FIDUCIARY
MANAGEMENT, INC.
Investment Counsel

100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545

INVESTMENT STRATEGY OUTLOOK - SMALL CAP EQUITY

Quarter Ended March 31, 2005

After a very strong December quarter, the March quarter was much more difficult. Our portfolios were approximately flat for the quarter, but given the 5.2% pullback in the Russell 2000 and the 8% decline in the Nasdaq, it was a "moral victory." Financial and technology stocks performed poorly in the quarter, so our underweight positions here helped.

The portfolios had a nice boost from Medco's announced buyout of Accredo as well as the continued strong performance of the energy stocks. Accredo, you may recall, was a relatively recent addition to the portfolios, about which we wrote in our letter dated September 30, 2004. This stock appreciated approximately 65% in the short time during which we held it. On average, we expect to hold our investments for about three to four years, but we don't mind getting our money more quickly! Oil prices continued to rise in the March quarter, driving energy stocks higher. Newfield Exploration was up over 25% in the quarter and St. Mary Land & Exploration was up 20%. We believe the fundamentals do not support oil prices in the mid $50's and took the opportunity in the latter half of the quarter to reduce the energy weighting of our portfolios. Stocks that detracted from the results in the quarter include Albany International, Global Imaging, MPS Group and Werner Enterprises. In each of these equities we remain positive on the long-term investment thesis.

In addition to selling Accredo after the deal was announced, we sold Scholastic and Spartech. We also began selling Delphi Financial toward the end of the quarter, and by the time you read this letter it will likely be out of all of the portfolios. Scholastic is a company we have discussed frequently, usually in frustration. The company has an excellent educational franchise but management has not been able to consistently bring the magic to the bottom line. Spartech was sold due to our loss of confidence in the management team, particularly with respect to driving a respectable long-term return on invested capital (ROIC). Delphi was a good stock for us over the past few years and it achieved our valuation target. We think A.J. Gallagher, a new addition discussed below, gives us exposure to the Property & Casualty field with a superior business model.

Our view of the markets and the economy remains about the same as we communicated three months ago. This letter, as well as those from previous quarters, can be easily accessed at www.fiduciarymgt.com.

A snapshot of our portfolios relative to the Russell 2000 at March 31, 2005, shows a weighted average trailing twelve months price-to-earnings (P/E) ratio of 17.2 versus 27.8. The weighted average price-to-book ratio of our portfolios is 2.2 compared to 3.6 for the Russell 2000. The debt-to-total capital ratio is 21.8% versus 32.5% for the Russell 2000.

As is our custom for the March 31 letter, we'll review a few of our holdings below, as we introduce four new investments in the portfolios.

A.J. Gallagher & Co.

Description

A.J. Gallagher is the world's fourth largest insurance broker and risk management firm, providing property and casualty products primarily to the middle market. It also provides third-party claims management and employee benefits consulting. Gallagher has a rich history, a strong selling culture and an outstanding track record. Insiders own a significant stake in the company. Gallagher has been public since 1984.

Good Business

- Insurance brokering, properly executed, is a high-margin business with little capital investment required.
- Approximately 90% of the brokerage contracts are renewed annually.
- The claims management business is predominantly recurring in nature and has 15-17% margins.
- Returns and free cash flow are excellent, and the balance sheet has net cash of $500 million.
- The business is relatively easy to understand.

Valuation

- The P/E ratio of 14.4 is in the bottom third of its ten-year range of 11-30.
- Its relative valuation versus the stock market is near the bottom of the long-term range.
- The yield (3.3%) is above average relative to the ten-year range of 1.6% to 4.0%, and near the high end of the relative range.

Management

- The Gallagher family has led the company since its founding over 75 years ago. Pat Gallagher, 52, is Chief Executive Officer. He is honest, hard working, and motivated to grow the business.
- Jim Gault, 53, is President and Chief Operating Officer and runs the brokerage business. He grew up through the internship program and has been with Gallagher for thirty years.
- Other senior-level business leaders have long tenures with the company.

Investment Thesis

A.J. Gallagher is positioned to continue to grow more rapidly than the Property & Casualty industry through an active acquisition strategy. The company has demonstrated an ability to integrate and grow acquired businesses. Due to turmoil in the insurance brokerage industry, Gallagher has a good opportunity to increase its market share, although this might impact near-term earnings per share (EPS). Company-specific issues and Property & Casualty industry pricing issues do not appear to be long-term impediments to performance. The valuation is attractive given the superior characteristics of this business franchise.

FTI Consulting, Inc.

Description

FTI Consulting has three main divisions: Forensic and Litigation Consulting (41% of revenues and 40% of earnings before interest, taxes, depreciation and amortization [EBITDA]); Corporate Finance and Restructuring (38% of revenues and 47% of EBITDA), which is the largest independent domestic advisory practice; and Economic Consulting (21% of revenues and 13% of EBITDA), which offers analysis of anti-trust and competitive issues that typically arise out of Mergers & Acquisitions activity. Thus, given the diverse revenues, the business should perform well through all economic cycles. Based on revenues, roughly 40% of the business is driven by a down-cycle, 30% from an up-cycle and 30% is non-cyclical.

Good Business

- The Corporate Finance and Restructuring practice is a durable, well-recognized franchise in the turnaround and bankruptcy area. The value of the other practices should increase as the company continues its successful track record of cross-selling services and deepening client relationships.
- Unlike demand for traditional consulting services, which depends primarily on companies' internal budgeting decisions, demand for FTI's services is most often driven by non-

discretionary engagements by businesses facing critical situations. This leads to a relatively inelastic price-demand relationship.

- Revenues are fairly recurrent as repeat clients and referrals generate 80% of the company's sales.
- Over the last four years ROIC has averaged 15%. Furthermore, assuming that profitability will ramp up due to new hires and/or an increase in the restructuring business, incremental margins and ROIC are attractive.
- FTI has strong free cash flow and low debt. Debt to forecasted EBITDA is approximately 1x.

Valuation

- Currently FTI trades more than 1.5 multiple points below its historical three-year average price to forward earnings of 17.5x (range 10x to 32x), in-line with the average enterprise value to EBITDA (EV/EBITDA) ratio of 8.8x (range 4x to 24x), and in-line with the average enterprise value to sales multiple of 2.2x (range 1x to 7x).
- Given FTI's fundamentals of low debt, 15-18% ROIC, 18-19% return on equity (ROE), consistent mid-single-digit top line growth, and 17% pre-tax margin, a 3x sales multiple is warranted.
- The private market value for the Restructuring business alone is roughly two-thirds of the market value.

Management

- Jack Dunn, Chief Executive Officer and Chairman, has been with FTI for thirteen years. He has served many important leading roles at the company including Chief Operating Officer, President, and Chief Financial Officer.
- Both Dominic DiNapoli, Chief Operating Officer; and Ted Pincus, Chief Financial Officer, have extensive industry experience, which is consistent with many other top executives at the company.

Investment Thesis

FTI will benefit from strong secular demand drivers including increased use of outside independent auditors, increased public scrutiny of accounting and fraud, and the large 114% increase in issuances of non-convertible high-yield debt in 2003. We believe many of these companies will require restructuring or bankruptcy consulting. An investment in FTI is somewhat of a hedge on the economy. Higher interest rates, slowing economic growth and a difficult capital market will actually benefit FTI.

The Valspar Corporation

Description

Valspar is a leading global paints and coatings manufacturer. The company has three reportable segments: Paints (32% of sales and 44% of earnings before interest and taxes [EBIT]); Coatings (56% of sales and 63% of EBIT), and All Other (13% of sales and -7% of EBIT). Valspar has three major business groups: Industrial (40% of sales); Architectural, Auto & Specialty (30% of sales); and Packaging (20-25% of sales). Industrial and Packaging fall mostly within Coatings, while the majority of Architectural, Auto & Specialty falls within Paints.

Good Business

- Valspar is a low-cost producer and technology leader in its markets.
- While slower growth, Packaging, at 20-25% of sales, lends stability to the revenue stream.
- The ROIC declined to 9-10% following the Lilly acquisition in fiscal 2001 and industrial

recession. While the industrial recovery should have improved returns into the low double-digits, Valspar has been hit by an unprecedented increase in raw materials costs. Management is focused on improving the ROIC to 12-13% within two to three years.

- Valspar has a solid balance sheet. Debt-to-capitalization is 35%; net debt-to-EBITDA is 1.6x; and interest coverage is 7.8x. The company's senior debt is rated BBB by Standard & Poor's. Valspar generated $184 million in free cash in fiscal 2004, comfortably covering its annual dividend requirement of $40 million.

Valuation

- The stock trades near the low-end of its five- and ten-year average valuation range on every metric. The stock is near its 52-week low following more than two years of relative underperformance.
- Valspar trades for 17.3x the fiscal 2005 (October) estimate. However, earnings are under pressure due to higher raw materials costs, which is masking the underlying earning power of the company.
- The stock trades at an enterprise value to sales (EV/Sales) multiple of only 1.15x, compared to an operating margin of around 11%. The latter is inline with the five- and ten-year average, which has been remarkably consistent.

Management

- Bill Mansfield, 56, recently succeeded Rich Rompala, 58, as President and Chief Executive Officer. Mansfield previously served as Chief Operating Officer. While he is viewed as a solid operating guy, Mansfield's transition to CEO requires him to be less hands-on and focused more on strategy.
- Paul Reyelts, 58, has been Chief Financial Officer since 1998. The company has a solid long-term financial record.

Investment Thesis

Management is focused on improving its ROIC, and appears to be on top of the issue of foreign sourcing/competition. Furthermore, the balance sheet is solid, and the company is a cash-generating machine. Finally, the stock is attractively valued. This is a quality company whose stock should outperform once raw material price increases abate.

Acuity Brands, Inc.

Description

Acuity is organized under two business segments consisting of the Acuity Brands Lighting (75% of sales) and the Acuity Specialty Product Group (25% of sales). Acuity Brands Lighting designs and manufactures a broad range of indoor and outdoor lighting products and fixtures for commercial, industrial and residential applications. It has the largest market share in North America. Acuity Specialty Products produces a variety of specialty chemical products (cleaners, sanitizers, polishes and pesticides) primarily for the industrial cleaning and retail markets.

Good Business

- Acuity has several strong brands, including Lithonia, Holophane, Gotham and Hydrel.
- The company's specialty products are generally consumable and are less economically sensitive than the lighting products.
- Management is focused on cost-reduction, which could increase operating margins by 300 basis points in the next three to four years.
- Acuity offers a wide breadth of lighting products, which allows it to compete favorably when a large project is being designed and engineered.

- ROIC is approximately 9%, about in-line with the company's cost of capital. This metric should improve as the company's overall profit margins improve.
- Acuity generates strong free cash flow, about in-line with net income. The company also pays $0.60 per share in annual dividend, implying a yield of 2%.
- Financial leverage has been reduced through cash flow and working capital management.

Valuation

- Acuity shares currently trade at approximately 19x and 13.8x fiscal year (August) 2005 and 2006 EPS and .6x revenue. In the company's limited trading history, it has traded between 10x and 22x EPS and .3x to .6x revenue. The current fiscal year P/E is inflated by highly depressed earnings.
- More profitable competitors trade at over 20x EPS and 1x revenue.

Management

Mr. Vernon Nagel was named the company's Chairman and Chief Executive Officer in September after serving as Chief Financial Officer for three years. Prior to joining the company's predecessor, Mr. Nagel was a principal of Wolverine Capital, a private investment firm. He appears to be aggressively addressing Acuity's cost structure.

Investment Thesis

As one of the leading companies within the lighting fixtures industry, Acuity should benefit from a cyclical upturn in commercial development and office turnover. New leadership appears to be driven to increase profitability. Near-term earnings difficulties are largely the result of higher raw material prices. The CEO recently announced plans to accelerate the cost-cutting initiatives. We believe these actions will ultimately result in earning power of approximately $2.50 to $2.75 per share. As the company begins to deliver acceptable margins, we believe the stock will trade for at least 1x revenue.

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