Fiduciary Management Inc.
Investment Counsel

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

INVESTMENT STRATEGY OUTLOOK

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FMI portfolios showed modest gains in the September quarter but generally underperformed the popular stock market indices, particularly the benchmark Russell 2000. This has been the story all year as the market has been driven by the so-called "high beta" stocks, which typically are the most speculative. The July ISO addressed this phenomenon in some detail and there isn't much we can add to this commentary other than to remind our clients that stock prices and fundamentals can diverge widely in the short run but eventually come together. No one can predict the timing, but the notion that it is possible to ride a speculative wave and get off before the crash is dangerous. Richard Bernstein, Merrill Lynch's Chief Strategist, recently related the findings of Dr. Vernon Smith, the 2002 Nobel Prize winner in Economics. Dr. Smith is best known for his work in experimental economics related to investment bubbles. Even after experiencing a bubble (and crash) in the first round of trading, participants in his studies consistently produced another bubble (albeit smaller) and subsequent crash. When asked why they took part in the second bubble, their responses were uniform, in that they thought they could make money in the rally, yet get out in time to avoid the crash.

Since some of our clients and many consultants use the Russell 2000 as a benchmark, we thought it would be instructive to take you inside this index. As a preface, however, we hasten to state that our investment strategy is to seek durable business franchises trading at a significant discount to their intrinsic value. We broadly diversify the portfolios to gain exposure to major economic sectors and industries. We pay little attention to the Russell 2000, despite it being generally considered our benchmark. Although the cumulative 23-year return of the FMI portfolio composite vastly exceeds the Russell 2000 (2,676.4% versus 979.5%), we have lagged the benchmark by as much as 16 percentage points (1999) and have outpaced it by as many as 19 percentage points (2000). No one could accuse us of being closet indexers! So far this year FMI has been a laggard.

By way of background, the Frank Russell Company sets the Russell 2000 constituents in May of each year, with the actual switch taking place on June 30. Without getting into the nitty-gritty details, roughly speaking, the 1000 largest market capitalization stocks become the Russell 1000, and the next 2000 largest become the Russell 2000. All the Russell indices are market capitalization weighted, meaning the larger capitalization stocks carry proportionately more weight. Thus, today Gateway, the largest company in the Russell 2000 at $1.8 billion in market capitalization, has 36 times the weight of Oneida, the smallest, at approximately $50 million.

Since anyone can buy an index fund that approximately tracks the Russell 2000, what exactly do you get for your money? Following is a table outlining some relevant characteristics of the Russell 2000 at the beginning of the calendar year, and at September 30.

	P/E	EV/EBITDA*	P/B	ROIC
12/31/02	<negative>	12.2	1.7	3.5%
09/30/03	<negative>	15.0	2.3	3.5%

Source: Factset, Compustat

*EV= Enterprise Value (total equity market cap plus net debt)
EBITDA= Earnings before interest, taxes, depreciation and amortization

The cumulative trailing twelve months net income for the Russell 2000 was negative at year-end 2002 and at 9/30/03. These are GAAP (Generally Accepted Accounting Principles) reported earnings. Some analysts use "operating" earnings, which we've come to describe as "earnings before bad stuff." Even on this basis, the Russell 2000 P/E was approximately 26 at the start of the year and is currently about 33. At year-end 2002, there were 682 companies in the Russell 2000 that were losing money; today there are 523. The return on invested capital (ROIC) was a very low 3.5%, well below the true cost of capital. The irony is that the Russell 2000, when viewed as a stock, looked expensive and unappealing at the beginning of the year, yet it outperformed FMI portfolios through 9/30/03. Investors must always look into the future, and while it is conceivable that investors have correctly anticipated a dramatic rebound in the fortunes of the Russell 2000 constituents, the price of this bet today appears to be enormously high.

Your portfolio, on the other hand, trades at a much more reasonable level and has a more attractive fundamental profile. To wit, the P/E of your portfolio is 16.5 times trailing 12 months earnings. It is 7.7 times trailing EV/EBITDA and 2.0 times book value. The ROIC is 10%. Thus, despite the frustration that always comes from lagging a benchmark, even for a short period of time, there is comfort in knowing we would much rather be us, than the Russell 2000!

As is customary in our October letters, we will review a few portfolio holdings. All four of the stocks listed below were added to the portfolios this year.

ALBANY INTERNATIONAL CORPORATION

Description:
Albany International is the world's leading designer, manufacturer, and marketer of paper machine clothing (PMC) for each section of the paper machine. PMC consists of large continuous belts of custom-designed and custom-manufactured, engineered fabrics that are installed on paper machines and carry the paper stock through each stage of the paper production process. PMC is custom-designed for each user depending on the type, size, and speed of the paper machine, the machine section, the grade of paper being produced, and the quality of the pulp stock used.

Good Business:

- Albany is the global leader in PMC, a niche market. This is the result of its ongoing technological innovation and fostering of customer relationships. New products introduced within the last five years accounted for approximately 50% of sales in 2002.
- PMC is a consumable product, resulting in a stream of recurring revenues.
- Industry consolidation has resulted in capacity rationalization and improved pricing. Albany has a leaner cost structure, and capital intensity should decline next year. This positions the company for improving returns on invested capital.

Valuation:

- Albany trades at the middle of its historical valuation range on a price/book basis (2.02x) and at the upper end on a price/sales basis (1.05x). However, the stock trades at a trailing P/E multiple of 13x (low end), an EV/EBITDA multiple of 6.5x, and a free cash flow yield of 9.7% — a compelling valuation, given the investment positives.

Management:

- Frank Schmeler is Chairman and CEO of Albany. He is a solid operator who has instilled much needed financial discipline at the company. Unlike the prior two CEOs, Schmeler will not accept a dilutive transaction. Also, the company has done a great job of reducing its working capital intensity on his watch.
- Although Albany has a dual class stock structure, Standish family members no longer occupy the executive ranks.

Investment Thesis:
One of the major attractions to this company is the recurring nature of its business. Additionally, Albany has attractive return on invested capital prospects given the changed competitive landscape, declining capital intensity, leaner cost structure, and improved financial discipline. The company will be a beneficiary of a rebound in the paper industry as the economy begins to improve.

IMATION CORPORATION

Description:
Imation develops, manufactures and markets magnetic and optical-based removable data storage products through both distributors and leading OEMs. The company was formed in 1996 as a result of the spin-off of 3M's data storage and imaging systems business. Products include magnetic tape cartridges for high-end data center applications, mid-range open-system applications, and floppy disks and optical media (CD-RW, DVD) for personal storage.

Good Business:
- Imation is the world's leader with a great brand name in removable storage media.
- The removable media business provides an annuity-like revenue stream.
- Tape should remain an important portion of the storage, back-up and archiving market for the foreseeable future. Cost, durability and retrieval are the main attributes.
- Imation has a strong manufacturing expertise that is highly automated.
- This business has high barriers to entry.
- The ROIC is superior. Excluding the large amount of cash on the balance sheet, the company generates returns in the high teens.
- The cash flow and balance sheet are strong. Currently, Imation has approximately $470 million in net cash on the balance sheet (over $12.50/share).

Valuation:
- Excluding cash, Imation trades at approximately 10x 2003 estimates, which is attractive on an absolute and relative basis. On an EV/ Sales and EV/ EBITDA basis, the company trades at less than 1.0x and 5.8, respectively.

Management:
- Imation is led by Chairman, President, and CEO William Monahan. He has been with the company since its formation and spin-off from 3M in 1996. Mr. Monahan is a 23-year veteran of 3M.
- The rest of the management team has had a long history with Imation and/or 3M.

Investment Thesis:
At current valuations Imation is an attractive way to participate in the growth of storage for corporations and consumers. Imation has the broadest product offering in the industry and is now exclusively focused on storage media after divesting a number of non-core businesses. The balance provides flexibility with respect to acquisitions, share repurchases and dividends. We think revenue and EPS will grow about 5% and 10%, respectively.

MICHAELS STORES, INC.

Description:
Michaels Stores operates approximately 840 Michaels Stores in 48 states and Canada along with 150 Aaron Brothers stores primarily on the West Coast. Michaels is the largest craft store operator in the world. It offers framing, floral and a wide range of craft and home decor items. Aaron Brothers Stores are focused on art and framing products along with prints.

Good Business:
- Michaels is by far the number one retail participant in the industry.
- Revenue at Michaels tends to be fairly predictable and recurring. The company sells low ticket, higher margin products in an industry that historically has been fairly stable and has limited exposure to economic slowdowns.
- Michaels has built reasonable barriers when compared to other craft retailers including: a broad assortment of products and categories, good prices and good locations.
- Compared to most retailers, Michaels experiences less competition from Wal Mart and Target.
- Return on capital at Michaels is approximately 10% and growing. This exceeds its cost of capital and is generally higher than competitors.
- The company has a strong balance sheet and cash flow profile. Debt/capital is under 20%, free cash flow approximates $150 million and the company pays a dividend.

Valuation:

- The company trades at 17.2x and 14.5x 2003 and 2004 EPS estimates, respectively.
- Historically, Michaels has had a P/E range of 10-30x.
- Given the characteristics of this business, a P/E multiple in the 20 range seems more reasonable.

Management:

- Michael Rouleau joined the company as President in 1996 and became the CEO in 2001. Prior to joining Michaels, Mr. Rouleau served as EVP at Lowe's and held executive positions with Office Warehouse and Target. Mr. Rouleau has been responsible for the transformation of the chain and the strong financial turnaround.
- Jeff Boyer, CFO, joined the company in January of 2003. Prior to this he held a variety of senior financial positions at Sears, Pillsbury and Kraft.

Investment Thesis:

Michaels is a solid business that is unlikely to face head-on competition with Wal Mart or Target. The company's business model is based on high gross margins and relatively low turnover of inventory. This contrasts the high turnover, low gross margin models of the large discount chains. Additionally, the company is currently implementing new inventory technology, which should increase revenues, margins and return on invested capital.

THE BISYS GROUP, INC.

Description:

BISYS provides business process outsourcing solutions to 20,000 customers in the fields of investments, insurance and banking. The Investment Services division (50% of sales, 37% of profits) provides accounting and administrative services for mutual funds and retirement plans. The Insurance group (25% of sales, 33% of profits) is the largest distributor of life insurance in the country. The Information Services division (25% of sales 30% of profits) sells bank processing software and services.

Good Business:

- All three businesses have recurring revenue features, either through long term contracts or highly consistent repeat sales.
- The company is a leader in most of its niches.
- The ROIC is well above average. Cash flow dynamics are quite positive.
- The balance sheet is sound.

Valuation:

- BISYS typically trades at a high multiple of earnings due to delivering strong consistent results over the past decade. Recently the company stumbled in the insurance area. The P/E multiple is approximately ten points below its normal trading range over the past ten years.
- The EV/EBITDA ratio is 8.3 times fiscal (June) 2004 estimates. This is a substantial discount its peer group and the market.

Management:

- Lynn Mangum, Chairman, recently gave up the CEO position after holding it since the company was founded in 1989. We have known Lynn for over ten years and feel he is a highly competent individual.
- Dennis Sheehan, President and CEO, has held various positions within the company, including CFO, since 1992. He is a growth driven executive.
- James Fox was recently named CFO. He is a 25-year veteran of the financial services industry, including a long tenure as CFO of the Investors Services Group at First Data.

Investment Thesis:

BISYS has an attractive business model with above average predictability. The slowdown in insurance provides the opportunity to increase our position at an attractive valuation.

Thank you for your support and confidence in FMI. We value and appreciate your commitment.