REPRINTED FROM APRIL 2003

THE WALL STREET TRANSCRIPT
Questioning Market Leaders For Long Term Investors

Disciplined Growth Investors

SCOTT D. LINK is a Portfolio Manager with Disciplined Growth Investors, Inc. He is a member of the firm's investment team. Mr. Link began his career at J.C. Penney headquarters, where he worked in the treasury, then in the pension area. He joined Advantus Capital Management with a team of professionals managing both large and small cap portfolios before joining Disciplined Growth Investors. Mr. Link earned a BS degree from the University of Wisconsin, Eau Claire and an MBA from the University of Texas. He is a Chartered Financial Analyst.

(SAL500) TWST: Would you give us a brief overview of Disciplined Growth Investors and your responsibilities there?

Mr. Link: We are an independent investment advisor managing about $600 million across three products: small cap growth, mid-cap growth, and balanced accounts. The equity portion of our balanced accounts is invested in our mid-cap growth product. I am a portfolio manager and analyst across all of our equity products.

TWST: What is your investment approach and why is it "disciplined?"

Mr. Link: We are growth managers but we are disciplined when it comes to valuation. Our goal when evaluating a company is to simply determine what it is worth or its intrinsic value. We perform a tremendous amount of fundamental analysis to arrive at our assessment of intrinsic value. Once we have determined what a company is worth, we simply compare that to the current stock price to see if the investment meets our expected return requirements. Our goal is to find emerging growth companies with high expected returns and hold them for many years as they develop into dominant large cap companies.

TWST: What are your performance benchmarks for the portfolios and how did they perform last year?

Mr. Link: For our small cap product we use the Russell 2000 and the Russell 2000 Growth and for our mid-cap product we use the Russell Midcap and the Russell Midcap Growth. For some of our client relationships that date back over 20 years we still are compared against the S&P 500 because the Russell Indices are relatively new. Last year, our small cap product held up really well early in the year, but then with the severe price declines in the June and September quarters we gave back a lot of our gains. But we were in line with the Russell 2000 Growth last year and we are exceeding that benchmark this year. In the mid-caps, our portfolios performed better than the Russell Midcap Growth Index, although we were down about 23% and the Russell Midcap Growth was down over 27%. However, our three-year and five-year numbers have held up quite well and are exceeding their benchmarks, so we're pleased with that.

Last year gave us an opportunity to search for names in technology and telecommunications sectors, two of the areas that had been decimated over the past two to three years. We took a hard look at those areas and began to increase our exposure to them for what we believe will be a tremendous period for both categories over the next three to five years.

TWST: What is the outlook for the small and mid-cap stocks going forward into 2003? Are you optimistic about their performance?

Mr. Link: Yes, we are. If you look at history, after periods of economic malaise such as the one we're currently experiencing, small and mid-cap stocks typically enter a multi-year period of outperformance. We believe the pieces are currently being put in place that will allow for this phenomenon to repeat itself.

Specifically for us, we like the small and mid-cap area because we can find companies in the less than $10 billion category that are very dynamic and offer tremendous growth opportunities. It's much easier for a company that's under $10 billion in market cap to double, triple or even go up five times than it is for a company that's already $100-$200 billion in market cap. Banks and brokers had a fantastic decade in the 1990s, but now many of those names are trading at peak margins and their book values are high relative to history, so they are not attractive to us at this time.

TWST: If you were a large cap investor overweight in technology and telecommunications, you could be called "contrarian value." Why is it different with the smaller stocks?

"Yahoo is one of the leading brand franchises on the Web. Roughly half of the people who have Internet access have Yahoo as their default home page. The company services over 200 million people and only 2% of their registered users are currently paying fees for premium services. We think they can increase that percentage substantially."

Also, in the small and mid-cap arena there tends to be more security-specific risk, meaning that these companies tend to march to the beat of their own drummer. Macroeconomic and geopolitical factors will influence the stocks, but a lot of their risk is company-specific and execution-oriented. These companies typically address very large, fast-growing markets, and if they execute on their business plan they can excel in a number of economic environments.

We think the environment for the stock market for the next three to five years is going to be a challenging one. We just finished a market piece entitled *Watching Paint Dry*, which we think is an appropriate analogy to how things will unfold. It's not going to be an exciting, straight up market, but we feel as if we're going to be able to make money for our clients along the way. It's going to be a stock-picker's environment, which plays right into our strength as investors.

Finally, if you compare equities in general to the other alternatives out there, particularly yields on Treasury bonds and other fixed-income instruments, the equity asset class in general looks quite attractive relative to history. So if you couple that with the promising prospects we see for the names in our small and mid-cap product, we expect to generate handsome returns for our clients.

TWST: In which sectors are you overweight, and where are you underweight?

Mr. Link: That's a good question. We have a definite overweight position in technology and we're also looking at names in the telecommunications area.

The areas in which we're underweight are the classic staples — the safety stocks, if you will — that people invest in in times of maximum uncertainty, such as drugs, for example. We don't have a lot of exposure to traditional health care, hospitals or pharmaceuticals. Our exposure to health care is in the biotech area, which we think holds a lot of promise. We are also underweight in financial services.

1-Year Daily Chart of Yahoo!

Chart provided by www.BigCharts.com

Mr. Link: We're firm believers that the technology revolution really began in earnest in the mid-1970s and then carried on into the 1980s with the advent of the personal computer. If you compare this technology revolution to the industrial revolution that began, arguably, in the late 1800s and lasted into the mid-1900s, then you would conclude that we are still well in the midst of the tech revolution. In the large cap technology arena, **Microsoft** (MSFT) capitalized on the personal computer revolution and **Cisco** (CSCO) capitalized on the buildout of the Internet. This helped pave the way for the next generation of technology companies that are now emerging in the small and mid-cap areas.

From an investment perspective, we like to draw an analogy to the buildout of the transcontinental railroad. The companies you wanted to own at the time of the buildout were the companies that were building the transcontinental railroad itself; once it was finished, the companies that really excelled were the rail companies themselves since they were able to capitalize on this wonderful new transportation infrastructure. We liken that to the wonderful Internet infrastructure that was put in place by the **Cisco**s of the world, and our goal is to find companies that can capitalize on that infrastructure, build brand franchises utilizing the Web and exploit that opportunity. That's where I would contrast the smaller companies with the bigger cap tech names.

What we've started to see since September of last year is the emergence of some Web franchises such as **Yahoo!** (YHOO) and **Adobe** (ADBE) and their stock prices are beginning to reflect that**.** I also think you'll see a leadership change within technology, as you often do after a big sell-off and a secular bear market. We don't think the technology revolution is dead, but rather the leading players in that sector will include a new cast of characters and those are some of the larger positions we currently hold in our portfolios.

AT&T, **Yahoo** is beginning to reap the benefits of being the leading media franchise on the Web. If you couple that with their opportunity to convert a portion of their massive base of users (in excess of 200 million) to premium services, it will just be icing on the cake.

The second name I would mention in our mid-cap area is **BEA Systems** (BEAS), a leading enterprise software company. The software they manufacture is really quite complex and solves a number of problems. **BEA** is in the eye of the hurricane of the Internet because it makes software that sits between applications and allows them to work in concert. If you think about the old local area network, it was a one-to-one connection between the server and PC. The Internet is far more complex with far more layers. Wide area networks link multiple hubs and the hubs themselves are organizations and not personal computers. So as the applications of these different organizations have to communicate both inside and outside the company, you need to have software that allows these different applica-

> *"BEA Systems is a leading enterprise software company. The software they manufacture is really quite complex and solves a number of problems. You need to have software that allows these different applications to talk to each other and translate data. BEA sits in the heart of that with a product called an application server. What we're betting on is that BEA will be able to leverage their dominant position in the application server market in order to gain headway into two of the new areas they are targeting."*

TWST: That's very exciting. These could be the mid-cap superstars of the future. So what are you currently placing your bets on?

Mr. Link: The most obvious one in our mid-cap portfolio that I'd point to is **Yahoo**, which we've featured in the past. **Yahoo** is one of the leading brand franchises on the Web. Roughly half of the people who have Internet access have **Yahoo** as their default home page. The company services over 200 million people and only 2% of their registered users are currently paying fees for premium services. We think they can increase that percentage substantially. The other transformation we are pleased to see is the changing of the advertising base at **Yahoo**. With the bursting of the dot-com bubble, a lot of their dot-com advertisers went away. Now you're seeing the acceptance and the adoption of traditional advertisers that are beginning to embrace the Web as an effective advertising medium. Arguably with the economic slowdown, advertising is still in what we consider to be a trough, but on the margin it's improving. With new advertising customers such as **General Motors**, **Pepsi**, **Sony** and

1-Year Daily Chart of BEA Systems

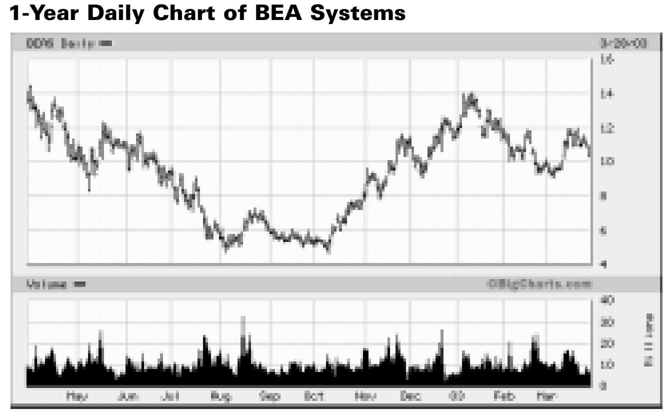

Chart provided by www.BigCharts.com

tions to talk to each other and translate data. **BEA** sits in the heart of that with a product called an application server. What we're betting on is that **BEA** will be able to leverage their dominant position in the application server market in order to gain headway into two of the new areas they are targeting.

"Level 3 built a nationwide all-IP or Internet protocol fiber-optic network that is second to none out there. The growth in Internet usage continues with the adoption of broadband and we think Level 3 is very well positioned to take advantage of that."

One new area is the enterprise application integration (EAI) market. EAI involves getting a new enterprise application to effectively integrate and communicate with existing, previously installed applications. This should be a natural fit for **BEA**. The other new area is the portal server space. As more and more organizations build portals that interface with customers or employees, these portals need to be able to communicate with internal applications and, more importantly, internal data on a real-time basis. We think **BEA** is well positioned to compete effectively in this space as well.

Both **BEA** and **Yahoo** were superstar stocks with significant run-ups during the dot-com bubble, but we didn't own them at that time. They were far too expensive to suit us. We said, "These are fantastic companies, but they're not good stocks right now." We loved **Yahoo** as a company back then but we weren't willing to pay $240 a share for the stock. So when **Yahoo** came down below $20 and it was no longer the darling of Wall Street, we still felt it was a wonderful company and we chose to capitalize on it at that point in time.

It's the same story with **BEA**. The stock was up in the $70s and $80s and Wall Street loved it. We thought it was a great franchise, just grossly overpriced. So as **BEA** came down into the low teens, we initiated a position and increased our position when it hit single digits.

Those two are great companies that we believe represent new leadership in the tech revolution as we move forward.

TWST: What are your feelings about telecom? Is the sector going to come back later this year or in 2004, and how are you positioning your portfolio to take advantage of that?

Mr. Link: We definitely think it's going to come back. The timing, however, might be a little precarious to predict. A name I'll mention that we own in both our small and mid-cap products is **Level 3** (LVLT). **Level 3** built a nationwide all-IP or Internet protocol fiber-optic network that is second to none out there. At the time they were constructing their network there was a land grab as a number of competitors were simultaneously building out their own networks. As a result, a tremendous amount of capacity went in the ground and created a lot of redundancy. But **Level 3** was able to secure an installed customer base and survive when the majority of its competitors began to fall by the wayside.

1-Year Daily Chart of Level 3

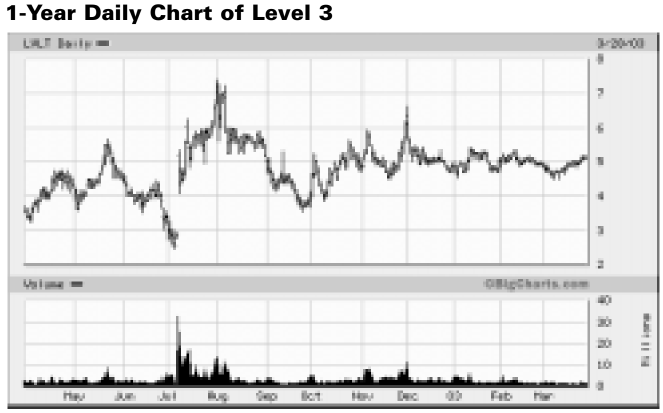

Chart provided by www.BigCharts.com

The growth in Internet usage continues with the adoption of broadband and we think **Level 3** is very well positioned to take advantage of that. In a recent *Barron's*, someone drew the analogy to **Level 3** as having built a 50,000-seat stadium, but having only 500 fans in the stadium. We wouldn't necessarily disagree, but what we've noticed is in their communications business, with only 500 people in the stadium, they're generating 86% gross margins. So they're running their business extremely efficiently and with every incremental fan their efficiency increases.

The timing is going to be tough. A lot of capacity came on, but we see evidence of capacity rationalizing every quarter. The survivors like **Level 3** will be able to really take advantage of supply and demand coming back into balance sometime in the future.

TWST: A sector that really underperformed in the last 12 months was biotechnology. You said you have some selections in that area. Could you tell us what you like?

Mr. Link: What we look for in biotech are companies that are further down the road in their product development. We like companies that are typically in Phase III or just out of Phase III with a new drug application in place and revenues and earnings in sight within a couple of years.

In our small cap product, we recently purchased **OSI Pharmaceuticals** (OSIP). This is a company that focuses specifically in the oncology space. They have a new drug for treating solid tumor cancers. They're in five advanced Phase III trials for their drug called Tarceva. When you consider solid tumor cancers, it's a very large market with a large unmet medical need. Their most promising study is in the area of non-small cell lung cancer. Tarceva is a daily pill, versus an injection or any sort of chemotherapy. It does not have adverse side effects and has demonstrated a high level of efficacy. Solid tumors have what are known as epidermal growth factor receptors within the cancer cells themselves. Tarceva inhibits these receptors and essentially short-circuits the replication of the cancer cells.

OSI traded down from the mid-$30s to $15 when negative news hit regarding a Phase III study by **AstraZeneca**'s (AZN) competing drug, Iressa. At that price it really attracted our attention because at $15 the company was in the $600 million market cap range with over $300 million in net cash on its balance sheet. We were reasonably confident **OSI** would not be faced with the same Phase III problems their competitor experienced. We could see the path to revenues and profits for Tarceva with results from the Phase III studies coming out in the summer of 2003, approval of the drug as we head into 2004 and significant ramping of revenues in 2005. The cash on the balance sheet would allow them to bridge the gap until Tarceva starts generating revenues and profits and, more importantly, cash flow.

Typically when we look at the biotech space we look for companies that are addressing a large, unmet medical need, have ample funding — i.e., strong balance sheets — and has approval right around the corner for one or more drugs. Tarceva is the first of many drugs that **OSI** has in its backlog, several of which should begin to bear fruit as we look out beyond Tarceva.

TWST: What is your sell discipline, and can you name a couple of stocks that you have recently sold or trimmed back on to illustrate that discipline?

Mr. Link: Our sell discipline is anchored on two points. There are two reasons to sell. If an individual stock's risk profile becomes elevated we will trim it back. The other reason is what we call managed Darwinism, whereby a fully invested portfolio requires a sale to make room for a new name. We monitor individual security risk by looking at four risk factors for each of our stocks, the first being valuation risk. How is the company valued? We look at that on an expected return basis. Companies with high valuations have low expected returns and vice versa. So as a stock continues to go up, all else being equal, its expected return will fall. The second risk that we look at is financial risk. How is the balance sheet structured? What is their debt to cap ratio? How is their accounting? That's how we address financial risk. Valuation and financial risk are fairly objectively measured.

On the subjective side the next parameter we look at is execution risk. That's a little harder to measure, but we'll simply try to gauge if it is increasing or decreasing on the margin. An example of execution risk becoming elevated might be a company that has historically grown internally and then decides to do an acquisition. If it's a fairly sizable acquisition that will require a lot of integration, they'll be taking on higher execution risk because not only will they have to run their underlying business, they will also have to integrate the new entity.

"OSI Pharmaceuticals focuses specifically in the oncology space. They have a new drug for treating solid tumor cancers. They're in five advanced Phase III trials for their drug called Tarceva."

1-Year Daily Chart of OSI Pharmaceuticals

Chart provided by www.BigCharts.com

The final risk is what we call position size or allocation risk. How big is the stock in the portfolio? Obviously, bigger positions carry more risk than smaller positions. This is the lever we use to control overall risk. If we have a company where the valuation, financial and execution risks have all increased, and it's grown from a 2% position in the portfolio to a 6% position, our lever or our way to control that risk is to sell some of the stock to reduce the position size.

We have a real-time model that we built in-house that monitors security-specific risks across all of our investments so that on any given day we can measure it. This is also helpful from a Darwinian standpoint. When we need to sell something to make room for a new position, we can rank all of our stocks on a risk/return basis and improve portfolio risk by selling the stock with the least favorable risk/return profile.

TWST: What have you sold in recent months or trimmed back on?

Mr. Link: Over the course of last year in both our small and mid-cap portfolios we sold a fairly significant portion of **Michaels Stores** (MIK). **Michaels** is a company that we had put into our emerging mid-cap superstar category and it had been a big winner for us. It benefited as the consumer hung in there and the rest of the economy fell off. **Michaels** continued to execute by making their existing store base more profitable while adding profitable new stores. They took the company to the next level in terms of systems, making the stores more efficient and doing a lot of things to take it from a medium-sized company to a national powerhouse.

Shortly after the terrorist attacks in 2001, **Michaels** was around $18 a share. As we ended 2001 and went into 2002, the stock went from $18 a share into the high $40s. It was in excess of 10% of our mid-cap portfolio and was about 8% in our small cap portfolio. The valuation had increased on **Michaels**, although we didn't feel that it had become excessive. Regardless, the position size or allocation risk had become elevated. We opted to decrease the security-specific risk of **Michaels** and trimmed back our position size. We cut it roughly in half in our mid-caps and brought it down to 5% in our small caps. We took that money out of **Michaels** and deployed it into other more attractive names on a risk/reward ratio, particularly in the technology space.

In our small caps we deployed a portion of the capital from **Michaels Stores** into a new name, **Select Comfort** (SCSS), which is also in the retail consumer area. **Select Comfort** makes the Sleep Number mattress, which you may have heard of. **Select Comfort** is something of a turnaround story. It was a darling of Wall Street three or four years ago when the stock was up in the $30s. They expanded their store base far too rapidly and the company got into some financial and operating trouble, so the stock traded down as low as $1.

1-Year Daily Chart of Michaels Stores

Chart provided by www.BigCharts.com

The Board of Directors then brought in a great new CEO from Frito-Lay. He understood that **Select Comfort** was really a product company, not a retailer. They had a superior, patented, wonderful product with great consumer acceptance. The first thing he did was close several stores and reposition the company. He said, "This

"Over the course of last year in both our small and mid-cap portfolios we sold a fairly significant portion of Michaels Stores. Michaels is a company that we had put into our emerging mid-cap superstar category and it had been a big winner for us. The position size or allocation risk had become elevated. We opted to decrease the security-specific risk of Michaels and trimmed back our position size."

is a product and we need to focus on selling." He revamped the advertising and came out with the Sleep Number campaign.

Select Comfort is in a great market. The domestic mattress market is an $8 billion market. Their stores were doing $650,000 in revenues a year and his goal was to get them up to $1 million per year and beyond. He overlaid the new Sleep Number ad campaign in select regional markets and noticed that it had a fantastic impact. It took their stores from $650,000 up to the $1 million target and really increased their profitability. He has continued to do a great job. In Minneapolis they currently have a 20% market share.

cash flow without having to deploy a lot of capital, the returns to the shareholder are incredibly handsome.

Another thing I would point out is that a number of the old economy stocks are saddled with legacy costs — pension and health-care-related liabilities. The new economy stocks typically, instead of having an old defined benefit or pension plan, will offer a 401(k) plan where they will contribute to or match employee contributions. But, ultimately, the employee determines where those monies are invested, thereby alleviating the potential massive unfunded pension liability that some of the older economy companies have.

"Select Comfort is something of a turnaround story. It was a darling of Wall Street three or four years ago when the stock was up in the $30s. They expanded their store base far too rapidly and the company got into some financial and operating trouble, so the stock traded down as low as $1."

We estimated that **Select Comfort** had probably $1-$1.15 in earnings power and it was trading around $6, so it was a really cheap stock. It's a local company here in Minneapolis and we had a chance to meet with management, perform a tremendous amount of due diligence and really develop a thorough understanding of the company. **Select Comfort** offered us a superior expected return when compared to **Michaels** and it made sense to sell a portion of **Michaels** to fund the new purchase.

TWST: Scott, I'd like to move to the question of what your firm calls the phenomenon known as the new economy. These new economy companies, in your view, have far better balance sheets and profit models than the so-called old economy companies. Could you tell us how this theory has affected your investments at Disciplined Growth Investors?

Mr. Link: Several of the companies that I've already discussed fall into that new economy realm. The old economy stocks tend to be more capital intensive; i.e., they've got bricks and mortar in the ground, factories or whatever it may be. So they require a lot of capital or dollars to continue to run, in contrast with the new economy companies that are much less capital intensive.

If you look at **Yahoo** for example, it has only $371 million in net fixed assets that are generating $1 billion in revenues. This modest investment in fixed assets supports over 200 million users, roughly 1.3 billion hits per day, and has created one of the world's top brand franchises.

When you look at many of the new economy stocks, you'll see that they're not capital intensive. As a result of that, if you can generate meaningful revenues and, more importantly, profits and

1-Year Daily Chart of Select Comfort

Chart provided by www.BigCharts.com

There was a lot of talk about the new economy stocks back when the Internet bubble was really starting to build. There was a lot of truth to those observations, and while there were several misguided business models and companies that really didn't have well thought out business propositions, those have fallen by the wayside. But the truth still remains that new economy companies don't have a lot of capital tied up in their business and they are not saddled with legacy costs. That is they key difference.

TWST: Your firm does a lot of top-down work, even though your approach for stock selectivity is bottom-up. Could you tell us about the competitive differences that Disciplined Growth Investors brings to the table that other money management firms don't?

Mr. Link: It is a very competitive business, but there are a couple of things I would mention. We're growth investors, so we look for companies that are growing, but we believe that growth is not linear. Companies just don't grow at a constant rate forever. Their growth rate is variable, and the variability in that growth rate creates tremendous volatility on individual stocks. We look to capitalize on that.

For instance, if a company is growing at 30% for a couple of years and the stock becomes richly valued and then the growth rate of the company slows, let's say, to 10%-15%, there will be a crisis. The stock will probably come crashing down. That growth rate typically moderates for an intermediate period, not permanently. If management effectively addresses the problems that caused the slowdown and does whatever restructuring of the company and/or products that is necessary, oftentimes that growth rate will resume.

So we'll look for companies whose growth rate has moderated for some reason or another and try to assess whether or not it's a temporary phenomenon. We see this occur day in, day out in the marketplace, and exploiting the most obvious opportunities for our client base gives us a competitive advantage.

The other competitive advantage I'd point to is really looking for these next generation growth stocks — what I call emerging mid-cap superstars. These are companies like the ones I mentioned earlier, such as **Yahoo**, that are going to emerge and take advantage of a number of things over the course of the next five to 10 years. Our goal is to identify these types of companies, get them into the portfolio and then make sure they're appropriately weighted.

When we've identified an emerging mid-cap superstar, ideally it's reasonably valued, it meets all our criteria, we've owned it for a number of years and we're comfortable with the management team. So we'll make sure it's a 3% position, the maximum position size we'll actively put into the portfolio. If we put **Yahoo** in there at 3% and the stock triples or quadruples, it's really going to help drive performance and make a lot of money for our client base.

The final thing I'll say is that we like to hold stocks for a number of years, forever if possible. That's always contingent on the expected return and risk associated with the company. As long as that relationship stays intact and intrinsic value is accurately reflected in the stock price, we'll continue to hold those names for a number of years. If the stock price races up and reduces the expected return, at that point in time we'll address that risk and perhaps cut it back. But if you take our view of growth — that it's variable and not linear — our focus on finding these next generation, emerging mid-cap superstars and our ability and willingness to hang onto them for long periods of time, the combination of those three things is unique to us and allows us to make a lot of money for our clients and produce strong performance.

TWST: Scott, what words of advice would you give to investors today about investing in the market?

Mr. Link: There are two things I'd say. I mentioned earlier how we think the stock market is attractively valued on a relative basis. So we would not avoid or sell stocks today. The first thing I'd say is to stick to your investment discipline. Do not sway from that. The second thing is to have a lot of patience. You really need to have those two things — an ironclad investment discipline and endless patience. Ultimately we think that as the geopolitical risks, terrorism risks and economic/recessionary fears lift, stocks will offer tremendous returns from current levels.

TWST: Thank you.

Note: Opinions and recommendations are as of 3/26/03.

SCOTT D. LINK
Disciplined Growth Investors, Inc.
100 South 5th Street
Suite 2100
Minneapolis, MN 55402
(612) 317-4104