Purchasing Managers' Index, which has historically been a very good harbinger of future business conditions, contracted to the lowest level since April of 1991. In addition, the consumer curtailed spending significantly. It appears now that the Christmas season of 2000 will be the worst in five years, from a retailing perspective. Even with huge markdowns at the retail level, consumer spending could grow only 2.0-3.0% in the fourth quarter. In addition to interest rate hikes over the last year and a half, the consumer also appears to be reacting to higher energy prices and the psychological impact of a lower stock market. The consumer is 67% of the economy and when he contracts so does the U.S. economy.

Corporate profitability has also slowed sharply. In its recent financial update of January 3, Merrill Lynch predicted operating earnings of the S&P 500 to be flat in 2001, down from the 12% growth rate expected in 2000, and over 20% in 1999. As mentioned earlier, the S&P still sports a multiple of about 24x earnings. In our opinion, it is still susceptible to some further decline, given the very moderate earnings picture this year.

The technology sector, from a macro perspective, seems even more vulnerable. According to First Call, earnings for technology firms in the S&P jumped 42% in last year's second and third quarters. Coming into the fourth quarter, it was expected that the quarter's earnings would rise in excess of 29%. At this juncture, however, analysts' estimates for the fourth quarter are only at 8%, and First Call reckons that the first quarter of 2001 will actually call for an 8% decline. It is still a little too early to get excited about this sector in general.

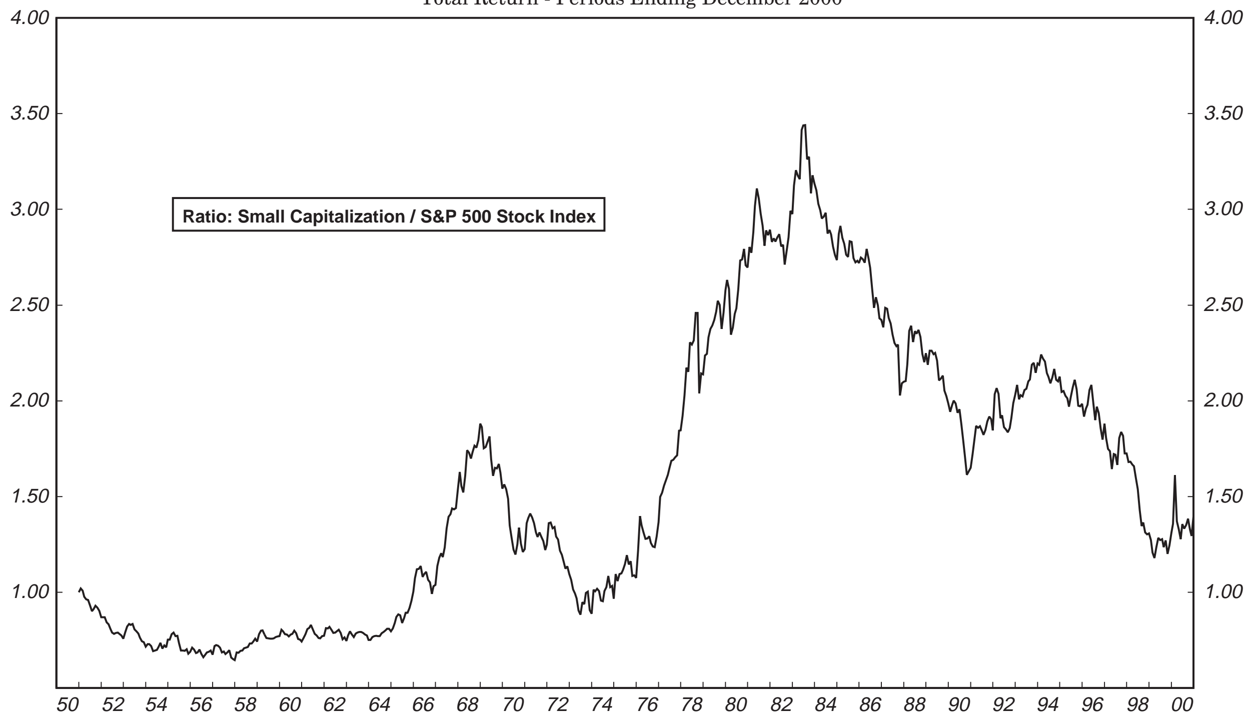
***Small vs. Large***

If we go back to 1983, many investors felt that the dominance of smaller cap stocks over bigger caps would continue. Instead, a 15-year period of the opposite scenario ensued, as the following chart depicts.

**LONG TERM ASSET ALLOCATION**

**By Capitalization - Equities**

Total Return - Periods Ending December 2000




*Sources: Standard & Poor's Corporation; Frank Russell Company; Financial Analysts Research Foundation; Copyright © 2001 Crandall, Pierce & Company*

This chart compares the performance of small-cap stocks to the performance of the S&P 500. A rising line means that small-caps are outperforming large-caps, and a declining line means that large-caps are outperforming small-caps. The relatively rare horizontal line simply means that the two sectors are performing identically.

Periods of outperformance and underperformance by large cap or small cap stocks have tended to be characterized by a herd mentality which carries valuations of one group or the other to extremes. From 1968 to 1972 small caps significantly underperformed as valuations on the Nifty Fifty rose to

unprecedented levels. This ushered in a 10-year period from 1973 to 1983 of strong outperformance by small caps, as valuations (price/earnings ratios) on the large caps not only came into line with long-term fundamentals, but actually dropped well below the long-term average. From 1983 to today (with the brief hiatus from 1991 through 1993), valuations on large cap stocks have once again far outstripped the growth of the companies, resulting in a long period of outperformance versus small companies, even though small companies have provided very good absolute returns. Almost half of the total return on the S&P 500 from 1980 to 1998 was the result of the price/earnings ratio rising from 7x to 33x.

***Growth vs. Value***

In a recent issue of *The Financial Analyst Journal*, Louis K.C. Chan, Jason Karceski and Josef Lakonishok examined stock price patterns relative to operating performance in a paper entitled, *New Paradigm or Same Old Hype in Equity Investing?* The study scanned a period of 20 years, ending in 1999. From the late 1970s to the mid-1980s, the study found that all classes of value stocks - large-, mid- and small-capitalization, significantly outperformed the same categories of growth stocks. A shift to growth outperforming value occurred in the mid-1980s, with the exception of the period 1991-1993, and in the last five years, through 1999, growth was a particularly strong performer relative to value. The authors looked for an explanation; the answer, however, was not found in an examination of the growth rates, as those had been fairly consistent over long periods of time. In 1997-1998, the authors found that growth stocks' average compounded annual rates of growth in sales and operating income were about 6% and 8.5%, respectively. These growth rates, in fact, were somewhat below the historical long-term average for growth stocks of 9.5% and 9.6%, respectively. They concluded that the better growth performance of late can only be accounted for by multiple expansion, and the current multiples, in their opinion, are not sustainable over long periods of time. In the authors' opinion, few companies have ever been able to maintain a long-term competitive advantage over the competition that would justify the current price/earnings multiples in some of today's stocks. It was their conclusion that, going forward, investors should reduce expectations in the growth segment, as multiples adjust to historic levels.

***Now What?***

Both the smaller cap and the value areas of the market appear poised for a sustained period of better performance. In fact, we expect a period very similar to the end of 1973 through May of 1983, during which small-caps outperformed by over three-fold. Small-caps during that period grew at an annual rate of 27.9% per year, a cumulative increase of 910%, compared to 10.8% annually for the S&P 500, an increase of 162%. While absolute returns are unlikely to match these levels over the next ten years, the relative returns could be as dramatic.

Even with an excellent 2000 behind us, the valuation of our equity portfolio (approximately 13.5x earnings) remains attractive. With expected flat earnings growth for the S&P 500 versus 10-15% for your portfolio, the relative attractiveness is compelling.

All of us at Fiduciary Management, Inc. thank you for your patience in the trying markets of 1998-1999. For our part, we have stuck to our disciplined approach of investing, and the fruits of our labor were certainly borne out in the year 2000. Thank you for your continued confidence.