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INVESTMENT STRATEGY OUTLOOK

Quarter Ended September 30, 2004

The September quarter was down slightly, modestly better than the benchmark Russell 2000 Index. The largest contributor to the relative performance was the underweight position in technology, a group that declined significantly in the quarter. Our consumer-oriented stocks had a positive impact on performance, but financial related equities detracted. Energy stocks remained strong as oil prices approached $50 per barrel at the end of the quarter. Concern about slowing economic growth was reflected in the bond market, with the 10 Year Treasury Bond rallying to 4.1% from 4.6%.

Although the government recently revised its second quarter Gross Domestic Product (GDP) to 3.3% from the 2.8% figure originally reported, there was widespread belief that the economy had hit a proverbial "soft patch." Several high profile earnings misses seemed to remind investors that the elevated growth rates experienced over the last few quarters were not sustainable. This was especially true in the technology arena. High raw material prices, particularly steel and energy, caused additional earnings problems. High gasoline prices were cited as a significant factor in the numerous earnings misses among retailers. The U.S. consumer is loaded with debt. Furthermore, the market appeared to be rattled by continuing problems in Iraq.

Despite this litany of negatives, the economy still appears to be growing. China and India continue to grow rapidly and worldwide GDP growth has improved. The International Monetary Fund's recently published economic survey predicts 5% worldwide GDP growth in 2004, the fastest rate in 20 years. Employment numbers, while choppy, have generally been better. Real wages, which have been weak for a few years, are showing nascent signs of improvement. Corporate balance sheets continued to improve in the September quarter. The reported "core" inflation rate is under control, but as we have discussed in the past, the official measurement may significantly understate true inflation.

Last quarter's letter articulates our current thinking on some of these big picture issues. Quickly summarizing, the consumer remains stretched due to a weak balance sheet. Housing prices look inflated and the refinancing wave, which positively impacted consumer spending in recent years, appears to be largely over. Additionally, and perhaps most importantly, stock market valuations are high by historical standards. This, along with the aforementioned factors, lead us to remain cautious and careful.

As is our custom, we offer some comments on a few of the holdings in the portfolio. Below are three relatively new additions, Accredo Health, Global Imaging Systems and PSS World Medical.

ACCREDO HEALTH, INC.

Description:

Accredo Health is the largest provider of specialized pharmacy services. The company provides overnight, temperature-controlled delivery of its biopharmaceutical drug portfolio, which currently includes 24 injectible and infusion therapies. Nine of these represent preferred or exclusive manufacturer relationships. Service level is the key differentiating factor for Accredo as the company focuses on chronic diseases, typically where treatments are used in the patient's home for the duration of their lives. The estimated annual drug costs per patient are high at $8,000 to $300,000 per year. The company also provides reimbursement specialists and product launch consulting, and clinical outcome data to biotechnology companies serving the chronically ill.

Good Business:

- Accredo has the leading market share and is recognized for their high service model.
- The business is durable, serving the aligned needs of biotech drug manufacturers, payers, and patients by ensuring that compliance dosage requirements are met.
- Size and scale allow for superior margins and low double-digit returns on investment capital (ROIC).
- Revenues are recurring; the products, while expensive, are necessities for the chronically ill patient.
- The capital intensity of the business is low, cash flow is high, and net debt-to-total capital is just 12%.

Valuation:

- At 14.6x forward earnings, the shares trade at almost half the historical average of 25.8x. The historical price-to-earnings (P/E) range is 10x to 50x.
- On a price-to-sales basis Accredo trades at .7x, which is 42% below its historical average of 1.2x and near the bottom of the long-term range of .5x to 3x.
- While the entire industry has declined over the past several months, Accredo still trades at an average 25% discount to Priority Health Care and Caremark, its two closest competitors.

Management:

- David Stevens has served as the company's chairman and chief executive officer since 1996, when he joined with the acquisition of LeBonheur Health Systems. Stevens has over 30 years experience in the health care industry, primarily in the health care services sector. He also has board duties at Thomas & Betts and Wright Medical Group.
- Joel Kimbrough, chief financial officer and treasurer, has been in this role since 1996 and has 15 years with Accredo. He had previously been a public accountant with Ernst and Young LLP, from 1980 to 1989.
- Since the stock's large decline, several insiders have bought shares outright.
- The management is highly disciplined with respect to gross margin hurdle rates. This instills a belief that they are more focused on the long term. Examples include the second quarter 2003 earnings commentary regarding their decision to walk away from lower margined Synagis business.

Investment Thesis:

Having declined 42% since April, the stock appears to have overreacted to reduced government reimbursements. Government only represents about 20% of the company's total payer base, which is roughly half of its competitors' exposure. Management appeared to outline a worst-case scenario in a recent press release. Some of the Medicare and Medical (California Medicaid) reimbursement proposals are quite severe and may perhaps be modified before they take their final form. Furthermore, there have been numerous acquisitions of specialty pharma companies and Accredo's valuation makes it an attractive target. New product additions should provide more operating stability and help regain a more respectable P/E ratio. Placing a P/E of 20x on normalized earnings of $1.80 yields a gain of approximately 55%.

GLOBAL IMAGING SYSTEMS, INC.

Description:

Global Imaging is a $700 million provider of office technology solutions, including digital copiers, analog copiers, network integration, electronic presentation systems and related products and services. The company is focused on providing equipment and services to the middle market. Unlike competitors such as IKON and Danka, who serve primarily large accounts, Global is focused on smaller companies that are much more profitable to service. Global Imaging Systems grows both internally and via acquisition.

Good Business:

- Global Imaging provides an important product and service to a large, diverse group of customers, with emphasis on the middle market.
- Approximately 40% of total revenues are recurring in nature. This recurring business includes service contracts, aftermarket supplies and parts, and maintenance agreements. The company achieves a 90% service attach rate with each piece of equipment sold.
- Global Imaging Systems is the most profitable publicly traded company within the industry. Global's selling, general, and administrative expense (SG&A) cost structure is at least 6% lower than the competition and the company generates earnings before interest and tax (EBIT) margins greater than 10%.
- Return on invested capital is 10-11%.
- The balance sheet is appropriately levered.

Valuation:

- At 13.6x and 12.3x 2005 and 2006 (March) estimates, respectively, Global Imaging is trading at an attractive valuation, both on an absolute and relative basis.
- The shares trade at a substantial discount to the Russell 2000. The shares should trade closer to a market multiple.
- The stock trades near private market value.

Management:

Tom Johnson, president and chief executive officer, founded Global Imaging through a partnership with GTCR in 1994. Before Global Imaging, Johnson spent a number of years with Danka Business Systems, including several years as chief operating officer prior to that company going public. He also has experience with Alco Standard, now called IKON. He is a graduate of Harvard Business School and owns approximately 2% of the common stock. His tenure in this industry of more than 25 years includes operating, managing and acquiring office equipment dealers.

Investment Thesis:

Global Imaging is a well-managed, highly profitable office equipment company that should produce better-than-average growth with a reasonable amount of predictability. The company has a very good acquisition track record and should augment internal growth with disciplined acquisitions. The valuation is reasonable and should continue to expand.

PSS WORLD MEDICAL, INC.

Description:

PSS World Medical is a specialty marketer and distributor of medical products, equipment and pharmaceutical related products, to physician offices, long-term care facilities and home care providers. The company operates 43 full-service distribution centers, which serve all 50 states. The Physician unit uses 720 sales representatives and 33 distribution facilities to market and distribute medical supplies, pharmaceuticals and equipment to over 100,000 offices. The Elder Care unit has 120 sales people and 13 distribution centers that cover 10,000 nursing homes, skilled nursing facilities and home care providers.

Good Business:

- PSS distributes low-priced consumable medical products to a diverse group of health care customers.
- The business model is fairly predictable and easily understood.
- The company is the largest healthcare supply distributor to the elder care industry and the third largest to physician offices.
- Management has taken initiatives to streamline the business, divest underperforming operations and increase profitability.
- ROIC approximates 9%, which is double what it was three years ago.

Valuation:

- PSS currently trades at 19x and 14.6x fiscal year 2005 and 2006 (March) earnings per share (EPS) estimates of $0.50 and $0.65, respectively. Similar healthcare distribution companies typically trade at 14x to 25x EPS.
- On a price-to-sales basis, PSS trades at .4x. This is on the low end of its 10-year range of .36x to 1.1x. Other healthcare distributors typically trade at price-to-sales ratios of .4x to .8x.

Management:

- David Smith was appointed chief executive officer in January of 2002 and has served on the board of directors of the company since 1993. Mr. Smith became president in 2000 and was chief financial officer from 1992-2002. He has spearheaded the effort to improve core operations and divest underperforming divisions.
- The company's chief financial officer is David Bronson. He is a 30-year veteran of the distribution industry and was formerly CFO of VWR Scientific Products, prior to its being acquired by Merck KGaA, of Germany.

Investment Thesis:

After a period of poor and erratic performance, management has undertaken several initiatives to improve operating results. New growth opportunities include a stepped-up effort to distribute non-prescription pharmaceuticals and private label products. The company's valuation should increase as predictability and growth improve. Recent weakness in the stock relates to the availability of flu vaccine and the impact of hurricanes. These issues appear to be transitory. The shares should move 30-50% if they are just moderately successful in executing their plan.

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