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# INVESTMENT STRATEGY OUTLOOK

January 2002

The two years ended December 31, 2001 showed strong positive returns in a dismal stock market environment, making this one of the best two-year stretches in the 21-year history of Fiduciary Management, Incorporated (FMI). Clients on board over the past two years enjoyed very strong relative performance. FMI equity portfolios advanced approximately 40%, compared to declines of 20% for the S&P 500, 52% for the Nasdaq Composite, and 1% for the Russell 2000. From a longer-term perspective, FMI portfolios have surpassed their benchmarks and have done this while taking less risk. We're grateful to clients who have kept their focus on the longer term!

Our January 2000 Investment Strategy Outlook letter included the following:

> *Barton Biggs, the chief investment strategist at Morgan Stanley, probably summed it up best when he said, "The technology, Internet and telecom craze has gone parabolic in what is one of the great, if not the greatest manias of all times. We understand the Net, and its implications for this economy, we just don't understand the valuations. The history of investing in 'paradigm-changing industries' such as today's Internet, has almost always been profoundly based on revolutionary developments that eventually do change the world. However, without exception, the bubble stage of the craze ends with a massive destruction of wealth." We then offered, "But nothing in the last 100 years rivals the valuations placed on big cap technology, Internet, and telecommunications companies in today's market...Suddenly, and for some yet unknown reason, a few of the investors will head toward the exit; then, the rest of the investment wildebeests will charge for the door. Greed will turn to panic, and share prices ultimately crumble."*

We believe that the two-year 52% decline in the Nasdaq Composite Index and the filing for bankruptcy of over 580 Internet, technology and telecom companies, speaks volumes about the merits of practicing the risk-sensitive, value-based investment approach employed by FMI. This, however, deals with the past. The obvious question on all investors' minds is the future.

## *Economy*

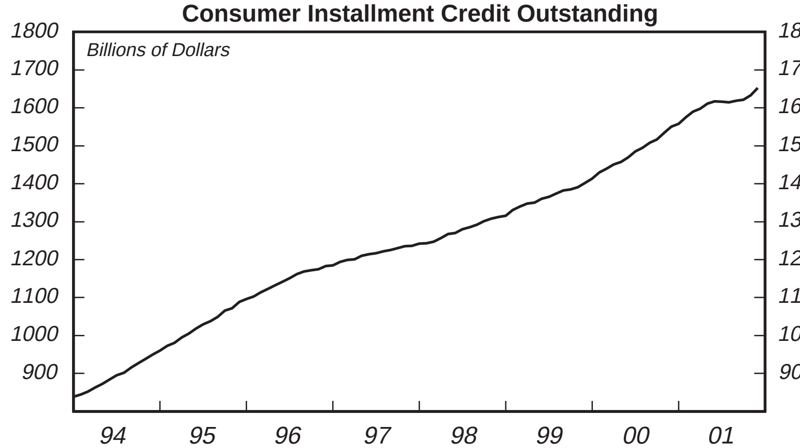
The National Bureau of Economic Research ("NBER"), the agency charged with charting economic activity, officially pegs the beginning of the current recession as March of 2001. That demarcation would put us nine months into the current downturn. Also, according to the NBER, the average recession over the last one hundred years has lasted approximately eleven months. As of this writing, then, we would be near the end of an average downturn. The Federal Government has responded with the largest fiscal and monetary stimulus package in history. The Federal Reserve has cut interest rates eleven times in the last twelve months and reduced the Fed Funds Rate to 1.75% from 6.5% in early 2001. Most pundits think there are still more rate cuts to come, although we're clearly past the inflection point with regard to their impact on the economy. From a fiscal standpoint, President Bush's record $1.3 trillion tax cut phases in slowly and is very much back-end loaded over its ten-year life. We believe it is highly unlikely that this tax legislation will see its 10th birthday in its present form.

Keep in mind that the economic expansion, which began in 1991 and lasted ten years, was the longest in the last fifty years, and naturally created some significant excesses within the system. As we commented in the last letter, recessions and tough times bring about a cleansing process.

Inventories are being liquidated, factories are closing and bankruptcies are accelerating. While painful to go through, these are all positives for the long term. We hasten to remind investors, however, that it is not an overnight process. Our best guess is that the recession will last longer than the average of eleven months. One major problem is the magnitude of excess capacity. Nearly 27% of the industrial capacity in America is idle, while in the technology and telecom sector, the number is over 40%. As we talk to companies each day, they tell us that with capacity plentiful pricing power is almost non-existent, and in some sectors outright deflationary. Until the cleansing process is further along, it will be difficult for the all-important earnings part of the equation to revive strongly.

When the final numbers are tallied, it is expected that S&P 500 operating earnings will have dropped 32% or more in calendar 2001, which would be the worst period for corporate profits since the Great Depression. Many economists forecast a fairly robust profit recovery in 2002, however, our fieldwork continues to tell us that profit recovery may come more slowly than expected. The consumer continued to layer on debt as consumer installment debt outstanding (not including mortgage debt) reached approximately $1.6 trillion. Historically, the consumer retrenches during recessions and this may still be in front of us. Additionally, with the latest unemployment figure at 5.8%, and likely headed higher before this recession subsides, overall consumer spending might weaken. Thus, our near-term outlook calls for a sluggish economy but with some long-term fixes at work behind the scenes.

**Consumer Installment Credit Outstanding**




*Includes noninstallment credit; does not include auto leases.*
*Source: Board of Governors of the Federal Reserve System*

A final note on the earnings component of the economic outlook: we have written on numerous occasions our jaundiced view of the quality of corporate earnings, particularly in the bigger caps. The recent trend toward "proforma" earnings is a thinly veiled attempt to deceive investors. In many cases proforma earnings bear little resemblance to GAAP (General Accepted Accounting Principles) earnings, and should be viewed with a great deal of skepticism, which your research team certainly does! Furthermore, one has to be even more cognizant of the widening gap between operating earnings and reported earnings. Operating earnings exclude one time items, which unfortunately have become all but one-time over recent years, and reported earnings is the final real or actual fully diluted number. In a recent article in the *Wall Street Journal* and in a disscussion we had with David Levy, chairman of the Jerome Levy Economics Institute, he commented that operating earnings of corporate America have outstripped reported earnings by 10% on average over the last nineteen years, and by almost 20% over the last five years. FMI has always tried to make our own internal adjustments to fully reflect what's really happening in corporate America.

## ***The Market***

Those of you who have been long-time investors with FMI know that our entire approach is focused upon finding the best 35-40 stocks that we can. We don't concentrate a great deal on the economy or the general market, as we believe that over the long term, our efforts are best spent finding good companies at attractive prices. Still, we offer our opinion on the market because it helps investors assess the bigger picture and the relative attractiveness of the equity world. Our view is always guided by the long-term returns that stocks have provided investors. Specifically, over the last 75 years, the S&P 500 has returned 10.7% compounded for investors. Over that same time frame, the valuation on the S&P 500, as measured by its price/earnings ratio, has averaged 15.3 times earnings. In the decade of the 1980s, the S&P 500 compounded at 17.6% per year, and in the decade of the 1990s, it compounded at 18.2% per year. These were unparalleled periods of performance, well above the long-term norm. If we were viewing the market as depicted by the S&P 500, and looked at its characteristics as an individual stock, our assessment would be lukewarm. Below is a table which details the market valuations at bear market bottoms for the last eight significant market declines.

**Bear Market Bottom Valuations**
**Standard & Poor's 500**

| Year | Price/ Earnings | Yield | Average Price/Book |
|---|---|---|---|
| 1970 | 14.0x | 4.2% | 1.7x |
| 1974 | 7.2x | 5.3% | 1.3x |
| 1978 | 7.3x | 5.6% | 1.2x |
| 1980 | 6.9x | 5.8% | 1.3x |
| 1982 | 8.6x | 6.3% | 1.2x |
| 1984 | 9.3x | 4.5% | 1.5x |
| 1987 | 12.6x | 3.4% | 2.0x |
| 1990 | 14.0x | 3.7% | 2.6x |
| **Average** | **10.0x** | **4.8%** | **1.6x** |
| **Current** | **29.0x** | **1.5%** | **5.9x** |

*Source: Fiduciary Management, Inc. and Factset, Inc.*

Keep in mind that this is how the market looked at the low points for each of those cycles. Bulls would argue that with a current inflation rate of less than 2% versus almost 4.5% over the last 40 years, and with 10-year Treasuries at 5% versus the long-term average of roughly 7%, the market could be valued higher. Bears would argue that P/E ratios and other valuation measurements are even higher than most previous market peak valuations. A high P/E ratio doesn't allow much wiggle room if the economy unexpectedly zooms, as rapid growth typically fuels higher interest rates and a compression in valuations. We try to stay somewhat agnostic with respect to these issues, but high S&P 500 valuations give us concern. Furthermore, Nasdaq valuations are extremely high again, given the rally in these stocks and the concomitant implosion in earnings. The trailing twelve month P/E ratio for the Nasdaq is currently 84 times!

The most important consideration continues to be the individual companies in your portfolio. They have, as we detailed at the outset, fared very well over the last 24 months. Yet these stocks continue to be attractive relative to both the S&P 500 and smaller cap indices such as the Russell 2000. Specifically, based upon our assessment of earnings for 2002, your portfolio currently sells at about 17x that estimate, which is about a 35% discount to the S&P 500. Against the Russell 2000, the P/E ratio is roughly equal, however, we believe your portfolio is significantly less risky. Based upon our expectations of better absolute and relative earnings growth rates compared to the popular indices, we are optimistic about the future.

We hearken back, however, to a statement Warren Buffett made at a conference last summer, in which he warned that investors' expectations were significantly distorted by the returns investors achieved during the 1980s and 1990s, and that in his opinion, returns in the stock market for the next ten years will be more closely aligned to the historic growth rate in corporate earnings of 7-8%. Investors may not like those numbers, but betting against Mr. Buffett over the last 40 years has not proven to be a financially successful exercise. We believe that given the better growth rates and the cheaper valuations of your companies, the next three to five years should see returns for our portfolio somewhat in excess of that level.

As always, we thank you for your long-term commitment to FMI and the confidence you have placed in us.