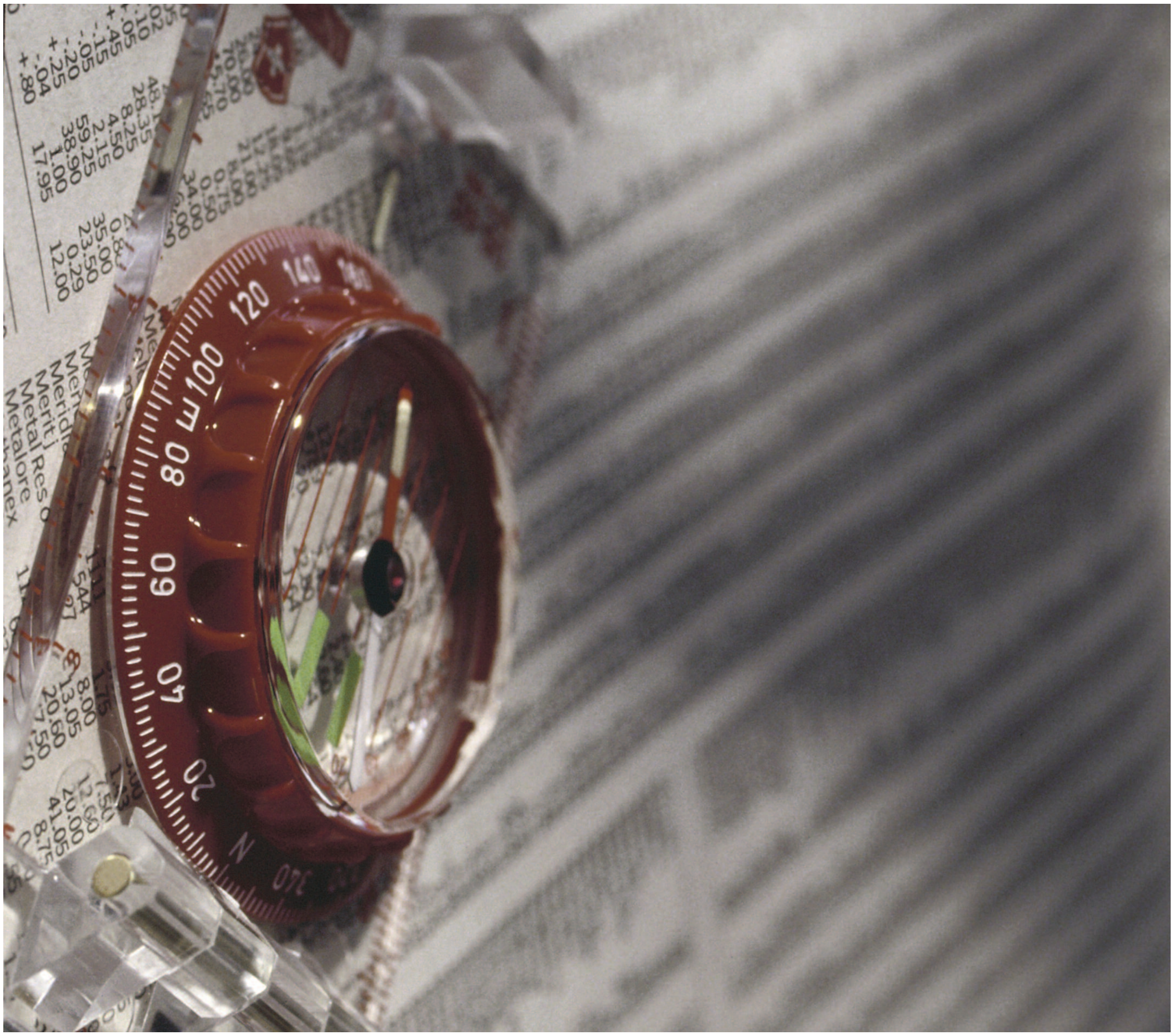
Disciplined Growth Investors



Current Investment Strategy

Insight from the perspective of our Chief Investment Officer.

By
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DISCIPLINED GROWTH INVESTORS
The Way Wealth Is Built

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Insight from the perspective of Fred Martin, our Chief Investment Officer.

I like to view events within the context of a calendar year and a decade. In investing, each calendar year tells a story, and each year one or two key decisions will determine the results for the year. Such key decisions change from year to year. Refocusing that lens to a decade brings a different perspective: A decade is long enough that the markets tend to reflect underlying asset values. The key to investing success in a decade is often the right mix of stocks and bonds.

We have just finished a calendar year and also the first decade of the new millennium. The two keys to investment success in 2009: avoid panic in the first half of the year, and—throughout the year—shut out the macroeconomic and political background noise.

Frankly, the end of the decade was more interesting than the end of the calendar year because it occurred almost coincident with the end of a 25-year boom period. The early chapters of that 25-year period began in 1981 with an extremely tight monetary policy designed to kill inflation, coupled with significant tax rate cuts. Those policies ignited a 25-year economic and financial boom. The final chapters of that boom period began with an overvaluation of the stock market in 2000 and ended in 2008 with the collapse of the massive shadow banking system, nearly dragging down the entire financial system of the U.S. and the world.

Consider that the first decade of the new millennium began on such a bright note for the U.S. At the end of 1999 the U.S stock market had enjoyed a tremendous bull market, five years in a row of strongly positive results. There was talk of a "goldilocks" economy. Unemployment was low. The Russian empire had been subdued. Asia had suffered a major crisis in 1998. The U.S. was on the dawn of a new beginning of worldwide dominance and technological innovation. The consensus key to investment success for the new millennium: invest heavily in common stocks, especially large capitalization technology stocks.

The End of an Era

Little did we know back in 1999 that the new decade would ultimately usher in the end of the 25-year boom period.

The new decade began badly. For the first three years the stock market declined, the first time since 1939 that the market had dropped three years in a row. And it was not a mild pull-back; the S&P 500 was down nearly 40% from 2000 through 2002, driven in part by unsettling political and macroeconomic events. In 2000, the U.S. experienced a disputed presidential election. In 2001 we suffered a horrific terrorist attack, which killed 3,000 people and closed the U.S. financial markets for four days. In 2002 several major U.S. corporations failed, not because of poor business decisions but flagrantly fraudulent activity by their senior managements. Even worse, the decade ended disastrously with the near collapse of the U.S. and world financial system, sending the S&P 500 down 38.5%, the second largest annual decline in the past 80 years. Only 1931 was worse.

The final tally for the decade is illustrative. The S&P 500 lost about 10% from 12/31/1999 through 12/31/2009. The consensus pick for the decade, the tech-heavy NASDAQ, lost 44% for the 10 years! Leading financial companies like Fannie Mae and Citigroup were disasters. From 12/31/1999 until 12/31/2009, Citigroup stock declined 91.5%. Fannie Mae managed to exceed this dismal performance, declining 98.1%! The winners for the decade rose from the forgotten of the last decade. Bonds, shunned earlier by investors, returned 7% per year. Asia recovered from its 1998 crisis and was lead by the Shanghai stock composite index, tripling during the decade. Gold nearly quadrupled.

Struggling With Excess, Coping With Collapse

Most of the past decade, for me, was very difficult. Even though I liked the quality of many of the leading tech companies, I did not like the rampant speculation in 2000. Bonds offered a safe haven, but returns of 7% per year were well below prior periods. The financial stocks looked crazy. Fannie Mae, an institutional favorite, did not issue valid financial statements for several years. How could any reasonable investor figure out what Fannie Mae was worth? The self-induced collapses of Enron and WorldCom tore at the very heart of capitalism—that companies would operate within a reasonable band of trust. China offered great potential but great risks as well. Gold was and is a speculation, not an investment.

Most important to me, the first bear market of the decade was not a game-changer. The 2000 bear market was a retrenchment of excessive valuation. Cisco was perhaps the darling stock of the 1990s. It was a great company before the bear market, and is still a great company. The stock simply became significantly overvalued. The run-up and decline of large-cap stocks was too short-lived to change the economy or investors' behavior, other than to produce a disturbing self-righteousness on the part of "value investors" who had shunned technology stocks. True, the bear market from 2000-2002 was as severe as any in history, yet speculation on the part of hedge funds and other major financial players was even more intense following the bear market. Even though we avoided owning financial stocks, I could not help but wonder if we would experience a bear market that would truly root out and destroy the speculative excesses developed over the last 25 years.

The financial collapse and bear market in 2008 and early 2009 easily met my criteria as a game-changing event. Not so oddly, it was curiously liberating for me. On the one hand, the collapse of Fannie Mae and others shattered the illusion that investing in the large lenders was prudent or safe. The sorry spectacle of Bernard Madoff demolished another seemingly safe haven for investors and shattered the consensus template for risk management, i.e., low volatility of returns. On the other hand, at the market bottoms in 2008 and early 2009 I saw expected returns on our stocks that dwarfed anything I had seen since the 1970s.

In the middle of a crisis like 2008 it was not humanly possible to do anything more than adhere to one's investment philosophy and hope the financial system held together. In retrospect, that was sufficient. It has been more than a year since the Lehman failure and it looks the like the financial system will survive, with huge lingering damage. It is now possible to begin to think about the future.

New Paradigms, a Changing Landscape

We begin by asserting that 25 years of gradually increasing recklessness on the part of investors has been smashed. The way the world worked until 2008 no longer applies. Prudence is in. There is no easy money to be made; investors will earn their return over the next decade.

The prevailing measurement of risk—historic volatility— came to dominate consensus thinking because of a seemingly low-risk financial environment. I have never used volatility as a measure of risk; historic volatility has never been an appropriate way to measure risk. In fact, we were inspired to write a paper on risk, titled "A New (Old) Era of Risk Management," which we sent to you sometime back. We view risk management differently, and offer what we believe is superior framework for assessing and managing risk.

I believe the rest of the industry will have to come to grips with their flawed risk models.

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The second decade of the new millennium begins as the mirror image of the beginning of the last. In contrast to the rampant speculation that dominated the market 10 years ago, stocks now offer the best risk-adjusted returns among liquid asset classes. Clearly, the financial system is not invincible. China is the new emerging king. Bonds are popular. The U.S. dollar is wavering. Gold is broadly viewed as a safe bet. We have not solved the war on terror. Neither the Democrats nor the Republicans seem to have a clue how to properly manage federal or state governments. In short, at the end of 1999 things looked rosy but stocks offered low returns; at the end of 2009 things look bleak and stocks offer good returns.

The past decade left us with lingering damage. The shadow banking system will take years to repair. The U.S. economy does not have a solid foundation for growth. Fannie Mae and Freddie Mac are zombie companies, described as "capital sinkholes." Our politics remain unsettled. The war on terror continues.

Uncertainty, Expectations and Opportunity

As we look forward, the coming decade will present significant hurdles. The federal budget deficit is dangerously high; the U.S. government may suffer a credit downgrade. There probably will be some kind of a new currency arrangement. I hope the budget deficit/currency problems will be resolved in a less catastrophic manner than the financial crisis in 2008. The war on terror looms, threatening life and worldwide stability. We can only pray and be vigilant. I expect more domestic political turmoil, including surprises such as the recent special U.S. Senate election in Massachusetts.

All that said, there are things we can know about the next decade, especially in the area of investments.

First and most important, when valuations are reasonable performance over a decade tends to reflect underlying asset values.
On that score, stocks in general offer significantly higher returns than other liquid assets, bonds and money market funds.

The area of greatest risk is in the bond market.
Nominal yields are low, about 3-4%. The debt markets (mortgages, corporate bonds, municipal bonds and U.S. Treasury bonds) are likely to bear the brunt of the extended fallout from this crisis; defaults and credit downgrades will continue. Fannie Mae and Freddie Mac are still receiving quarterly capital infusions from the federal government. Will the feds bail them out forever? Can the feds bail them out forever? Bonds will be victimized if inflation rears its ugly head. Nominal yields are too low to offer much of a cushion if inflation comes back. At the end of this new decade, I feel fairly confident that investors in bonds will be disappointed.

China and gold look speculative.
I cannot help but recall the near unanimous opinion about large-cap tech stocks at the end of 1999. China may struggle to fully validate its status as a major economic power. Gold is advertised everywhere.

In contrast to the overconfidence about stocks at the end of 1999, most investors do not want to own stocks today.
Yet the expected return for large cap stocks (i.e., the S&P 500) at today's prices is somewhere near normal, about 7-9% per year. The greatest opportunity lies in mid and small-sized companies as reflected in our portfolios. At current market prices, these common

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stocks offer above average expected returns over the next seven to ten years (15%+). In an economic environment of slow growth, market share gains will be one of the key drivers of revenue growth for individual companies. These gains will come from two areas: From weaker competitors unlikely to survive a more challenging environment and from large companies forced to focus efforts and investments on their own core competencies. Similar conditions after the 1974 bear market paved the way for the decade to be a very profitable period for small and mid-cap stocks.

For the next several years we also want to own companies with good enough business models to finance their own growth.
This should be a competitive edge during the period of lingering damage to our financial system.

The Bottom Line

I am at peace with the market environment. I believe we are (finally) entering an extended period favorable to hard-nosed, long-only investors like us.

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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.

About the Author

Fred Martin is Disciplined Growth Investors' founder and Chief Investment Officer. Fred has been managing portfolios since 1976 and is the primary architect of the investment philosophy employed by the firm.