EDITION 5



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INVESTMENT MANAGEMENT

Contents

05 Position

07 Context

08 Bulldogs in a New Era of Disruptive Growth

11 Driving Unit Growth in the Digital Era

13 Forces at Work

15 Market Relevance in the Digital Economy

17 Bulldogs Unleashing the Power of Generative AI

18 Investment Implications

19 Premium Valuations

21 Growth-Cyclicals

21 Global Bulldogs

23 Bulldogs Think Global, Sell Local

24 Emerging Bulldogs

27 Bulldogs at the Intersection of Biology and Technology

29 Competitive Alliances

31 Competitive Duration

33 Bulldog Characteristics

34 Mindset

36 In Summary

37 Bulldog Portfolio Management Team

38 C.J. Lawrence Products and Services

BULLDOG

Equity Portfolios

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The Pedigree to Succeed



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. With the rapid adoption of disruptive technologies like generative AI, the pace of competitive change and realignment is more intense than ever. To perform successfully, companies must demonstrate the same Bulldog characteristics we identified in our investment process in the early 1990s. In the age of disruption, growth is driven by a company's ability to innovate and adapt. Our investment process focuses on identifying sustainable business models in growing sectors. These companies, which we call Bulldogs, have an edge and zest to succeed.



Context

Three major factors contribute to a new phase of hyper-competition among companies in our investable universe. Technologies like generative AI and quantum computing are driving unprecedented change. The global COVID pandemic was the ultimate stress test for businesses and supply chains worldwide and unleashed a wave of reshoring of industrial capacity and manufacturing. The post-Cold War order is again dominated by superpower competition and regional conflict. The net effect of these forces is hyper-competition for markets and resources.

In previous decades, central banks implemented policies leading to zero interest rates and aggressive quantitative easing to manage extreme boom-bust cycles. The net effect elongated the typical expansion period of the business cycle and shortened periods of stagnation and financial disruption. Investors became accustomed to the so-called ”Fed put,” where the Fed would come to the rescue whenever financial conditions demanded.

In the wake of the global pandemic, we are still dealing with the inflationary pressures unleashed by aggressive fiscal spending combined with easy money. Although the current origins of inflation are unlike those of the 1970s, market practitioners have not operated in such an intense inflationary environment in 40 years.

With the rising share of the digital economy now driven by the adoption of generative AI, a wide segment of the labor force may be permanently displaced. This has already become a source of political rancor for administrations and legislators. The push and pull of more support for pro-business policies versus support for an increasingly obsolete labor force will determine the next generation of policymakers.

On the more optimistic side, implementation of these technologies across the greater economy may unleash a productivity boom not seen since the widespread adoption of the internet in the 1990s. It is also accelerating lead times to bring breakthroughs in science to market in areas of healthcare and energy transition.

The global trend to reshore vital production and manufacturing capacity has largely been enabled by the adoption of technology. Industrial companies are turning to technologies like digital twins to test the efficiency of production lines, warehouses, and even data centers to drive down costs. The days when labor costs determined a country’s competitive position in global trade may be a thing of the past. The retooling of global supply chains has highlighted the need to spend on aging infrastructure. Time will tell if ballooning fiscal deficits will derail this need for capital. In summary, the companies we define as Bulldogs tend to thrive in this highly competitive landscape.

Bulldogs in a New Era of Disruptive Growth

Shifting competitive forces are not new factors facing leading-edge business managers, but they are accelerating due to the digital economy. Technologies like generative AI, quantum computing, and blockchain are driving what Professor Klaus Schwab, Founder and Executive Chairman of the World Economic Forum, called the Fourth Industrial Revolution. The evidence of dramatic change is all around us and it's happening at exponential speed. AI is ushering in an era of product and service growth that exploits enormous cloud-based data sets.

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 will adopt 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 concluded that AI could potentially deliver an additional economic output of around $13 trillion by 2030, boosting global GDP by about 1.2% annually.

This is a meaningful shift in economic activity and could usher in another long wave of disruptive growth even without considering the effects of the pandemic.

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 40 to 60 years and consist of alternating intervals between high sectoral growth and intervals of relatively slow growth. There is much disagreement among economists about how these long waves affect economic growth and when. There is, however, no disagreement that the bunching of several innovations at a time results in profound socioeconomic change and alters competitive conditions.

The adoption of AI will 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 invest in companies that can manage through these changes and continue to provide sustainable stock growth over time.

Driving Unit Growth in the Digital Era

Successful companies adapt quickly and approach new competitive threats with a “no holds barred” attitude toward 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 digital sharing economy where many services are freely available on smartphones, it is difficult to compete on price alone, and unit growth becomes the goal of successful companies.

Cutting-edge business managers have therefore adopted a new and highly disciplined modus operandi. This is particularly true in high-tech businesses 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 products or providing more economic value per dollar with a new product, and in the process, defending and 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 creating 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 the 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 is a shell of its former self today. A technology giant like Apple is 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 labels are carefully monitored balances that 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 is more evident. When the economy is growing rapidly, it tends to be camouflaged. In low global growth environments, winners are apparent.

The collective wisdom of the market is extraordinarily good at sensing changing competitive winds. Historically, research analysts and market pundits introduced news and intelligence into the information network. Today the internet is spreading corporate intelligence and competitive trend analysis in real time. In the future, generative AI will be the primary interface, curating information for the user. Word-of-mouth filtering has been replaced by ChatGPT, and a growing number of applications have been unleashed by OpenAI. As a result, computing is being democratized.

One reason the U.S. stock market has outperformed developed countries' markets over time is global investors' appreciation for this competitive management style. Nvidia, Microsoft, and Meta Platforms 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 in e-commerce and cloud computing across all categories. It is not only the fastest-growing e-commerce retailer but has also become an enabler for many retailers looking to expand distribution into online channels. Amazon's technology and cost advantage in next-day shipping are reshaping what is today known as omnichannel retailing, the convergence of brick-and-mortar retail with e-commerce.

Nvidia has become the most significant company shaping technology since the internet became widely used by the public. Nvidia's innovation in GPUs has pushed aside former Bulldogs like Intel. Nvidia's head start in a new era of supercomputing is immense, and demand for its chipsets and associated software exceeds supply.

Specialty retailers like Costco, Home Depot and newcomer Ulta Beauty, have successfully defended their brick-and-mortar businesses in the digital age. These companies have found a way to create competitive moats around their stores by creating a shopping experience that cannot be replicated online.

Costco has created a unique shopping experience among its growing membership by providing a scavenger hunt-like experience for its customers. Shoppers go to Costco not only to get a great deal on gasoline but also 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 by selling products like lumber and appliances that 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 stores and online, produces industry-leading unit growth. In just 10 years, Ulta Beauty has more than doubled its store count to over 1300 and has become a leader in omnichannel retail.



Bulldogs and the Power of Generative AI

In a recent interview at the World Government Summit in Dubai, Nvidia's CEO Jensen Huang gave the following answer regarding the future of education and AI: "Years ago we said to our children, you should learn how to program. Today it is the opposite because the program language is human. Thanks to the miracle of generative AI, everybody is now a programmer."

Jensen Huang highlights how powerful a tool AI will become across all sectors, driving entirely new businesses and services, while enhancing efficiency and better predictive outcomes within the enterprise.

We are already seeing early adoption of generative AI at software giants like Microsoft, Adobe, and Intuit, who have integrated this new computing power into their latest operating systems. Semiconductor companies like Nvidia, Broadcom, and Taiwan Semiconductor are making sure there is ample supply of next-generation GPUs to run today's data centers.

Communication companies like Meta Platforms and Alphabet are using generative AI to improve their customers' user experience, better predict consumer behavior, and optimize advertising targeting. Amazon's technology prowess allows it to extend its dominance in e-commerce by using AI to better predict consumer buying patterns.

Investment Implications

Stock market differentiation has evolved from a “risk on, risk off” environment where correlations among asset classes and within sectors converge. As investors recognize the intensity of today’s sales battles and reward winners, premium valuations are likely to accrue to dominant competitors. In 2023, we witnessed the phenomena of the so-called Magnificent 7, a case in point. Few would disagree that this narrow group of stocks has experienced explosive growth. Having applied our Bulldog strategy to investing for 30 years, we recognize that premium valuations can only be sustained if a company can generate superior returns on equity and unit growth under many business cycles. Costco is a good example of a company that has sustained its premium valuation over time. Its unique business model has produced a consistent 20+% return on equity and returned more than 3 times the market’s returns on a 10-year basis, and more than 2 times on a 5-year basis, as measured by the S&P500.

Premium Valuations

Premium valuations afforded to companies like Costco, Mastercard, Intuit and Broadcom, to name a few, are not yet applied to other leading companies. On average, our current universe of 200 stocks with Bulldog-like characteristics still sells at a modest premium, 1.2 that of the S&P500 P/E multiple. In the early 1970s, when portfolio 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. By comparison, the Magnificent 7 currently trade at 1.7x the market.



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. They can, however, achieve capitalization premiums within their respective sectors. These companies can be found among industrials like FedEx or Rockwell Automation.

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.

Novo Nordisk, a Danish global healthcare company founded in 1923, is known for discovery, development, manufacturing, and marketing of pharmaceutical products in the diabetes, obesity care, and rare disease segments. Together with Eli Lilly, Novo Nordisk dominates the fast-growing GLP-1 class of drugs, promising both weight loss and cardiovascular benefits.

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



Bulldogs Think Global, Sell Local

Global Bulldogs demonstrate their ability to supply products and uninterrupted services even during severe periods of disruption. Adapting to different local markets with products and services that local customers value is a key differentiator of the global Bulldog. Companies like Mercado Libre in South America and T-Mobile in Europe have grown their global reach far beyond their home markets.

Today's Bulldogs are confronted with geopolitical challenges and anti-competitive government policies not seen in decades. Bulldogs' keen sense to navigate these challenges allows them to extend their market share lead during adverse business conditions. While "think global, sell local" has long been the marching order for business leaders looking to grow globally, this strategy requires a management team with vision who can adapt to an ever-changing competitive landscape.

Emerging Bulldogs

Size and reach are key advantages in today's globally competitive landscape, but only if they are managed effectively, and economies of scale are exploited. A company's ability to fund its own expansion is a distinct advantage. Large companies have an edge when 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 and strengthen unique niche positions through product enhancements and geographic diversification.

Emerging Bulldogs, like Motorola Solutions, have used their technological edge in mobile communication devices to become the dominant technology provider for first responders. Within command centers, its technology unifies voice, video, and data feeds so first responders can stay connected and communicate clearly. Motorola's competitive moat is considerable in this segment, preventing competitors from easily entering this highly lucrative market.

Bulldogs at the Intersection of Biology and Technology

By turning to big data, pharmaceutical companies have accelerated improvements at each step of the drug development process, starting from drug discovery and identifying new targets through clinical trials and regulatory approval, to marketing and post-launch monitoring.

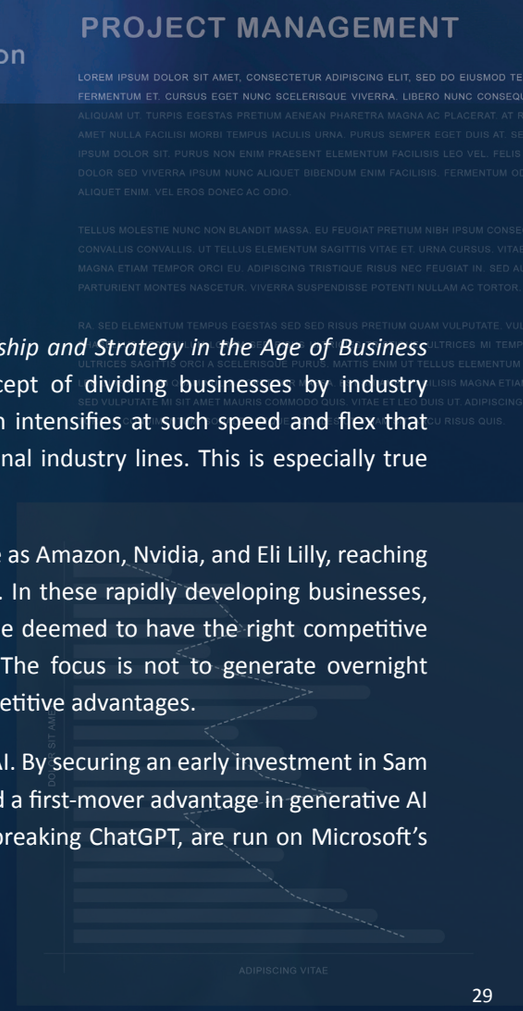
Healthcare big data refers to collecting, analyzing, and leveraging consumer, patient, physical and clinical data that is too vast or complex to be understood by traditional means of data processing. Instead, big data is often processed by machine learning algorithms and data scientists.

This technology driven research and development has produced some of the breakthroughs in human genome and single cell sequencing, leading to major discoveries in the vaccine space. Data science is driving this research further. We are already making considerable progress in cancer research with targeted immunotherapies.

The healthcare sector is a fertile ground for companies with unique Bulldog characteristics. This is not limited to the pharmaceutical sector but also includes biotech, medical devices, life sciences and medical IT companies.







Competitive Alliances

In his 1996 book, *The Death of Competition: Leadership and Strategy in the Age of Business Ecosystems,* James F. Moore argued that the concept of dividing businesses by industry is no longer useful. His notion was that competition intensifies at such speed and flex that companies no longer operate or think along traditional industry lines. This is especially true with companies at the forefront of technology.

Alliances crop up daily between companies as diverse as Amazon, Nvidia, and Eli Lilly, reaching 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 to create fundamental and lasting competitive advantages.

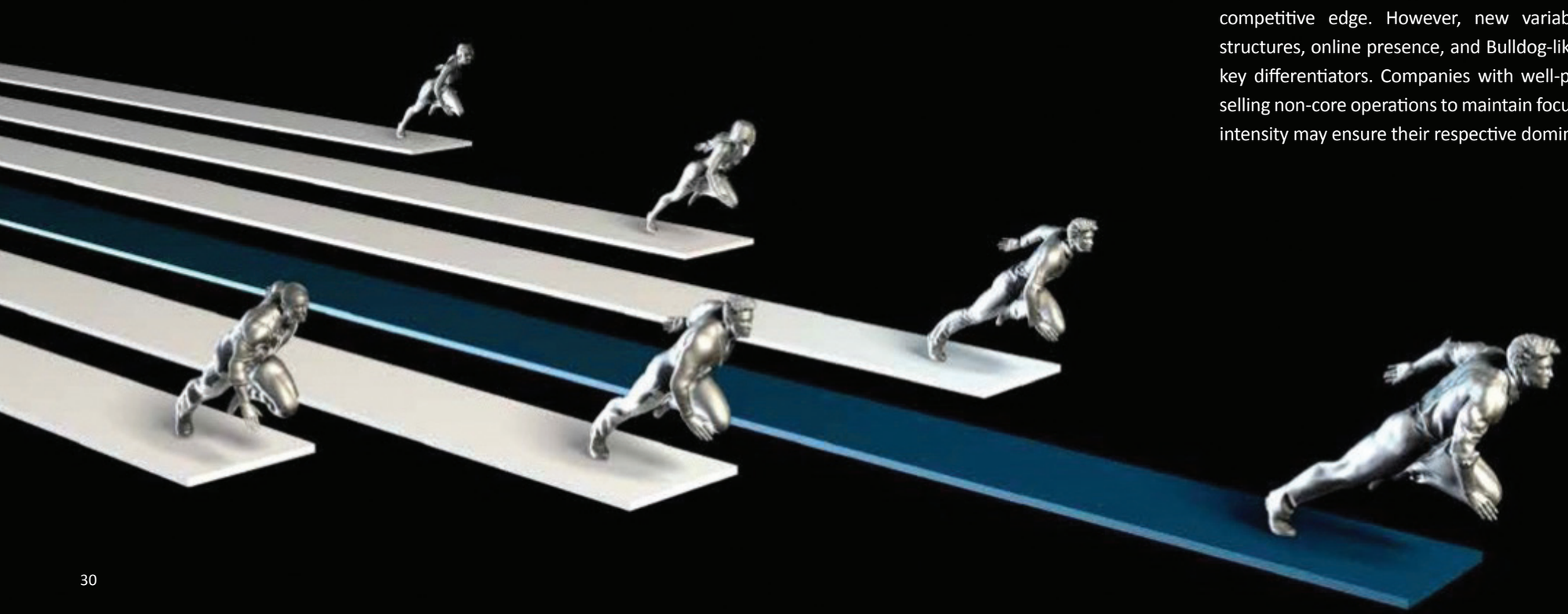
A case in point is Microsoft's involvement with OpenAI. By securing an early investment in Sam Altman's highly innovative start-up, Microsoft assured a first-mover advantage in generative AI because OpenAI's new applications, like the groundbreaking ChatGPT, are run on Microsoft's cloud platform Azure.

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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 management. Complacency becomes the enemy of success; even the smallest competitors should not be dismissed. Winning management and winning companies stay close to their customers and promote 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 production 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. However, new variables, including streamlined corporate structures, online presence, and Bulldog-like approaches to new markets, are also key differentiators. Companies with well-positioned businesses have resorted to selling non-core operations to maintain focus in select businesses. This “born again” intensity may ensure their respective dominance for a long time.





Bulldog Characteristics

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

The key trait of Bulldogs' 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 must grapple with the reality that some of their investment favorites do not always generate "straight-line" results.

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.

For more than 25 years, our team has applied this discipline to establish a universe of about 200 stocks of companies that embody Bulldog characteristics. New ones are added, and others are removed as the competitive landscape shifts. Once dominant companies like Kodak and Xerox are examples of companies that ultimately lost their edge and their preeminent market positions. Premier companies like Microsoft, Nvidia, and Amazon have replaced them.

Our buy universe of 200 potential Bulldogs is continually measured by our relative valuation model and ranked by return expectation versus the S&P500 over a 3-year investment horizon. We construct a portfolio of 30-40 stocks. Our multi-step investment process is geared towards identifying which Bulldogs to own and in what proportions.

Mindset

As Portfolio Managers, we often experience information overload. By applying our Bulldog Strategy, we have focused our investment process by filtering out of our information inbox stock ideas that do not meet our investment prerequisite of having a discernible Bulldog characteristic.

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.



In Summary

As our Chairman, Jim Moltz, famously said, “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.” Unit growth is a telltale trait of a true Bulldog.



The Bulldog Portfolio Management Team

C.J. Lawrence’s investment team shares decades of experience and has followed the Bulldog investment philosophy for individual clients and institutions for many investment cycles.

About C.J. Lawrence

C.J. Lawrence is a New York-based investment management firm providing platinum-level service and investment portfolio customization to individuals, families, foundations and institutions.

With a legacy that dates 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 its clients.

C.J. Lawrence Products And Services

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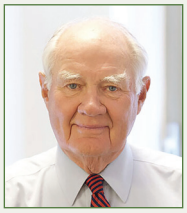
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