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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Mid-Cap Growth

FRED MARTIN has 31 years of professional money management experience to serve the clients of Disciplined Growth Investors. A co-founder of the firm, Fred manages the majority of clients' portfolios and leads the firm's investment process serving as chief investment officer. He is directly responsible for equity research along with the firm's other investment professionals. Fred is highly respected by the firm's clients and in the investment management community for his long-term vision and dedication to sound and consistent investment practices. Fred initiated his professional investment career in 1973 as an equity analyst and later as a portfolio manager at Northwestern National Bank of Minneapolis. His entrepreneurial and innovative spirit led him to build from scratch the only office of Mitchell Hutchins Asset Management outside of New York. Fred began the successful process of building his loyal client base and investment management business in 1979. For over an 18-year period Fred managed equity and balanced portfolios for a variety of institutional clients and high net worth individuals. Most importantly during this period Fred achieved excellent investment results for his clients. The performance numbers were a result of a fundamental investment process that he developed supported by his independent and diligent research. Fred's disciplined approach to investing and his reputation as a premier money manager allowed him to attract topnotch investment talent to Disciplined Growth Investors.

SECTOR – GENERAL INVESTING

(AAY505) TWST: Would you please start with an overview of Disciplined Growth Investors? I know you're the founder of the firm, so who better to ask?

Mr. Martin: We are going to be 13 years old in February. We were founded in 1997 as a single-process firm focused on prudently exploiting inefficiencies in small- and mid-cap stocks. With our one process we have three types of accounts. We have small-cap growth portfolios, mid-cap growth portfolios and balanced portfolios that are a blend of our mid-cap growth stocks and fixed-income securities.

TWST: How do you define your growth investment approach? What are you looking for?

Mr. Martin: What we're really looking for is high returns over the next seven years from each of our stocks. The growth component is just one element of the expected return. The other element is the discount to the intrinsic value of the company. We often look like a value manager when we buy the stock, but we're buying companies that we think have above-average growth. This is our chosen process for yielding high returns with low turnover. We build a seven-year budget, including balance sheets and cash flows, for each of our companies. We forecast what the company is likely to be worth in seven years using reasonable assumptions for growth. We look at the stock price today, and we assume that the stock is going to trend towards the intrinsic value seven years from now. For small-cap stocks we require at least a 15% annual expected return prior to purchase; for mid-cap stocks, a 12% expected return.

TWST: These past 12 to 18 months have been such a rough time for the market with its extreme volatility. Would you tell us how your portfolios performed and how you dealt with the events of the past year?

Mr. Martin: Let me tell you about what happened before the crisis. I'm going to just talk about our mid-cap portfolios. In 2003 and 2004, we were uncomfortable with the decline in interest rates and what that meant for the likely business models for a lot of the financial service companies. We thought if interest rates were down, that meant that there was just less money for these guys to slice and dice, and their return on equity had to drop just because the spreads would not be as good. We began to reduce our exposure to the lenders; we continued that process through 2007. In 2007 we sold half of our position in a company called E-TRADE. Our portfolios entered 2008 with less than a half of 1% of our portfolios invested in any kind of a lender. We had a fairly extreme posture. We did not anticipate the severity of the market reaction to the Lehman Brothers' collapse in September. Our work showed very good returns in our stocks prior to the Lehman collapse, so we just said, "We're going to go with what our work shows." When the crisis hit, we went through our portfolios fairly rigorously. We wanted to emphasize companies that were self-financed, had sound management and good growth prospects. If we had questions about the company's business model, about its ability to get external financing, about the execution by the company, we replaced it with a stronger business franchise. From September of 2008 until March of 2009, we switched around 15% of our portfolios into better companies.

Our work has yielded surprisingly good results in 2009 — we're up 61.3% in calendar 2009. In 2008 we were down 39.5%. So over the two years of 2008 and 2009, we are now breaking even. We're aware that these are very good results. I don't think we did anything real fancy. We stayed out of areas we didn't understand; we improved the portfolio on the margin during the crisis. In our balanced accounts, we sold our Treasury bonds during the crisis and used the proceeds to rebalance our clients' portfolios. We had been generally bullish on Treasury bonds for the last 28 years; we thought they became grotesquely overpriced in the fourth and first quarter with all the panic. Our balanced accounts are actually above their previous all-time highs.

Highlights

Fred Martin says that what he is really looking for is high returns over the next seven years from every one of his stocks. The growth component is just one element of the expected return; the other is the discount to the intrinsic value of the company. He often looks like a value manager when he buys a stock but he is still buying companies that he believes have above-average growth. His process for yielding high returns and low turnover is building a seven-year budget, including balance sheets and cash flows, for each of his companies. He forecasts what they are likely to be worth in seven years. He looks at the current stock price and expects the stock will trend toward the intrinsic value seven years from now. For mid-cap stocks he expects a 12% return. His experienced management team works hard on selecting the companies they like to own, on the valuation models and the modeling techniques, and the performance over the last two years is far better than the market would imply by a large margin.

Companies include: Plexus (PLX); OpenText (OTEX); Trimble Navigation (TRMB); Garmin (GRMN); Edwards Lifesciences (EW); ARM Holdings (ARMH); Ralph Lauren (RL); Intuitive Surgical (ISRG); FactSet Research (FDS).

TWST: Did you take advantage of the lows when everything was very undervalued in March?

Mr. Martin: Our portfolios down in line with the market in the fourth quarter. What we did do is take advantage of that period and do what I call "housecleaning." Other than avoiding the lenders and rebalancing our balanced portfolios, we did not try to time stock market during this period. But as I mentioned, we added stronger business franchises and sold weaker ones at the margin. We also did a lot of client handholding.

TWST: How would you say the portfolio has shifted in emphasis from this time last year?

Mr. Martin: The biggest thing we perceived was major damage to the financial system as a result of the Lehman problems and **AIG** (AIG), etc. The damage was not with the regulated banks, it was with the shadow banking system. For any of your readers, the best description of what happened in 2008 was written by Jamie Dimon, the Chairman of **JPMorgan Chase** (JPM), in his 2008 letter to shareholders. It is a brilliant summary of what happened. So the shadow banking system has suffered tremendous damage and it was a major part of the lending mechanism. The damage to the financial system suggested that we should invest in companies able to finance their own growth. Longer term it should be a large competitive edge to be able to self-finance. The second area we focused on in a slower-growing economy overall are companies that could gain market share. We believed the crisis would probably cause the bottom feeders, which can garner a 10% to 20% share in good times, would probably wither away. We also believe big companies will focus on their core competencies, which will leave opportunities for small and mid-sized companies.

TWST: Tell us about the mid-cap portfolio in particular. How do you define mid cap?

Mr. Martin: It's any company with a market capitalization greater than $1 billion and less than $10 billion at purchase.

TWST: How many companies generally are there in the portfolio?

Mr. Martin: Typically 45.

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1-Year Daily Chart of Plexus

Chart provided by www.BigCharts.com

"Plexus is an outsourced electronics design and manufacturing company, a superbly managed Appleton, Wis., company. Wonderful business plan, self-financed and a terrific company. Plexus provides engineering and product development expertise plus end-to-end manufacturing. Often Plexus ships directly to the end customer, bypassing the intermediate customer."

TWST: What are some companies you can tell us about and that you feel are representative of your investment approach?

Mr. Martin: Plexus (PLX) is an outsourced electronics design and manufacturing company, a superbly managed Appleton, Wis., company. Wonderful business plan, self-financed and a terrific company. **Plexus** provides engineering and product development expertise plus end-to-end manufacturing. Often **Plexus** ships directly to the end customer, bypassing the intermediate customer. **Sybase** (SY) is another example, one of two remaining database management companies. It's a money machine that generates a lot of excess cash, and they've been gradually increasing their growth rate certainly in the wireless data management area. **Intuit** (INTU), with its QuickBooks and TurboTax franchises, is a dominant force in its sector. **Edwards Lifesciences** (EW), which has come out with a major new product — a heart valve inserted via transcatheter. Our clients' portfolios own these companies. **OpenText** (OTEX), a Web content management company, has a strong core portfolio and has been acquiring a number of companies very carefully. **FactSet Research** (FDS), we use their product. We think they have a competitive edge against Bloomberg and **Thomson** (TRI) with their superior analytics and tremendous client support. We are satisfied users of their products; we bought the stock. We own two GPS companies, **Trimble** (TRMB) and **Garmin** (GRMN). **Trimble** is strong in agriculture and construction. **Garmin**, of course with the handhelds; but they are also very strong in aviation and fitness, and a lot of sportsman applications. **Ralph Lauren** (RL) is another holding; it's a worldwide brand.

1-Year Daily Chart of Edwards Lifesciences

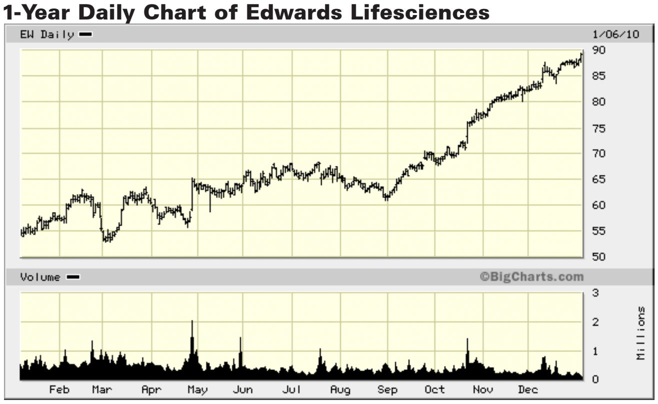

Chart provided by www.BigCharts.com

We also own a number of different retailers. Even though the retailing sector looks tough, we think that well-managed retailers do pretty well. In that sector we own **Ralph Lauren** (RL), and the **TJX Companies** (TJX) — they also own Marshalls, the discount retailer and a wonderful company. Also **Cabela's** (CAB) and **Ethan Allen** (ETH)**.** We have one restaurant, which is **Cheesecake Factory** (CAKE).

We're hopefully buying these wonderful companies with good franchises, ability to generate excess cash flow, good managements — that's how to think about us.

TWST: And they've all recovered from the March lows? They're all doing well?

Mr. Martin: Yes, substantially recovered.

TWST: Are there any areas that you deliberately underweight that you are not interested in?

Mr. Martin: Electric utilities aren't really a growth area. We still haven't made a major commitment to the lenders. We think that that's an area that is going to be attractive to banks and other lenders, but we'll work our way in pretty slowly as we gain comfort with the balance sheet risk. We virtually have no exposure to the raw material companies, the resource companies and the like. In our opinion, trading around low-growth businesses is a hard way to make money.

"Our tech holdings tend to be oriented around the Web, making the Web operate better, that would probably be a pretty good way to think about it. Adobe and Akamai are two companies we own in the space. GPS technology is revolutionary; we've got two of them."

TWST: Do you look for growth areas and for the companies in that area? What are your weightings compared to a benchmark?

Mr. Martin: Usually the big growth areas are pretty obvious. Because we think that there is still a huge technological revolution going on, our weightings tend to be heavier than the benchmark in the tech area. But there are lots of different kinds of technology. Our tech holdings tend to be oriented around the Web, making the Web operate better, that would probably be a pretty good way to think about it. **Adobe** (ADBE) and **Akamai** (AKAM) are two companies we own in the space. GPS technology is revolutionary; we've got two of them.

In the health care area, we're looking for proprietary product companies; we don't own any health insurers. Early in 2009, we were lucky to be able to purchase **Intuitive Surgical** (ISRG) with the da Vinci product, **Varian Medical Systems** (VAR), **Edwards Lifesciences**, which sort of gives you an idea of we're looking for: — proprietary companies with real demonstrated ability to execute well. We've owned **Genzyme** (GENZ) for years; it sells proprietary biotech drugs.

1-Year Daily Chart of OpenText

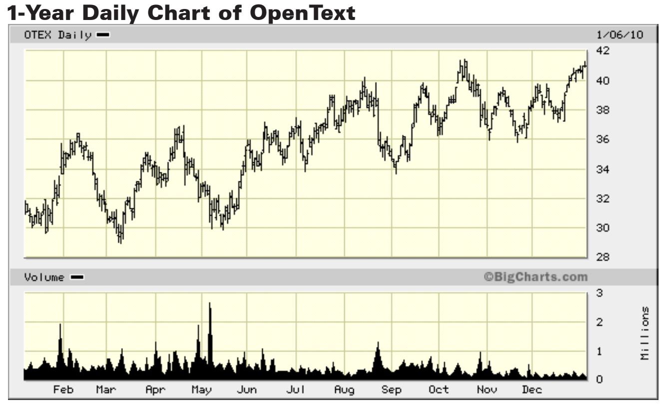

Chart provided by www.BigCharts.com

TWST: Like the cyclical companies?

Mr. Martin: Yes, the cyclicals or the commodity companies. We think they rarely have sustainable competitive advantage. It is just a hard way to make money. We don't have much exposure there.

TWST: What about companies with international operations, which there are several in the mid-cap arena?

Mr. Martin: We have long thought that to be a good money manager, you had to own world-class companies. We don't think you can hide just inside the U.S. anymore and hope that you'll be protected. We would prefer to have the companies be domiciled here because we can check the management out better, and the financial information is both timely and reasonably accurate. We own **OpenText**, a company headquartered in Canada, and we own **ARM Holdings** (ARMH), which is a company in England. **ARM Holdings** purchased one of our holdings for stock and we decided to hold on to the surviving entity. So you might see us slowly own more foreign-listed stocks, but it's really a function of the opportunities as they show up

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TWST: What about the management side of these companies? That must be a vital component of your research.

Mr. Martin: It's a vital component that commands a lot of our analytical focus. One of the advantages we have, we think, is that we own our companies for long periods of time, and this gives us the chance to really get to watch how managements perform. We're looking for "Level 5" leaders, as defined by Jim Collins. Because Level 5 leaders are self-effacing, it takes a while to identify them. We evaluate managers by their stated focus and how well they perform against their own benchmarks. We think talk is relatively cheap; we try to evaluate management by what they do. Let me give you an example in our own business. Lots of money managers show good results. How do you look for the special manager? I would ask three questions: One, what is your annual portfolio turnover? Two, what is your annual turnover of clients? Three, what is your annual turnover of employees? Those three questions will tell me a lot about how the manager views the investment world, his customers and his employees. You see, the Level 5 investment manager is sell-effacing and unlikely to toot his own horn. We turn our portfolios over less than 10% a year, our customer turnover is less than 1% per year, and our employees remain here for long periods of time.

TWST: You brought up turnover. What is the sell process? What criteria triggers an exit of a holding from your portfolio?

Mr. Martin: Let me say a couple of controversial things. First of all, the buy decision is much more important than the sell decision. So I'm a lot more concerned about what we are buying than what we are selling. If we could buy a wonderful set of companies, they stay reasonably well priced for a long period of time and we never had to sell them, we think our customers would be better off. There are three reasons to sell a stock. The first one is that the stock is clearly overpriced, and I mean clearly, where we're talking about a subpar return somewhat less than 5% per year over the next seven years; where you've done your work, and you've made reasonable assumptions, but you are not going to make much money with the stock. The second one, which is far more difficult, is to sell a stock because the fundamentals are deteriorating because usually they deteriorate slowly. We struggle with that. We think we're getting better, but this is a tough business. The third reason is to fund new purchases. Let's say we're buying a new position in the portfolio and we are running fully invested. We will go through the portfolio and look for the lower-return stocks. We will typically trim those positions to fund the new purchase.

TWST: What about risk control? How do you incorporate risk management in your portfolio handling?

Mr. Martin: We just published a piece on risk management. We have used the same risk management model for years. We measure five risks with a company and the stock. Four of the risks are passive, meaning we're just measuring, and the fifth is what we can change. We measure valuation risk, which is the inverse of the expected return. The lower the expected return, the higher the valuation risk. The second risk is business execution risk. The third risk is financial risk. The fourth is governance risk. This is the company's demonstrated willingness to treat shareholder capital with respect. The fifth risk is allocation risk, which is the position size in the portfolio. A 4% position at market value of the portfolio represents four times more risk than a 1% position. We control overall portfolio risk by adjusting the individual stock weightings or the allocation risk. What is notably missing from our risk management model is volatility. We don't believe volatility is a measure of risk.

TWST: Is that because you take advantage of volatility to get opportunities?

Mr. Martin: There you go; we should hire you as our straight man. Of course we use volatility to accumulate our positions. Here's the problem, Buffet says this: "A true investor welcomes volatility because you can buy wonderful companies at cheap prices." What he doesn't really explain is that once you own the stock, you own the volatility. So you have to understand that that's the way life is, there's no free lunch out there. But you are absolutely correct that we use volatility to accumulate positions. We then have to condition our clients to live with the volatility.

TWST: What do you think gives Disciplined Growth Investors its edge? What do you bring to the table that other companies with growth portfolios might not?

Mr. Martin: I am always hesitant to talk about a competitive edge, but I do think we have a sustainable competitive advantage. We have a clearly defined investment process. We prize intellectual honesty. We have a very experienced team, it's me with my 35-plus years and Scott Link's 18 years, and Rob Nicoski's 16 years. Scott and I have worked together for 13 years, and Rob has been here for 6-plus years. We've worked really hard on identifying the kind of company we like to own, on our valuation models and our modeling techniques. We are strong in a thing called "cumulative knowledge." Our performance the last two years is far better than the market would imply by a pretty good margin. We shouldn't be doing this well. I think it comes back to do you believe in what you do? Do you stick to it through thick and thin? When I look at our relative success, we really didn't do anything that was all that fancy. I think we just stuck to our knitting and executed pretty well. We also think we have a competitive advantage in how we manage our business. We have a very good firm. We are very careful on new business we're willing to take — not that we're high and mighty, but we evaluate whether we would do a good job for our new customer. That seems to me like a reasonable way to think about it. We only need 15 people to manage about $1.5 billion in assets. We have a got a great set of employees. I'd like to tell this funny story. There was a hedge fund that went out of business here in Minneapolis, a big hedge fund, $4 billion hedge fund. We have had a pre-planned move to the office tower next door early in 2010. We heard the hedge fund's furniture was for sale. We called them up, and we bought their furniture for pennies on the dollar. It's much nicer than the furniture we have now.

TWST: That's a business edge, you are absolutely right.

Mr. Martin: It is a business edge, and I don't think that's appreciated. In the end, I am running a business. We have to do all the stuff that a good businessman does. So there is a series of competitive edges, but obviously the number one is real clarity of focus on what we are trying to accomplish on our investments. That's really, really, really important.

TWST: What is your outlook for 2010? What is your advice to growth investors going forward?

Mr. Martin: 2009 started off really poorly and finished very strong. The key to 2009 was to to your discipline and invest in exceptional business franchises. That may not sound like much, but if you recall the panic-stricken environment in the first half of 2009, it was not easy to remain focused. 2010 should be an average year. The expected returns from our stocks are no longer at the stratospheric levels of early 2009 but are still above average. Corporate earnings may be very good. Inflation and interest rates are likely to remain tame. The government of Iran might fall. The U.S. voters may use the 2010 mid-term elections to express their displeasure of the large budget deficits, among other things. On the negative side, our budget deficits are not sustainable; something has to give. If I could just be philosophical for a second more, I think investors are misreading the risks in the investment arena. I think the risks are on the bond side, they are not on the stock side. Problems have been building in the debt market for a long time. Imagine owning Treasury Bonds today. The federal government is arguably broke. Why would you want to own T-Bonds when you receive a lousy yield and the U.S Treasury debt may be facing a credit downgrade? Private debt, including mortgages, has an elevated risk of default. Today's bond yields are not high enough to compete with common stocks, especially if you factor the probability of default of one or more bonds.

TWST: Thank you.

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