

FEBRUARY 2020

2019

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(with contributions from the investment team)

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Much of our lives are consumed by the daily challenges of living. Even seasonal weather plays a major role. In Minnesota we wear light clothing and sunscreen in the summer and parkas and gloves in the winter. A couple of weeks ago a sleet storm turned our roads into skating rinks. As I drove just a short distance my entire focus was on keeping the car on the road. This was not a time for quiet reflection!

Daily challenges get in the way of a valuable exercise, the practice of examining the past. I have found this activity more valuable than making a forecast. Most forecasts are futile (like New Year's resolutions), whereas a true understanding of the past can help us prepare for the vagaries of the future.

For me, the two best times to examine the past are the end of each calendar year and the end of each calendar decade. There is something magical about the end of each year/decade and the beginning of a new one. Today I have chosen to focus on what lessons we can take away from the year just ended, 2019. In a subsequent piece I intend to ruminate on the decade that began in 2010.

For our purposes here we will focus solely on the investment world.

In some years the markets' messages are subtle, almost like a whisper. In other years the message is loud and clear. 2019 spoke loudly and clearly.

There were three investment messages. One was specific to how we invest on behalf of our clients at DGI. The other two were things that happened within the larger world of investing.

MESSAGE # 1:
OUR PORTFOLIOS ENDED 2019
WITH A LOT OF GAS IN THE TANK

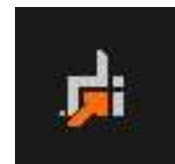
Our portfolios had a heck of a year. Our Mid Cap Growth Composite was up over 30% and our Small Cap Growth Composite was up about 18%.

The stock market was narrow, (i.e. only a relatively few stocks went up a lot) and fortunately we owned enough of the favored stocks to have a fine year.

Here is the exciting and largely unnoticed story of 2019. Many, many stocks were left out of the huge price increases. The stocks of many good companies simply bided their time.

We were focused last year (especially in the second half) on reducing our exposure to those stocks which had sizzling price increases (but are now expensive) and invested in some existing and new ideas where the company has terrific prospects and a lackluster stock price.

To use a poker analogy, we finished the year with a good hand and continue to draw good cards.



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MESSAGE #2: GRANDDADDY OF INDEX FUNDS BECAME DANGEROUS

We confess we have been fans of index funds for many years, especially Vanguard's version of the S&P 500 index. Index funds were a reasonable solution for many investors, especially when their expense ratios are far lower than active managers.

In 2019 the S&P 500 had a terrific year, increasing over 31%, including dividends. The five largest companies in the index enjoyed fantastic price appreciation. Apple was the standout, increasing 88%. Facebook and Microsoft tied for second, increasing about 57% each. Google increased 28%. Amazon was the laggard, increasing a "mere" 23%. The index weighted performance of these stocks exceeded 50% last year.

The price appreciation of only five stocks (out of 500) accounted for nearly one quarter of the total price increase of the S&P 500 in 2019.

Further, the collective market value of these five companies now exceeds \$5 trillion and comprises over 17% of the S&P 500 index. Normally, the top five companies have equaled about 12.5% of the index's market value; we cannot find a time when this index has been so concentrated.

The market value of these companies suggests they are large, mature companies, but their stocks are priced like small growth companies.

It gets worse. Fifteen years ago, the top five companies were very different businesses with distinct end markets—Exxon, Wal-Mart, Pfizer, General Electric, and Microsoft. Today,

Apple, Google, Amazon, Facebook and Microsoft may appear to be very different companies. But we find commonality in their extraordinary success. If the trend towards centralizing various functions on the web, via a concept called the "cloud" slows or reverses, this group of companies will be hard-pressed to duplicate their past successes.

Dangerous, indeed.

MESSAGE #3: SOMETHING STRANGE IS HAPPENING IN THE BOND MARKET.

About \$17 trillion face amount of bonds are trading at negative yields.

Let's unpack negative yields. I want to borrow money from you. You lend me the money. And you *pay* me to borrow money from you. (If any of you have a desire to lend me money and pay me to borrow from you, let's talk. I cannot, in good conscience take your money, but I will recommend a good psychiatrist).

Negative bonds yields are ridiculous.

In 2019 the bond market sent a clear message: too much money is chasing too few borrowers. The lender has become subservient to the borrower.

WE ARE RELIEVED THAT WE DO NOT
OWN THE S&P 500 INDEX FUNDS OR
BONDS WITH NEGATIVE YIELDS.

WE LIKE OUR PORTFOLIO'S LONG-TERM
PROSPECTS

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.

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