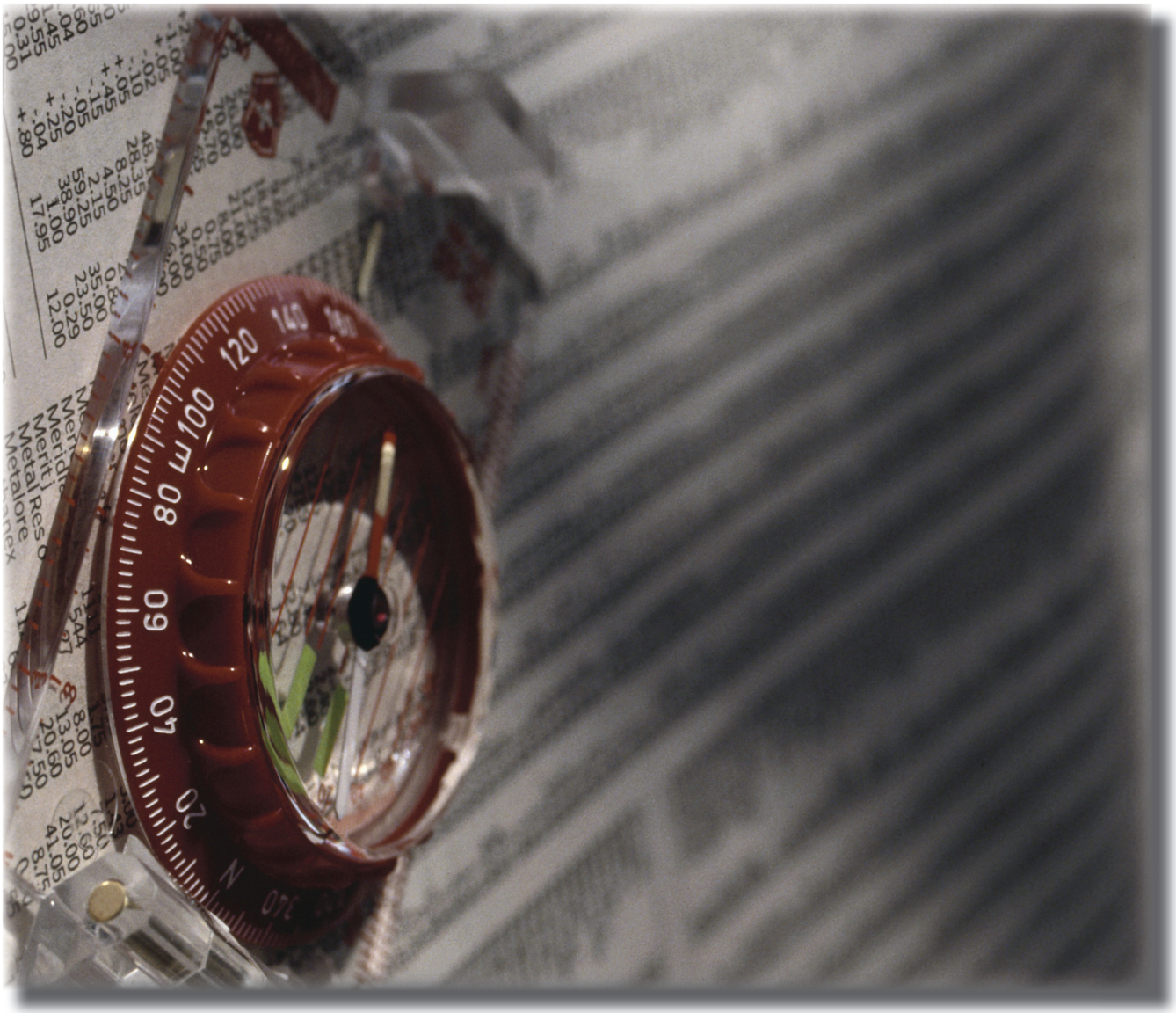

Current Investment Strategy

Insight from the perspective of our Chief Investment Officer

November 2011

By
Fred Martin, CFA

DISCIPLINED GROWTH INVESTORS

The Way Wealth Is Built

Current Investment Strategy

By Fred Martin, CFA

The third quarter of 2011 was rough on long-term investors. The market decline during the quarter was caused in large part by irresolute action on the part of governments in the United States and Europe. In the United States the political leadership failed to significantly reduce federal budget deficits. In Europe, the political leadership has not yet faced the Greek debt crisis.

The stock market declined sharply in the face of this lack of leadership. The S&P 500 declined by 13.9% and the Nasdaq by 12.9%. The Russell mid-cap growth index declined by 19.3%. In our view this is not a sustainable market decline because the valuation of our stocks remains highly favorable and the profit/cash flow progress of our holdings has been excellent.

For the last three years we have asserted that the valuations of our stocks were highly favorable. We believed our stocks could perform well in a poor macro-economic environment. Also, our stocks faced little or no competition from the two other major areas for liquid investments, bonds and money market funds. Even though the negative headlines dominated the news during this past quarter, we are beginning to see a glimmer of hope in the macroeconomic environment. This represents a major change in our thinking about the investment landscape.

Before we outline our thoughts we want to caution our readers that we are only seeing a glimmer of hope, not a full burst of sunshine.

After the severe damage to the financial system from the 2008 crisis, we did not then see the basis for a vigorous, normal economic recovery. We estimated that the economy might begin to recover in 2015 or 2016. Among our concerns was the collapse in housing prices and activity.

We now feel more confident that a full recovery should be underway by 2015-'16, with a possible slight improvement in the economy beginning in 2012.

What is the basis for our view?

1) The political environment

We did not know how the American people would react to the 2008 financial meltdown. Would they prefer a larger or smaller government? Would they engage in self-pity or would they be willing to roll up their sleeves and tackle the problems? Would they allow their political leaders to maintain the same policies? We believe the answer is clear: The American people want to put their country back on track. They are very dissatisfied with the political leadership, as evidenced by the popularity of the Tea Party and recent emergence of the Occupy Wall Street protesters. They do not accept the status quo and are willing to accept personal sacrifice for the greater benefit of the country. The 2010 mid-term elections were a vote against national economic policies, and we expect the 2012 election will reflect similar sentiments.

"We now feel more confident that a full recovery should be underway by 2015-'16, with a possible slight improvement in the economy beginning in 2012.

2) Changes in national economic policy

The prescription to restore our economy is becoming increasingly clear and is achieving a rough consensus. To improve our intermediate-term prospects, the key points are to simplify and flatten the tax code and reduce regulatory impediments to economic activity. The top priority is to encourage domestic hydrocarbon energy production. The second priority is to significantly revise or rework the recent legislated changes in the U.S. health care system.

The third priority is to rationalize the regulatory oversight of the financial industry. These changes alone would begin to restore business confidence in the U.S. business climate. It is also becoming clear that federal spending, including entitlements, is not sustainable over the long term.

3)Positive game-changers

The Bakken oil/gas field in North Dakota has emerged as a major find, helped by new exploration technology, horizontal fracking. There is little question that the field is very large. It now appears that oil and gas can be produced from this field with lifting costs only slightly higher than Saudi Arabia. The Bakken field is likely not the only domestic hydrocarbon field with significant reserves and reasonable lifting costs. Increased domestic hydrocarbon energy production could be transformative, adding domestic jobs and also radically changing our balance of trade. And, as though the Mideast did not already have enough unrest, increased U.S. production and reserves could change the balance of economic power in the energy industry. Second, the technology revolution continues to unfold at a rapid pace. The proliferation of the Web and mobile computing and communications is driving prices down and offering potentially major opportunities for productivity gains. We expect this technology revolution to take years to unfold. The process will be Darwinian: Many companies will fail to grasp the extent of the change, while others will embrace it and thrive.

4) Housing and banks

It is only a matter of time before both sectors become contributors to the U.S. economic picture. U.S. banks are improving their balance sheets. The remaining threat to them is the collateral damage from a European default. Net interest spreads are still depressed, and loan growth is problematic. Both conditions should improve with a more robust economy. The affordability of housing is now at a generational high. The extremely attractive value of U.S. homes today will provide the basis for a recovery in housing.

5) European stasis

The pace of European response to the 2008 financial crisis is becoming clear. Europe is in no particular rush to solve its debt crises. Western Europe does not have the same fascination with growth and technological innovation as we in the United States. We expect Europe will make changes slowly and only as necessary under the threat of a collapse in the Euro or its banking system. The slow pace of European progress will continue to cause varying levels of discomfort to U.S. investors. So long as Europe does not collapse, however, the U.S. economy can recover—if we improve our domestic business climate.

Conclusion

The above comments are not to imply that the level of macroeconomic uncertainty will recede soon. The more likely progression will involve two steps forward and one step back.

The investment environment will still have the "normal" set of risks. The stock market has always been subject to uncomfortably severe price declines. Individual companies will continue to face competitive threats from other companies. The rate and duration of every economic recovery is always uncertain. China may experience a slowdown. The world will continue to have pockets of political instability. The Arab "spring" may morph into increased existential threats to Israel. The Iranian and North Korean regimes are likely to cause trouble of one sort or another.

Strong corporate earnings, reasonable valuations, and gradual macroeconomic improvements should enable the stock market to continue to make healthy progress over the next several years.

For more information,

contact Robert Buss, CFA, CIPM
Managing Director of Marketing and Client Relationships
150 South Fifth Street
Suite 2550
Minneapolis, MN 55402
612.317.4107, 800.510.4766
www.dginv.com

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 Authors

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.