Fiduciary Management Inc.
Investment Counsel

225 East Mason Street
Milwaukee, Wisconsin 53202
414-226-4545

INVESTMENT STRATEGY OUTLOOK

July 2001

Just Give Me the Good News!

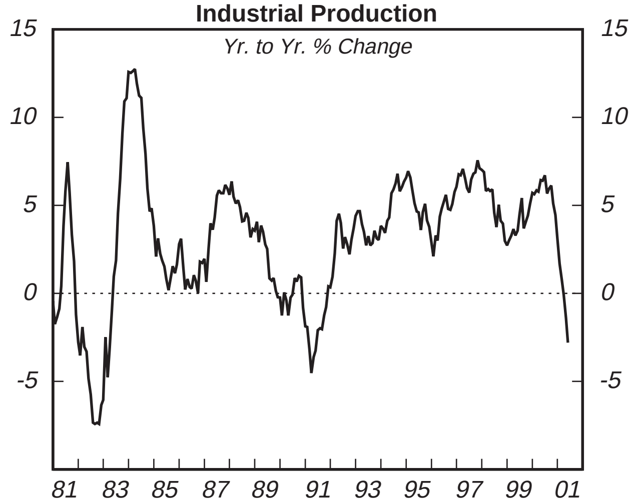
In the song *Good News* by the popular Irish band, the Saw Doctors, the lead singer laments endless bills, lousy jobs and bad girlfriends. The evening news is filled with depressing events, compelling him to cry out, "Just give me the good news...you can keep the bad!" If we heed the advice of the Saw Doctors, then we are pleased to report very good news as it relates to your portfolio performance. The June quarter was one of the best absolute and relative quarters in our twenty-one year history. Investors have continued to come back to solid values in the small- to mid- capitalization stocks. In the course of discussing portfolio performance with various clients in recent months, it became clear that many only have a vague notion of how well they have done, or how badly they could have done had their money been invested in stocks tracking the popular indices. Over the past year, the Nasdaq is down 45%; the S&P 500, down 15%; and the Russell 2000, roughly flat. Most of our client equity accounts are up 25% or so over this time period. Obviously, this was a very tough period for technology stocks, but even when we include the up part of the cycle - the greatest speculative rise in the history of the stock market - the numbers are startling. Over the past three years, since June 30, 1998, the Nasdaq is up 15%; the S&P 500, up 12%; and the Russell 2000, up approximately 16%. Most of our client equity accounts are up in the neighborhood of 32% during this period. That is definitely good news!

With all due respect to the Saw Doctors, there is, unfortunately, a good deal of bad news to report. Worldwide economic growth has declined rapidly. The US economy has experienced a very sharp downturn, with the manufacturing sectors exhibiting recessionary conditions. A stubbornly strong dollar, rising raw material prices, weak end-market demand, rising wages and excess capacity have all conspired against the producer side of the domestic economy.

If you will refer to Chart 1, you will see that in May, the output of the industrial sector posted its eighth consecutive decline for the first time since December of 1982. Capacity utilization in the industrial sector, depicted in Chart 2, fell to its lowest level since August of 1983. Goldman Sachs reduced its estimate of real GDP growth from 4% at the start of the year to 0.5% recently, saying, "We would not rule out a modest decline... In fact, we estimate that final sales are falling at a 0.6% annual rate."

Chart 1

Industrial Production



The U.S. consumer has nearly single-handedly kept the overall economy from slipping into an officially designated recession.

Given the state of the consumer's balance sheet, which is leveraged, and the increasing number of layoff announcements, we will be fortunate to sail through unscathed. So much for the "Goldilocks" economy!

If this economic growth picture was not bad enough, the slippery snake of inflation has sneaked back into the scene. The CPI has more than doubled off the bottom to nearly 3.5%, as shown in Chart 3. We have ample anecdotal reports of reduced consumer retail spending due to high utility bills and gasoline prices.

We certainly do not relish the reciting of dry economic statistics, particularly when they are this unfavorable. Their impact on corporate earnings and the stock market, however, has been remarkable. First quarter S&P 500 earnings were down approximately 12%. According to Barron's, the latest consensus earnings expectations for the second quarter suggest a decline of 15-17%. While the lion's share of the negative news over the last half of 2000 and the first quarter of 2001 occurred in technology and selected manufacturing industries, the scope has widened considerably. Technology companies continue to report dramatic shortfalls, perhaps even at an accelerated rate, but others have joined this ignominious party. Kimberly Clark, Proctor & Gamble, Gillette, Avery Dennison, Gap and many other traditionally predictable earnings companies have faltered.

Chart 2

Capacity Utilization

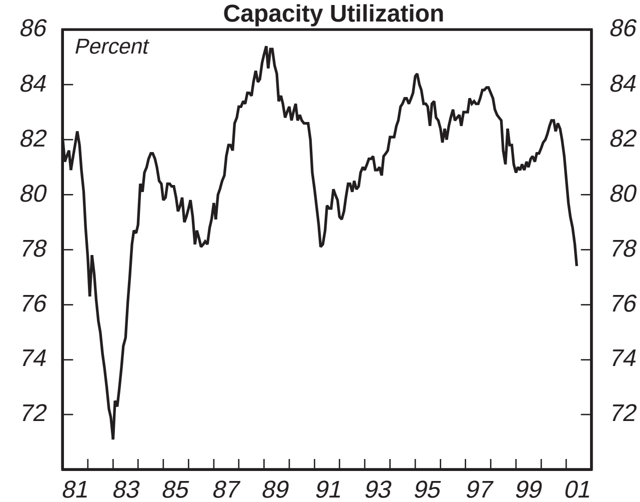
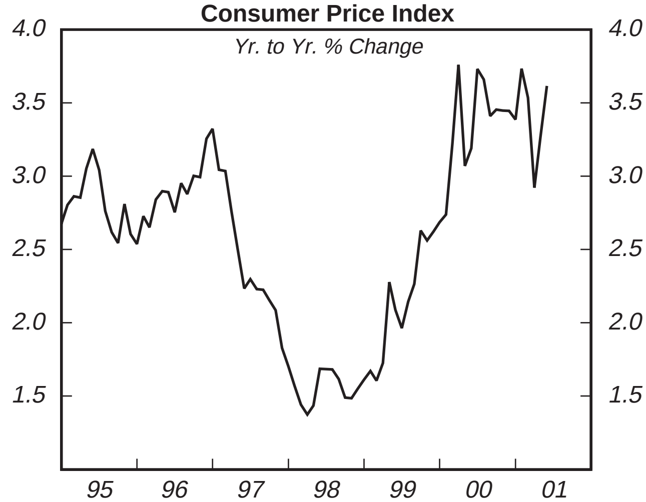


Chart 3

Consumer Price Index



Your portfolio has also had its share of disappointments, but overall the growth has held up much better than the aforementioned numbers. For example, your portfolio earnings growth in the first quarter was just under 8% and it looks like the second quarter is going to land in the 6-8% range. Your research team is proud of these numbers in a difficult environment, but we believe that even better relative numbers are possible.

Earnings Revisited

In last quarter's communication we discussed corporate earnings in the context of the "15% Delusion." We received a great deal of feedback on this piece and if you'd like to review it in its entirety, it can be accessed on our website, www.fiduciarymgt.com. Quickly summarizing, the essence of the discussion is just how rare achieving 15% earnings growth has been over the long term. Less than 3% of the best of the Blue Chips achieved this target. Over the 1991-2000 time period, S&P 500 earnings grew approximately 12.5%. This nine-year period, coming out of the

Gulf War recession and extending through the technology bubble, was the highest nine-year growth rate ever for the S&P 500. This extraordinary growth may not have been the result of new era productivity, but rather a catch-up period following a decade of very poor earnings.

Corporate profits (all corporate earnings, as determined by the National Income Accounts) appear to track nominal GDP over time, as delineated in Chart 4. As presented in Chart 5, S&P 500 earnings have actually lagged nominal GDP over time for a variety of reasons, which are not germane to this discussion. We urge readers to take a hard look at these charts. *Over time, earnings growth will essentially track nominal GDP*. If real GDP growth is 4% and inflation is 2%, nominal GDP and earnings should advance 6%.

Chart 4

Corporate Profits After Tax vs. Nominal GDP

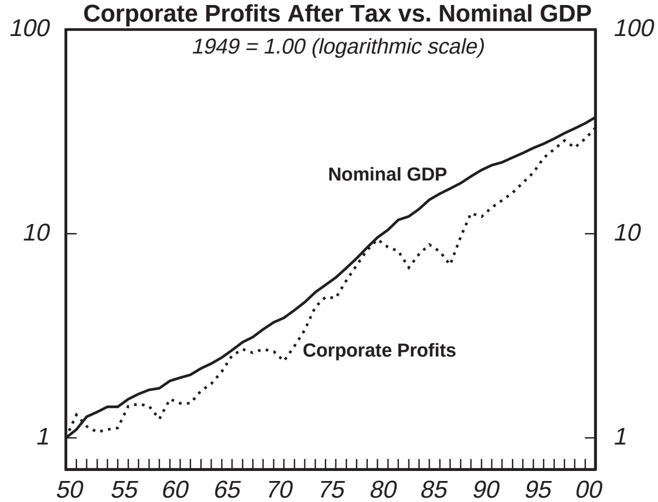
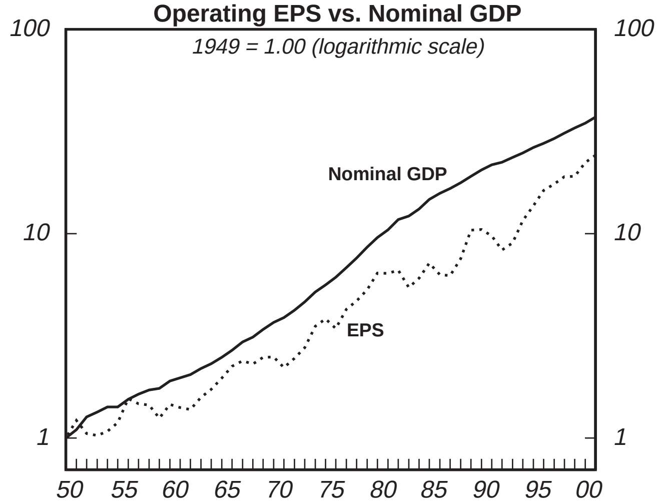


Chart 5

Operating EPS vs. Nominal GDP



Investors, particularly those who have only been involved over the past ten years, may have misguided expectations. When a yield of roughly 2% is added to normalized 6% nominal GDP, one could logically expect an 8% total return in stocks, provided P/E multiples do not change. Since the S&P 500 P/E ratio is still well above average (25 times earnings versus the fifty year average of 14), 8% may even be optimistic for an S&P 500 investor over the next several years. Having said this, we hasten to remind our clients that over the twenty-one year history of Fiduciary Management, the average annual portfolio earnings growth has slightly exceeded 12%. While the S&P 500 has experienced dramatic P/E multiple expansion over the past ten years, our client portfolios have not. Recently that has begun to change, giving us more optimism about the future relative performance of your portfolio.

We obviously cannot predict what level of earnings growth the portfolio companies will achieve over the next ten years. We can say, however, that our approach gives us a better chance than most of finding superior growth. Additionally, our valuation discipline means we will not pay-up for this growth. The combination should continue to produce solid investment performance.

In closing, we want to pay our respects to a man who has been a great inspiration for all of us over the years. Jack F. Kellner, father of Ted and friend of many, passed away recently after a battle with cancer. Mr. Kellner was a loyal supporter of Fiduciary Management, an outstanding businessman, investor and philanthropist. He will be dearly missed.

Thank you for your support of Fiduciary Management, Inc.