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INVESTMENT STRATEGY OUTLOOK

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Equity investors were reintroduced to the concept of systemic risk in the third quarter. Systemic risk is when an unpredictable and typically exogenous event causes widespread losses in the stock market. We all know that event took place September 11th. In the third quarter, the S&P 500, Dow Jones Industrial Average, Russell 2000 and Nasdaq Composite retreated 15%, 15.8%, 21.1%, and 30.7% respectively. Your portfolio declined in the third quarter, although it did better than any of these indices, continuing the strong relative performance of recent periods. It is still up on the year, which is gratifying given the environment. While it is never pleasant going through difficult markets, these periods have typically provided exciting opportunities for long term investors. Later in this letter we will discuss a few of these ideas.

A great number of clients have asked for our views of the September 11th tragedy and what to expect from an investment standpoint. Over the past few weeks we have read literally dozens of opinions of what to expect in the aftermath of these terrible events. What is clear is that nobody knows. But nobody ever knows what the future holds, so from this standpoint, nothing has changed. Equity investors are constantly faced with uncertainty and the price of this uncertainty is captured in a stock's valuation.

Prior to September 11, stocks had already been transitioning from extraordinarily high valuations to lower ones. The tech bubble had burst, and investors were finally coming to grips with the fact that much of the growth over the late 1990s was illusory. You may recall in several letters over the past few years, we discussed the general decline in the quality of earnings. A recent study by the investment firm Sanford Bernstein suggests there really wasn't any acceleration of growth due to the "New Economy," once one-time items, options and other non-operating gains are excluded. S&P 500 earnings grew at about a 5% clip in the second half of the 1990s when adjusted, rather than the 9-10% reported. Moreover, a recent study by Multex, which was analyzed by the Wall Street Journal, showed that losses over the past four quarters in the Nasdaq erased over five years of earnings. Huge write-offs, combined with aggressive accounting and management's "spinning" of the numbers to please Wall Street was a game getting long in the tooth; confidence and thus earnings multiples had already begun to erode.

We've tried to put the terrorist attacks into a broader context. The so-called peace dividend that existed in the 1990s may have been a bit inflated. While the fall of the Berlin Wall in 1989 did usher in a wave of capitalism and democracy, it came with increased risks. Formerly repressed regions gained titular freedom and sovereignty, yet were highly unstable. The Gulf War victory created the illusion that the USA could muster a coalition to smote renegade countries and dictators. Anti-Americanism grew dramatically in the aftermath of the Gulf War. While the risks from renegade dictators and terrorists increased throughout the 1990s, earnings multiples did not reflect this. In fact, it was just the opposite as U.S. investors focused on strong economic growth, global trade and the flowering of technology. Complacency reigned. Of course, this is a gross simplification, but now one has the recognition of the risks that existed all the time. Earnings multiples have been moving lower to reflect this changed perception.

Bear markets tend to make investors more negative than they should. They are the mirror image of a bull market. Earnings multiples went to extraordinary levels in the 1990s based on a misperception of risk. More recently investors are jumping to the other side of the boat. Yet despite growing negativism, we see a number of developments that make us more optimistic about the long term; specifically, low interest rates, low inflation, low inventories and more rational cost structures. Weaker players with diminished balance sheets are merging, selling assets, or filing Chapter 11. This is a positive for the survivors. Incrementally, the portfolio is adding some exposure to more economically sensitive areas, technology and financials.

As is our custom for the October letter, we highlight a few of your portfolio holdings.

Manpower Inc.

Manpower is a world leader in the temporary help business. It is based here in Milwaukee and in this case, familiarity breeds respect. We are confident in the management and their long-term outlook. It is a good business, characterized by relatively high return on capital and a growing market share of total employment. Manpower is a global brand name and the Company has extended its footprint dramatically in recent years. Major growth opportunities exist in Germany, Scandinavia and Japan. Europe accounts for 66% of its revenues, with roughly half of this coming from France. The temporary help industry was virtually nonexistent in Germany until recent law changes. It is essentially virgin territory for growth. Attitudes in Japan have also changed dramatically in recent years and that region appears poised for growth.

Our interest in Manpower at this stage of the economic cycle might seem curious. Every day we are reading about layoffs, plant closures and weak economic growth. Temporary workers often get hit the worst in this scenario. We readily recognize that Manpower is unlikely to hit consensus estimates for the near term. Yet we are attracted by the valuation and the leverage to a rebounding economy. At less than 14 times depressed earnings, with a solid balance sheet and tremendous earnings leverage, the stock is attractive. We also like the fact that this is a good way to play a better economy, which we feel is likely to be the case sometime in the not-to-distant future. Manpower is not terribly capital intensive, its service is not subject to heavy discounting and it is quick to experience an upturn when economic activity accelerates.

Rockwell Automation

Despite its relatively modest market capitalization, Rockwell is a $4 billion global leader in industrial automation, power systems and service. The industrial automation products include controllers, I/O systems, sensors, software and service. Power systems include drives, motors, gear reducers and power devices. These products are used by manufacturers to power and control their processes. Rockwell has a $650 million service business that is growing nicely. The Allen-Bradley, Dodge and Reliance Electric brands are strong and the Company has the number one share in the USA and a number two share worldwide. Rockwell has an installed base of $20-25 billion, which we feel the Company can leverage with new products and services over time.

Don Davis, the CEO of Rockwell, recently stated that the worldwide manufacturing sector was "the worst I have ever seen." Like many manufacturers, Rockwell has repeatedly missed estimates and recently announced a second round of layoffs, in addition to several plant rationalizations. Other than energy, the Company's end markets are weak virtually across the board. We obviously can't predict when the worldwide manufacturing sector will rebound, but we believe it will. Your portfolio has benefited in recent years from a fairly defensive posture and we feel the time is right to add a few stocks that have a little more economic sensitivity. Rockwell has a durable business franchise. Despite the current weakness, the Company should generate $225 million in free cash flow before $120 million in dividends. The valuation is attractive at less than 15 times highly depressed earnings and the stock yields 5%. Additionally, we believe the Company is an attractive acquisition candidate.

Parametric Technology Corporation

Parametric Technology is a leading software and service company whose products aid manufacturers in the development, design, simulation and collaboration of new products. The Company's mechanical computer aided design product, Pro/Engineer, has over 31,000 customers and generates $700 million in revenues. It is one of the leading engineering tools to many of the top corporations around the world. Although ProEngineer is a relatively mature product, it nonetheless should experience reasonable growth and outstanding cash generation. $325 million of ProEngineer's revenues are steady maintenance software sales. Parametric's Windchill solution has emerged as a leading collaborative software application, an area that is in the early stages of growth. This area leverages Parametric's large installed customer base with a product that allows customers and manufacturers to collaboratively develop products, decrease the time to market and manage the entire lifecycle digitally over the Internet. Software and service revenues derived from Windchill approximate $200-$250 million annually, which is a significant increase from $13 million just three years ago.

We like Parametric because of the current valuation, strong balance sheet and above average long-term growth opportunity. At current prices we believe that investors are getting the base ProEngineer business for approximately 10 times earnings (excluding revenues and investments in Windchill). The Company's balance sheet is very strong with over $275 million in cash and no debt. Additionally, despite a brutal environment, the Company continues to generate cash from operations. Finally, we like the prospects of Windchill on a longer-term basis and feel we are obtaining this business "for free."

Stone Energy Corporation

Stone is a high-quality exploration and production company focused mainly on the Gulf of Mexico coast (both onshore and shallow water). Stone is really more of an exploitation rather than an exploration company. They are smart operators and get their money out quickly. The Company typically acquires mature (low current production) properties that were previously cash cows for the prior operator. Stone does its homework, generally with newer seismic data, and targets more optimal drilling, such as an updip location on a known producing sand. Often, multiple sands are objectives in a single well. Sometimes, Stone will target a deep exploratory zone with home run potential. If a home run is not hit, the Company is usually still left with a single, upon completing the well in shallower sands. Stone's completion success rates are high at 75-80%. The Company is conservative in both the booking of reserves and the use of its balance sheet.

Stone has become an interesting investment idea for at least three reasons. First, the downturn in the economy and decline in the price of natural gas and oil have hammered the stock by over 50%. At 3.5 times cash flow, the valuation is compelling. Second, we believe this company will benefit from not only a rebound in the economy, but from successfully exploiting the prospects they acquired in the Basin acquisition earlier this year. Third, strong cash flow should enable the Company to be nearly debt free within a couple of quarters. With these characteristics and deals finally taking place in the E&P sector, Stone could be acquired.

Thank you for your continued support of Fiduciary Management, Inc.