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INVESTMENT STRATEGY OUTLOOK

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Enron - WorldCom - Tyco - Adelphia - XEROX - Global Crossing - Arthur Andersen - Holy moly, not Martha Stewart too! What's going on here?!

The financial landscape is littered with fallen corporate angels of late, relating not so much to the outlandish and egregious valuations in the technology and telecom arena we've discussed with you in the past two years, but rather, to outright corporate and accounting fraud. Over the past 24 months, we've discussed almost ad nauseam that the market had placed valuations on certain industries and individual securities, which we deemed to be unrealistic and unsustainable. Many of those companies are now defunct. The issue that has come to the forefront of investors' minds in the last six months is that of the trust that investors can place in the numbers that companies report. The veracity of the reported numbers forms the bedrock for our capitalist system. Any hint that these numbers are not as they appear on the surface will - and clearly has - caused major financial tremors.

There is the beginning of a groundswell of opinion that change is in order, and most assuredly, there will follow action to address these transgressions from quarters such as the Securities and Exchange Commission, Congress and FASB, the accounting oversight body. On the whole, efforts by these groups will help restore faith in our system. Perhaps a more immediate aid will come from corporate boards and chieftains that recognize the game has changed, causing them to behave in a more professional and ethical manner. It may take a few jail sentences to accelerate the process. We are reminded of a quote from Voltaire, the eighteenth century French philosopher, commenting on transgressions in the admiralty, "It's good to hang an admiral from time to time, to encourage the others to act accordingly."

We hasten to add, however, that even as we read almost daily of flagrant corporate greed and that over 150 companies restated their earnings in each of the last three years, this still represents <u>less than one percent</u> of all publicly-traded companies. By and large, most companies and corporate officers do fulfill the duties for which they are hired, and do heed and respect the trust placed in them by shareholders. At Fiduciary Management, the quality of our companies' management teams has always been one of the cornerstones of our investment process.

The second quarter was difficult for most investors, and we were not spared. However, our persistent application of a sound philosophy and our constant focus on valuations have resulted in strong relative performance in these difficult times, and our equity portfolios have now outperformed most broad equity indices over 1, 3, 5 and 10 year periods ended June 30.

There are two issues that we would like to briefly address: our oversight of options and corporate governance of the portfolio companies; and the quality of earnings these firms report.

With regard to the former, we have always closely monitored option programs. With few exceptions, we have voted against option grants that dilute existing shareholders by more than 1-2% per annum. This has been unpopular with many management teams and has resulted in

some unpleasant skirmishes. Since we are invested along with you, these are fights with a personal interest. We don't like dilution! Over the past half-decade we have turned decidedly negative on most option programs. While we continue to vote yes on "reasonable" option packages, we favor and encourage direct stock ownership. Traditional stock options carry no risk for management. It is a one-way street to increase compensation, sometimes to outlandish proportions. It encourages risky and short-term behavior, both anathema to long term investment results. Only through direct stock ownership is management truly aligned with shareholders.

Increasingly we are observing other investment advisors taking a stand on options and other corporate governance issues. We see more vigilance with respect to "hidden" compensation arrangements and board independence. Relative to most investment managers, we can happily report that most of our companies do not have the aforementioned issues. Part of our investment philosophy is to seek managements with good reputations that promulgate sound corporate governance policies.

The second area where investors are concerned, and it is related to the first, is the quality of earnings. It is interesting to note that until the last quarter, IBM managed to meet or "beat" the consensus estimate, usually by that magical $0.01 per share, for sixteen straight quarters. This was accomplished at a time when sales were flat to up slightly. Aggressive assumptions on service contracts, pension gains, gains on sales of assets and other nonoperating events helped them achieve these results. Clearly these earnings were "managed." The sharp decline in IBM's stock recently may be reflecting some of the building skepticism about the quality of their earnings.

As mentioned above, we fully expect to see a groundswell of legislation and additional oversight of accountants as well as laws and regulations to tighten accounting standards. We have always subscribed to the belief, however, that in a relatively free market, the system tends to self-correct. Indeed, we are already beginning to see that. Many of you may have read of the recent confrontation between General Electric and Pimco's Bill Gross, one of America's most prominent and successful long term bond investors, wherein he questioned the veracity of some of GE's accounting practices and statements. The upshot of that rather vocal teleconference and its widely disseminated publication, was a significant spike up in GE's term borrowing costs. That got GE's attention! The market can and will police itself, and we believe we are beginning to see it.

Interestingly, we view very positively Standard & Poor's new "core" earnings proclamation. S&P's core earnings will include many of the items that some CEO's and Wall Street cheerleaders would rather exclude from their pro forma calculations. At Fiduciary Management, we have defined this proliferation of pro forma earnings from Wall Street as "the earnings the corporations want to have, adjusting for the things they wish to forget." In most cases, pro forma earnings bear little relevance to an accurate reflection of the underlying corporate operation. The new S&P core earnings will include in expenses stock option grants, restructuring charges, as well as the write-down of the value of certain assets, pension costs and certain research and development items purchased in an acquisition. At the same time, the S&P will exclude from income items it doesn't consider as coming from the company's operating business, to include gains on its pension plan, asset sales, hedging operations, or non-operating gains and losses.

Will this be significant, and will it result in a valuation change for the S&P? We think that the answer, on both counts, is definitely, "Yes." To get a glimpse of that, one only needs to look at General Electric earnings for the last year, to see how those earnings stack up with S&P's new "core earnings" definition.

Restatement of GE's 2002 Earnings to Comply with S&P's New Core Earnings

2001 Earnings Per Share as Reported	**$1.42**
Changes from Asset Sales	(0.06)
Stock Option Expense	(0.04)
Less Pension Gains	(0.19)
Other Adjustments	(0.02)
GE's Core Earnings, according to S&P Guidance	**$1.11**

This effectively reduces GE's reported 2001 earnings by almost 22%, but more importantly, it takes GE's valuation from roughly 21x trailing 12-months earnings to almost 27.1x earnings which makes GE 29% more expensive. We would argue that this is a truer reflection of GE's operating earnings. With GE's stock cut nearly in half over the past year, the market may be beginning to recognize this.

Over time we think that investors will begin to gravitate towards the type of adjustments seen above. A clearer picture of what companies are truly earning will take shape. The upshot for the general market (S&P 500), is likely to be an increase in the P/E ratio, from roughly 23-25x forward 12-months earnings to something closer to 30x - or almost 20% more expensive. Again, as we've discussed in many of our past letters, the market, even before these adjustments, was not cheap, and certainly after these adjustments will be even less so. Keep in mind that over the past 100 years, the average multiple for the S&P has been 14.5x earnings.

What many investors have been going through is painful, and in some cases will change their lifestyles for years to come. The euphoria of the good times blinded many to the reality of excess valuations, and investors could not, or would not, believe what the unwinding of the excesses would entail. Overall, however, the self-cleansing process is healthy. Alan Greenspan observed back in 1996 that "irrational exuberance has unduly escalated asset values." With the market decline and stock implosion that we've witnessed in the past 24 months, we may revert to a mood of "irrational depression." That, however, will create the opportunities, and that is what we look forward to as value investors. As Warren Buffett has referenced in the past, Wall Street is one of the few places that can run a 30-40% off sale, yet buyers flee the store. Current valuation levels would suggest that we may not be there yet, but we sense a movement toward the doors and some good values beginning to surface.

As always, we thank you for investing alongside your management team here at Fiduciary Management, Inc., and we remain optimistic about the long-term future.