DISCIPLINED GROWTH INVESTORS

Cutting Through the Bull

October 17, 2001

It has been one month since the terrorist attacks on the World Trade Center and the Pentagon. We have enough data to present our market forecast to you.

We have been intensively analyzing the market data over the past month. We have concluded that all of the ingredients are in place for a multi-year bull market in stocks. This bull market will be lead by small and mid-cap stocks. Bonds and money market funds will yield returns disappointing to investors. Further, we have concluded that the market environment will be especially favorable for our kind of approach. The market will richly reward those investors with an eye for both growth and value, regardless of market capitalization.

Why are we so optimistic?

1) **Discounted Stock Prices** Many stocks are selling at discounts to intrinsic value last seen in 1974 and briefly in 1998. Many of these heavily discounted stocks are terrific companies with bright futures, excellent management teams, and pristine balance sheets. The huge and rare discounts of stock prices today are the single best indicator of the future return potential from stocks. These huge discounts to intrinsic value are concentrated primarily in small and mid-cap stocks.
2) **Fed Policy/Interest Rates** The Fed has turned to ease. Short-term interest rates have declined to levels last seen in the 1950's. One-year Treasury Bills yield 2.3%, two-year Notes 2.8%, and five-year notes 3.87%. Low interest rates are terrific for consumers, businesses and investors but lousy for retirees.
3) **Market Psychology** Many indicators reflected rare levels of panic selling the week after the terrorist attack. Many indicators hit all-time levels of bearishness. One indicator, the ARMs index hit the extreme oversold levels twice in 1962, 1974, and 1987. After 1962, 1974, and 1987 the stock market shrugged off horrible macroeconomic conditions to provide investors with great multi-year returns in subsequent years. The ARMs index hit extreme oversold levels in March and August of this year and a record third time after the terrorist attack.
4) **Commodity Prices, Especially Oil, & Currencies** Since the terrorist attack commodity prices have acted favorably. Oil declined from $29

$290/oz and has settled back to $281/oz. The dollar is up slightly against the Euro, the British Pound, and the Japanese Yen and is down slightly versus the Swiss Franc. Declining energy prices are very good for the consumer.

5) **<u>Fiscal Policy</u>** The terrorist attack has shaken the Federal politicians out of their lethargy. The war on terrorism has in part focused the politicians on the need to help stimulate an economic recovery. While I do not know the exact nature of the stimulus, I expect a combination of spending and tax cuts, probably in excess of $100 billion, including the relief efforts.
6) **<u>The Tech Revolution</u>** Investments in enterprise-wide networks and the Web continue to provide a high ROI to corporations. The terrorist attack should continue to move companies towards distributed work forces connected by high speed, computer-driven bandwidth. While many tech stocks are undergoing a wrenching inventory/overbuilding correction, the idea that the tech revolution is over is nonsense.
7) **<u>Stock Market Imbalances</u>** For several years I have been grousing that the very large cap stocks are significantly overvalued. Today the big-cap tech stocks are reasonably valued. Even GE, a bellwether stock that was dangerously overvalued in September of 2000, has declined from $60 then to $36 per share today. I believe GE is still slightly overvalued (intrinsic value is $24-28 per share) but not dangerously overvalued. When very large cap stocks were significantly overvalued, it was clear that the stocks had to decline to more normal levels. From our perspective the question was how deep their sell-off would be and what the collateral damage would be on small and mid-cap stocks. The experience of our stocks over the past three months has unfortunately answered that question: our stocks were ultimately unable to swim upstream against such a tide. With very large cap stocks now reasonably valued, our stocks are no longer so vulnerable to an associated markdown.

Our optimism is not based on any foreknowledge of the path of the war on terrorism. Our working assumption is that the war will be long, difficult and unlike any war we have seen. Nor is our optimism based on any special knowledge regarding the pace or timing of the economic recovery, although we believe the evidence increasingly points to a recovery. Nor is our optimism based on a forecast that the stock market will quickly return to its recent past days of glory.

The foundation of our optimism is the fact that many stock prices are selling at their biggest discounts to intrinsic value since 1974 and 1998. This is the central tenet of investing and is the primary driver of returns from the stock market.

So with this letter to you we are going to ask you to spend some of your precious time and read why we believe the discount to intrinsic value is the best predictor of future returns. We are also going to take you on a guided tour through our equity valuation process. We hope you will become as convinced as we are that 2001 has presented a terrific investment opportunity for you and us.

Frankly, we need to bolster our credibility by offering you some quotes regarding the great success, which accrues to those who accurately measure intrinsic value and compare them to stock prices. In this we turn to Warren Buffett. Over the past ten years my admiration for Mr. Buffett has grown many-fold. Warren Buffett is the pre-eminent investor of the 20^{th} century. Michael Jordan and Tiger Woods have not dominated their chosen sports the way Buffett has the investment world. Over the course of his career Warren Buffett has been generous enough to discuss his investment philosophy and practices. I read his writings after 25 years of successful investing; I found his observations to be a treasure trove of wisdom and advice. My unqualified admiration for Mr. Buffett does not mean I wish DGI to imitate his investment style; I simply want to understand and apply his principles applied successfully in the real world in a manner consistent with DGI's own strengths.

One of the themes through Mr. Buffett's writings is that an investor should look at the public markets as a business partner. Here is what Mr. Buffet writes in his book, The Essays of Warren Buffett: Lessons for Corporate America, about his unseen business partner, "Mr. Market":

> "Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.
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> Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On those occasions he will name a very low price, since he is terrified you will unload your interest on him.
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> Mr. Market has another endearing characteristic: he doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.
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> But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to ignore him or take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business better than Mr. Market you don't belong in the game. As they say in poker, 'If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy.'"

In our opinion, the slowing economy, coupled with many new investors, caused "Mr. Market" to become extremely depressed after the September 11th terrorist attack.

During the first six months of 2001, our client portfolios largely escaped the experience of many others and held price. In the third quarter of 2001, our clients' portfolios succumbed to the economic slowdown and the terrorist attack and posted declines that were uncomfortably large to us and we suspect to you as well. This kind of market action always brings forth a natural reaction to question our basic approach. Is there any meaning in such volatility? Are the portfolios too risky? Again, we call on Warren Buffett to offer some sage comments on the question of short-term volatility.
In the same treatise, The Essays of Warren Buffett, he writes:

> "Academics, however, like to define investment 'risk' differently, averring that it is the relative volatility of a stock or portfolio of stocks- that is, their volatility as compared to that of a large universe of stocks. Employing databases and statistical skills, these academics compute with precision the 'beta' of a stock- its relative volatility in the past- and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a simple statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.
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> For owners of a business- and that's the way we think of shareholders- the academics definition of risk is far off the mark, so much so that it produces absurdities. For example, under beta-based theory, a stock that has dropped very sharply compared to the market- as had the Washington Post when we bought it in 1973- becomes 'riskier' at the lower price than it was at the higher price. Would that description have then made any sense to someone who was offered the entire company at a vastly reduced price?
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> In fact the true investor *welcomes* volatility. Ben Graham explains why in Chapter 8 of The Intelligent Investor. There he introduced 'Mr. Market,' an obliging fellow who shows up every day to either buy from you or sell to you, whichever you wish. The more manic-depressive this chap is, the greater then opportunities available to the investor. That's true because a wildly fluctuating market means the irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly."

With the above thoughts in mind, the rest of this piece seeks to convince you that our stocks suffered a markdown in price but our companies (with one exception) have not suffered a decline in intrinsic value. In fact, economic and political events before and especially after September 11th served to cause "Mr. Market", in his depression and fear to offer up stocks then and now, which offer the highest sustainable returns in a generation.

In order to build a base from which to discuss intrinsic value, we need to review for you our framework for valuing stocks. One of our prime criteria is P/E ratios. In this effort we turn to the writings of Benjamin Graham. Mr. Graham was the first equity analyst; the first known investor who tried to apply investment analysis to the ownership of common stocks. For us, the "Bible" of investing is Mr. Graham's book, Security Analysis, first published in 1934. We currently utilize the fourth edition, published in 1962. Mr. Graham's analysis and theories have withstood the test of time and his death in 1976. No serious investment scholar has ever refuted the work of Ben Graham. Indeed, his most apt pupil is Warren Buffett.

In his 1962 edition of Security Analysis, Mr. Graham approaches the question of valuing growth stocks. In his customary thorough fashion, Mr. Graham examines several different methods for valuing growth stocks. Using four different rigorously developed formulas; Mr. Graham developed the following ratio between P/E ratios and growth rates:

Expected 10-Year Growth Rate	P/E Ratio (Normalized Earnings)
0%	8.5-11.5x
2.5%	13.1-13.5x
5%	16.1-18.5x
7.2%	18.9-22.7x
10%	23.0-28.5x
14.3%	31.0-37.1x
20%	41.5-55.3x

For those of you looking for a simple formula, Graham suggested a P/E of 8.5 plus two times the growth rate. For those of you who wish to read Mr. Graham's analysis in its entirety, please request a copy from Sheri, or send an email to sherin@dginv.com .

Mr. Graham exercised prudence by refusing to forecast growth rates in excess of 20%. Graham also stressed that a careful analyst would use normalized earnings, i.e., earnings adjusted for the economic or industry cycle. Graham's focus in 1962 on normalized EPS seems particularly relevant today in this era of momentum investing based on the latest quarterly results. Finally, Graham cautioned investors not to forecast high growth rates in perpetuity.

We can think of no better statement of our discipline than to assert we are entrusting your fortunes to a rigorous time-tested manner of valuing stocks.

The stock of Coca-Cola provides a great case study of the appropriateness of Graham's framework. Many of you may recall that several years ago we argued forcefully that Coke was a great company but that it's stock was overvalued. From 1991 until 2001 Coke EPS doubled, for an average annual compound growth rate of 7% per year. Importantly, Coke's earnings in 1996 were far above long-term norms. In 1996 Coke reported EPS of $1.38 per share versus a long-term norm of $1.01. In June of 1996 Coke stock sold at a price of $47 per share, or 47x normalized earnings. In 1996 Coke's intrinsic value was 18.9-22.7x normalized EPS, $19-23 per share. What has happened to Coke since then? The stock has slowly succumbed to the overvaluation.

If you had bought Coke in 1996, you would have earned -0.63% per year including dividends through October 15, 2001, a period over five years long. If you had bought Coke stock on October 9, 1998, right in the depths of that bear market, your return, including dividends, would have been -10.0% per year. Incidentally, Coke today sells at 27x normalized EPS and is only mildly overvalued.

As mentioned earlier in this piece we believe GE is still slightly overvalued. GE is a flagship stock today. The company has a market value of $389 billion and revenues of $120 billion. The company is superbly managed and has grown at 15% per year over the past five years. Because of GE's size and slower nominal GDP growth, we believe it is prudent to forecast that GE will grow at 7% per year over the next decade. This is no small achievement; in order to achieve 7% growth at the end of the decade GE will have to achieve revenues of $240 billion. At a 7% growth rate GE would sell at a similar multiple to Coke. Normalized EPS for GE is about $1.20 per share. GE's value today is about $23-27 per share. GE's stock today at $38 is somewhat overvalued but is not dangerously overvalued as it was last year at $60 per share.

What is the outlook for GE? The stock must inevitably sell at its intrinsic value. This process could occur either quickly or slowly. Our guess is that the company is so well managed that the stock will subject its shareholders to the same fate as Coke, i.e., a long period of poor performance until the intrinsic value catches up with the stock price.

In subsequent pages we have explicitly applied our valuation discipline to eleven of our holdings. Please note the exceptionally high seven-year forecast returns for the stocks. Please also note that our growth assumptions are reasonable and that we did not cherry-pick the list of stocks. *****

At DGI we do make mistakes but our mistakes do not involve an abrogation of our valuation discipline. These mistakes, which are painful, reflect that we simply incorrectly analyzed the key characteristics of the company's business. Our mistakes have been thankfully rare. One such holding is McLeod. ***** We have included an analysis of that mistake. I hope we have learned from our analysis.

In summary, there are many uncertainties in the environment. The key elements (valuation, interest rates, fiscal/monetary policy, currencies, oil, and market psychology) suggest the highest sustainable returns in many years.

Let us leave you with a quote from the famous financier J. P. Morgan when asked by a reporter what the market will do:

"It will fluctuate."

Disciplined Growth Investors, Inc.
100 South 5th Street, Suite 2100
Minneapolis, MN 55402

Phone: 612.317.4108
Fax: 612.904.2546
Web: www.dginv.com

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