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PRICE POINT

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Timely intelligence and analysis for our clients.

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U.S. Equities

FINDING OPPORTUNITIES IN BLUE CHIP GROWTH STOCKS

KEY POINTS

- The potential benefits of tax reform should not be underestimated—the reduction in tax rates could have profound effects over time.
- As a bottom-up stock picker, we believe that fundamental research is the key to identifying companies that can generate long-term growth.
- Despite valuations that are somewhat above historical averages, we believe that blue chip companies can continue to generate solid corporate earnings and cash flow growth.

WE ARE STILL BULLISH

Global equity markets performed remarkably well in 2017, with large-cap growth stocks leading the advance. However, heading into the first quarter of 2018, geopolitical events, the specter of rising interest rates, and other legislative initiatives created turbulence in equity markets that had experienced relatively low volatility for several years.

We focus on the long term, and we sometimes look at market pullbacks as an opportunity to buy our favorite ideas. We employ a bottom-up stock selection process and are willing to take large positions in companies that can benefit from our favored investment themes.

FOCUS ON ALL-SEASON GROWTH STOCKS

In our view, the global economy will continue to grow, albeit modestly. We favor companies that possess leading market positions, seasoned shareholder-oriented management, and strong fundamentals, including durable earnings and free cash flow growth. We refer to these kinds of firms as all-season growth companies because they are not overly dependent upon strong economic growth to prosper. Typically, these companies are seizing market share in large addressable markets. We like owning companies that we view as disruptors—companies using new technologies and processes to stay on the right side of change—and those that can demonstrate secular

Consequently, we have confidence in our time-tested stock selection process and that, over the long term, high-quality growth stocks can continue to perform reasonably well.

growth characteristics over multiple-year periods. These core companies represent sizable allocations in the information technology, consumer discretionary, and health care sectors, areas we view as fertile fields for growth-oriented stock pickers.

CAPITALIZING ON CHANGE

The U.S. economy should benefit, at least to some degree, from reduced regulation and the effects of lower corporate taxes; however, the ultimate effect remains uncertain. The potential benefits of tax reform should not be underestimated. Taxes have been reduced for most individual taxpayers, and the reduction in the corporate tax rate from 35% to 21%, as well as the repatriation of cash held overseas by corporations at more favorable tax rates, could have profound effects over time.

Perhaps more important than legislative actions, game-changing technologies are creating tremendous efficiencies and benefits for consumers but are also disintermediating portions of major industries. For example, e-commerce is having a significant impact on retailing, while cloud-based computing is disrupting the software industry.

The shift toward e-commerce has also led to a change in the way consumers are paying for goods and services. Cash and paper forms of payment, such as checks, are being replaced by credit card, online, and mobile payments.

Advancements in e-commerce, cloud processing, enhanced payment systems, and other disruptive technologies are resulting in the replacement of some forms of labor with technology and are also having a deflationary effect on many goods and services. In our view, the benefits of these changes outweigh the drawbacks as consumers are clearly benefiting from low-cost, easy access to a broader array of goods, services, and information.

Changing technology and other trends, including globalization, align well with our investment strategy. Many of the stocks that we find compelling are multinationals that have created or adapted to new technologies. They are often well diversified by product line and geography, which tends to provide stable growth in earnings and free cash flow.

AMAZON—A DIVERSIFIED DISRUPTER

The prime example of this investment philosophy is Amazon.com in the consumer discretionary sector. The company has continued to impress with its well-executed moves into advertising, video streaming, and logistics. Its third-party sales and Amazon Web Services, which provides cloud-processing services for other companies, generated profit margins above the company average and grew more rapidly than its core retailing business. As a result, gross profits have expanded rapidly.

As an industry disruptor, Amazon’s acquisition of Whole Foods Market in 2017 sent shock waves through the entire retailing sector. We are often skeptical about acquisitions, and we recognize that the integration of Whole Foods will be complex. However, Amazon has demonstrated its expertise in logistics, and it has acquired over 460 food stores, with 63% of the U.S. population living within 20 miles of a store. The demographic profile of the typical Whole Foods customer is similar to that of an Amazon Prime customer. Over time, we would not be surprised to see Amazon grow its already meaningful food retailing business and drive sales of other goods and services through this new brick-and-mortar platform.

Amazon's latest quarterly results were strong across the board, as profitability continued to improve and revenue growth accelerated. Amazon has the potential, given its enormous market opportunities, broad competitive advantage, and outstanding innovation capabilities, to generate durable free cash flow growth for many years.

PUGLIA REMAINS BULLISH ON BLUE CHIPS

There are unmistakable signs of improvement in several sectors of the U.S. economy. Even if various legislative growth initiatives are implemented slowly, it appears that economic growth will improve somewhat. We believe that a backdrop of slow but sustained growth can be quite supportive for the overall market.

The broad market and large-cap growth stocks, in particular, have enjoyed a multiyear period of outperformance. Valuations are now somewhat above their long-term historical average. Consequently, there is probably less opportunity for continued outperformance. However, corporate earnings should be solid, and the passage of tax reform legislation could result in strong positive earnings revisions for selected companies and positive stock performance.

Further, many U.S. large-cap equities generated significant free cash flow and have been repurchasing their own stock, which, in addition to tax reform initiatives, may boost per-share earnings. Shareholder-oriented management can also use this cash to pay dividends or make value-added acquisitions. While stronger economic growth and rising oil and commodity prices could result in higher inflation and interest rates, we continue to believe that the interest rate backdrop will not be so onerous as to preclude stocks from performing well. Consequently, we have confidence in our time-tested stock-selection process and that, over the long term, high-quality growth stocks can continue to perform reasonably well.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. The strategy is subject to the volatility inherent in equity investing, and its value may fluctuate more than a strategy investing in income-oriented securities.

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