Fiduciary
Management
Inc.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK

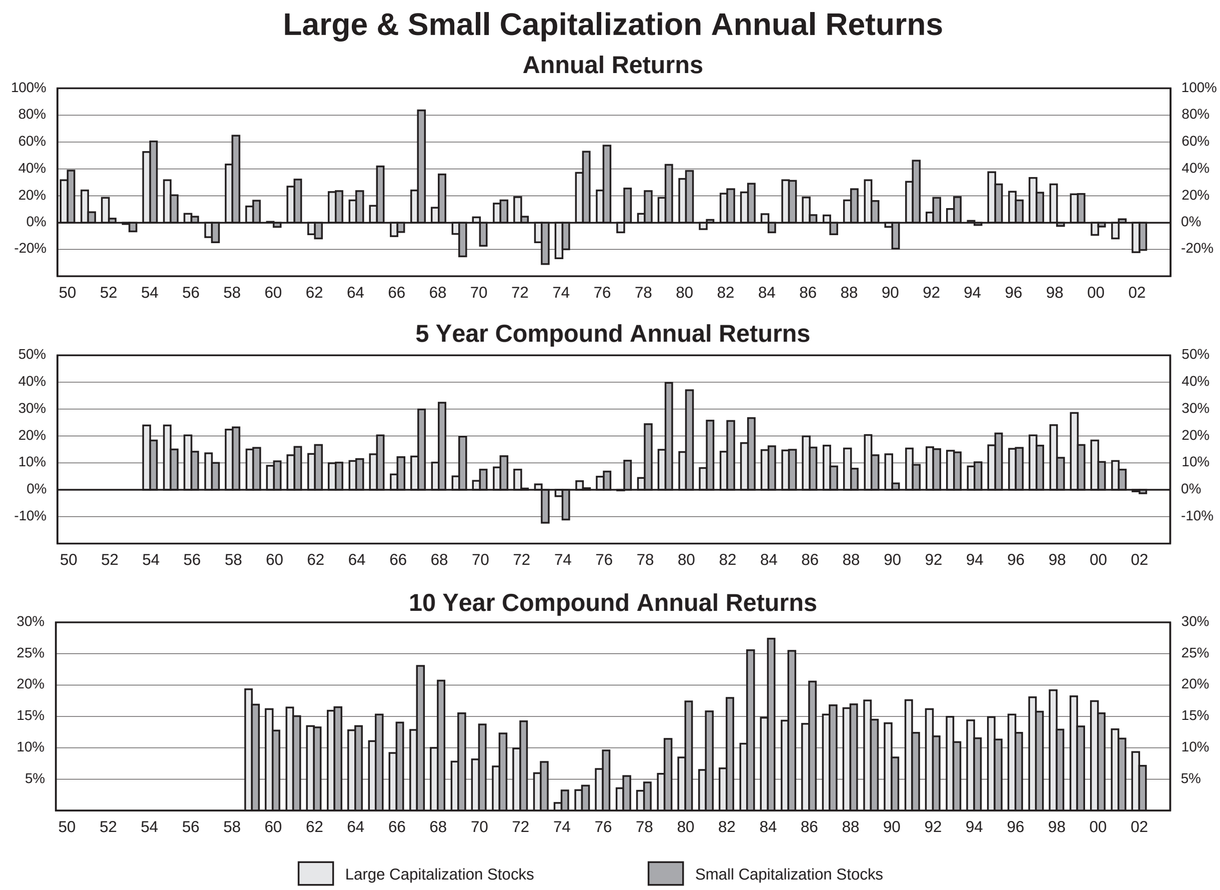
April 2003

During the first quarter of 2003, our equity portfolios declined roughly in line with the 4.8% decline in the Russell 2000. Other indices faired modestly better, with the Standard & Poor's 500 down 3.2% and the Nasdaq up 0.4%. Large cap technology stocks, which have taken the brunt of the market decline, and others traditionally perceived as growth stocks, did slightly better than value stocks in the period. Like most equity-related investments, our stocks were affected by worries about the war in Iraq, the sluggish economy and higher unemployment levels. Market action since the recent “war rally” reinforces our feelings that “it’s the economy” and that a sustainable advance is not likely until we can see, or at least anticipate, improvement in the economy.

Recent economic news has not been particularly inspiring. The jobless number jumped significantly in February and real household weekly earnings fell, too. The National Association of Purchasing Management-Chicago reported the factory index fell to 48.4 in March from 54.9 in February. Consumer confidence is low and capital spending plans remain subdued. The automotive sector has also weakened and housing, while remarkably resilient, remains on the watch list.

While we all yearn for a better economic backdrop, it is important to remember that both economic and investment sentiment are cyclical in nature. In the late 1990’s some believed we were in a “Goldilocks” economy. The stock market sold at unprecedented valuations. Behind this porridge-is-just-right perception was a litany of negatives that only came to be recognized after the fact. Human nature being what it is, the same phenomenon could occur in reverse. The popular press today is quite negative. Yet behind the scenes, inefficiency is being addressed, excess capacity is being reduced and latent demand is building. These things may take longer to become apparent than short-term investors or economists hope, but the probability of their eventual occurrence is quite high.

We’ve updated three charts that we haven’t used in a number of years. These charts go back to the 1950s and show the one-, five- and ten-year annual returns for small and large cap stocks. One can readily see the volatility of one-year returns compared to the longer time periods. These charts clearly demonstrate the importance of keeping a long-term focus. The charts also show long periods of outperformance by either small or large cap stocks. Small stocks did much better than large caps for nearly 20 years beginning in the mid-1960’s. Large caps returned the favor for most of the next 15 years or so. Over the last couple of years small stocks have once again done better. We believe small caps have the fundamental and valuation characteristics that could lead to further outperformance in the years to come.



Sources: Standard & Poor's Corporation; Frank Russell Company; Financial Analysts Research Foundation

While the investment landscape today is filled with large macroeconomic and geopolitical themes, we constantly remind ourselves that money is typically made with small ideas; in other words, by investing one stock at a time. Below we highlight four recent additions to the portfolio.

TUESDAY MORNING

Description:

Tuesday Morning is a leading closeout retailer of upscale home furnishings, gifts, and related items. The stores carry first quality brand name merchandise that is commonly purchased from suppliers or other retailers (e.g. closeouts) and sold in their stores at 50-80% of their original retail value. The first Tuesday Morning store opened in 1974, and at the end of 2002, the company operated 515 stores in 42 states. The company is best known for its unique sales events (beginning on Tuesday mornings!), which occur 8-10 times per year and last between 3-5 weeks.

We have known Tuesday Morning for many years as we have followed other companies in the discount retail group for several years including Big Lots, Family Dollar Stores and Dollar General. The company experienced temporary distribution problems in 2001-2002 that caused the stock to fall from a high of $29.00 per share to $15.00 (it is currently $20.00).

Good Business:

- High return-on-invested-capital (ROIC) and a low-cost operating model are positive attributes; Tuesday Morning generates an ROIC of 20% and operating margins of 11%. Both of these are high relative to other retailers. The store level ROIC approaches 50%.
- Tuesday Morning has a unique marketing and merchandising strategy. The company has a loyal customer base (6.5 million-person mailing list) that enjoys the "treasure hunt" experience of finding a great bargain. The average customer is between 35-54 years old and has a median household income of $65,000.
- The company stands to benefit from the increasing availability of closeout merchandise from retailers and catalog companies who need to clear inventory. The high ROIC and strong cash flow generation should allow Tuesday Morning to grow organically and increase square footage by 10% per year.

Attractive Valuation:

- The company trades at a significant discount to other growing retailers. Comparable companies trade in excess of 20x earnings.
- Tuesday Morning trades at 15.7x 2003 earnings per share (EPS) of $1.27. Historically, when fundamentals have been strong, the company has sold for 25-30x earnings. Now that the company has corrected supply chain and inventory issues, they should be able to expand and grow their top and bottom line by 12-15% per year.
- The company's balance sheet is improving, as debt is down to $73 million. Management has indicated that debt could be totally eliminated in the next two to three years through free cash flow generation.

Management Assessment:

- An experienced management team leads Tuesday Morning. Chief Executive Officer, Kathleen Mason, has extensive experience in the retail closeout industry including employment at TJ Maxx and Filene's Basement. She is focused on improving operating margins and inventory turns while tweaking store execution.
- Chief Financial Officer, Mark Jarvis, has been with the company for over 10 years with prior experience at Pier1.
- Chairman, Benjamin Chereskin, is a managing director at Madison Dearborn Partners, a private equity firm that owns 50% of the shares.

ENGELHARD CORPORATION

Description:

Engelhard Corporation is the world's leading chemicals company specializing in surface chemistry and materials science. This means that the company mechanically and chemically manipulates elements like platinum and palladium and minerals like zeolite to produce a wide range of catalysts with important business uses. These uses include the abatement of carbon monoxide, oxides of nitrogen, and hydrocarbon emissions from gasoline, diesel, and alternate-fueled vehicles; the removal of odors, fumes, and pollutants associated with a variety of process industries; and making processes safer, more productive, and efficient. Engelhard also sells a variety of performance chemicals to the paper, coatings, plastics, cosmetics and construction industries.

Approximately 35% of Engelhard's business is tied to the automobile market worldwide. Concern about new competition in the auto catalyst market has affected the stock. Their auto exposure has been shrinking as the company has expanded into many other markets including diesel, co-generation and gas turbine power generation, household appliances, and lawn and garden power tools. A major driver to the industry's growth rate, as well as that of Engelhard, is the tightening of environmental standards in developed countries and the initiation of standards in the developing regions of the world.

Good Business:

- Customers seek to do business with Engelhard on a repeat basis. The company is either number one or number two in its key markets.
- Investment in Research & Development (R&D) and the strong working relationships with customers make it more difficult for new competitors to enter the company's markets. New products (those introduced within the last two years) typically account for one-quarter of sales.
- Engelhard has consistently generated ROIC between 15-20%. It is abundantly clear that the management team is focused on the returns on their business units rather than growth for its own sake.
- Once catalysts are specified into processes, the revenue becomes recurring in nature.

Attractive Valuation:

- At $22.41 per share, the stock trades at 12.8x the 2003 estimate of $1.75, and an enterprise value/trailing 12 months EBITDA (earnings before interest, taxes, depreciation and amortization) multiple of 7.3x, an attractive valuation given this company's ROIC.
- The price/book ratio is 2.7x, near the low end of its 5- and 10-year ranges. The stock is off one-third from its 52-week high and is trading near its 52-week low.
- The company has a solid balance sheet with a debt-to-capital ratio of 38% and an interest coverage ratio of 15x.

Management Assessment:

- Chief Executive Officer, Barry Perry, joined the company in 1997 as Chief Operating Officer and became President in 2001. His background includes 20 years in senior management at General Electric.
- The previous CEO had a reputation of being overly optimistic, which led to repeated disappointments on Wall Street. Perry has worked hard to restore credibility.
- Chief Financial Officer, Michael Sperduto, joined Engelhard in 1983 and has held numerous financial positions within the company. He became CFO in 2001. The company has a solid long-term financial record.
- Management will also be careful regarding acquisitions, purchasing niche operators that typically have $30-80 million in revenues, versus making major acquisitions. In other words, these people do not appear to be empire builders.

SCHOLASTIC CORPORATION

Description:

Scholastic is a leading publisher and distributor of children's books, classroom magazines and other educational products. The company's core franchise is its Book Clubs and Book Fairs, which have large market shares in their respective niches and are very profitable businesses. Additionally, Scholastic is publisher of retail Trade children books, including the popular Harry Potter book series. Franchise Trade properties besides Harry Potter include: Clifford, I Spy, The Magic School Bus, Dear America, Goosebumps, Baby Sitter's Club and Captain Underpants.

Like many booksellers, Scholastic had a difficult holiday selling season in the Trade business. Book clubs had a rare miss, too. The combination of this one-two punch dropped the stock. We anticipate a strong rebound in the Trade business and plans are in place to return the Clubs business back to solid growth, although the success of these endeavors won't be apparent until the fall. The company appears to be a classic case of a good business that is temporarily down.

Good Business:

- A good business generally maintains a reasonably predictable core business; the Book Club and Book Fairs operations have higher-than-average predictability, good margins and very high market shares. The company's Trade business can be somewhat volatile based on the titles at any given time.
- Scholastic has a durable franchise. It is a trusted name and has been around for decades. The company has a very solid back-list of children's book titles, which should provide an annuity-like core business in the Trade area.
- The ROIC is greater than its weighted average cost of capital. Additionally, measures being taken by management in this tough economic environment should increase returns.
- Revenue growth at Scholastic is expected to accelerate over the next twelve months and should be in the 7-10% range over the next three years based on positive demographics, increasing market share, strong back-list titles and new teacher penetration. Earnings per share growth should exceed revenue growth by 3-4% due to operating leverage.

Attractive Valuation:

- The stock currently trades at approximately 13x this May's EPS of $2.00 and 11.2x the $2.40 EPS estimated for next May. Additionally, the enterprise value of the company is trading at less than 7.5x EBITDA.
- Based on historical takeovers, mergers and spin-offs, the intrinsic value of the company is at least 40% higher than the stock price.

Management Assessment:

- Dick Robinson is Scholastic's Chairman, President and Chief Executive Officer as well as the company's largest individual shareholder. He has a direct ownership of approximately 9% and 51% of the company's Class A shares.

- Management has a mixed record of delivering value. We are willing to look through our reservations given the current depressed valuation and the recovery plans they have articulated.

IDEX CORPORATION

Description:

IDEX is a manufacturer and distributor of a broad range of engineered industrial products, with $740 million in sales, to a diversified worldwide customer base. Roughly 42% of revenues are international. IDEX consists of three reportable business segments: Pump Products Group, Dispensing Equipment Group, and Other Engineered Products Group.

The Pump Products Group accounted for 58% of sales and 62% of operating profits in 2002. This business segment produces a wide variety of pumps, compressors, flow meters, and related controls for the movement of liquids, air, and gases. The devices and equipment produced by this group are used by such industries as chemical processing, machinery, water treatment, medical equipment, liquid petroleum distribution, oil and refining, food and beverage, biotech, and drug processing.

The Dispensing Equipment Group accounted for 19% of sales and 16% of operating profits in 2002. This business segment produces highly engineered equipment for dispensing, metering, and mixing colorants, paints, inks, and dyes; industrial and automotive refinishing equipment; and centralized lubrication systems for the precise lubrication of machinery and transportation equipment. This equipment is used in retail and commercial industries.

The Other Engineered Products Group accounted for 23% of sales and 22% of operating profits in 2002. This business segment produces firefighting pumps, rescue tools, and other components and systems for the fire and rescue industry, and engineered banding and clamping devices used in industrial and commercial applications.

Like a great many U.S. based manufacturers, IDEX has suffered in recent years by reduced demand and foreign competition. They continue to address these challenges by aggressively implementing best practices and process reengineering. IDEX has also dramatically increased its global sourcing capabilities.

Good Business:

- IDEX is either the number one or number two player in durable, tough-to-replicate niche markets. The company garners a weighted average market share of 40%.
- The company is a strong generator of free cash. Last year, IDEX generated nearly $100 million in free cash, or $3.00 per share.
- IDEX will be a direct beneficiary of a rebound in the industrial economy. Approximately 45% of orders ship in the same month, so an industrial economic revival will be felt immediately.
- ROIC, though currently depressed, is higher than comparable companies and full-cycle ROIC is comfortably higher than their cost of capital.

Attractive Valuation:

- Although earnings have recently been weak, the valuation is still attractive at less than 15x the $2.00 estimate for 2003 earnings. The enterprise value-to-EBITDA ratio is 8.5.
- Looking out a few years, we think the company can earn $3.00 or more per share and the stock could trade for $45. The biggest risk in the story is a protracted industrial downturn.
- The company has a solid balance sheet with a debt-to-capital ratio of 32% and an interest coverage ratio of 7.9x.

Management Assessment:

- Chairman, President, and Chief Executive Officer Dennis Williams joined IDEX in May 2000 from General Electric, at which time he instituted several "GE-type" initiatives at IDEX, including Six Sigma, Kaizen & Lean, and Global Sourcing.
- Chief Financial Officer Wayne Sayatovic has been with the firm for 31 years. There have been no accounting issues to reflect poorly on their financial controls.
- The track record of the senior operating executives at IDEX is very good.

Despite the unusually volatile stock market and uncertain economic backdrop, we are optimistic about the long-term outlook for these four new ideas as well as the rest of the portfolio.

And finally, FMI has reached a milestone of sorts, our first retirement party. Gary Wagner, who has been our associate, partner and friend for nineteen years, will be retiring as of June 30. Gary's contributions to the growth and reputation of FMI have been invaluable, and all of us wish him many wonderful years of retirement.

Thank you for your continued confidence in Fiduciary Management, Inc.