DISCIPLINED GROWTH INVESTORS
The Way Wealth Is Built

ECONOMIC & MARKET *Update*

CURRENT INVESTMENT STRATEGY

MAY 2008

We entered a cyclical bear market which began last summer and probably ended in March of this year. Normally, cyclical bear markets occur every 3-7 years and cause price declines of 20-30% and are just plain frightening, but do little lasting damage. The basis for this cyclical bear market was the FOMC tightening, which began nearly four years ago. Normally the FOMC tightens until the weakest part of the economic/financial system breaks down. For this cycle we believed housing and oil prices were the weak links. Housing broke first. The FOMC began to ease in response to the credit issue problems in mortgages; oil prices have continued to rise, stimulated in part by easier monetary conditions.

Every cyclical bear market has the potential to become a secular bear market. Secular bear markets are far less frequent, occurring three times in the last century (1929-32, 1972-1974 and 2000-2002). Secular bear markets involve declines of around 80% or more in the leading indexes and change the financial status of many investors.

The primary reason a cyclical bear market becomes secular is that stocks prices are extremely overvalued at the start of the bear market. In 2000, stocks, (especially NASDAQ-listed companies) entered the bear market with high prices and very poor future returns. A painful and large retraction in stock prices was needed to restore the expected return from those securities.

The primary reason why today's bear market is cyclical and not secular is that stocks offered excellent returns prior to the start of this bear market.

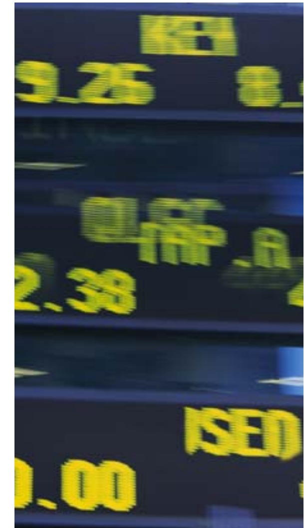
DISCIPLINED GROWTH INVESTORS

The Way Wealth Is Built

It must be noted that every cyclical bear market has some new factor which causes commentators and investors to become bearish. Why else would "investors" sell stocks at lower and lower prices, when their prices offered increasingly attractive returns? This current cycle has headlined the effects of derivatives wrapped around the debt outstanding. The extensive use of derivatives has created an environment of murkiness; there is little transparency about the quality of the debt owned by the derivative investor at the far end of the chain. The problem is compounded by the use of mark-to-market accounting. In a thinly traded market, if one investor marks down the price of a debt instrument, all other players must follow, regardless of their own assessment of the quality of the underlying security. Excessively worried auditors (remember Enron?) require immediate write downs, which damages leveraged balance sheets of lenders, which increases counter-party risk, leading to a vicious circle.

The FOMC initially tried to stabilize the markets by reducing interest rates. We have come to believe the problem was not solvable with lower interest rates alone but required increased transparency. We believe the actions of the FOMC around the collapse of Bear Stearns finally began to address the issue of transparency. The cyclical bear market likely bottomed on March 17th, reflecting in part the assessment of market players that the FOMC was at last getting at the heart of the problem.

The other reason that the cyclical bear market probably bottomed in March was that stocks began to offer exceptional future returns.



As of the quarter just ended, the expected returns on our stocks approached the expected returns at the bottom of the secular bear market low in the fall of 2002. This is not surprising and is consistent with our observations after the 1974 secular bear market low. Investors remained bearish for a decade or more after the end of that secular bear market. This cyclical bear market leaves both our small cap and mid cap portfolios (and the equity portion of our balanced accounts) in an advantageous position; after an extended period of 20+% compound annual returns for both our composites we have high odds of another extended period of high returns.

During the last two weeks the worry in the stock market seems to have shifted from a financial collapse to oil prices and the dollar. We think it is imprudent to forecast that oil prices will rise or the dollar must inexorably decline from current levels. We can make some observations about energy prices in particular. First, the price of oil at $115 per barrel is far above

the price at which major fields such as the Canadian Tar Sands are commercially viable. Exploration around the world should and will increase. Second there is evidence of massive speculative activity in the oil futures markets. Third, consumption in the U.S. is running below expectations. Fourth, China has been the major source of incremental worldwide demand. The Chinese stock market has been cut almost in half over the past six months and the China central bank is trying to tighten monetary conditions. If China grows more slowly, worldwide oil demand will also grow more slowly. Along with some stability on the financial crisis, the FOMC and significantly, the politicians will begin to turn their attention to oil prices. The political class does not want high oil prices for the elections later this year and oil companies offer a tempting target. Finally, the combination of high energy prices plus extensive publicity about global warming is beginning to foster innovation around substitutes for hydrocarbon fuel conservation.

An easing of oil prices would reduce inflation concerns, grant the FOMC more flexibility in managing interest rates, and remove a source of consumer anxiety. Overall, an easing of oil prices would be good for non-oil stocks.

A stable or rising exchange rate for the dollar would have a mixed, complex effect on worldwide economic activity. Our stronger dollar would be somebody else's weaker currency.

There is other very good news regarding the financial environment. Interest rates have declined precipitously and offer little competition to stocks. We also believe, controversially, that the U.S. consumer is in far better shape that the "urban myth" suggests; this suggests the U.S. consumer and the economy is not on the verge of collapse. We have considerable data to back up our view if you are interested. Finally, the politicians in Washington have not done anything stupid this cycle to make the economy worse.

There are clearly identifiable risks to our forecast. While we can make a conceptual case for a decline in oil prices, thus far oil prices have continued to rise. From these price levels oil prices can stabilize, rise, or fall. We believe stabilized oil prices would be a drag on the economy but would be manageable. Further price increase for oil would threaten to derail the economic recovery and force the FOMC into a tightening stance earlier than desirable. A decline in the price of oil would generally be positive.

DISCIPLINED GROWTH INVESTORS
The Way Wealth Is Built

The trading activity in the U.S. dollar remains a largely unquantifiable risk. The dollar has fallen to a level which could threaten the stability of world trade. Further declines in the exchange value of the dollar could damage the role of the dollar as the most important transaction currency in the world. An unstable and deteriorating dollar could slow or even reverse the trend towards increased global trade.

Our investment approach during these uncertain times remains unchanged. We are honoring our work showing high expected returns from our stocks by a fully invested position in both our products as of 3/31/08. We are continuing to look for fine companies with sustainable growth prospects whose stocks sell at prices which yield an expected return of 12% for mid caps and 15% for small caps or higher over the next seven years. The cyclical bear market has been presenting us with some terrific opportunities. We have been adding names to both of our products during these past few months.

One feature of the companies we have been finding is that they have excellent business models and lots of free cash flow. Our quarrel with several of these companies is that they have not returned cash to shareholders in the form of dividends. This is beginning to change. Nutrisystems (both small and mid cap) just commenced paying a dividend with an initial yield of 3.6%. Corporate Executive Board (mid cap), a recent new purchase, had a dividend yield in excess of 4% at the purchase price. Noble Corporation (mid cap) just paid a $0.75 extra dividend to shareholders, increasing the yield this year from 0.2% to 1.4%. We hope many more of our companies follow suit.

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:

DISCIPLINED GROWTH INVESTORS, INC.

PHONE: 612.317.4100
FAX: 612.904.2546
E-MAIL: robertb@dginv.com

ADDRESS: 100 SOUTH FIFTH STREET
SUITE 2100
MINNEAPOLIS, MN 55402