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INVESTMENT STRATEGY OUTLOOK

October 2000

We are nine months through what is likely to be the most volatile year in stock market history. According to the Leuthold Group, 39% of the trading days for the S&P 500 and 75% of the trading days for the NASDAQ have been “high volatility.” That is to say these indices were up or down by more than 1%. The 39% figure for the S&P compares to the post-1945 median of 16%, and the 75% number for the NASDAQ is over four times more volatile than the median of 16.7%. What a way to start the millennium! We are pleased to report that in spite of the tremendous volatility, we have experienced strong relative performance versus the popular indices, including the benchmark Russell 2000, for the quarter and year-to-date periods, respectively.

The years 1998 and 1999 were relatively difficult for value oriented managers as investors sought risk, particularly in high valuation technology stocks, and were rewarded for it. Even as the environment turns more favorable to our style of investing and punishes some speculations, e.g. internet stocks, we continue to see highly optimistic and arguably unrealistic valuations in various sectors. Well-known stocks like Lucent, Microsoft and Dell have declined sharply this year, over 50% on average, while others such as Ciena, Juniper and Siebel have been rocket ships and sell at phenomenal valuations — how does 400 times earnings sound? Two weeks ago Intel blew up. Last week it was Apple, this week, Dell - for a third time - and the stock still sells at 37 times earnings. Each bomb sends the momentum crowd toward the ones that haven’t blown yet. Ultimately, this strikes us as a loser’s game and it would all be quite amusing except that the collateral damage affects everyone. All stocks are more volatile as a consequence. With this sort of backdrop to the investment landscape, it is no wonder our risk sensitive approach is regaining favor. We see more investors seeking to escape the rat race of chasing technology stocks and instead moving toward equities that offer solid growth at a reasonable price.

The stocks that fit this bill have a long way to go to close the gap that emerged several years ago between aggressive and conservative investment results. We see at least two good things happening over the near term. One, growth in many low valuation companies could exceed expectations. Two, investors should migrate toward a more risk averse investment approach as technology and high valuation stocks inevitably disappoint. Both of these conditions should drive superior performance for your portfolio over the coming years.

As is customary twice a year, we would like to highlight a few of your portfolio investments. In boilerplate fashion, we would like to remind shareholders that the stocks we highlight are not our “best ideas.” If we knew which ones were our best ideas, we’d have all of your money in only those! While we like all of the stocks in your portfolio, it’s impossible to predict which ones will move first or by how much.

Update

In the March letter we highlighted three stocks that hadn’t performed, but which we believed had strong prospects. Consolidated Stores is up 15% over the past six months, despite awful performance in the retail sector. We think this stock has a long way to go. Casella Waste continues to struggle with the disposition of noncore assets, yet the stock has gained over 30% since March 31. Although it remains inexpensive, it is likely to remain quite volatile until the dispositions take place and the Company is back delivering steady earnings growth. G&K Services has gained 41% since March 31,

yet still sells for just 11.5 times next year's earnings. We've had some real stinkers this year, too, including Nova and Covance. Nova stumbled with an acquisition but continues to have a terrific business in the transaction processing area. We think this stock will perform nicely from here. Covance has been a combination of self-inflicted wounds and changes by their largest customers, the big pharmaceutical companies. We see no change in the bigger theme of continued outsourcing of drug development activity by the large drug companies, but it will take some time for Covance to adjust. The Company remains a leader in their core franchise.

Prologis Trust

With more than 1600 facilities throughout North America and Europe, Prologis is a leading global provider of integrated distribution centers and services. The Company has distinguished itself from other industrial REITs by building a worldwide network around the largest users of distribution space. Global clients in the network can streamline the distribution and logistics procurement process through standardization and benchmarking. Despite popular myths to the contrary, the new economy needs warehouses and distribution. In fact, high throughput distribution is a vital aspect to ecommerce, and Prologis is literally at ground zero in this endeavor. We like the industrial sector of the real estate market because of the versatility of the space and the growing level of worldwide trade.

We are particularly pleased to be associated with the management of Prologis, as they have repeatedly demonstrated an innovative yet conservative approach to financing their business. The Prologis business model is becoming less capital intensive and thus the return on invested capital continues to rise. As this fact becomes more apparent to The Street, and the overall REIT sector continues to regain favor, the stock should do well.

Prologis has grown funds from operations (the proxy for earnings in the REIT world) consistently in the 10-12% range. We expect that rate to continue for the next several years. Most of their customers have long-term leases with price escalators, which locks in recurring revenue. As more customers utilize the network, the leverage becomes attractive. The yield on Prologis is currently 5.8%. With double-digit growth in funds from operations and a 5.8% yield, we think the total return possibilities are quite attractive, even without multiple expansion. The P/E ratio (price-to-funds from operations) is just 10.5 and 9.5 times 2000 and 2001 estimates, respectively.

MGIC Investment Corporation

MGIC is the leading provider (with about 25% market share) of private mortgage insurance (covering residential first mortgages) to lenders to protect them from loss on low down payment loans. Long term clients may remember MGIC, as it was a very successful holding in the mid 1990s. While MGIC is a national player and is widely recognized as the highest quality company in the mortgage insurance sector, it is also a local Milwaukee based institution. This has afforded us the opportunity to know the people more intimately than is typical. In MGIC's case, familiarity breeds respect. Management has done a wonderful job so far dealing with Fannie Mae, Freddie Mac and the legislative side of this business. They have also positioned themselves conservatively from a reserve and exposure standpoint, which is not easy to do when times are good and others are trying to grab market share. Additionally, MGIC has undertaken some exciting technology initiatives, which we feel really puts them way out in front of the industry.

We like the mortgage insurance business because the earnings are largely recurring in nature. Over the next few years, we expect insurance in force to grow in the high single digits and expenses to fall as a percent of revenue. This should continue to drive solid earnings per share growth. While new business written fluctuates due to interest rates, insurance in force remains quite steady. Modest

population growth, immigration, stronger household formation, increasing home ownership rates and new products drive long term growth. MGIC is well-reserved and has “stress tested” their book nearly every conceivable way. That is not to say this company will never have any earnings problems; it just means it is highly unlikely we will see “one-time” large reserve additions.

Although MGIC has been a strong performer recently, we find the stock still reasonable on a valuation basis. The Company is on track to earn $5.00 this year and $5.60 or so next year. The P/E ratio of 11 times next year’s number is actually on the low end of MGIC’s historical P/E trading range of 9-19.

Old Republic International

Old Republic has been a long term holding in the portfolio for a variety of reasons. First, we know and trust the management, which is a key factor in any financial stock. Second, we understand their three lines of insurance, as well as how and why they approach their markets. As Warren Buffet says, “It’s in our sphere of competency.” Finally, the stock is significantly undervalued.

Despite sizeable assets of nearly $7 billion, Old Republic is a niche insurance company based in Chicago. In terms of earnings, the biggest contributor in recent years (about 60%) has been mortgage insurance, where they are the sixth largest player (10% market share). This is a solid operation that gets high marks from their competitor, MGIC. We think this business is worth $17-19.00 per share as a stand-alone entity. Commercial trucking lines dominate the general insurance operation, which generates just a third of the earnings, even though it is over half of the revenue. This area has been weak in recent years, primarily due to increased severity of losses. Management aggressively repriced this business and screwed down the underwriting, and the results have been impressive over the past two quarters. We think there is upside to next year’s numbers as this business improves rapidly. As a separate company, the general insurance business could be worth $9-11.00 per share. The third business, title insurance, is considerably more volatile as it fluctuates with mortgage interest rates and refinancings, and thus carries a lower multiple. It is, however, a good business with solid return characteristics. It is worth $2-3.00 per share, in our opinion. In total, the Company appears to be worth $28-33.00 versus the current price of $25.00.

We believe this value can grow at a double-digit clip over the next few years as general insurance recovers. With a yield of 3.5% and a P/E ratio on 2001 of 10.6, we think the stock can appreciate another 30% over the next 12-18 months.

From time to time we have discussed with you the significance of share buybacks by our portfolio companies. Currently, 27 of the 37 companies in the portfolio are repurchasing shares. It would seem intuitive that when insiders are buying the shares of a company either personally or with corporate funds it would be indicative of a security that they felt may be undervalued.

But just how does that translate into positive wealth creation for us, as shareholders? The following table shows you the impact of a 20% share repurchase would have on Republic Services, which we believe to be significantly undervalued. The stock is currently priced at $13.57 in the marketplace, which we believe understates the true private market value of this company. Applying various matrixes, we come up with a value of Republic Services of somewhere between $22-25.00 per share. Assuming a $23.50 current private market value, a 20% repurchase would have the following impact on Republic’s valuation (Republic is currently in the throws of a $50 million share repurchase program):

If, as the exercise shows, we purchase 20% of the shares of Republic, the number of shares outstanding will drop by 35.12 million. The nominal value, or new appraised value, would go down accordingly

Current Market Value	
Total Market Value	$2,382 Million
÷ Shares Outstanding	175.6 Million
= Stock Price	$13.57
Current Private Market Value (at $23.50 per share)	$4,126.6 Million
÷ Shares Outstanding	175.6 Million
= Stock Value	$23.50
Value After 20% Share Repuchase	
New Appraised Value *(Original $4,126.6 Million less $13.57 per share Repurchase Cost of $476.58 Million)*	$3,650.00 Million
÷ New Shares Outstanding	140.48 Million
= New Stock Value	$25.98

for the shares repurchased, or $476.5 million, leaving a new appraised value for the Company of $3,650 million. The intrinsic worth of the Company with the share repurchase, in this case, goes up by $2.48 per share, or 10.6%. The management teams of our companies understand this exercise, and this is why, with excess funds, almost 75% of the companies in your portfolio are exercising share repurchases. Share repurchases by companies, therefore, increase the value of the shares owned by the remaining shareholders, with little incremental risk, as long as the leverage is low. Long term, it will drive the value of the shares we own that much higher.

"A-HA!" You say, "I see Microsoft continuing to buy shares in the open market!" Not so fast! The flaw here is the underlying value of Microsoft. If one believes, contrary to our current belief, that the private market value of Microsoft is greater than the current stock price, then the above exercise would hold. We, however, don't share that view, no matter how great a company Microsoft may be. In the case of Microsoft, they are actually repurchasing shares as a defensive measure to avoid dilution in earnings to remaining shareholders.

The reason for this is the continued significant issuance of stock options to management, in Microsoft's case, to lure attractive talent. When these employees cash in their options to purchase stock, the number of shares outstanding increases, resulting in a watering down of the earnings per share and value for the remaining shareholders. This can hurt a company's stock price. We believe, in situations such as Microsoft, and a lot of the technology companies that continue to issue stock options as a form of compensation, that the share buyback is actually a defensive counter-measure to avoid diluting earnings and, potentially, shareholder value. Recently, Pat McConnell, the highly respected accounting analyst at Bear Stearns, reported that S&P 500 earnings growth would have been 6% less if the options were figured as compensation.

It is obvious from the above Republic Services example that share buybacks can indeed be a good thing. However, one has to delve into what the intrinsic value of the underlying company is before one can assuredly determine whether a share repurchase is, as in the case of Republic Services, a move which enhances shareholder value, or, as in the case of Microsoft and many of the technology shares, a defensive measure.

As of September 30, 2000, with regard to the 27 companies we currently own that are undergoing significant share repurchases, we feel very strongly that the underlying value of the companies is substantially in excess of the current market price, and that the share repurchases that are in place are adding significant value to the stock that we own as shareholders.

As always, we thank you for your continued support and belief in our approach to value investing here at Fiduciary Management, Inc.