A ONCE-IN-A-LIFETIME OPPORTUNITY

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The average person enjoys a working life of 30-50 years. During that period we're likely to encounter one or perhaps two major buying opportunities in the stock market and eight to 10 important, but lesser buying opportunities.

The once-in-a-lifetime buying opportunities occur when there is high systemic failure risk and economic uncertainty, and a related extremely high potential for stock price gains.

The market decline in September and October of this year has given investors a once in a lifetime opportunity. The colossal and multiple failures of many leading financial institutions and the government sponsored institutions of Fannie Mae and Freddie Mac have paralyzed the credit markets and sent the stock market into a free fall.

We in no way seek to diminish the seriousness of the financial crisis. The worldwide financial system needs a major overhaul. The corrupt and ineffective regulation of Fannie Mae and Freddie Mac must be investigated and improved. Trust in the banking system must be restored. Wall Street greed must be held in reasonable check. The path to improvement will not be quick or easy.

We also want to acknowledge the severe damage to investor confidence from this financial crisis. During the past month we have watched stocks decline with concern, chagrin and ultimately a sense of horror. At moments it seemed that the financial system would collapse entirely and the stock market would never stop going down.

We also want to acknowledge that we do not know if the stock market is going lower. We do not know if the panic selling of two weeks ago will suffice or whether investors grow so disenchanted with stocks that they refuse to own them.

It is at times like this that we are left only with our discipline, our sense of how the markets work and the fundamental belief that price-value relationships will prevail. Our discipline has been shaped over the past 35 years and refined over the last 11.

And our discipline says "buy 'em".

Our discipline uses a seven-year time horizon. We normalize earnings for our companies and make reasonable forecasts of revenue and earnings growth. We believe the stock price and the intrinsic value of a company will eventually converge. We demand that each of our mid-cap stocks give us at least a 12% expected return and our small cap stocks a 15% expected return before we buy the stock.

Our discipline has produced excellent historical results. For the 10 years ended September 30, 2008, for example, our mid-cap portfolios achieved nearly 12% per year versus 3% for the S&P 500.*

Our discipline serves us well in difficult conditions, because our inputs do not rely on recent economic events.

Earlier this year our discipline showed returns from our portfolios, both mid and small-cap, beginning to rival the returns available at the lows of the 2002 bear market, about 20%. Our working belief prior to September was that our stocks were anticipating a

return to the economic turmoil in 2002. The extent of the current financial crisis is clearly more substantive than the conditions in 2002 and our stocks have declined with all others. The expected return on our small and mid-cap portfolios is now comfortably above 25% per year and dwarfs the returns available in 2002. The last time we can remember forecast returns this high was late in 1974, a year after I entered the industry. From December of 1973 until November of 1983 the CRSP small cap index achieved a total return of 11.3 times, for a compound annual return of 31.2% per year. During the same period the CRSP mid-cap index achieved a total return of 7.4 times, for a compound annual return of 25.1%. And these returns occurred in a poor economy; after 1974 the U.S, economy did not really establish sustainable growth until 1983!

The extremely high expected returns are the basis for our optimism, rather than any knowledge about the duration and shape of the current financial crisis. We believe we are on solid ground.

Consider the other choices to the expected return from our stocks: 1) U.S Treasury Bills at less than a 1% yield, 2) 10-year Treasury notes at less than 4% yield, or 3) Investment-grade U.S. corporate bonds at a 7-8% yield.

A variety of internal market dynamics also support our view.

First, we own wonderful companies with superb business models. Listed below are some key financial characteristics of our top 20 mid-cap stock holdings. Every holding generated free cash flow (cash flow from operations less capex and working capital needs) during the last 12 months of reported results. The vast majority of our holdings have very strong balance sheets; many have no debt. The stock market could shut down for a year or two and our companies would continue to generate excess cash!

Second, during the past 11 years the markets have kept us generally uncomfortable. We have observed a series of boom-bust cycles that have temporarily favored professional investors

10/10/2008	FCF Yield	LTMFCF ($mil)	Market Cap ($mil)	Debt/Equity %	Cash/Debt ($mil)
intu	6.5%	524	8,081	48%	828/998
tjx	9.6%	1,036	10,758	39%	517/833
adbe	8.5%	1,224	14,414	8%	2,001/350
sy	10.3%	213	2,066	60%	561/460
plxs	6.3%	40	639	0%	206/0
etn	10.7%	854	7,978	42%	463/2,921
ew	5.0%	139	2,797	16%	208/142
genz	0.7%	129	17,352	0%	1,473/0
otex	12.2%	159	1,305	48%	255/304
yhoo	8.2%	1,404	17,031	0%	3,214/0
dwa	13.5%	316	2,333	0%	402/0
armh	5.9%	112	1,883	0%	51/0
trmb	7.9%	185	2,342	4%	70/51
lstr	4.8%	95	1,989	53%	103/133
fds	5.2%	107	2,065	0%	143/0
ptv	6.3%	206	3,282	101%	37/1,425
jns	12.0%	235	1,948	69%	466/1,106
ltd	9.9%	427	4,326	132%	978/2,901
plt	12.7%	102	804	0%	200/0
aapl	9.8%	8,397	85,990	0%	24,490/0

Source: FactSet

who took wildly imprudent risks, granting each their 10 minutes of fame. Nearly all of these one-hit investment wonders have collapsed on the downside of each of these cycles. We have watched the tech boom/bust, the housing boom/bust, the China boom/bust and the oil/commodity boom/bust.
As investors (not speculators), we have been accused of not getting "with it" and have lost clients as a result. We have observed a considerable degree of speculative activity in the financial markets. We were keenly aware that Fannie Mae and Freddie Mac were overleveraged and their management teams were questionable. We have long wondered how they could maintain their questionable business practices. Now both companies have collapsed.

We think the financial crisis has ended the decade of boom/bust cycles. The need for financial institutions to reduce leverage should ensure a subdued level of speculative activity for years. The environment will not be conducive for companies to behave like Fannie Mae and Freddie Mac.

The recent market decline has sharply expanded the universe of buyable stocks.

We have also witnessed incredibly stupid practices in the investment management industry. Two practices stand out. The first is over-diversification at very high fees. Typically investors own eight to 10 mutual funds in their IRA. Since each mutual fund routinely owns 100 or more stocks, it means the investors owns somewhere between 800 and 3000 stocks in an IRA. Worse, the investor is paying fees of at least 1.5% per year to own what is in effect a giant index fund. With low single-digit investment returns for most investors over the past 10 years, we expect 401k participants will insist on lower fees. The second practice is the placement of money with hedge funds. Investors have willingly chosen to trust hedge funds to manage their assets. For this "privilege" the hedge fund operator charges a typical fee of 2% per year and 20% of the profits. And the hedge fund industry is noted for its lack of transparency. The hedge funds have woefully under protected their clients in this latest market crash. We expect most hedge funds to restructure their operations and/or go out of business.

This financial crisis leaves DGI in an enviable position:

- **A strong discipline**
- **A clear view of where to invest**
- **A reasonable fee relationship with our customers**

We look forward to mutually capitalizing on the current market travails.

*Past performance does not guarantee future results.

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To receive a complete list and description of Disciplined Growth Investors, Inc.'s composites and/or a presentation that adheres to Global Investment Performance Standards (GIPS®), contact Robert Buss at:

DISCIPLINED GROWTH INVESTORS, INC.
PHONE: 612.317.4100 ADDRESS: 100 SOUTH FIFTH STREET
FAX: 612.904.2546 SUITE 2100
E-MAIL: robertb@dginv.com MINNEAPOLIS, MN 55402

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DISCIPLINED GROWTH INVESTORS IS A MINNEAPOLIS-BASED INVESTMENT MANAGEMENT FIRM SPECIALIZING IN PRUDENTLY EXPLOITING INVESTMENT OPPORTUNITIES IN PUBLICLY HELD SMALL CAP AND MID CAP GROWTH COMPANIES. FOUNDED IN 1997, THE FIRM REMAINS EMPLOYEE OWNED AND COMPLETELY INDEPENDENT.

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CONTACT:

ROBERT BUSS
CFA, CIPM DIRECTOR OF MARKETING
612 317 4107
ROBERTB@DGINV.COM