DISCIPLINED
GROWTH
INVESTORS

THE OLD-FASHIONED WAY

Small-cap U.S. stocks are on the verge of a great bull run likely to last several years. This bull run will most likely begin within the next twelve months. This bull run may rival the great bull run from 1975-1983, during which small cap stocks increased over eight-fold from trough to peak.

Our forecast is based on an analysis of six factors:

1) Current market conditions closely resemble those that existed in 1973-74.

2) Relative and absolute valuation of small cap stocks is the most favorable in at least two decades.

3) Slow resolution of the worldwide currency/economic crisis will favor companies that can achieve excellent earnings progress in market niches.

4) Supply/demand environment for small cap stocks has shown dramatic improvement.

5) The Federal Reserve has changed its policy towards monetary ease.

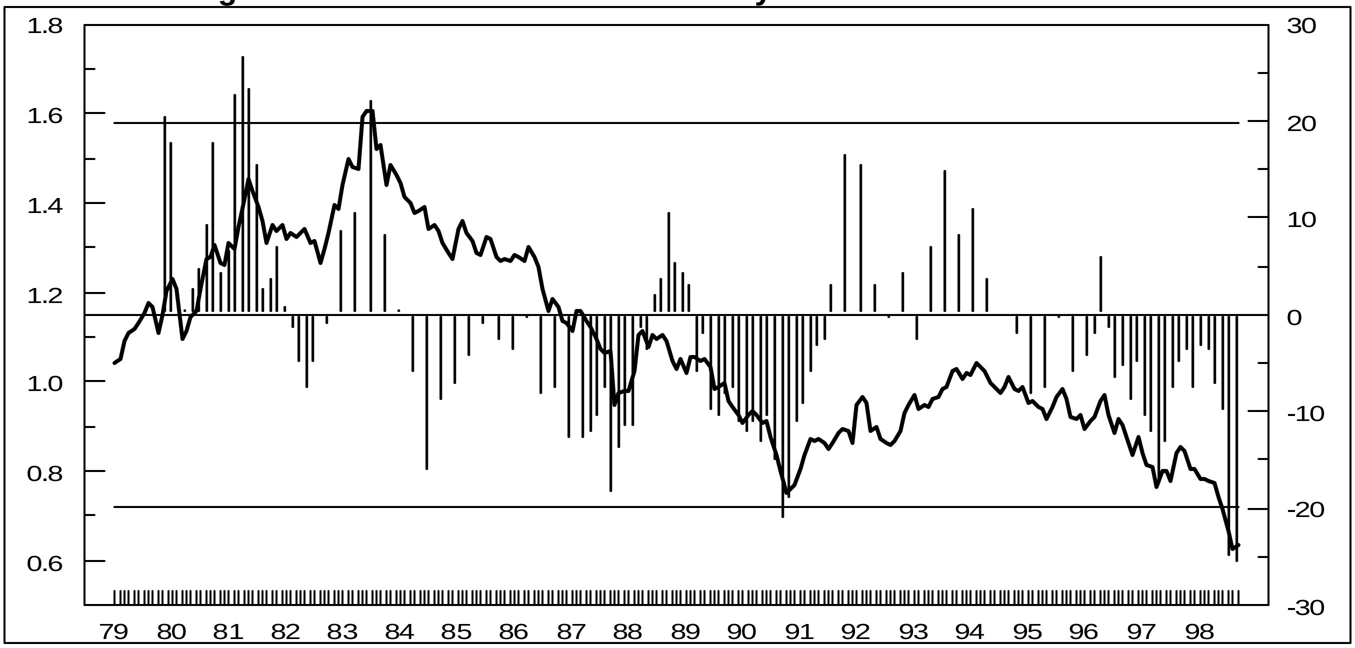
6) Large-cap stocks and hedge funds are likely to provide disappointing performance.

HERE IS AN EXAMINATION OF EACH FACTOR IN GREATER DEPTH:

1). Current Market Conditions During the twelve months ended 8/31/98, small-cap stocks, as represented by the Russell 2000, underperformed the large-cap stock proxy, the S&P 500, by over 25%. This was the largest divergence since the Russell 2000 was created 19 years ago. A respected market analyst, Claudia Mott of Prudential Securities, recently analyzed the performance between small and large caps for periods prior to the advent of the Russell 2000. She found that the current performance divergence was exceeded only (slightly) by two prior periods, 1932 and 1974. Chart I. clearly illustrates that the performance gap is the largest in the 19-year history of the Russell 2000.

CHART I. RUSSELL 2000 versus S&P 500 COMPOSITE

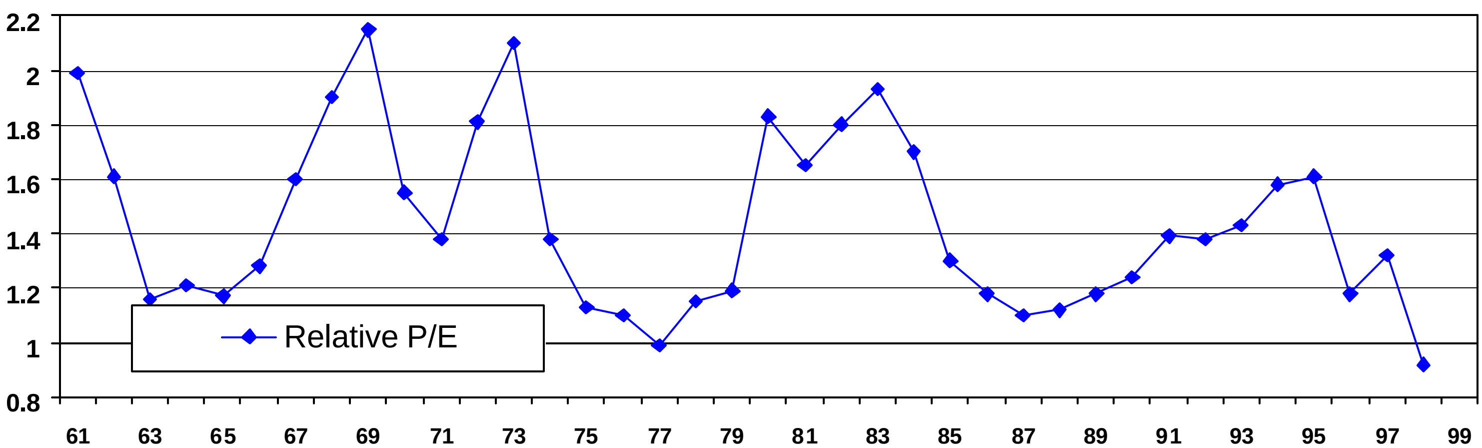
Trailing 12-Month Relative Performance by 2 Standard Deviations is Rare



Source: Prudential Securities
Line: Left Scale = Cumulative Relative Performance
Bar: Right Scale = Trailing 12-Month Relative Performance
Top Horizontal Line = Positive Two Standard Deviations
Bottom Horizontal Line = Negative Two Standard Deviations

<u>2.) Relative and Absolute Valuations</u> For the past two years we have been detailing the growing imbalance between valuations of small and large-cap stocks. Today those valuations are more extreme than anytime in the 19-year history of the Russell 2000 index. Perhaps the best long-term perspective is offered by the experience of the well-known T. Rowe Price New Horizons Fund, a mutual fund focused on small-cap stocks. The current relative multiple of the New Horizons Fund is 86% that of the S&P 500. This is the lowest relative valuation in the 38-year history of the Fund. Chart II. shows the relative P/E of the New Horizons Fund over its existence. Absolute valuations are also at extremes. On this score we are relying on our long experience (25+ years) in the investment business. Today's absolute valuations for small-cap stocks rival the extremes of any period we can remember, including the bear market in 1974. At the bottom of the 1974 bear market, it was possible to find companies selling at less than net-net working capital. (Net-net working capital is computed by subtracting all liabilities, including long-term debt, from current liquid assets.) In theory, buying a stock at less than net-net means an investor is buying the long-term assets, franchise, and earnings power of that company for free.

CHART II. NEW HORIZONS FUND P/E RATIO RELATIVE TO S&P 500



Source: T. Rowe Price and Salomon Smith Barney Estimates

There are many of these stocks today; and the last time we remember these values was in 1974. Today we are examining companies selling below unencumbered cash on the balance sheet. Why are these stocks so cheap? As we have said many times before, stocks are an asset class wherein the cheaper they get the less investors want to own them. Major selling makes major bottoms in valuations.

<u>3.) Macro Economic Environment</u> Our current working assumption is that the world faces major challenges relating to currency volatility, the Japanese banking crisis, the Russian default, and the teetering economies of Latin America. None of these problems are likely to be resolved quickly. Our best forecast is that the world will muddle through the current problems with some damage to financial institutions. Worldwide economic growth will suffer. From a market perspective, large-cap stocks will not have a robust economic environment in which to grow. We believe S&P 500 earnings will struggle to grow much faster than 4% over the next several years. In this sub-par macroeconomic environment, small-cap companies will be able to post significantly higher growth rates. Typically the earnings performance of small-cap companies are more dependent upon execution and industry conditions than the overall economy.

<u>4). Supply/Demand Picture for Small-Cap Stocks is Dramatically Improving</u> First, the carnage in small-cap stocks during this year has halted the IPO boom. We estimate IPO activity will not regain active levels until a major restoration in investor confidence is rebuilt. This is very positive for those stocks fortunate enough to have gone public in the past three years. Not only are these companies now well capitalized, but also the odds of a new competitor emerging from the private-company arena with strong financing are significantly reduced. Second, the public is reducing their purchases of small-cap mutual funds; many small cap funds are actually experiencing outflows. Third, corporate purchase activity has picked up. In August, corporate purchase activity surged to the second highest level of the year. The following is a quote from an October 12, 1998 equity strategy piece by Elizabeth Mackay, of Bear Stearns. "In a decided trend change, companies capitalized at less than $1 billion accounted for 78% of share repurchase activity in the third quarter. This compares with 27.6% of the companies in the first quarter and 9% in the second quarter. Formerly, the equity shrinkage phenomenon had been lopsided in favor of large companies because they were buying back stock but issuing very little, and small companies in recent quarters were net issuers of stock by almost a 10:1 ratio versus repurchases…Corporate managements may be finding these valuations too compelling to pass up." Fourth, insider buying is becoming highly favorable. According to CDA/Investnet Technologies, a service that tracks insider buying, insider activity is reminiscent of the activity of the bullish readings back in 1990. Insiders tend to be early but often presage major moves. The analysts in this service believe the aggressive pace of insider buying is similar to the pattern in the bank stocks in the early 1990's. If the insider activity continues, then this would be a very bullish signal for the broad stock market. Thus, while the less knowledgeable set of investors (mutual fund investors) have lost their ardor for these stocks, the IPO activity has effectively stopped and corporate insiders are buyers. This action shifts ownership of these stocks from weak hands into stronger hands.

5). Thursday, October 15th, The Fed Unexpectedly Cuts the Discount Rate This move by the Fed signaled a major policy shift towards monetary ease. We believe the Fed did this to forestall a developing credit crunch caused by the collapse of a giant hedge fund. According to Claudia Mott of Prudential Securities, since 1954 during the twelve months when the Fed cut the discount rate, small-caps beat large-caps in eight of ten times over the next twelve months. The greatest period of relative performance came after the discount rate cut in December of 1974. This marked the beginning a multi-year cycle of outperformance for small-cap stocks.

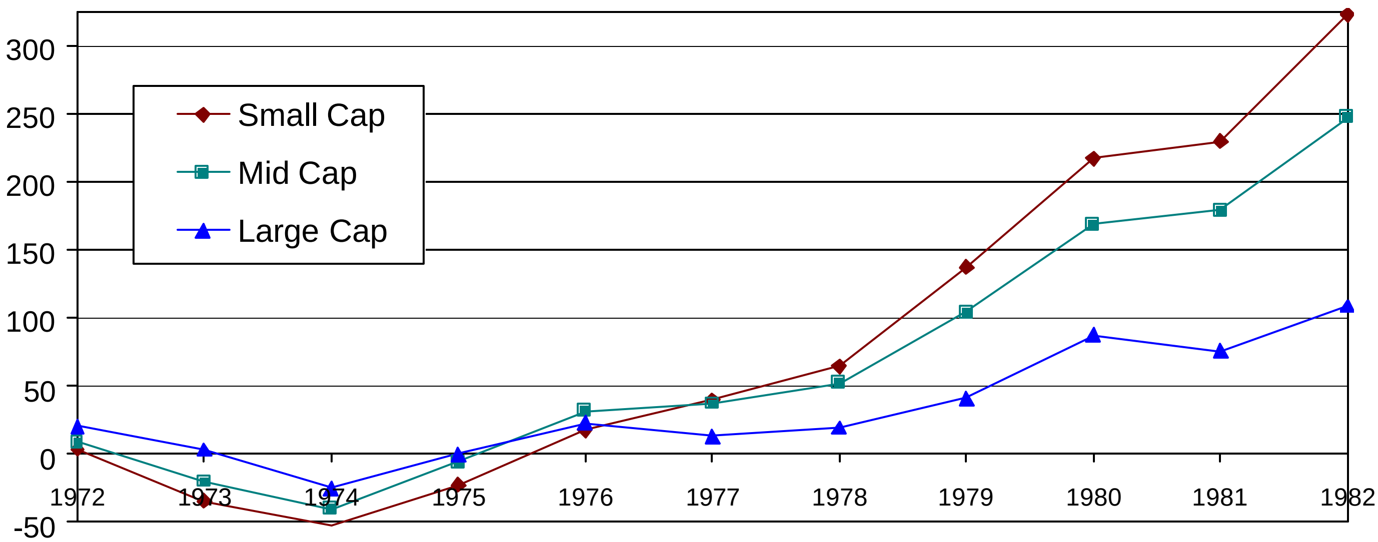
6). Large-Cap Stocks Face Two Major Obstacles First, the slow pace of economic progress around the world is likely to limit their earnings progress to perhaps 4% per year. Second, the large-cap stocks are priced as though their earnings growth is likely to be 8% per year. We believe large-cap stocks will have to incur a valuation adjustment from about 22x earnings to 15-16x earnings. It should be noted that that this P/E is still well over the extreme lows of the early 1980's, but the benign interest rate environment should support P/E ratios in this range. It should also be noted that we are not forecasting an immediate return to these P/E levels, but we are strongly asserting that large-cap stocks need to remove the excess of 25% from their current valuations. Inevitably, this means the large-cap stocks will provide disappointing performance, whether it comes quickly or more slowly. We also believe the troubles of the major hedge funds are positive for small cap stocks. We cannot quantify our thoughts, but we believe hedge funds have taken risk capital away from the small cap sector. Investors in these funds have been lured by the siren of high returns with no monthly volatility.

They are finding out that high returns always involve high risk. In the case of small-cap stocks, high monthly and quarterly volatility is the price one must pay for high long-term results.

In closing Chart III. presents the performance of three market cap segments from 1972-1982. Study it carefully.

Chart III. Ten Year Cumulative Performance Returns

Source: Prudential Securities



	Large-Cap	Mid-Cap	Small-Cap
Cumulative Returns:	**108.87%**	**247.04%**	**322.75%**

During the first three years of that period, it appeared that small-cap stocks were dead. Yet, had an investor held small-cap stocks during the entire period, that investor would have enjoyed a great decade. The period from 1975-1982 offered exceptional returns. It is important to remember that this period of outperformance occurred in a truly lousy economic environment.

In summary, we now strongly assert that the opportunity in small-cap stocks is the best in a generation. While it is possible that small-cap stocks hit major lows earlier this month, we wish to note that small-cap stocks could still suffer price erosion if the large-cap stocks were to quickly fall to normal valuation levels. However, we believe a major bull market will begin anytime from the lows earlier this month to sometime next year.

As a firm, Disciplined Growth Investors is dedicated to capitalizing on this opportunity.