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INVESTMENT STRATEGY OUTLOOK

July 2004

The quarter ended June 30 saw strong absolute and relative performance in our client portfolios, putting them about 400 basis points ahead of the Russell 2000 Index for the year to date. Stocks that helped the portfolios include Paxar, Albany International and Idex Corporation. Paxar appears to be benefiting from restructuring; Albany, from improved demand in the paper industry; and Idex, from stronger industrial activity. Darden and Bisys detracted from returns in the quarter. Darden's Red Lobster division has been slow to improve and Bisys' turnaround has been hampered by deeper problems in their insurance operations. We continue to like the long-term appreciation potential for both of these stocks.

The Market

We are encouraged by the strong rebound in earnings over the past year. While it is clear that the rate of growth will slow, the near-term outlook for earnings looks healthy. Valuations, however, remain very high by historical standards. When we examine a variety of measures, including price-to-earnings, price-to-sales, and enterprise value-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratios; price-to-book multiples; and broader measures of valuation, such as the market value of stocks compared to the Gross Domestic Product (GDP), they are all above-average — and in several cases, near record highs. Given this backdrop, it will be more difficult than usual to achieve above-average rates of return in coming years. Valuations suggest the expectation of a "Goldilocks" scenario, i.e., continued strong earnings growth coupled with balance sheet repair, little inflation, low interest rates and geopolitical stability. While we cheer for Goldilocks, she may run into a few bears along the way. Below we discuss some issues that will impact stock gains in coming periods.

Inflation

Official measures of inflation leave a lot to be desired. Years ago there was just the inflation rate. Now it's the core Consumer Price Index (CPI), which excludes food and energy, two very important inputs that have increased significantly. Additionally, about one-third of the CPI is an imputed rent figure, which attempts to capture housing inflation. Apartment overbuilding has actually depressed rents (and the CPI) in recent years, while at the same time, housing and home improvement prices have increased dramatically. Since approximately 70% of households own a home, this housing cost proxy in the CPI calculation is misleading. Health care, education, property taxes and user fees have all increased substantially over recent years. So while apparel, information technology hardware, furniture, autos and restaurant prices have been flat to down, it appears that more of the consumer's budget is going to the other, more inflationary items. We think the core CPI number of 2% is understated.

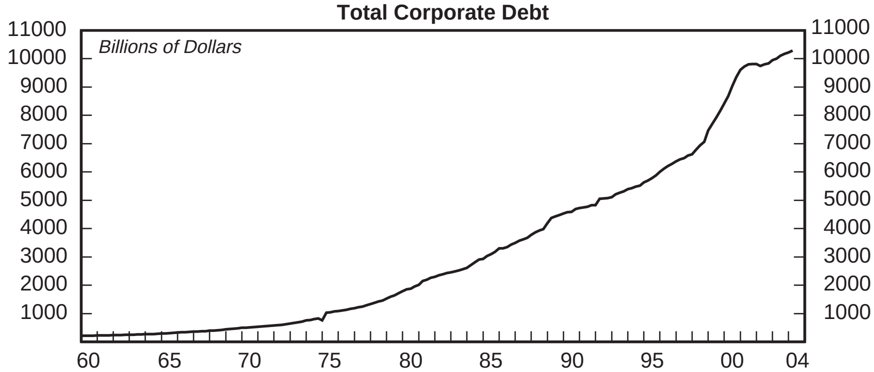
From the standpoint of business, input costs are typically raw materials and labor. Raw material prices are up significantly over the past year, but labor is not. Labor is a far larger cost factor than raw materials and we do not see a long-term case for sustained wage inflation. There are isolated bottlenecks on the producer side of the economy, but overall there appears to be plenty of productive capacity. To summarize our inflation scorecard, we are concerned that near-term inflation is higher than perceived, and that could unsettle the stock market. Longer term, global capacity additions and wage arbitrage will help keep a lid on what otherwise might be a traditional wage-price spiral.

Debt

Excessive debt remains one of our biggest concerns. Corporate balance sheets have recently improved after two decades of mostly declining quality. A massive restructuring of the industrial economy, along with huge write-downs related to acquisitions and ill-fated investments have drained equity values. Wall Street's love affair with earnings per share has thrust the balance sheet into a subservient role; the spotlight remains on the profit and loss statement (Chart A). We are encouraged by the recent strengthening in corporate liquidity, but recognize that corporations overall are not in a strong position to handle unexpected problems or a difficult economy.

Chart A

Total Corporate Debt



Source: Federal Reserve Board

A veritable explosion in the use of derivatives is also worrisome. The notional amount of bank-held derivative contracts outstanding increased over $5 trillion in the first quarter to $76.5 trillion, as compared to a figure of just $34.8 trillion four years ago. We recognize that the vast majority of these derivatives are hedging interest rates and foreign currency and the default rates are very low; but there has also been a very significant increase in credit derivatives, from just $55 billion at the end of 1997 to $1.2 trillion at the end of the first quarter of 2004. To put these numbers into context, the GDP of the United States is approximately $11 trillion. While it looks like banks are transferring credit risk to capital markets, we are not sure. We freely acknowledge that we are not equipped to evaluate the risk involved in these transactions -- an admission that Warren Buffet makes as well. We recently posed some questions about these derivatives to a couple of bankers as well as a bank analyst at a major brokerage firm. It would be charitable to say these people had only a vague notion about how these instruments work, much less what might be the potential company-specific or systemic risks. Given our parochial mind-set, we are suspect of any financial instrument that grows so rapidly and is so little understood.

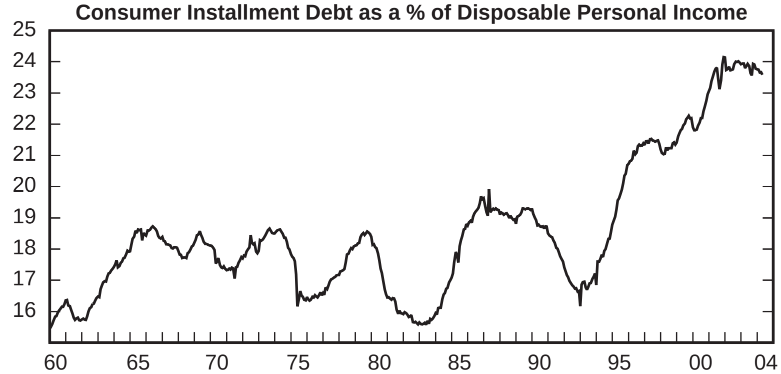
On a more positive note, commercial banks have been generating good cash flow, and loan losses appear to be in good shape. Lending appears to be skewed too heavily to the consumer, but commercial activity is starting to escalate.

The dramatic increase in the number of hedge funds and their leveraged assets is another area of concern. From just a few hundred hedge funds less than ten years ago, there are now over 8,000. According to Hedge Fund Research, there is over $860 billion invested in hedge funds, many of which are levered two to three times or more. With borrowing rates extremely low in recent years, the so-called carry trade (financing longer-term assets with short term loans) can take many forms, and we believe the hedge funds are heavy players. Six years ago we had the Long Term Capital Management (LTCM) debacle, yet the scope of hedging activity is far greater today. It is an unregulated market where each firm believes their strategies can be executed according to a model. We believe a very large number of these firms are playing the same trades and, if we learned anything from LTCM, it is that what works in the micro does not always work in the macro. Securities and Exchange Commission chairman Bill Donaldson described the industry recently as "an accident waiting to happen."

The consumer has been on a borrowing binge for several years. Consumer debt as a percentage of disposable income is at a record high [Chart B]. Despite very low borrowing rates, the interest burden is also near record levels. Yet the biggest increase in debt has been in the mortgage market. Mortgage debt outstanding, as a percentage of disposable income, is at a record high [Chart C]. Consumers have taken a page out of the corporate playbooks and have emasculated their balance sheets in order to continue spending. It is estimated that consumers extracted somewhere between $140 billion and $500 billion from home equity in 2003, helping to boost the consumer spending figure significantly. While home prices have increased at unprecedented rates, home equity value has plummeted from 70% in the early 1980's to 55% today. This probably doesn't tell the whole story, however, because it's likely that home equity is distributed in a barbell fashion. Older Americans likely have 90-100% home equity, whereas younger American homeowners have very little. This is the age of little or no money down, and a gamble on the husband and wife staying employed and home prices continuing to rise. The rule of thumb on how much house one could afford used to be 2.0-2.5x annual income. Recently, we read a *New York Times* article highlighting a couple in California who obtained a $360,000 mortgage with nothing down and a combined income of $60,000! *Grant's Interest Rate Observer* reports that in 1965, there was about $3,300 in mortgage debt for every employed American. Holding the value of the dollar constant, the equivalent figure today is $52,000. Complicating matters further is the fact that increasingly, borrowers are using adjustable rate financing. In May, nearly 50% of new mortgage originations were ARMs. This compares to the 20% average over the previous two-plus years. So the carry trade is alive and well in the mortgage market.

Chart B

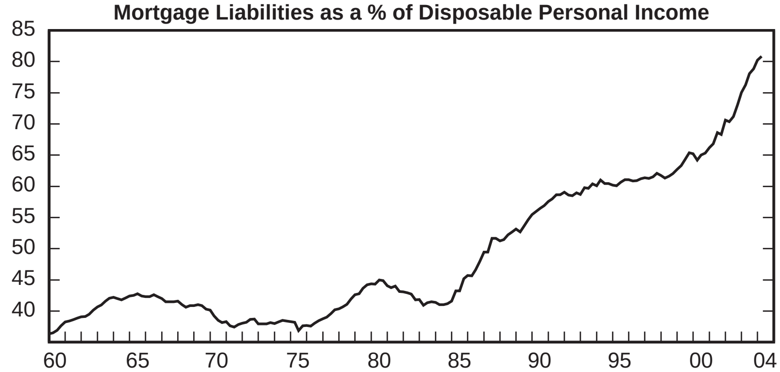
Consumer Installment Debt as a % of Disposable Personal Income



Sources: Federal Reserve Board; Bureau of Economic Analysis

Chart C

Mortgage Liabilities as a % of Disposable Personal Income



Sources: Federal Reserve Board; Bureau of Economic Analysis

The summary on the debt picture: little room for error. The implication for stocks is more opaque. If consumers rebuild their balance sheets in coming years, it means slower consumer spending and potentially slower earnings growth than the market expects.

Housing

The unusually low interest rate environment (a 1% Fed Funds Rate used to be called an emergency rate) and a perception that real estate might be a better place to invest than the stock market has, in our opinion, created a bubble. Housing price gains have far outstripped personal income growth and inflation. Those who argue that there is no bubble may concede "problem areas" on the Coasts, but it is our observation that prices have escalated substantially all over, even in Midwestern markets. Areas around Chicago, Milwaukee, Minneapolis, Kansas City, Detroit and elsewhere have seen double-digit increases in recent years. Merrill Lynch had a piece recently that reprinted some of the characteristics of a financial bubble, as articulated by Edward Chancellor in his work, *Devil Take the Hind Most: A History of Financial Speculation*. The five mentioned were:

- Available liquidity
- Increased use of leverage
- Democratization of the market
- Increased turnover
- Increased new issuance

These factors are plainly prevalent in the housing market today. Just as there was no way to know how long the technology/telecom craze would last, we cannot offer any time frame on the ultimate deflating of the housing bubble.

Luckily, the economy has been getting better; and employment, marginally better. As long as these two factors continue to go in the right direction, we don't see a near-term crash in housing prices, although we still believe that prices will flatten or fall sometime in the next few years. Our worries are not immediate... in fact, home default rates have started to improve after a fairly difficult period. The problem comes when the economy and employment stumble. With little margin for error, the impacts are magnified.

Housing's effect on stocks is indirect. There are implications for stocks that are related to the housing market, such as finance companies, construction firms, home improvement stores and so forth. Additionally, a housing crunch will impact consumer confidence — and perhaps, ultimately, stock market valuations.

Employment

While the current recovery can no longer be called a jobless one, the new job creation machine appears to be operating on less than all cylinders. A significant portion of the "one million new jobs" that we have all read about was due to an adjustment in the estimation procedures for measuring job creation. Still, we can observe anecdotally that firms are beginning to hire again, and this is encouraging. Temporary employment levels have been on the rise for most of the past year. The official unemployment rate is 5.6%, although the denominator (those actively seeking employment) has dropped. Wages don't appear to be gaining much at all — a real issue longer-term if this doesn't show improvement. In previous letters we have discussed global wage arbitrage, undoubtedly one factor in the wage picture. The world is more connected and more integrated and it will be difficult for wages to grow at historical rates in the U.S. Other regions are simply more competitive.

Outlook

The picture we have painted is less than rosy. We would rather be prepared for more difficult times and invest in sensible, conservative ideas, than bet on everything going right in order to support very high expectations and valuations. Make no mistake about it: good, inexpensive companies are more difficult to find today. This will most likely result in returns that are less than those experienced in the past decade. We still believe, however, that our client portfolios will achieve acceptable and relatively attractive returns (versus our competition and the market) for investors with a long-term time horizon. Be assured that our own money sits alongside of yours.

Earlier this year we announced that we were no longer accepting new small cap account relationships. While existing clients are welcome to add additional funds or accounts, we felt it was prudent to limit the amount of assets under management in order to improve the odds of delivering solid long-term investment results. Three and a half years ago we started managing large cap portfolios employing the same value oriented disciplines as we have in small cap equities, yet without the liquidity constraints. Please contact us if you would like further information about our large cap portfolio management.

Thank you for your support of Fiduciary Management, Inc.