DISCIPLINED GROWTH INVESTORS

The Way Wealth Is Built

ECONOMIC & MARKET *Update*

GIVEN RECENT MARKET TURBULENCE AND THE PREPONDERANCE OF GLOOM AND DOOM HEADLINES AND FORECASTS, WE WANTED TO SHARE OUR PERSPECTIVE ON THE CURRENT MARKET ENVIRONMENT AND THE OUTLOOK FOR STOCKS HELD IN OUR PORTFOLIOS.

CURRENT INVESTMENT STRATEGY

FEBRUARY 2008

U.S. economic growth slowed sharply in the fourth quarter and may have entered a recession late in the fourth quarter of 2007. Consumer spending is soft and credit availability is tight. The financial headlines are unsettling. At least three major lenders received large infusions of capital to offset massive loan losses. Countrywide Credit just agreed to be acquired by Bank of America for pennies on the dollar. Citigroup and Merrill Lynch obtained capital infusions totaling $25.3 billion and $6.6 billion, respectively. The FOMC is caught between the need to reduce interest rates, fight commodity inflation, and protect the dollar.

The short-term picture is ugly, but the process of recovery most likely started as the economy began to slow. Interest rates have fallen sharply since last summer. The 90-day Treasury Bill now yields 2.24% while the Ten-year note yields 3.65%. The yield curve has shifted from inverted to upward-sloped. Credit standards are being tightened. When the lenders begin to more rationally extend credit, the crisis will ease. It looks like Citigroup and others will receive

necessary infusions of capital. Notwithstanding those who say a U.S. recession will not affect such countries as China, we believe a U.S. recession would threaten economic activity elsewhere in the world. It is also increasingly difficult to see how oil prices will remain near $100 per barrel if the U.S. economy recedes; lower oil prices would ease consumer anxieties.

The debate has shifted from whether we will experience a recession to how severe the recession might be. In this debate there are four factors which might produce a more serious than normal recession.

The first is improper policy responses by the federal government. While the FOMC has allowed the Federal Funds target rate to lag the decline in T-Bill rates, the FOMC seems to now be moving more aggressively to close the gap. Congress and the President are seeking to quickly pass a stimulus package. The important point here is that taxes are being lowered, not increased. The Federal authorities are not doing anything too dumb thus far.

The second involves credit quality issues. In every economic expansion cycle we have lived through, lenders have lowered their lending standards. In this cycle it appears that many lenders did not know the actual credit quality of the packaged financing they were purchasing. This lack of transparency has effectively frozen a significant part of the credit markets: How could a buyer and seller agree on a transaction price if neither knows what the underlying credits are worth? We expect a major push by regulatory authorities to increase transparency. We suspect the credit quality issues will be less severe than the dire forecasts, but there is no way for us or anyone to be sure at this time.

The third involves the current slowdown in consumer spending. It is our strong belief that the U.S. consumer has elected to reduce spending because of rising energy prices and dreadful headlines. The data suggests the consumer remains highly liquid and cautious. Mutual fund data is a timely and accurate source of data on individual investor behavior, which should be linked to spending behavior. As of the end of 2000 the market value of U.S-based mutual funds of all kinds totaled nearly $7 trillion dollars, or 70% of U.S. GDP. As of November 2007, U.S. based mutual funds assets

totaled over $12 trillion, nearly equal to U.S. GDP. Since the end of 2000 the assets in mutual funds have increased by $5 trillion, or $700 billion per year. As you may recall the year 2000 was the last peak in stock prices; this means that over the past seven years a significant portion of the increase in mutual funds has come from savings, not investment results. Further, the investment posture of the mutual funds has been quite conservative. As of November 30, 2007, money market funds total more than $3 trillion, slightly more than the average of the last seven years. The U.S. investor is highly liquid and cautious. We believe it is reasonable to assume the U.S. consumer is also highly liquid and cautious.

The fourth factor is the wealth effect from the very soft housing market. According to the Federal Reserve's Flow of Funds Accounts the gross value of U.S. household's real estate was $21 trillion at the end of the third calendar quarter of 2007. Net of home mortgages, household's equity interest was $10.6 trillion. If housing prices were to fall by 10%, homeowner's equity would fall by 20%. Since home equity equals about 18% of total household net worth, a 20% decline in home equity would cause a decline of 3.6% in overall household net worth. A decline of this percentage could easily be offset by gains elsewhere.

While the forecasts have tended to emphasize the possibility of a more severe recession, there is also a significant chance of a mild recession or no recession at all. The secular trend towards globalization may well overpower cyclical negative forces. This year should begin to resolve the relative importance of these various factors.

Since the vast majority of Wall Street research is focused on a 12-18 month earnings time frame, stocks do tend to decline when the 12-18 month outlook is recessionary. Assuming stocks are reasonably valued entering a recession, the bear market will be cyclical in size (about 20%) and short-term in nature. If stocks enter a downturn in an overvalued condition, the bear market may approach the more extreme reactions experienced in 1929-32, 1969-74 and 2000-02, with declines greater than 70%.

In this cycle stocks entered this economic downturn with reasonable valuations. Importantly, our stocks entered 2008 with an expected return far above our required 12% for mid-caps and 15% for small-caps. In fact, the expected return on our stocks at January 2008 prices is

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only slightly lower than the expected return at the bottom of the secular bear market in 2002. This strongly suggests a cyclical bear market with declines of around 20% or so.

Economic crises can bring about changes in market leadership. This one has clearly spotlighted the loss of leadership status of the financial service sector, especially lenders. We identified this area as a source of concern in April 2004. We expect to continue to underweight our investments in the lending sector. The larger question is whether this recession will damage the pricing structure on selected commodity producers, especially oil.

It is important to understand that Disciplined Growth Investors uses a much longer time horizon (7 years) than Wall Street. This leaves our stocks subject to a temporary price decline entering a recession but well positioned to return a 12% mid-cap and 15% small-cap annual result when 12-18 months earnings estimates begin to rise again. It is also important to note that we continue to orient the portfolio around U.S. companies extremely well-poised to lead the U.S. in a global environment. These include web-oriented technology companies, innovative medical technology companies, retailers able to develop an overseas presence, companies with worldwide brands, and companies with global distribution networks. These companies have tremendous business models and represent the leading edge of the current competitive advantages achieved by the U.S. in a global economy. We believe sustainable returns will accrue to these types of investments, rather than the current market leaders (raw material and intermediate goods manufacturers), most of whom do not have a sustainable competitive advantage over foreign competition.

The content herein reflects the opinion of Disciplined Growth Investors, Inc. (DGI). Any use of this piece for personal investment purposes by persons not employed by DGI is at the risk of the user.

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:

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