EDITION 03

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PORTFOLIO STRATEGY

BULLDOGS
AT THE FOREFRONT OF DIGITAL TRANSFORMATION

The Pedigree to Succeed

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Dominant, Tenacious Marketers Have an Edge — Exploit It, Analyst Says

Bullish on "Bulldogs"

An Interview With James E. Moltz • Companies — and their securities — don't exist in a vacuum. They do their things, instead, in an increasingly intense pressure cooker of a globally competitive environment. One that, all too often, Wall Street and investors tend to give short shrift when sizing up, say, a stock's prospects. So says Jim, the chief investment officer at Deutsche Morgan Grenfell/C.J. Lawrence Inc. in New York. He recently penned a report entitled "Buy a Bulldog," meaning aggressive and tenacious companies that dominate their markets, to try to redress that imbalance. Jim's idea, which he graciously expanded on when we called last week, is simplicity itself. This superior breed deserves premium multiples—so snap them up before that's widely recognized.

— *Kathryn M. Welling*

Barron's: *What's this we hear about you investing in cats and dogs?*

Moltz: Not "cats and dogs." But we did recently send clients a strategy report entitled "Buy a Bulldog," by which we mean leading-edge corporations that have a "no holds barred" attitude geared toward market share dominance.

Q: *Isn't that tantamount to advising, "Invest in a winner"?*

A: Not really. Considerably more thought has gone into this than that. In fact, as I look back on things that we don't do well in this business, one is really trying to understand the competitive conditions that the companies we invest in face. Yet, it's so fundamental. Today, with all the databases available, you can get all the statistics in the world. But whether analysts and investors understand the conditions that companies are up against is a whole other subject. As I thought about it, I realized that

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"These businesses won't tolerate losing market share."

POSITION

When we first published **Buy A Bulldog** 20 years ago,

we were still living in a largely analog world. The infrastructure of today's digital economy was just being built. Then, we observed that future long-term investment success would be influenced by investors' understanding of how pronounced changes in global competitive conditions impact equity performance. Today, the pace of competitive change and realignment is more intense than ever. To perform, successful companies need to demonstrate the same Bulldog characteristics we first began to apply to our investment process in the early 1990s. In the digital age, growth is driven by a company's ability to innovate and adapt. Our investment process continues to focus on identifying future Bulldogs in growing sectors that have an edge and the zest to succeed.

Context

We have witnessed tremendous change, in recent years, in the world's economies and competitive landscape. Centers of economic and political power are shifting. The traditional definition of emerging, versus developed, markets has become blurred. China has emerged as an economic super power and is assertive in projecting its purchasing power in everything from global trade to securing new sources for its growing demand for raw materials. India is also emerging quickly and may soon follow China as a regional growth engine.

Developed economies have recovered from the 2008 financial crisis, but growth in productivity, business investment, and wages are normally higher at this stage of the business cycle. Economic conditions based on zero interest rates and easy money which has been referred to as the "new normal" are now giving way to more traditional relationships where competition for capital will intensify. Fiscal policies aimed at lowering corporate taxes and embracing deregulation are taking hold in some countries and showing signs of success. Aggressive unilateral trade policies focused on managing the balance of trade levels and trends between nations have replaced the post war consensus which led to the formation of institutions like the World Trade Organization (WTO). Trade levels between nations had previously served as a proxy for the relative demand of goods between nations. Today tariffs are used as a blunt tool to alter the terms of trade. The days of complacency around running chronic current account deficits or surpluses seem to be a thing of the past.

More than two centuries ago, Adam Smith and David Ricardo laid the foundations of classical free market economic theory. In Smith's *The Wealth of Nations* he developed the concept of division of labor and expounded upon how rational self-interest and competition can lead to economic prosperity. With the theory of "comparative advantage" Ricardo expanded on this and argued in favor of industry specialization and free trade. He suggested that industry specialization combined with free international trade always produces positive results. Ricardo attempted to prove theoretically that international trade is always beneficial. This theory is now being challenged and global business leaders are already forced to adjust long standing global trade relationships and complex supply chains to conform to the whims of today's policy makers. Time will tell if free trade will continue to create wealth among nations.

Bulldogs in a New Era of Disruptive Growth

Shifting competitive forces are not new factors facing leading-edge business managers, but are accelerating due to the digital economy. Technologies like artificial intelligence (AI), quantum computing, and blockchain are driving what Professor Klaus Schwab, Founder and Executive Chairman of the World Economic Forum has called the Fourth Industrial Revolution. The evidence of dramatic change is all around us and it's happening at exponential speed. AI will usher in an era of growth of products and services that exploit enormous sets of data that have been assembled by dominant companies operating from the cloud.

A study published by McKinsey & Company in September 2018, titled "*Notes from the Frontier, Modeling the Impact of AI on the World Economy*", shows that around 70% of companies in its study adopting at least one type of AI technology by 2030, and less than half of large companies may be using the full range of AI technologies across their organizations. The study concludes that AI could potentially deliver additional economic output of around $13 trillion by 2030, boosting global GDP by about 1.2% per year. This is a meaningful shift in economic activity and could usher in another long wave of disruptive growth.

Disruption is not a new phenomenon facing today's business leaders. In the early 1920s, Russian Economist Nikolai Kondratiev developed the concept of the long wave when applying technological change to traditional economic cycles. He observed that these periods of long waves can range from forty to sixty years and consist of alternating intervals between high sectoral growth and intervals of relatively slow growth. There is much disagreement among economists how these long waves affect economic growth and when. There is, however, no disagreement that the bunching of in many cases several innovations at a time, can launch profound socioeconomic change and alter competitive conditions.

The adoption of AI will also widen performance gaps between countries, companies and even workers, according to the McKinsey & Co. study. 'AI leaders' will emerge and may accrue an additional 20-25% of potential economic benefit compared with today. How companies choose to embrace new technologies will determine the success of our future Bulldogs. The challenge for us as portfolio managers is to select investments/companies that can manage through these changes and continue to grow.

Driving Unit Growth in the Digital Era

Successful companies adapt quickly and approach new competitive threats with a “no holds barred” attitude towards taking market share. Shares of companies that exploit sustainable competitive advantages are ultimately rewarded by equity market participants and carry premium valuations. An important characteristic of the current business cycle is the inability of companies to raise prices. In a web-based, sharing-economy where many services are freely available on smartphones, it is difficult to compete on price alone. Unit growth becomes the goal of successful companies.

Cutting-edge multinational business managers have therefore adopted a new and highly disciplined modus operandi. This is particularly true in high tech business, but can increasingly be discerned in more prosaic product firms as well. Their mission is to persistently offer the customer enhanced value. That is best achieved by obsolescing existing product or providing more economic value per dollar with a new product, and in the process, taking market share. Today’s corporate Bulldog operates as though wage and price controls are in effect. The only way to grow is to innovate and focus on penetrating new markets.

With market share dominance, companies gain the leverage to control competitive conditions. Business theorists have labeled it “the school of increasing returns.” The thesis is that the more a company makes and sells a product, the higher the odds are that company will excel. The share leader has economies of scale and can choose which weapon - price, advertising, tie-ins, etc. - to shape the industry landscape. This can be exercised as long as the customer remains front and center. It also necessitates instilling a corporate mindset which is highly adaptable to constantly changing market conditions. This is easier said than done but can be achieved even in the largest organizations. In the digital age the network effect kicks in to reduce transaction and labor costs, leading to a “winner-takes-all” dynamic.

Forces at Work

Once market share is captured, today's corporate Bulldogs will not let go. No longer will they abdicate the low end of a market just because margins could erode. "Let competitors in the bottom and it will not be long before they are nibbling in the middle" are lessons learned from companies like Xerox, which today is a shell of its former self. Technology giants like Apple, are willing to tolerate lower margins on MacBooks and cheaper iPads, to defend its premium iPhone franchise and unique eco-system, making it increasingly difficult for other industry participants to take share.

The price / value relationship and the price spread between brand name and discount label, are carefully monitored balances which market share leaders seek to control. They believe pricing power leads to profit power.

The length and depth of economic cycles are becoming less predictable especially during times of rapid technological transformation. The need for a tenacious management style will become more evident. When the economy is growing rapidly, it tends to be camouflaged. In low global growth environments, it will be increasingly apparent who the winners are.

The collective wisdom of the market is extraordinarily good at sensing changing competitive winds. Historically, it was research analysts and market pundits who introduced news and intelligence into the information network. Today it is the internet, spreading corporate intelligence and competitive trend analysis in real time. Word-of-mouth filtering has been replaced by Twitter feeds and Snap chats. As a result, information has been democratized and fierce competitors like Apple and Starbucks have figured out how to shape the narrative, putting them near the top of nearly every major brand ranking category in social media.

One of the reasons the U.S. stock market has outperformed developed countries' markets over time is global investors' appreciation of this competitive management style. Amazon, Google and Adobe have created businesses that did not exist just a few decades ago. They were disrupters at inception and rapidly gained market share in new segments.

Market Relevance in the Digital Economy

Amazon, which began as an online bookseller is now the most feared competitor of brick and mortar retailers across all categories. It is not only the fastest growing e-commerce retailer, but it has also become an enabler for many retailers looking to expand their distribution into online channels. Alphabet's Google search engine continues to dominate paid search with over 60% market share. The company's YouTube franchise continues to be the dominant player in online video and has developed a profitable business model. For Alphabet this is not enough and it uses its financial strength and competitive edge in computing power to invest in innovations such as self-driving car technologies under its Waymo division.

Delphi, is another example of a company which began as an auto parts supplier largely captive to its former parent, General Motors some 20 years ago. Today it has transformed itself into a leading technology company shaping the future of the electric car industry. In 2017 the company bought the self-driving startup NuTonomy for just $450 Million in October 2017. The company then spun off its powertrain division (now Delphi Technologies) and aftermarket related businesses in December 2017 and changed its name to Aptiv PLC to become the dominant technology company in its segment.

Specialty retailers like Costco, Home Depot and newcomer Ulta Beauty, have successfully defended their bricks and mortar businesses in the digital age. These companies have found a way to create a competitive moat around their stores by creating a shopping experience that cannot be replicated online. Costco's has created a unique shopping experience among its growing membership due to its scavenger hunt-like experience for its customers. Shoppers go to Costco not only to get a good deal, but to discover new products from high end jewelry to the newest flat panel TV. Home Depot's industry leading profit margins and market share are driven by the quality of its service and by selling products like lumber and appliances which cannot easily be sold online. Ulta Beauty is quickly taking market share from traditional beauty salons and cosmetics retailers by focusing on the highly lucrative "beauty enthusiast". Ulta's innovative loyalty program rewarding high volume shoppers both in its stores and online, produces industry leading unit growth.

Bulldogs Unleashing the Power of Blockchain

Broadridge and S&P Global are two competitors that are using their technology edge to transform the financial sector as we now it. Broadridge, is the leader in global proxy voting services, last year launched a pilot test of a blockchain-based solution with its largest customers JPMorgan, Northern Trust and Banco Santander to facilitate global proxy voting transparency. Breakthrough technologies like distributed leger technology, also known as blockchain, drive enormous efficiencies for customers that deal with large quantities of data.

At S&P Global, Director of Innovation, James Rilett, announced at its recent Annual Asia Pacific Conference that it has invested to create a full-time innovation lab in Singapore which will be focused on key market themes including blockchain and real-time analytics. The company will dedicate its efforts in the region to host market participants in innovation workshops – or hackathons – that will enable the exploration of using blockchain, alternative data sets and new computational methods to trade and risk manage commodity portfolios.

Investment Implications

Stock market differentiation is evolving from a "risk on, risk off" environment, where correlations among asset classes converge. Premium valuations are likely to accrue to dominant competitors, as investors recognize the intensity of today's sales battles, and reward the winners. Costco is just one example of a company that has been recognized for its success, and as a result, its shares sell at a consistent premium the S&P 500 price-to-earnings (P/E) multiple. The company's focus on providing a premium shopping experience for its cost-conscious members, while creating industry leading earnings growth and consistent dividend growth, has helped the company retain a premium P/Emultiple for the past two decades. At the same time, the shares have returned almost twice the market's total return over the past 10 years.

Premium Valuations

Premium valuations afforded to companies like Home Depot and Costco, are not yet broadly applied to other leading companies. Our current universe of 200 Bulldog-like companies sells, on average, at a modest premium, 1.2x that of the S&P 500 P/E multiple. We believe these types of stocks can be afforded a much greater differential in the future. In the early 1970s, when fund managers hungered for the original Nifty Fifty stocks, which continued to grow earnings under wage and price controls, their average relative multiple reached 2.4x. The current group is a different mix of companies, in a different set of conditions, so it is unlikely that such a wide margin will be repeated, but there is ample room for improvement.

Growth-Cyclicals

Bulldogs are not limited to traditional growth sectors. A number of these competitive leaders are considered either cyclical or "growth-cyclical" companies and can also be found in traditional value sectors. Thus, it is rare that they would be awarded premium valuations on normalized earnings. However, they can achieve capitalization premiums within their respective sectors. These companies can be found among industrials like Federal Express or defense contractor Raytheon, and even specialty chemical companies like DowDupont.

Global Bulldogs

While most of our Bulldog universe is domestic, an increasing number of candidates are surfacing from other developed economies and rapidly growing emerging markets. The digital economy has enabled corporations in emerging economies to leap into global leadership positions. Alibaba Group, founded in 1999, has leveraged the Internet to transform commerce in China, and position itself as the dominant online marketplace and mobile payment provider via Alipay. The company captures over 80% of online sales in China and is rapidly expanding into new markets across the region and beyond. Alibaba holds a prime position in the single largest consumer expansion of the century.

Another example is Taiwan Semiconductor (TSMC) which has successfully fused their technological manufacturing edge with their global supply chain to become the largest foundry chip-maker in the world. Continuous and aggressive capital spending has cemented the company's competitive position, and its expansion of production capacity ensures TSMC can meet an increase in global demand for semiconductors.

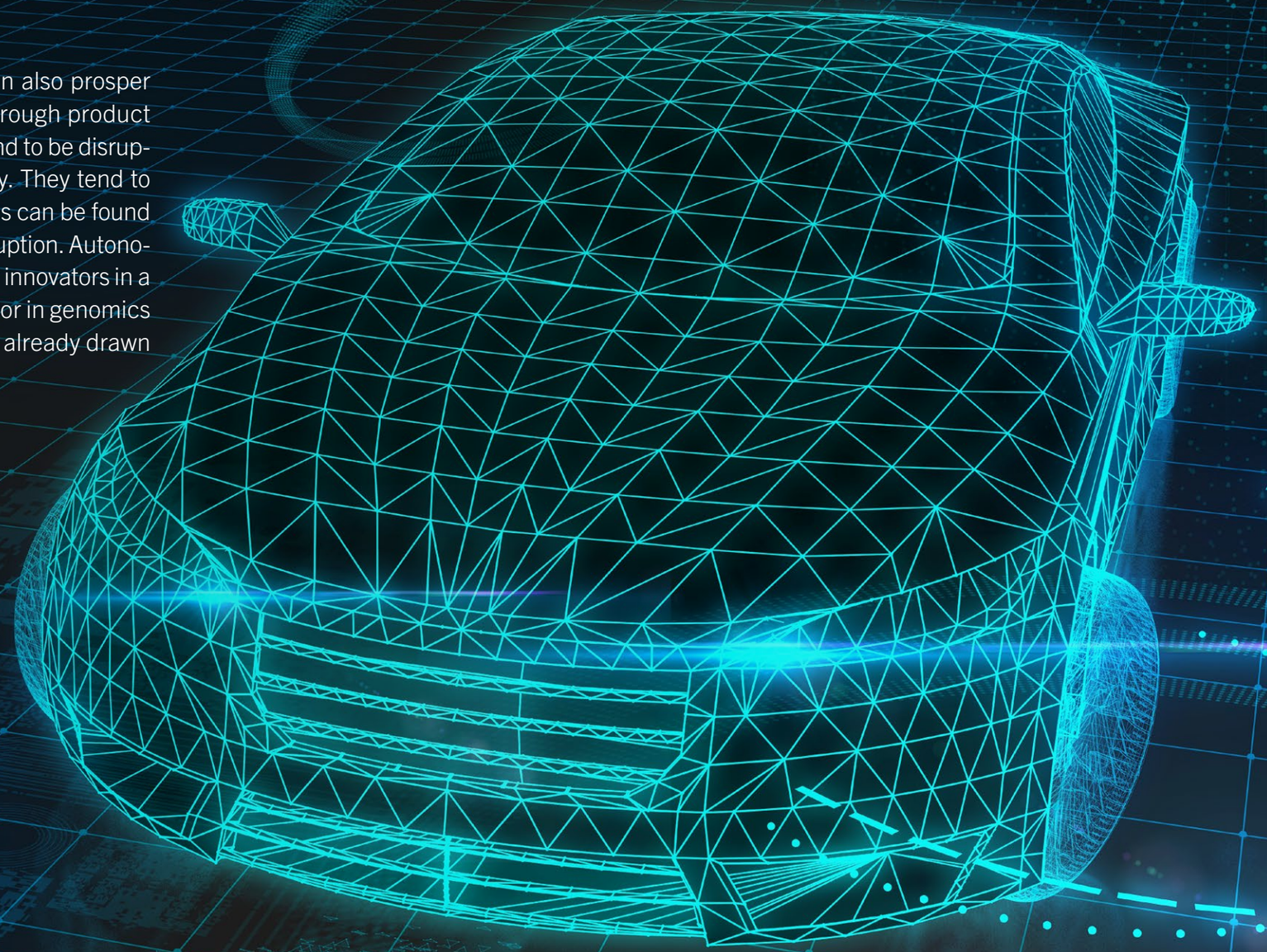
Bulldogs Think Global, Sell Local

Today's domestic Bulldogs are increasingly searching internationally for new markets and broader supply chains. "Think global, sell local" has become the new marching order for business leaders. Markets, and the modes of production, have become global. No longer are components for smart phones or cars sourced from only one country. Corporate managements are carefully weighing the balance between creating an efficient global supply chain for their products and opening new end markets. Meeting global demand in a timely, and cost-efficient manner, is what sets companies apart. Global Bulldogs have demonstrated their ability to adapt to different cultures and offer products and services that local customers value. Most of us have seen pictures of consumers lining up in China to buy the newest iPhone, latest Nike shoe, or a new latte from Starbucks.

Emerging Bulldogs

Size and reach are key advantages in today's globally competitive landscape, but only if managed effectively and economies of scale are exploited. A company's ability to fund its own expansion is a distinct advantage. Large companies also have an edge when new global markets open for participation for the first time.

Bulldogs do not need to be large to be successful. Smaller companies can also prosper if they create unique niche positions and continue to strengthen them through product enhancements and geographic diversification. These emerging Bulldogs tend to be disruptors and seek to take the lion share in their respective markets very quickly. They tend to have first-mover advantage in a product or service. Many of these companies can be found in the healthcare and technology sectors where we are seeing continual disruption. Autonomous vehicle technology companies like Mobileye and Aptiv are examples of innovators in a new segment. An example, in the healthcare sector, is Illumina, the innovator in genomics sequencing machines. Its market share lead in this fast-growing niche has already drawn the attention of big pharma.



Bulldogs at the Intersection of Biology and Technology

Illumina, Inc. has emerged as a dominant player in the genomics sequencing segment, serving customers in the research, clinical and applied markets, enabling the adoption of a genomic solutions. As a startup, Illumina aspired to transform human health. Its initial products enabled researchers to explore DNA at an entirely new scale, helping them create the first map of gene variations associated with health, disease, and drug response. Today, Illumina is a global market share leader in genomics – an industry at the intersection of biology and technology.

The genomics revolution is at the forefront of transforming healthcare as we know it. This would not be possible without the quantum computing power of companies like Google, a division of Alphabet. In July 2018 Google announced it had joined the National Institutes of Health (NIH) as a partner on the STRIDES (Science and Technology Research Infrastructure for Discovery, Experimentation, and Sustainability) Initiative to bring the power of Google Cloud to biomedical research. As part of this agreement, it will make some of the most important NIH-funded datasets available to users with appropriate privacy controls. To simplify access to these datasets, it will integrate researcher authentication and authorization mechanisms with Google Cloud credentials. Google will work with the Global Alliance for Genomics & Health and the BioCompute Consortium to support industry standards for data access, discovery, and cloud computation.

Competitive Alliances

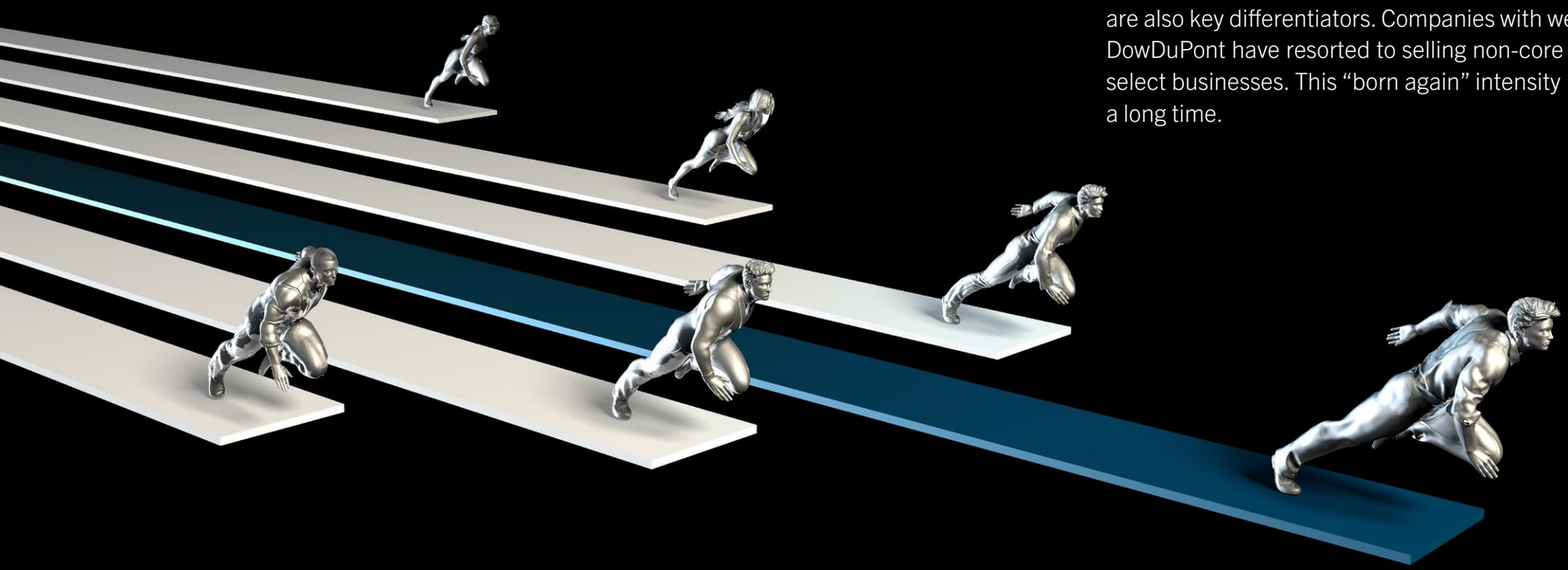
James F. Moore argued in his 1996 book, *The Death of Competition: Leadership and Strategy in the Age of Business Ecosystem*, that the concept of dividing businesses by industry is no longer useful. His notion was that competition is intensifying at such speed and flex that companies no longer operate or think along traditional industry lines. This seems to be especially true with companies at the forefront of technology. Alliances are cropping up every day between the likes of Amazon, Google, Apple, and Microsoft, which reach far beyond traditional industry or sector boundaries. In these rapidly developing businesses, substantial investment premiums can accrue to those deemed to have the right competitive combination, but they can also evaporate quickly. The focus is not to generate overnight wonders, but instead to create fundamental and lasting competitive advantages.

A case in point is biomedical research, which is facing enormous challenges as the volume of genomic, transcriptomic, metabolomic, phenotypic, and other data generated in research labs across the world continues to grow. According to the National Center for Biotechnology Information, the total amount of sequence data alone is doubling every seven months. Analyzing this staggering amount of data presents the potential for enormous positive impact. Combining the cloud computing power of Google Cloud services with traditional Biotech research labs can overcome these challenges by providing scalable storage, elastic computing resources, fast global networks, and tools for data preparation and analysis. These new alliances are going to drive new growth for existing Bulldogs.

Competitive Duration

Companies with longevity or what we call competitive duration possess consistent management aptitude and focus. Flexibility, the zest to win, and commitment to the customer are all common traits of successful company managements. Complacency becomes the enemy of success and even the smallest competitors should not be dismissed. Winning managements and winning companies stay close to their customers and eschew cultures that consider customer feedback before head-office feedback.

Companies providing essential services and products directly to customers tend to have the highest odds for long-term success. They have a lower chance of product obsolescence if they match value with price. Component producers, on the other hand, are subject to product substitution risk as well as pricing pressure from customers and systems integrators. Traditional barriers to entry, such as patents, capital, economies of scale, and access to low cost raw materials provide a competitive edge. But new variables including streamlined corporate structures, online presence, and Bulldog-like approaches to new markets are also key differentiators. Companies with well positioned businesses like Microsoft and DowDuPont have resorted to selling non-core operations in an effort to maintain focus in select businesses. This “born again” intensity may ensure their respective dominance for a long time.



Bulldog Characteristic

One common characteristic of a corporate Bulldog is its willingness to fight to protect its turf. On a long-term basis, dominant market share positions help deliver top-tier returns on assets and income, but it also breeds envy on the part of competitors. Those competitors are not always docile, and on occasion, a new entrant attempts to upset the mix.

The key trait of a Bulldog's operating philosophy is their insistence on protecting and growing market share. This philosophy, however, does not always comport with Wall Street's focus on quarterly operating result progression. Bulldogs take a strategic, long-term view of the competitive landscape and are willing to make tactical moves that may sometimes come at the expense of near term income generation. Portfolio managers and analysts will have to grapple with the reality that some of their investment favorites do not always generate "straight line" results.

Mindset

As Portfolio Managers, we have simplified our investment process by filtering out of our information inbox those stocks that do not meet our investment prerequisite of having a discernible competitive edge. Our advantage is gained by not expending resources on companies that may be considered "also rans." The challenge for us is in discerning uniqueness, competitive fervor, and competitive moat. Company size, market value and industry become secondary.

Over the past 25 years we have applied this discipline to establish a universe of about 200 stocks of companies that embody Bulldog characteristics. New ones are added, and others removed as the competitive landscape shifts. Once dominant companies like GE, Kodak and Xerox, are examples of companies that ultimately lost their edge and their pre-eminent market positions. They have been replaced by premier companies like Apple, Amazon and Google. Our multi-step investment process is geared towards identifying which Bulldogs to own, and in what proportions.

IN SUMMARY

Jim Moltz taught us that:

"buying stock in a company that takes market share is the only insurance policy one can get in a stock purchase." Furthermore, "Bulldogs are all about growth in units, and that is real growth. They are also good at dropping unit costs". For example, Corning tells its LCD customers: show us a price a competitor offers lower than ours and we will match or beat it a month later, i.e. they have more efficiency. This is a telltale trait of a true Bulldog. Importantly, Bulldogs sell high quality products that give purchasing agents comfort that contracting with a Bulldog poses no career risk to the agent. Bulldogs have strong balance sheets and do not hesitate to use them in ways that include longer payment terms, consignment of inventory to customer usage regions, company sales promotions, cooperative advertising, etc. In short, Bulldogs use their strengths to drive unit growth that leads to superior results.

THE BULLDOG PORTFOLIO MANAGEMENT TEAM

C.J. Lawrence's investment team share many decades of experience and have followed the Bulldog investment philosophy for individual clients and institutions for many investment cycles.

ABOUT C.J. LAWRENCE

C.J. Lawrence is a leading New York-based investment management boutique providing platinum level service and investment portfolio customization to individuals, families, foundations and institutions. With a legacy that dates back to 1864, C.J. Lawrence was re-launched in 2014 as an independent SEC registered investment advisor. The firm combines the talents of a highly experienced portfolio management team with an environment centered only on delivering optimal results for our clients.

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