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COVID-19

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In contrast to the financial crisis in 2008, there has been little time to prepare the portfolios for the COVID-19 crisis. We offer the following insights into what we are observing and what we have been doing since this crisis began.

Our client portfolios have suffered from exposure to some very fine companies whose businesses are close to the epicenter of the COVID-19 crisis. For example, JetBlue, an airline, has reported a steep decline in passengers. At time of printing, Royal Caribbean, a cruise ship operator, ceased operations for 60 days. The next ring of companies would be retailers like TJX Companies (TJ Maxx, Marshalls, Homegoods), which closed its stores for two weeks. All three of these companies are long-term holdings with highly competent management teams.

The investment team at DGI has been tightly focused during the last three weeks. When prudent, we have collaborated in person and made use of remote connection capabilities available to all employees. During the first two weeks we were in a maximum "sponge" mode, focusing on talking with our companies and trying to understand the ramifications (health and economic) of the virus. To better assess our specific portfolio risk in this crisis, last week we began to divide our portfolio holdings into four groups:

PORTFOLIO HOLDING GROUPS
1. Companies close to the epicenter.
2. Companies indirectly impacted (potential business model impairment, prolonged demand destruction, elevated financial risk).
3. Companies whose business may be affected short term by the virus but whose business models are not affected long term.
4. Companies who actually benefit from the virus.

TWO OBSERVATIONS

First, the price of Brent crude oil has collapsed from $62.34 per barrel on February 21st to $25.99 as of March 30th. Energy is an important cost driver for businesses and an important barometer for consumers. When the "dust" settles consumers are likely to see lower gasoline prices. During the last three weeks we have learned that the oil price decline has had a positive effect on our natural gas producer holdings. Low oil prices mean a likely decline in oil production in the Permian Basin in Texas. This prolific oil field has been throwing off natural gas as a byproduct and exerting downward pressure on natural gas prices. This source of pricing pressure is now likely to recede.

Second, the bond market is a mess. Yields on US Treasury Bonds and Notes are now at or near the lowest yields in history. The bid-ask spreads in corporate bonds is wide and variable. Last week US T-Bills were trading at negative yields meaning investors were willing to knowingly accept a small loss because of extreme fear of a larger loss. This violates our view of investing.

CONTEXT

Bear markets of this magnitude represent a major opportunity to improve the portfolio at the margin. We monitor the expected return of both individual stocks and the portfolio as a whole. This calculation is made by comparing the current stock price to the expected value of the company seven years from now. At today's market prices, the annualized expected return of our portfolio over the next seven years is far above our minimum hurdle rate of 12%. This is the second highest expected annual return in our history, second only to our 25% expected annual return in the fall of 2008. Because of low yields the portfolio's excess return over bonds is similar to the depths of the 2008 bear market. Low stock prices are a direct byproduct of the high economic and health uncertainties. Obviously, the highest expected returns tend towards those companies closest to the epicenter. We have effected only a few

transactions, shifting from relatively lower return stocks to much higher return stocks with similar risk profiles. Over the next few months we will continue to carefully optimize the portfolio to balance the risks and potential rewards. We are prudently developing our revenue and earnings forecasts assuming a severe virus-caused recession and a slow recovery.

BEAR MARKETS OF THIS MAGNITUDE REPRESENT A MAJOR OPPORTUNITY TO IMPROVE THE PORTFOLIO AT THE MARGIN. AT TODAY'S MARKET PRICES, THE ANNUALIZED EXPECTED RETURN OF OUR PORTFOLIO OVER THE NEXT SEVEN YEARS IS FAR ABOVE OUR MINIMUM HURDLE RATE OF 12%.

COVID-19

We are examining the COVID-19 crisis as statisticians, not as medical experts. We think there are two numerical critical relationships to be monitored. First is the ratio between the number of infected persons and the number of infected persons who succumb to the virus (fatality rate). If the virus infects a typical 10-20% of the population and the fatality rate is 1%, then 300,000-600,000 Americans could die. These are catastrophic numbers. If the fatality rate is more like other viruses and .1% of the infected pass away, then 30,000-60,000 Americans could die. This would be more like a bad flu season. We know with certainty the number of reported cases; critically we do not know how may Americans have *actually* caught the virus. Anecdotal evidence suggests that a significantly higher number have contracted and recovered since January. Any estimate of the fatality rate must be considered highly speculative at this time. Second, we are watching the ratio between those who need hospitalization and the number of available hospital beds. If we run short on beds some Americans could suffer needless deaths. It is also important that you understand that we do not know at this time how these two factors will play out. Importantly, we have not locked into any particular scenario.

RISK ASSESSMENT

This crisis has continued to sharpen our thinking regarding risk. Allison Schrager, an economist and acquaintance or ours, recently published a worthwhile article in the Wall Street Journal about risk. Risk and uncertainty are two different things. Risk can be mitigated through intentional forethought, clear processes, and disciplined adherence to processes. Uncertainty cannot be managed, only measured. For many years we have developed and strictly adhered to a risk mitigation discipline. The two elements of our risk mitigation are our investment discipline and DGI's business enterprise. Our investment discipline is centered on two key pillars—know what you own and pay a fair price for the asset. Our enterprise discipline is centered on extreme financial strength at both the corporate and individual shareholder level. The challenge for every risk mitigation effort, including ours, comes during periods of rising uncertainty, like today. Rising uncertainty may threaten to derail our risk management models over the short term, i.e., our investments will be marked down in price. Inevitably the uncertainty recedes. Finally, periods of extreme uncertainty like today give us a chance to stress test our risk mitigation practices and improve them in calmer times.

RISK AND UNCERTAINTY ARE TWO DIFFERENT THINGS. RISK CAN BE MITIGATED THROUGH INTENTIONAL FORETHOUGHT, CLEAR PROCESSES, AND DISCIPLINED ADHERENCE TO PROCESSES. UNCERTAINTY CANNOT BE MANAGED, ONLY MEASURED.

We will be conveying more insights in the weeks to come as we gain more clarity.

ABOUT DISCIPLINED GROWTH INVESTORS

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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