Fiduciary Management Inc.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK

January 2004

Investment Performance Overview

While equity performance in excess of 20% is gratifying in an absolute sense, this performance lagged all the small and midcap benchmarks for the calendar year ended December 31, 2003. In our letter of October 2003, we discussed many of the factors that drove performance in the Russell 2000 (and other small and midcap benchmarks) in 2003. Briefly, the biggest drivers of performance in the Russell 2000 were low-priced and typically low-quality (negative net income, poor balance sheets, etc.) companies. Additionally, cyclical stocks advanced dramatically, especially in the technology arena. This one-two combination, paired with a return to a momentum style of investing, resulted in spectacular results for the Russell 2000, as it advanced over 45%. The discrepancy in performance in the Index versus our portfolio brings two thoughts to mind. First, the market's short-term moves are inherently unpredictable. We thought the Russell 2000 was somewhat overpriced at the start of 2003. Now we think it is significantly overvalued. Second, there have often been wide gaps in annual performance between the Russell 2000 and our client portfolios. Since we do not manage to an index, this is to be expected. In years when the market craves "beta", i.e., stocks that swing much greater than the market, animal spirits prevail and our conservatively postured portfolio typically trails.

This same dynamic was visible in the bond market. Whereas the 10-year U.S. Treasury total return for 2003 was 1.27%, the corporate high yield ("junk bond") total return was 29%. Without exception, the lower the bond rating, the higher the return. Companies on the verge of bankruptcy experienced spectacular returns in both the bond and equity markets.

We do not want to imply that 2003 was without mistakes. In hindsight, it is clear that the economic rebound was stronger than we had anticipated, and that fact drove cyclical stocks much higher than expected. We did not have enough exposure here and we compounded this by harvesting profits in some of these stocks too early. Financial sector equities also had a big move in 2003 and for a variety of reasons we were, and remain, underweighted here. The financials we did own, primarily in the insurance area, underperformed. We didn't get anything right here, but nevertheless still like our companies for the long pull. We continue to have major concerns about a number of the financial related sectors that enjoyed outsized returns in 2003, so we are content to be underweighted today. Additionally, we could have done a better job of finding technology beneficiaries that might have participated in the rapid run-up of this sector.

Despite our shortcomings, our disciplines have served us well over the years. FMI remains focused on investing for a rolling 3- to 5-year time frame. Incidentally, Fiduciary Management small to midcap portfolios have significantly exceeded the Russell 2000 historically, on a cumulative basis.

Stock Market Overview

Although we are fundamental, bottom-up investors, we operate with some general notions about the stock market environment. In short, we view the broad market as overvalued. On just about any valuation measure one can use, this market is expensive. Absent the chaotic spike in 1998-1999, year-end 2003 valuations for the Russell 2000 and the S&P 500 are near 75-year highs.

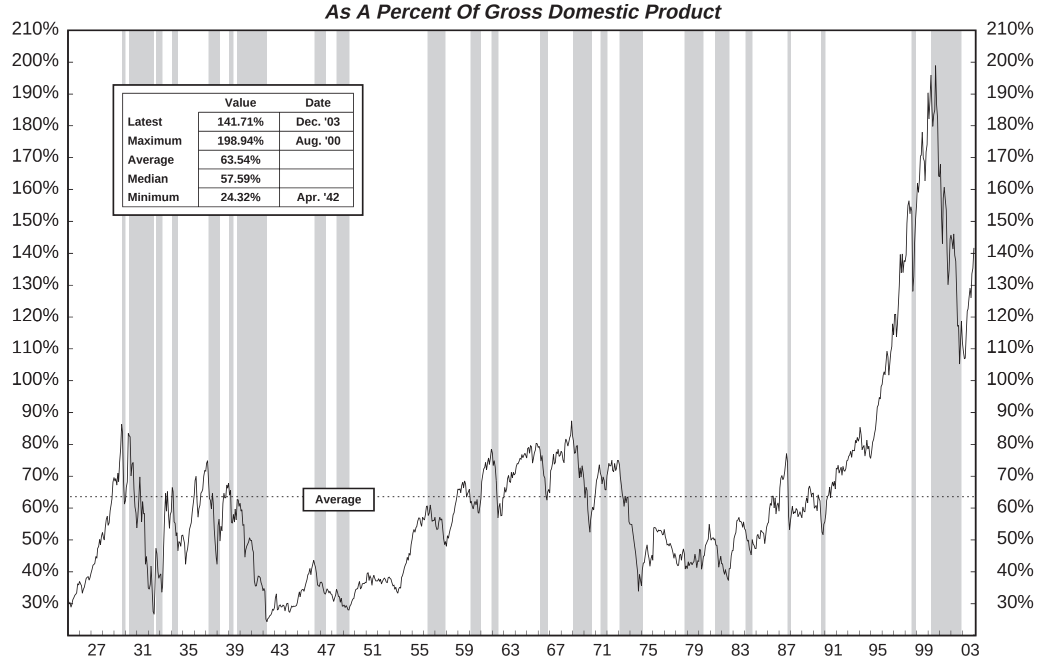
Wall Street is interesting in the way it contorts to fit the prevailing wisdom, which is that the bear market is over, a new bull market has begun, interest rates will remain low, economic growth will remain high, and valuations are not terribly high -- if we look forward to 2005 and ignore option dilution, pension contributions and write-offs. Just click your heels three times and say, “There’s no place like home, Dorothy!” Indeed, the economy has been improving and several statistics, including the December ISM (Institute for Supply Management) Index reading of 66, point to better conditions. Still, many prognosticators live in ignominy for their interest rate and economic predictions, and over the years we have cataloged well the inability of analysts to predict earnings, at least over short time frames. As educated guessers, the best we can hope for is to get the general direction correct and make some assessment about whether the absolute level (interest rates, economic growth, earnings) is reasonable. *The only piece of the puzzle that is somewhat knowable is current valuation.* We can measure price or enterprise value (market cap plus net debt) relative to earnings, revenue, cash flow, assets or book value. One can argue about the current and historic quality of each of these denominators, but it is unlikely that the conclusion (that stocks are expensive) would change.

Think about it this way. Imagine that each year over the past 75 years is represented by a dot. This dot is the market’s valuation, or as Chart 1 depicts, the total market value of equities relative to the gross domestic product. This is roughly akin to the price-to-sales ratio. Every dot embodies that year’s expectations for the future profitability and growth of the equity markets. The dots in the 1930s reflect fear about jobs, profits and the viability of capitalism. The 1940s dots anticipate wartime difficulties and post war adjustments. The 1950s and 1960s dots largely reflect more optimism, the burgeoning of industrial and technology industries and a benign interest rate environment. The 1970s and early 1980s dots reflect pessimism about Vietnam, inflation and the competitiveness of industrial America. The 1990s dots, particularly in the second half of the decade, reflect the magic of telecom and technology and the feeling that we were in “a new world order.” Today’s dot, still near the top, reflects a great deal of optimism about future earnings growth, with little room for negatives. Where would we put today’s dot? In a word, lower.

Chart 1

The Market Value of Equities

As A Percent Of Gross Domestic Product



Shaded areas represent Bear Markets.

The Market Value of Equities includes the market value of the New York, American and Nasdaq Stock Exchanges.

Sources: The New York Stock Exchange; The American Stock Exchange; The National Association of Securities Dealers; The Bureau of Economic Analysis

Copyright © 2004 Crandall, Pierce & Company • All rights reserved.

China and India

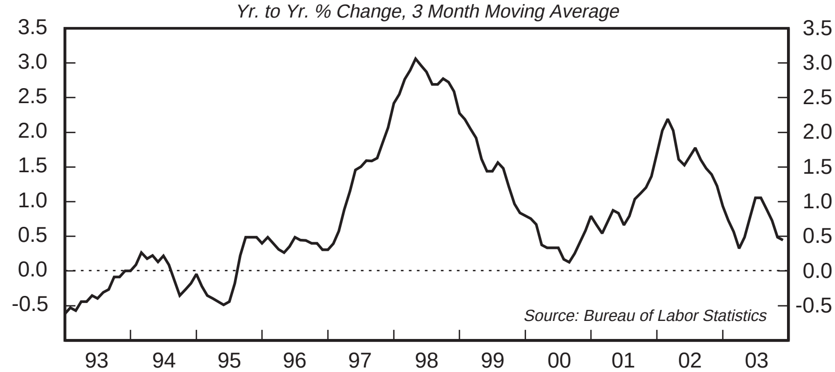
Most equity investors are optimists, and although we would also put ourselves in that camp, our first collective investment mindset is to be realists. As we look at America and the world today, we see many reasons to be optimistic. Near the top of this list is the rapid industrialization and economic growth of China and India, the two most populous countries in the world. China's GDP has grown at a rate triple that of the U.S. over the past two decades, and in a few years will likely be the third largest economy in the world. China has some huge issues to contend with, including a creaky banking system and several ills that surround the vestiges of a planned economy. Undoubtedly, they will have economic and financial stumbles as well as political problems in coming years, but it seems a reasonable bet that China will achieve well above average growth. Similarly, India has made remarkable progress over the past decade. Both countries are investing heavily in infrastructure and education and have a veritable limitless supply of cheap labor. American businesses are increasingly intertwined in the fortunes of these two countries. *While there are important and sometimes severe ramifications to U.S. companies and citizens, the net effect of the rapid growth of China and India is very positive for world economic development and stability. That is a positive for the U.S.*

The sunny view that Wall Street paints must be tempered by important realities. U.S. wages, wage growth, employment and employment growth have been, and will continue to be, affected by the powerful forces at work in China, India and other developing nations. An estimated 25-30 million people left rural China last year to work in cities, primarily in manufacturing but also in software and other industries. India's software and business service prowess has been well documented. It is likely that these forces have had, and may continue to have, a negative impact on wages and employment in the U.S. There is little wonder that two years into this recovery (officially) we have yet to see meaningful employment growth. Wage growth remains stagnant (see Chart 2) and we would not be surprised to see these conditions continue, perhaps for an extended period of time. A strong cyclical U.S. economic rebound may mitigate this effect over the short term.

Chart 2

Real Hourly Wages

Yr. to Yr. % Change, 3 Month Moving Average



There are at least two differentiating factors to this wage disintermediation versus historical ones. First, unlike Brazil or Mexico, there is effectively an unlimited supply of workers with respect to China and India. Out of 1.3 billion people, China has 800 million people who live in rural areas, most being subsistence farmers. At current migration rates, adjusting for modern agricultural methods, there is at least a twenty-year supply of labor for the industrializing cities. India reveals a similar picture. The sobering thought, if you are an American, is that these workers are happy to work six or seven days a week for ten or more hours and do it for 1/10 to 1/20 the U.S. wage. Now of course the all-in cost differential is not this wide due to many logistical and other inefficiencies, but many years of labor cost advantages is a safe bet. Second, unlike most previous offshore outsourcing endeavors, multinational companies appear to be moving entire Research & Development departments to China and India. Increasingly these are the places that are graduating the scientists and engineers, and multinational companies are recognizing this by moving design teams close to production. Since 1997, China has consistently graduated more engineers than Japan, Germany and the United States combined. In recent years, both China and India have approached the U.S. in terms of advanced scientific and engineering degrees. Any look around American graduate science departments will find a huge proportion of foreign students. These students are returning to their homeland in greater numbers as entrepreneurs and managers. As previously stated, this is a huge positive for the world and ultimately America, but the adjustment process could be longer and more painful than prevailing wisdom suggests.

Americans have always found a way to "out innovate" and "out entrepreneur" our competitors. This may well be the case yet again, but probably not to the extent it has been historically. If the knowledge centers are moving toward Asia, it stands to reason that more inventions and perhaps more value added will take place there. Asian societies appear to be much more dedicated to education and excellence in education, particularly in the primary grades, than is most of America. To borrow a phrase from the Chinese, "Americans love to watch TV; Chinese love to make TV." A corollary from the Indian perspective might be "Americans love to play video games, Indians love to write them."

Other Considerations

High valuations of today seem to suggest the expectation of continued positives in other areas, i.e., low interest rates, strong economic growth, low inflation, and the "world peace" sought by all Miss America candidates. These are all possible and desired, but should you bet on it? With nearly 50% of recent Treasury offerings being purchased by foreigners, should you bet that interest rates remain low even as the dollar skids? With more rapid economic growth should you bet that interest rates and inflation (of raw materials) remain in check? On the world peace front, there doesn't appear to be a threat to our military supremacy, but the so-called peace dividend may have disappeared. The theory was that in the post cold war era, tens if not hundreds of billions of dollars could be diverted from the military to other uses. With Al Qaeda, Afghanistan, Iraq and Homeland Security, it's conceivable that the peace dividend has turned into a protection tax.

Debt levels remain high across consumers, businesses and the government. Mortgage and other installment debt is at record levels, as consumers never undertook the balance sheet repair that normally takes place in weaker economic environments, witness Chart 3, which illustrates consumer installment debt. Businesses have been building some cash, but haven't reduced their debt loads significantly, as seen in Chart 4. Many have the added burden of pension and asbestos liabilities. The federal government is operating with record debt and deficit levels (see Chart 5), and state and local finances are highly strained. So, if one thinks about the source of incremental spending, it is unlikely to come from debt-financed

Chart 3

Consumer Installment Debt as a % of Real Gross Domestic Product

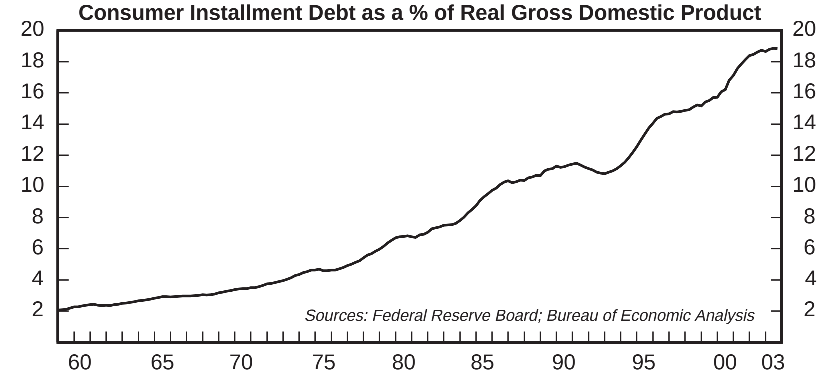
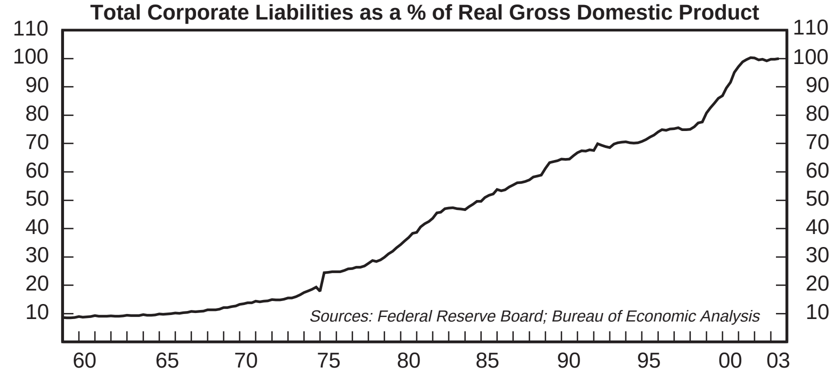


Chart 4

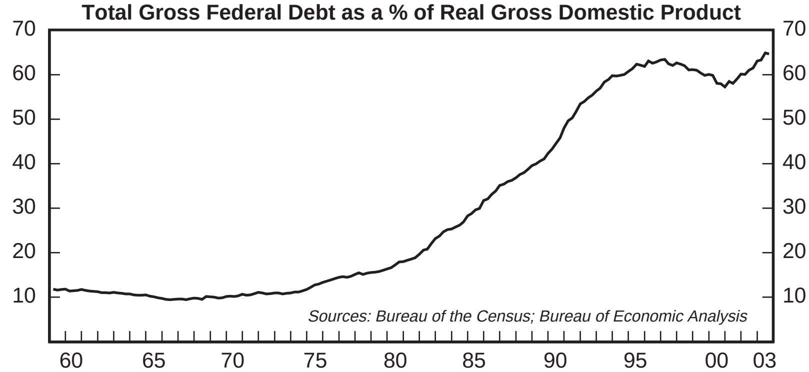
Total Corporate Liabilities as a % of Real Gross Domestic Product



activities. With U.S. capacity utilization near a twenty year low of 73%, it's difficult to envision a strong rebound in business spending. The optimists say higher employment and higher wages will save the day. The realists are less sure.

Chart 5

Total Gross Federal Debt as a % of Real Gross Domestic Product



There also appears to be a great deal of complacency with respect to the investment landscape. Most feel that since we have already experienced a correction (2000-2002), the bear market must be over. Never mind the fact that even after the correction, valuations only reached long-term median levels, at best. Today, people feel that just because the Nasdaq is 60% below its peak, it must be cheap. That's true if you consider 73 times earnings and 9 times sales as inexpensive! The Russell 2000 sports a weighted average P/E multiple of 42 and a price-to-sales ratio of 5.8. These are spectacularly high multiples.

Outlook

Our best guess is that over the next several years, events will transpire that will result in a correction in valuations. Whether we simply return to a median level or lower is unknowable. When comparing today's investment landscape to all of the historical ones we have studied, it's difficult to make the case that future growth will be significantly higher than average. Earnings growth has averaged 4-9% in nearly all rolling 10-year periods over the past 75 years. Even the vaunted 1990s saw just a 5% compound earnings growth rate, if you adjust for options. If earnings growth actually exceeds this band, interest rates and inflation would still have to stay low to avoid sub par investment returns.

Given this significant valuation risk, we remain relatively conservatively postured. The next five to ten years will almost certainly exhibit lower than average investment returns for the popular indices. We believe, however, that it is possible to make decent, if not good returns, even in a stock market that has contracting valuations. That has been the case several times in the 24-year history of Fiduciary Management, and particularly in 2000-2002.

Thank you for your support of Fiduciary Management, Inc.