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MARKET CALLS

Portfolio Secrets of Neutron Jack

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In the early 1980's **Jack Welch**, then the new CEO of **General Electric**, earned the nickname "Neutron Jack" because he ruthlessly restructured his troubled company during troubled times, selling off businesses and firing tens of thousands of employees. Well, in case you hadn't noticed, times are troubled again. So you should think about applying Neutron Jack's strategy to your own portfolio, and do a little ruthless restructuring yourself.

In his new autobiography *Straight From the Gut*, Welch recalls the strategy he launched in 1981, when he'd only been on the job as CEO for 8 months. He decided to hold in General Electric's portfolio of companies only those that were "the number one or number two leanest, lowest cost, worldwide producers…" He warned that managers that "…hang on to losers for whatever reason – tradition, sentiment, their own management weakness – won't be around..."

Twenty years later, with General Electric transformed by Welch's strategy into the world's most valuable company by market capitalization, this strategy has never been more relevant. But it's been out of fashion for several years. The great bull market of the 1990s made investors soft and sentimental.

During the good times – made possible in part by the painful restructuring of American industry in the 1980s by giants like Welch – investors fell in love with thousands of new companies that were competing in crowded but rapidly growing markets. In the boom years you didn't have to worry about a company being number one or number two – number three and number four could get rich, too, and their stocks would go up more because they'd get rich off a smaller base.

But now the good times are over. The global economy has been sliding down the slippery slope of recession all year, and the terrorist attacks of September 11 gave it a big push downhill. It's a world of slowing consumer spending and business investment, and for companies operating in that world, it's like a science fair experiment where you submerge objects of different sizes in acid. The small objects completely dissolve. The big ones are eroded, but they survive.

So now's the time to be like Neutron Jack. You'd better look at each stock in your portfolio and ask whether it's a number one or a number two player. If it's not, and you hold it "for whatever reason – tradition, sentiment…weakness," you'd better prepare yourself for the possibility that it "won't be around."

In fact, it might not be a bad idea to insist on number one. Because number one players have the ability to not only to survive the hard times with fewer losses – but *also* to emerge in the next round of good times vastly strengthened… because all their smaller competition has been wiped out. The smart number one players know that, and have been using this year's adversity to set themselves up for exactly that outcome.

Consider number one **Intel** and it's long-running rivalry with number two **Advanced Micro Devices**. Coming into this year, AMD had a rare competitive opportunity to unseat Intel, in the form of a window of significant product superiority – its Athlon processor both ran faster and

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cost less than Intel's latest Pentium 4. For the first half of the year AMD grabbed market share from Intel – *unheard of!* – and its traditionally doggy stock strongly outperformed the blue chip. At its peak in May, AMD was up 139% year-to-date against the backdrop of a falling market – while Intel was down 3%.

But over the summer Intel used its vast financial power to ruthlessly cut prices and accelerate its product cycle to gain back market share. In trying to keep up, AMD was forced into structural unprofitability: Intel has put AMD in a position where the more chips its competitor sells, the more money it'll lose. AMD's stock has crashed, and given up all its outperformance relative to Intel, and then some. As of Monday, AMD had gone from being up 139% being down 33%! Over the same period, Intel went from being down 3.7% to being down 18.5%. Ugly for both – but which would you rather have held?

The economic shock of the September 11 terrorist attacks has only accelerated Intel's domination. In fact, on September 10, the year-to-date performance of the two stocks was virtually tied. But since the attacks, Intel has lost only 2.9% while AMD has lost 19.2%.

Why? In times of such frightening instability, the benefits to consumers of microprocessors for doing business with number one – the company that's going to be there for you no matter what – have become irresistible.

At this point, AMD essentially has no reason to exist. So why is it in your portfolio? Would Jack Welch hold it?

Consider the case of **Dell Computer**. This number one player has so consistently and ruthlessly destroyed its competition that it would be painful to watch if it weren't so profitable for investors. And consumers – Dell has always used its number one position to lead prices lower for the whole industry.

Year to date Dell's stock is up 37.4%, against the backdrop of a NASDAQ crash and a collapsing PC market. At the same time, **Gateway** is down 67.0%, and **Compaq** is down 33.8%.

And the acid bath of the post-attack world has been positively salutary for Dell. It's factories have been working around the clock churning out PCs, many of the them presumably destined to replace the tens of thousands of them that were destroyed on September 11. And **CEO Michael Dell** has bought 4.3 million shares of the stock of the company he founded – in a period when market-wide insider selling is running three-to-one ahead of buying. Since September 10 Dell is up 8.8%, while Gateway is down 34.6% and Compaq is down 6.7%.

Why? Because even in a shrinking world, the number one player can grow by grabbing market share. For Dell, a 1% gain in market share in the PC market at the expense of the Gateways and the Compaqs of the world is $2 billion in revenues.

You think maybe Jack Welch was on to something?

Not every company is equally skilled at playing the number one position. I've frequently criticized **Cisco Systems** this year for *not* being more aggressive in slashing prices of its core routers, ridding itself once and for all of competition from **Juniper Networks**. Since September 11, Cisco *has* played the pricing card aggressively against **Extreme Networks** in the layer 3 switch market – and so while Cisco's stock is up 16.3% since September 10, Extreme's is down 28.5%.

That's the good news for Cisco. The bad news is that Juniper's stock is *up* 86% since September 10. And every single point of that is a gift from Cisco.

The lesson? It's not enough to *be* number one – you have to *act like number one*, too. That's the way Jack Welch did it, anyway.

If all this sounds like nothing more than a recommendation to hold large-cap stocks during challenging economic times, then you're missing the point. The point is to invest in the number one players who can exploit their number one positions to come out on the other side of adversity stronger than ever.

There are plenty of smaller, newer companies that qualify – companies with unique products, markets, or technologies that make them number one in their own small way. It's not a matter of size, although size certainly confers strength – and strength is a good thing right now. More than that, it's a matter of competitive dominance.

It's that simple. Now all you have to do as an investor is have the courage of Jack Welch – the courage to do the obvious. Go with the winners.

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