SMALL CAP STRATEGY:
"FROM TINY ACORNS MIGHTY OAKS GROW"

November 30, 2001

Over three years ago in October of 1998, we asserted that small cap stocks had experienced a major bear market bottom and were likely to achieve a multi-year bull run that would provide superior absolute and relative performance versus the large cap stocks. We will provide a copy of that analysis on request.

Since that piece was published, the U.S stock market has experienced a boom-bust cycle in the NASDAQ and a bear market in all of the other major indexes. The internet IPO market became white-hot from 1998 until 2000 and has since collapsed. On September 11th, the U.S suffered a devastating terrorist attack which closed the U.S. stock markets for an unprecedented four days.

It has been a busy three years. How have small cap stocks performed? Is our thesis still intact?

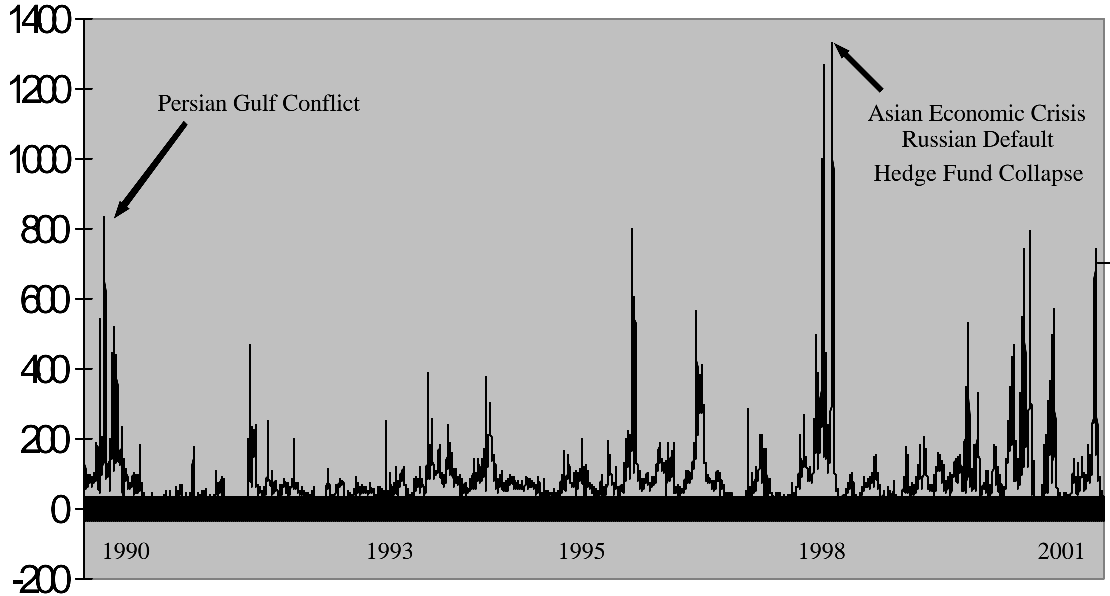
We are pleased to report that small cap stocks have provided excellent absolute and relative returns from the bottom of the bear market in 1998 through mid-November. Here is the performance of three major stock indexes from 10/9/98 until 11/16/01:

Stock Index	**Total Return** (10/9/98-11/16/01)	**Annual Compound Return** (10/9/98-11/16/01)
Russell 2000	+48.2%	+13.5%
S&P 500	+20.2%	+6.1%
Nasdaq Comp	+28.3%	+8.3%

We believe the Russell 2000 is a good proxy for small cap stocks while the S&P 500 and the Nasdaq Composite reflect returns provided by large cap stocks. The statistics above show that the small caps have provided an excellent double-digit return and a superior relative performance in spite of all that has happened during the past three years.

We present additional data below which validate that October 1998 was the bear market bottom for the average stock, including small caps. You may recall that 1998 was the year in which the Asian economic model finally cracked and Russia defaulted on its debt. The severe economic problems in 1998 caused widespread selling of stocks; this selling is best measured by the number of stocks simultaneously declining to new 12-month low prices. Charts I and II report the number of new 12-month lows on all stocks on the Nasdaq and the New York Stock Exchange. Please note that October 1998 represented a peak in new lows for the decade in both markets. The number of new 12-month lows after the 9/11/01 terrorist attack failed to exceed the numbers posted in 1998.

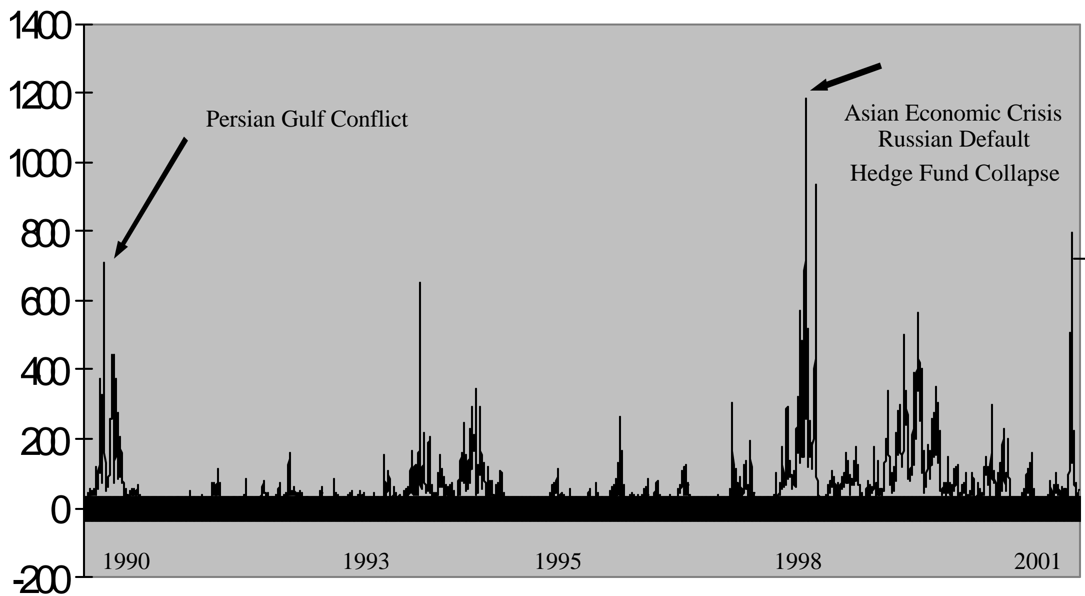
Chart I. NASDAQ New 12-Month Lows 1990-2001



Data Source: Bloomberg

The number of new 12-month lows after the 9/11/01 terrorist attack failed to exceed the numbers posted in 1998.

Chart II. NYSE New 12-Month Lows 1990-2001



Data Source: Bloomberg

What is a small cap stock?

Over the past two decades a new category of money managers has emerged: small cap managers. This new money manager category has developed around a definition of small cap stocks based primarily on each company's current stock market value. This approach offers high precision but little practical value as a guide to success in this difficult investment arena. The path to a helpful working definition of a small cap stock must begin with a clear statement of what the investor is trying to accomplish through the ownership of small cap stocks. We seek to invest in companies which can become major factors in their industries and ultimately, major companies. If we invest well (i.e., a sufficient number of our holdings achieve major league status) our clients will be rewarded with an acceptably high rate of return. An accurate definition of a small cap stock will not only help our research focus but will also give us a competitive edge in forecasting small cap investment cycles.

The standard today for categorizing a stock as "small cap", "mid-cap" or "large cap" is the current market value of the stock. Small cap stocks are considered to be those stocks selling for less than $1.5 billion market value.

The use of market value to identify a small cap stock leaves the practitioner at the mercy of market volatility. In an economic system as dynamic as the United States', individual stocks have moved from small-cap to large and back to mid-cap in the space of abbreviated economic time. Yahoo is such an example. The company went public as a small cap stock in 1995 at a market value of $330 million. At its peak stock market price in January of 2000 Yahoo's market value was $138 billion; it was then a large cap stock. Yahoo's stock has since fallen 96%; it is now a mid-cap stock at a market value of $7 billion.

The use of market value also tends to pull investors towards buying high and selling low. In the money management industry it is common for investment firms to set limits on the minimum market value of those companies their firm will consider as suitable for investing. Again, consider the example of Yahoo. As the stock price (and market value) of Yahoo declines lower and lower, fewer and fewer institutional investors consider the stock as part of their investment universe. Consider that the stock was probably on everybody's radar screen at $250 per share but was an unwanted stepchild at $8 per share. The true investor is advantaged if the arbitrary classification of stocks by market value causes a stock to appear less attractive to institutional investors because the stock has fallen in price!

The classification of small cap stocks lies not in the stocks but in the companies themselves, i.e., in the assets underlying the stocks. We believe the following three characteristics offer an appropriate and helpful guide to identifying small cap stocks:

1) **High Risk-High Reward.** Small companies have less total resources, fewer product lines, and less seasoned management than larger companies. Small companies may have a less developed distribution system. Small companies will have fewer chances to make large strategic errors. On the other hand, small companies have the chance to grow into major factors in their industry. Those skillful enough to succeed will richly reward their investors.
2) **Ability to Exploit Economic Turmoil/Technological Innovation.** Periods of economic uncertainty or rapid technological innovation increase the stress on all companies. Many large companies will fail to manage their businesses properly during these conditions, opening the door for small companies to gain significant market share. This is not to imply that all small companies will thrive but that a sizable minority will take advantage of the uncertainty to become major factors. Massive technological change offers small companies a similar chance to seize the opportunity. Conversely, periods of economic or technological calm make it far more difficult for small companies to gain market share.
3) **Sensitivity to IPO Activity.** High numbers of new IPO issuance can quickly change the competitive landscape for a small cap company. High levels of IPO activity divert the attention of the investment community. An IPO boom funds an army of well-financed economic revolutionaries (the new companies) who will seek to change the world. During periods of reduced IPO activity small companies have greater chances to blossom.

Why we believe the small cap cycle will continue for several more years

Most investors believe that small cap stocks have higher risk and higher reward than large cap stocks. Surprisingly, there has been little research on how much of a premium return is necessary to justify the higher risk. Further, the large number and constantly changing inventory of small cap companies makes it difficult to estimate the future returns from the entire group of stocks with sufficient precision. Our approach to this important issue has two elements. Instead of seeking to estimate the relative attractiveness of small cap stocks we focus on absolute returns. Occasionally small cap stocks are priced to provide our clients will a very high (15%+) annual return; we believe returns of that magnitude should be acceptable to our clients in both absolute and risk-adjusted terms. Second, rather than try to estimate the returns available from a large sample of small cap stocks we have chosen to estimate the returns from those companies with whom we are familiar. If DGI can find lots of small cap stocks with high expected returns, we think it is prudent to infer that the returns available from small cap stocks as a group are probably high as well.

In October of 1998 we predicted that small cap stocks would begin a multi-year period of superior performance. The primary basis for our forecast was the discounted stock prices associated with many of our holdings. We were able to find many companies selling at or near the value of their liquid balance sheet assets; the stock market was assigning little or no value to companies with bright futures. We had only seen this extreme discount once before, in late 1974. The performance in small cap stocks from 1974 until 1982 was far in excess of our 15% per year hurdle rate.

The price action of small cap stocks in late summer/early fall of 1998 bolstered our confidence that we were seeing unusual activity. For the twelve months ended in August of 1998, the Russell 2000 underperformed the S&P 500 by the widest margin in the twenty-year history of the Russell 2000 index. At our request Prudential Securities looked for other one-year periods in which small cap stocks significantly underperformed large cap stocks; Prudential found nine such instances. In every case, small cap stocks outperformed large cap stocks in the following five-year period.

In the midst of the panic selling after the 9/11/01 terrorist attacks, we saw small cap stocks briefly sell at valuation levels last seen in 1998. This important gauge offers the best evidence that small cap stocks will continue to reward patient investors.

The economic environment is conducive to major progress by small companies. The terrorist attacks occurred in the middle of a stiff recession. Many companies will not adequately handle the ensuing challenges. Consider that only one year ago Enron Corporation enjoyed a market value of $62.6 billion; today the company is facing bankruptcy. Perhaps the biggest technological revolution ever is further stirring the economic pie. We cannot imagine a more fortuitous set of circumstances for a small company with vision, courage and discipline to become a major industry factor. Most will fail but those that succeed will richly reward their investors.

The 1990's witnessed an unprecedented level of IPO activity. We believe the effects of elevated IPO activity on small cap stocks has not received sufficient analytical attention. The amount of IPO activity has a significant, perhaps dominant, effect on small cap companies and stocks. There is early evidence that the great IPO boom of the 1990's is beginning to recede. This would be positive for small cap stocks.

The IPO Boom

Charts III and IV show by year the number of IPO's and the dollar amount of the IPO proceeds from 1979 until the present. During the 1990's IPO activity was unprecedented. Over 5,200 IPO's came public from 1991-2001. This activity swamped the prior decade which in turn swamped the 1970's. The number of IPO's peaked in 1996 and remained high until this year. The recent internet IPO boom was only a part of a larger boom, which extended through the entire decade.

Chart III. U.S. Number of IPO's per year

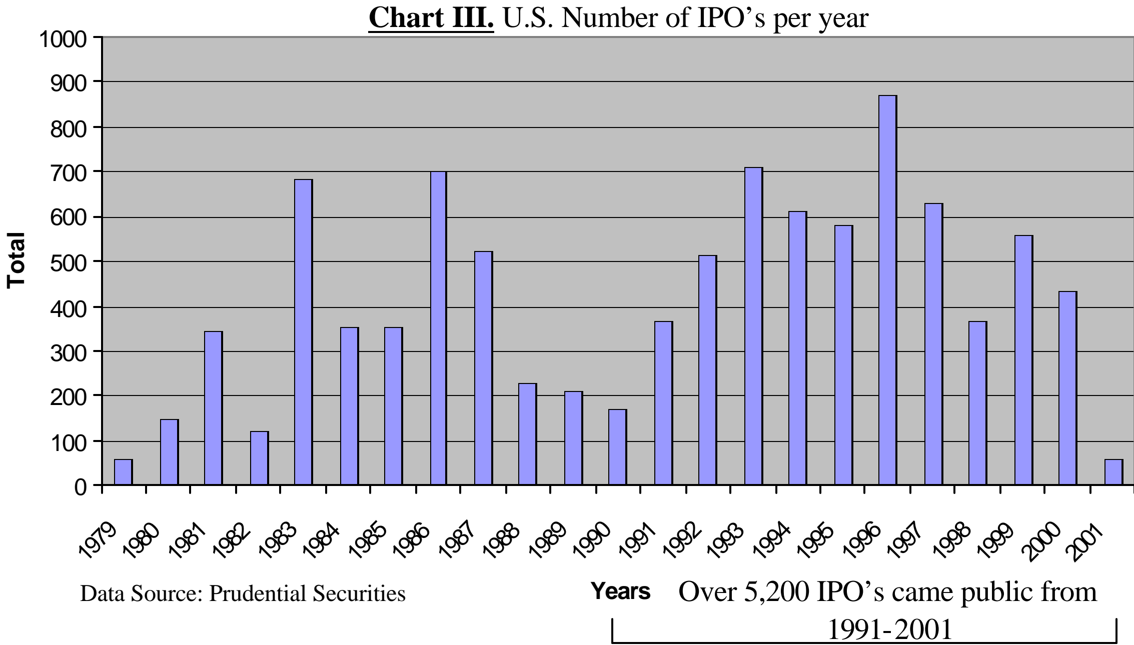
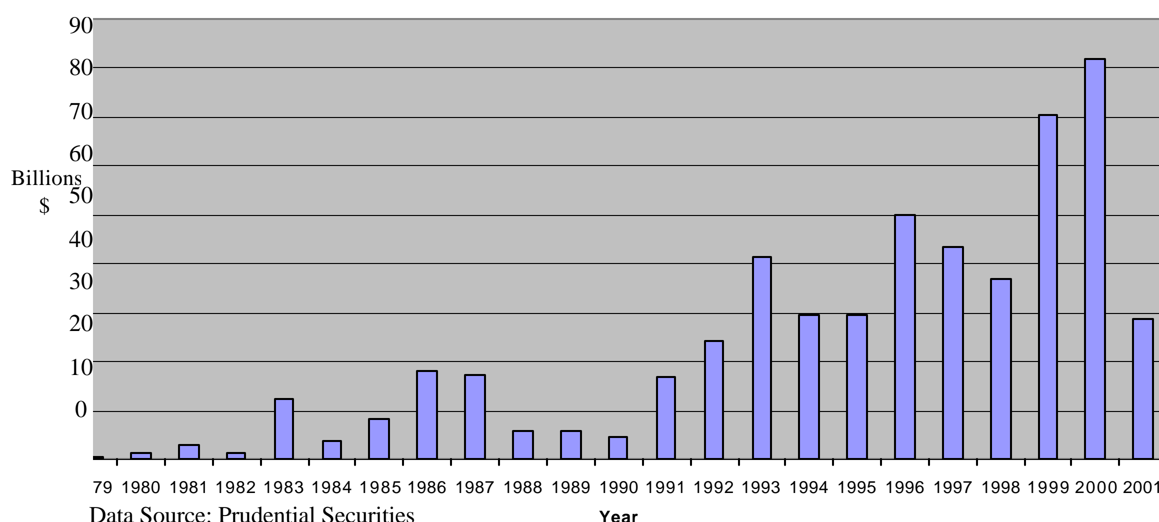


Chart IV. U.S. IPO Proceeds per year



The effects of an IPO Boom

Intense IPO activity has an enormous effect on the competitive landscape. Consider that you and your associates have just developed a nice private company with $30 million in revenues. You have been battling some other competitors for years. One of them raises money through an IPO. Now you are faced with a well-financed competitor. Your business problems are increased many times. Your competitor may decide to use this newfound capital to reduce prices and gain market share. Your competitor's balance sheet may be stronger than yours and more attractive to your customers. If two or more of your competitors raise money through an IPO your problems may be magnified. To be sure, there are some benefits to you when your competitor goes public. One major advantage is access to their public financial statements.

Raising funds specifically through stock sales is fundamentally different than raising funds through debt offerings. Raising funds through the issuance of debt involves a contract to pay fixed interest payments plus the original proceeds back at maturity. Proceeds from sale of equity have no fixed obligation. While an IPO might carry with it an implied cost of capital, the fixed cost of capital is effectively zero. This low fixed cost is a magic elixir indeed!

If we look past the intermediate effects of heavy IPO issuance, the effects are strongly positive. An IPO boom arms a generation of economic revolutionaries with a lot of capital having no fixed costs. We believe it is appropriate to assume that 90% of the IPO's will not survive and that only 5% will become big-time companies. While these mortality statistics seem daunting, from 1991-2001 over 5,200 companies issued IPO's. If only 5% of these companies make it to the big-time, then 260 companies will become major companies. According to Baseline, as of 11/13/01 there were 68 companies, including many overseas companies, with market caps over $50 billion. There were 350 companies over $10 billion in market cap. If 260 companies join the ranks of these elite companies over the next decade, investors in these companies are facing a bright future indeed.

The effects of an IPO boom on the investment environment are equally profound. It is important to understand that sales commissions associated with IPO's are often 10-20x the level of normal trades. The extreme profitability from IPO's means that when the IPO market is hot, the brokerage community focuses almost exclusively on selling IPO's. Here in Minneapolis the Marquette Hotel is the spot for IPO breakfasts; on some mornings in 2000 there would be ten limos parked in front of the Marquette.

The high commissions associated with IPO's also drives Wall Street brokerage firms to sell a fundamentally overpriced product. Table I shows the one-day and longer-term performance of the ten hottest IPO's of the past two years. For example, if you purchased VA Linux Systems, you enjoyed a huge first day gain but you would subsequently lose 94% of your initial investment.

Table I. Selected IPO Performance

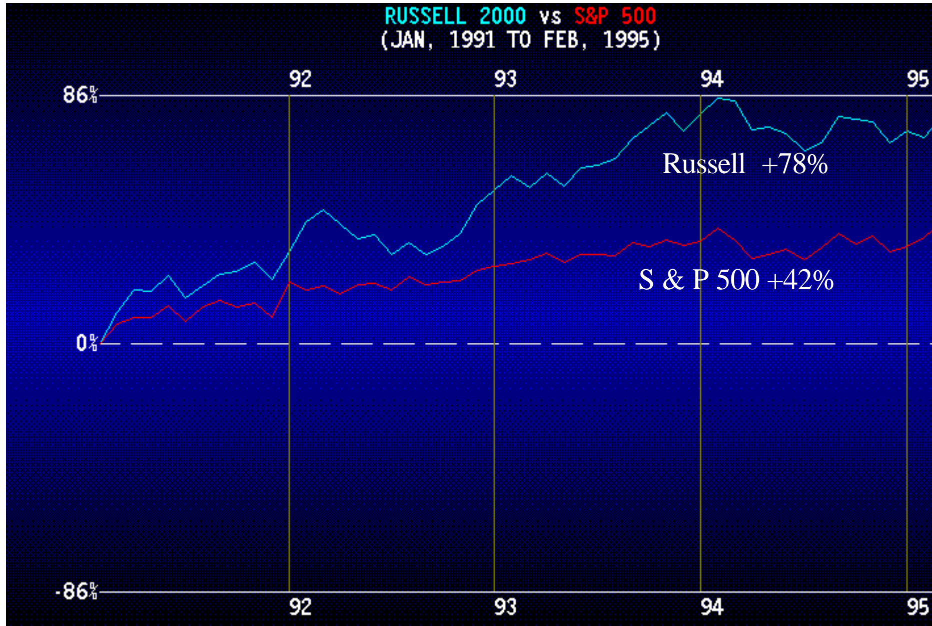
Issuer	1st-Day Gain	IPO Date	Current Vs. IPO Price *
VA Linux Systems	698%	12/9/99	-94%
Theglobe.com	606%	11/12/99	-98%
Foundry Networks	525%	9/27/99	**30%**
WebMethods	508%	2/10/00	-71%
FreeMarkets	483%	12/9/99	-61%
Cobalt Networks	482%	11/4/99	**101%****
MarketWatch.com	474%	1/14/99	-86%
Akamai	458%	10/28/99	-80%
CacheFlow	427%	11/18/99	-83%
Sycamore Networks	386%	10/21/99	-55%

Source: Dealogic and Marketwatch.com

* Price as of 08/16/01
** Cobalt acquired by Sun Microsystems on 12/7/00 for $1.3 billion in stock.

The following two charts illustrate the effects of an IPO activity on small cap stock performance. Referring back to Chart III shows that IPO activity was subdued from 1988-1990. During the subsequent period from 1991-1995 the Russell 2000 performed significantly better than the S&P 500. This is illustrated in Chart V. Again, Chart III shows that IPO activity began to regain prior levels of activity in 1993. The expansion in IPO activity beginning in 1993 had a major effect on the relative performance of the Russell 2000, which lagged the S&P 500 from 1995-1998, as shown in chart VI.

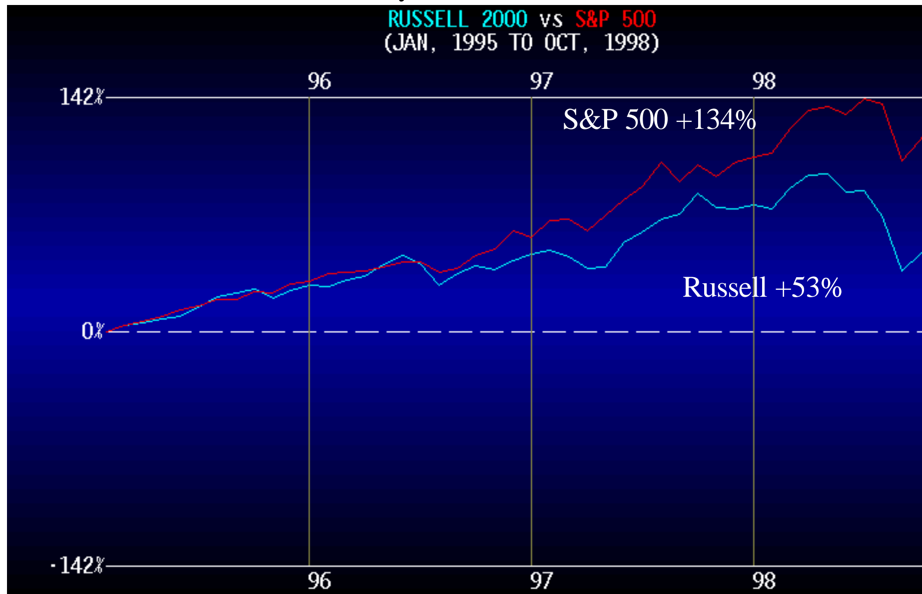
Chart V. Russell 2000 Vs. S&P 500
January 1991 – February 1995



Source: Baseline

Because of the suppressed 1988-90 IPO activity, small cap stocks enjoyed a period of superior performance from 1991-1995. (See Chart III Illustrating low IPO activity 1998-1990)

Chart VI. Russell 2000 Vs. S&P 500
January 1995 – October 1998



Source: Baseline

Beginning in 1993, the number of annual IPO's began to rival activity in the 1980's. The effect on small cap performance became quite pronounced from 1995-1998.

Will the level of IPO activity remain subdued? Perhaps a valuable clue was offered in September of this year; for the first time in at least 20 years there were no IPO's issued that month. We think it is prudent to expect IPO activity to resume gradually.

Summary

In October 1998 we asserted that small cap stocks would begin a multi-year period of superior relative and absolute performance. The performance data since then has begun to validate our forecast.

Our definition of a small cap stock begins with a look at the company underlying the stock. A small cap stock is a small company who wants to become a major factor in its industry.

Superior small cap stock performance is based on attractive valuations, economic uncertainty, rapid technological innovation, and subdued IPO activity. Such conditions exist today and should allow for continued high returns from selected small cap stocks.

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