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INVESTMENT STRATEGY OUTLOOK

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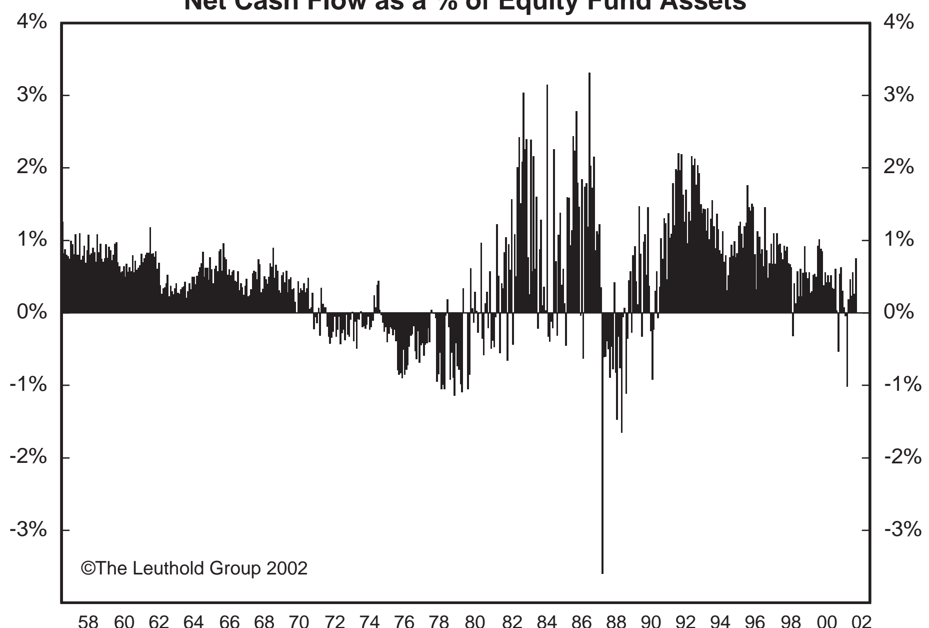
Solid investment results were achieved in the first calendar quarter of 2002 even though fundamentals remained weak in many sectors. Client portfolios exceeded the benchmarks, but we can assure you that your research analysts are not complacent. Our eyes are fixed on the future and the many pitfalls that are present in the equity markets. High valuations continue to be our overriding concern. These concerns were articulated in last quarter's letter and we will not dwell upon them further, other than to point out that a number of equity sectors advanced in the March quarter despite starting the year at historically elevated valuation levels. The economically sensitive sectors were particularly strong, as investors decided the recession was over and that strong growth lay ahead. We recognize that there are some signs of better economic activity, including a widely watched manufacturing index that advanced for the second straight month, but we are concerned that most Wall Street strategists and economists have already jumped on the recovery bandwagon. Any time there is an overwhelming consensus of opinion, it makes us just a little more cautious. After a period of inventory liquidation, it is common to see some replenishment, creating the feel of a recovery. It would not be surprising to then slip into a so-called "double dip recession." We are not making this economic call; we are simply observing that many difficult conditions still exist. The escalating violence in the Middle East is additional cause for concern.

The unusual behavior and performance of the consumer over the past 12-18 months is worth noting. Unlike past recessions, consumers have continued to spend relatively freely. Home prices have escalated at record levels and new and existing home sales have been very strong. Big-ticket consumer durables have been much stronger than expected, as have been other consumer related purchases. Record debt has been layered on to help fund these purchases. The typical pattern in a recession is the consumer gets religion, then re-liquefies his balance sheet, which provides the juice for the next up-cycle. This cycle's unemployment rate ostensibly topped out at 5.8%, not much higher than before the recession, so the normal pattern of a strong employment rebound driving higher spending will also likely be absent in this cycle. Consumer-investor behavior has also been highly unusual. In the aftermath of a typical bear market, the public usually becomes disillusioned with equities and fund flows run negative. As the accompanying chart depicts, investors have yawned at this bear market. With the possible exception of telecom and some technology-related sectors, we have not seen the ugly phase of a typical bear market.



With that less than positive preamble, we would like remind our long-term clients that our outlook is usually inversely proportional to valuations. When stocks are cheap, we are more willing to look through various concerns. When equities are generally rich, like today, we become even more risk sensitive. This approach has served us well for over twenty years.

Following are some of the investments in your portfolio and our reasons for holding them.

Parametric Technology Corporation

Parametric Technology was introduced to you in our October letter. Normally we would not feature it again so soon, but we thought it provided good insight into our investment process. Recall that Parametric is the leading provider of mechanical design and collaboration software and service. The Company has over 33,000 installations, $800 million in revenue and a strong service and maintenance base that provides recurring revenue. Parametric has no debt and over $230 million in cash.

After a fast start in the December quarter, the stock retreated over 20% in the March quarter in response to an announced earnings miss, and now is just slightly in the black from a performance standpoint. We recently bought more shares because we felt the investment thesis was still sound and that the long-term outlook remained positive. Early in the quarter, two of our analysts spent half a day with a local Fortune 400 manufacturer, visiting with users of Parametric software and their supervisors. This exercise reinforced our belief in the franchise value of the Company. Later in the quarter one analyst spent a day in Boston at a company-sponsored analyst meeting. There he was able to better understand the new product pipeline as well as to confirm the Company's strategic direction.

The earnings miss has to be viewed in the context of the economy and the environment for technology and industrial spending. The industrial and software markets have been very weak and many other companies are reporting delays or cancellations in orders. We recognized that a rebound in fundamentals might not happen right away. Buying the stock at an attractive valuation gave us a margin of safety. Six months later the story remains the same.

ABM Industries Inc.

ABM is one of the largest facility service contractors, providing janitorial, air conditioning, elevator, engineering, lighting, parking and security services to thousands of commercial customers across North America. Although these may seem like mundane businesses, the Company has compiled a long history of consistent sales, earnings and dividends. We like companies that do the dirty work! The fundamental business model at ABM is attractive because the revenues are fairly predictable, it is not capital intensive, and is easy to understand. We see the franchise value building over time as companies outsource these services to this branded player. Over time, the Company will offer a package of services across a wide spectrum of customers. This should prove beneficial to margins.

An opportunity to purchase ABM resulted from the tragic events of September 11. The World Trade Center was ABM's largest account, generating nearly $65 million in revenue (3.3% of revenue) and $10 million of gross profit. The stock dropped significantly and also reacted negatively to an increase in insurance reserves. While terribly unfortunate, these events were certainly not catastrophic to ABM. Our analysis of the insurance issues and the Company's ability to eventually replace the World Trade Center revenue led us to conclude that ABM would rebound. The Company continues to have a rock-solid balance sheet and a positive long-term outlook.

Allete Inc.

Allete is a diversified company that we recently purchased at an attractive discount to intrinsic value. The Company is refocusing its core operations around its utility and auto auction businesses as the board of directors replaced the CEO who was the chief architect of the prior diversification effort. The businesses to be sold are water and wastewater utilities in Florida, Georgia and North Carolina, and various residential real estate holdings in Florida. We were attracted to the two core businesses, as they are solid operations with good cash flow characteristics. The main utility, Minnesota Power, is well run and appears to be positioned nicely for future competition in the upper Midwest as it charges among the lowest power rates in the Country. The auto auction business, ADESA, is the second largest auction house in the US and the largest in Canada.

Upon the completion of the water utility sales in Florida, approximately 60% of the earnings will come from auto auctions. Auto auctions have taken market share from other sources of used cars from an auto dealer's perspective — such as trade-ins, wholesalers, other auto dealers and street purchases. Auto dealers have also been taking market share from private individual transactions — due primarily to financing and warranty issues. Additionally, used car sales have been shown to be remarkably recession-resistant when compared to their new car sales counterpart. We found the valuation, at 10 times 2002 earnings, attractive for the utility and considerably undervalued for the auction business. We also liked the fact that the 4.4% dividend yield was supported by a reasonable 45% payout ratio, resulting in retained earnings adequate to grow the business.

Other

You may have noticed a couple of old soldiers missing from your portfolio: Sungard Data Systems and Big Lots Inc. Sungard was held for eleven of the past twelve years. It has been and remains an excellent company with a first class management team. We felt the current valuation as well as the big market capitalization warranted our move to the sidelines. Big Lots was sold due to our determination that they would not be able to regain a respectable competitive edge in discount retailing.

Thank you for your support of Fiduciary Management, Inc.