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# ECONOMIC & MARKET *Update*



## THE SWORD OF DAMOCLES

JUNE 2009

Investors early in 2009 must feel like actors in the tale of the sword of Damocles. You may recall that Damocles is a flatterer in the court of Dionysius, a tyrant in the fourth century B.C. Dionysius decides to show Damocles the perils of being a ruler by offering him the chance to be emperor for a day. When Damocles assumes command he notices a sword hanging above his head by a thin hair; this is too much for him and Damocles decides to become a commoner once again.

The fable of Damocles serves as a metaphor for the foreboding engendered by a precarious situation. The image of a razor sharp sword dangling ominously over the heads of investors captures the sense of unease enveloping the economy and the markets today. This is the second time in the past ten years investors have felt so threatened by the sword of Damocles, the first having been the unease that seized the markets after 9/11 also weighed heavily on investors' minds. The passage of time has caused those painful memories to recede, even though the world geopolitical situation remains deeply troubled.

Make no mistake about it: The banking system nearly collapsed in the fourth quarter of 2008, directly threatened by a run on money market funds and bond mutual funds. At the time, there was even a significant chance that the banks would suffer a run on their deposit base. Such a development would have been catastrophic for the U.S. and world economies. Fortunately, the deposit base of the banking system has remained intact. Successful defense of bank deposits largely prevented a re-run of the Great Depression of the 1930s. The world economies are likely to stabilize and eventually recover. This major systemic threat to the economic system has been held at bay, but there is and will be a lingering sense that the sword of Damocles is still hanging over the system.

That said, we have learned a great deal as the financial crisis has unfolded, and we can now begin to estimate the long-term effects of the past several years, culminating in the crisis of late 2008.



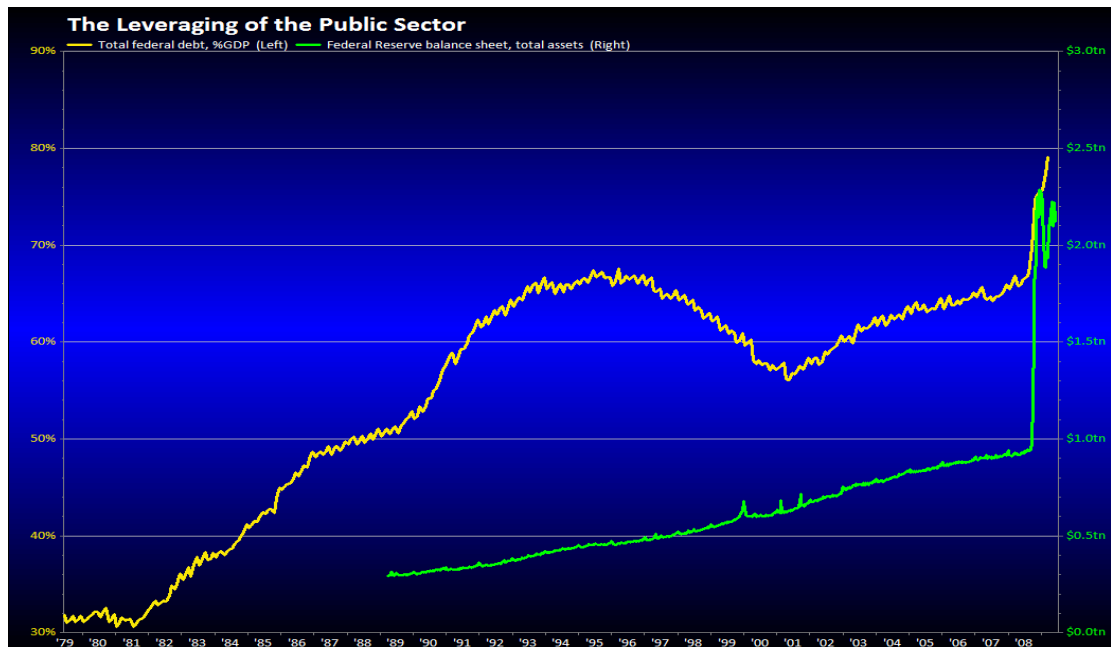
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There are at least five major developments to consider:

1. The shadow banking system has collapsed. As its name implies, the shadow banking system is a loose amalgamation of investment banking firms, government-sponsored enterprises (GSEs), hedge funds, and non-bank loan syndicators. In recent years the shadow banking system had dominated the regulated banks in providing loans. According to Jamie Dimon, chairman of J.P. Morgan/Chase, regulated banks' share of loans in 2007 were only 20% of total loans. Beginning with distress in the sub-prime mortgage originators in 2007 and ending with the collapse of Lehman Brothers and AIG last fall, the shadow banking system effectively ceased to function. Worse, the shadow banking system was loosely regulated and had no protocol for dealing with failed entities. The now-obvious result was the largest financial panic in more than 50 years.
2. The damage to the shadow banking system will take years to repair. Fannie Mae and Freddie Mac are zombie-like entities, neither public nor private. Yet, Fannie and Freddie remain at the center of the financial crisis with an incredible \$5 trillion of mortgages and guarantees. Curiously, there has been little public mention of either company since September, except for brief reports of billions more infusions of federal dollars. Eventually, both entities will have to be fixed. AIG remains embroiled in financial and legal disputes. Hank Greenberg, the founder and CEO of AIG for 35 years until his ouster in 2005, is arguably the one man most qualified to salvage the company at the lowest cost to taxpayers. Mr. Greenberg is now suing his old company. As of today, there is no effective regulatory structure in place to supervise the shadow banking system. Even the seemingly simple goal of greater transparency in the securitization markets will take years to be realized.
3. The problems in the shadow banking system have severely shaken consumer confidence and business ability to fund capital investments. The world economy is experiencing the worst recession since the early 1980s. The economy must adjust to a different and as yet not fully defined financial system. This process is likely to hamper economic growth over the next several years.
4. The problems in the real economy have stressed the balance sheets of many borrowers, including municipalities and states.



5. In part because of the financial crisis, the U.S. is arguably undergoing the greatest transfer of liabilities from the private sector to the public sector in U.S. history. Both the Federal Reserve Bank and the federal government are leveraging their balance sheets. The Federal Reserve Bank balance sheet has grown by \$1.28 trillion in the past nine months. The federal government is poised to add trillions to its indebtedness over the next several years, the result of skyrocketing budget deficits. This new debt is in addition to the implied government backing of \$5 trillion of liabilities from Fannie Mae and Freddie Mac plus the large unfunded liabilities of Social Security and Medicare. Over the past nine months the center of risk has shifted from a possible run on bank deposits to the disproportionate response to the crisis by the federal authorities. The federal government's role has grown from protecting bank deposits (a necessary and vital step) to providing day-to-day funding for AIG, Fannie Mae, Freddie Mac, General Motors and Chrysler.

Publicly held federal debt is due to double and perhaps triple over the next 10 years. The issue is not whether deficits of this magnitude are sustainable but how they will be resolved. Funding of these deficits will require continued willingness of other countries to purchase our debt plus a subdued U.S. consumer willing to invest in U.S. treasuries. We cannot know when or how messy the resolution of our deficits will be. It is reasonable to envision reduced government spending, higher taxes, inflation, or some combination of the above.

The shareholders and bondholders of General Motors and Chrysler, along with stakeholders in the banks receiving TARP funds, have experienced the effects of increased federal involvement in the private sector. Chrysler and General Motors have entered bankruptcy proceedings. There is much turmoil in the debt markets over the treatment of secured creditors of Chrysler. Many of the banks want to repay TARP money as soon as possible and have taken the extraordinary step of reducing stock dividends to do so. A significant gap in the level of trust between the private sector and the federal government has opened.

In random order the following risks have been elevated by the sharply expanded government role in the U.S. economy, especially since the increase is funded by borrowing:

1. A significant decline in the exchange rate for the U.S. dollar.
2. A significant increase in inflation.
3. A significant increase in interest rates.
4. An aborting of the economic recovery if taxes are increased.
5. Increased economic uncertainty along with high unemployment and reduced capital spending.
6. Increased concern over sanctity of debt contracts.

The scale of the federal response has tempted some observers to forecast an immediate return to high inflation or a dollar crisis. We believe such forecasts are premature. For the moment it is sufficient to note that the risks of such developments have been elevated. It will likely take several years, if ever, for the increased federal involvement to metastasize into a full-blown economic crisis. That said, there are some immediate steps investors can take to protect one's portfolio from the threat of government excess.

U.S. Treasury debt is to be avoided. The leveraging of the federal balance sheet is so extreme that the AAA credit rating of the U.S. government may be called into question. Fortunately, the yield on Treasury debt is so low today that investors will likely suffer little to avoid this area. We are also skeptical of the quality of government agency debt backed by the implied faith of the U.S. government; we would avoid that debt, too. Avoidance of these kinds of issuers is a "no-brainer."





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A second prudent step is to limit the maturities of one's bonds. Long-term yields are low and inflation ruins the value of long-term fixed income obligations.

A third step is to be generally skeptical of quality ratings on debt. The best way to avoid the travails of the Chrysler and GM bondholders is to shun debt in companies likely to fail. The state and municipal issuers should also receive a thorough analysis; California is not alone in its budget problems.

The financial crisis has opened up major opportunities for investors, especially in stocks. Capitalizing on the returns available from stocks will not be easy. My brother Frank, a fine money manager, said it best in a letter to his clients: "Careful stock selection, a steely temperament, incredible patience, and the belief that this too will pass may be all that's necessary."

The forecast of future long-term returns from stocks tells the story best. Our portfolios offered potential seven-year returns in excess of 25% annualized from the recent market bottoms last fall and this spring. The S&P 500 index, composed of the largest capitalization companies, offered at least average returns (8% or higher) over the next seven years. These expected returns should dwarf the return from such prior "star" sectors as U.S. Treasury notes and bills.

As you may recall, our instinctive reaction to the events of the market last year was to intensify our efforts begun three years earlier, emphasizing investment in companies with excellent managements, growing markets, and good business models able to self-finance reasonable growth. We declined to invest in the lending business; we believed that sector was too speculative.

We believe developments since last September have validated our investment focus in the equity markets. Our companies' ability to self-finance growth will be a strategic competitive edge in light of the damage to the financial system. Weaker competitors will likely fail and allow for market share gains by surviving companies. Our companies are poised to take advantage of the likely economic environment: a sub-par U.S. economy in the midst of a major long-term trend towards innovation and globalization. Our companies are also likely to enjoy a competitive edge as larger companies bear the brunt of federal government involvement in the U.S. economy.



At least two economic sectors may emerge as attractive areas to investigate. Over the past decade and increasingly over the past five years, regulated banks have lost market share to the shadow banking system. With a secure deposit base (and low cost of funds) the regulated banks are poised to gain market share. The health care insurance system is likely to be restructured this year. At the moment we have concentrated our health care holdings on companies with proprietary products offering a superior price/value relationship to other products in the market. We expect a major restructuring of health care insurance; this may create opportunities.

The expected return for our stock portfolios is so high that we are willing to invest in stocks in the face of a tepid economic outlook and a disproportionate federal response to the financial crisis.



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