My Detailed Notes to Moats and Competitive Advantages

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One of the hardest part about investing is not knowing where to start.

I started Old School Value 9 years ago in 2008 just before the crash and as a complete and utter newbie, I had no idea where to begin, what to read and who to believe.

I'm sure you've experienced it yourself.

Think back to your first year of investing (if you can haha).

The onslaught of information, tips and the promise of how to make money quickly.

My journey went from trying to learn about options, patterns, buy the hot stocks strategy until I clicked with fundamental value investing.

Compared to many of you, my nine years is a drop in the bucket. But throughout all this time, there are certain authors and books that never fall off my recommendation of best investment books list.

In fact, there is only one author who achieves two spots on my list.

Not Buffett.

Not Munger.

Pat Dorsey.

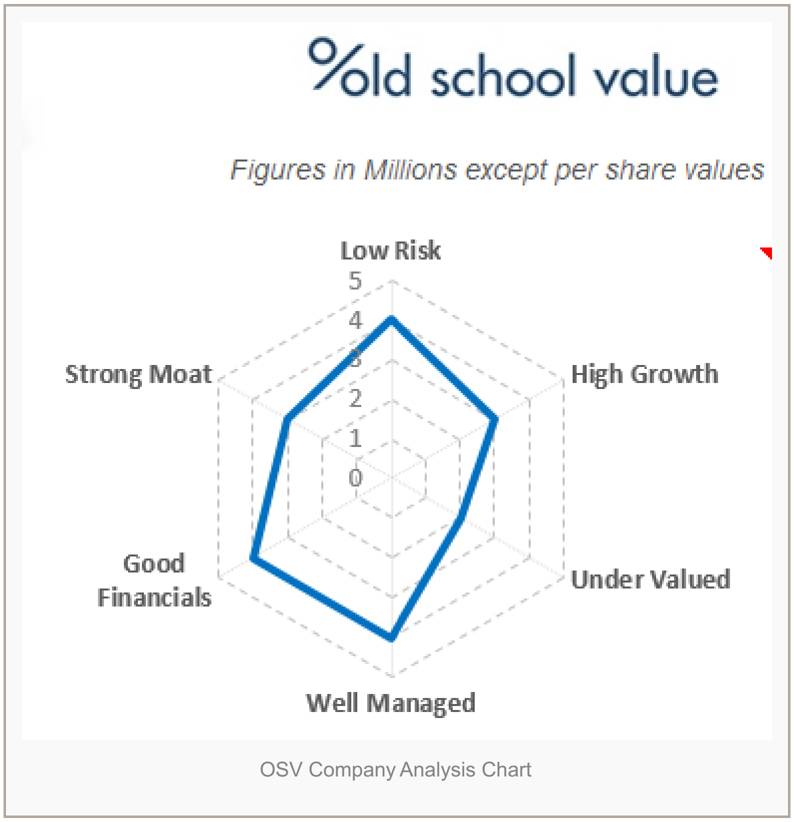
Relatively unknown investment manager who ran Morningstar's Equity Research Group before branching out.

His two books are:

1. The Five Rules for Successful Stock Investing
2. Economic Moats: The Little Book that Builds Wealth

With Old School Value, I've tried to come up with creative ways of quantitatively coming up with a moat calculation.

In the current rendition of the OSV Analyzer Spreadsheet, users can adjust numbers to come up with a chart like this.



OSV Company Analysis Chart

But at the end of the day, this type of chart is only something a person can update reliably.

There are too many intangibles and non-quantifiable aspects to a moat.

Moats vs Competitive Advantage

One thing I've learned the hard way is that most companies do not have a moat.

Also a competitive advantage is not a moat.

Therefore having a competitive advantage is not a moat.

Which brings me back to Pat Dorsey.

This Google talk based on the The Little Book that Builds Wealth looks at competitive advantages and moats.

(Youtube videos are best watched at 1.5x speed)

Notes to Pat Dorsey's Google Talk on The Little Book that Builds Wealth

About Pat

- Founder, Dorsey Asset Management
- Former Director of Equity Research at Morning Star: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
- Author of The Five Rules for Successful Stock Investing and The Little Book that Builds Wealth
- Runs a concentrated portfolio of 10 stocks.
- Current holdings are below:

Stock	Sector	Shares Held	Market Value	% of Port	Previous	Share Change	% Change
FB	INFORMATION TECHNOLOGY	264,159	39,883,000	18.7%	18.4%	35,600	15.0%
CMPR	CONSUMER DISCRETIONARY	257,326	24,325,000	11.4%	12.5%	No Change	0.0%
YELP	INDUSTRIALS	736,000	22,095,000	10.4%	0.0%	736,000	New
GOOG	INFORMATION TECHNOLOGY	23,061	20,956,000	9.8%	10.8%	No Change	0.0%
BAM	REAL ESTATE	520,454	20,407,000	9.6%	10.7%	No Change	0.0%
DG	CONSUMER DISCRETIONARY	278,400	20,070,000	9.4%	11.0%	No Change	0.0%
ANSS	INFORMATION TECHNOLOGY	155,651	18,940,000	8.9%	9.4%	No Change	0.0%
ROP	INDUSTRIALS	78,305	18,130,000	8.5%	10.5%	11,948	-13.0%
DSGX	INFORMATION TECHNOLOGY	658,340	15,993,000	7.5%	10.9%	184,400	-21.0%
WK	INFORMATION TECHNOLOGY	645,973	12,306,000	5.8%	5.7%	No Change	0.0%

Capitalism Works

- Capital seeks the highest returns possible: High profits attract competition.
- Most businesses with high returns on capital decrease over time as competition comes in.
- Only small minority of businesses achieve high returns of capital over long periods.
- Look for such companies.
- These companies create structural competitive advantages.
- e.g. companies like Nvidia vs AMD swap market share every six months whenever they release a new version.

Moat Basics

- Economic moats are structural and sustainable qualities that are inherent to the business
- Not hot products like Heely's or Krispy Kreeme.
- Not just a cool piece of tech (Iomega drives, plasma TV)
- Not the biggest market share (GM, Compaq)
- Moats generally manifest themselves in pricing power: A company that can't raise prices is unlikely to have a strong moat.
- If a company typically raises prices 2-4% every year, but one year, they suddenly don't and blame it on the economy or something else, that's a load of crap. Means something has changed in the industry or a competitor is out there.

Intangible Assets

- **Brands** which increase willingness to pay or lowers search cost.
- Sony is a well known brand, but very few will pay a 30% premium for a Sony TV over a Samsung TV.
- People pay a premium for Tiffany branded jewelry. Brand has value.
- Coca-Cola or Heinz are examples of lower search costs. People grab it without thinking. Nobody wants to spend 5 minutes deciding which brand of coke or ketchup they want to buy.
- **Patents** offer legal monopoly but are subject to expiration, challenges and piracy.
- Be careful of a business where one assets gives all the economic value. If patent is challenged and lost, you're dead.

- Powerful when you have a portfolio of patents. e.g. QCOM.
- **Licenses** and approvals are limited in number. Not easy to get a casino license.
- Landfill license and approvals are monopolized. Municipalities don't give out landfill licenses blindly.
- Aircraft part must be FAA certified. Most get 40% margin on aftermarket.

Widening the Moat: Brands

- Brands are valuable if they deliver a consistent or aspirational experience.
- Consistency lowers search costs and drives loyalty.
- Aspiration increases willingness to pay.
- People think Tiffany of a very expensive brand, but over 40% of their revenue comes from stuff sold for under $200.
- Only company that can hit volume and hit high price.
- Tiffany maintains brand power with scarcity and exclusivity. Cheap stuff at the back, expensive at the front.
- "You don't own a Patek Philippe, you merely take care of it for the next generation."

Switching Costs

- The cost of switching to a competitor outweighs the cost or product benefits of a new and better product.
- Look for companies that integrate with the customer's business. Get huge payback for renewals.
- E.g. Oracle database – ripping it out and replacing it is virtually impossible
- Will cost millions and thousands of man hours to rip out and replace. Business will blow up before everything is working smoothly. So Oracle can raise prices every year.
- Enterprise software, data processors, are examples that integrate tightly with customer's business.
- Can also sell ongoing service relationship – think elevators. Once an elevator is installed, it ain't coming out. Elevator companies attach a service contract to the elevator. Long service relationship.
- Find high benefit to cost ratio.
- e.g. Lubricants – if you have one that can increase uptime of a giant mining machine down in the hold by 10%, you don't have to take it out and lube it up as often.
- Even if the product is 20% more expensive than competitors, the benefit to cost ratio is so high, that it's a no brainer.

Network Effect

- Network effect is simply providing a service that increases in value as the number of users expand.
- Aggregate demand between fragmented parties.
- e.g. Henry Schein is a one stop shop for dentists. Most dental clinics are owner operated and they must buy little detailed bits and pieces. Too much stuff to buy by visiting 50 different stores. Consolidates fragmented demand to become a powerful distributor due to network effect.
- Strong network effects is based on non-linearity of nodes vs connections.
- One node can produce thousands of connections. e.g. Google.

- Watch for radial vs interactive networks. Google, Facebook are interactive networks where nodes interact with each other.
- Western Union is a radial network and is less valuable. Marketing hypes up having the most number of branches of any money transfer organization. True. The problem is that no one sends money from Bangaledesh to Mexico City. Money is sent from USA to Mexico and vice versa, but not Pakistan to China. Useless route.
- Such nodes are easier to pick off by underpricing service in a popular node.

Cost Advantages

- Process based advantage: Invent a cheaper way to deliver a product that can't be replicated quickly.
  - Inditex, RyanAir, GEICO, Dell
- Scale based advantage: Spread fixed cost over a large base. Relative size matter more than absolute size.
  - UPS, Aggreko, Stericycle
- Niche based advantage: Establish minimum efficient scale.
- Some niches and industries can only support one or two players.
- Business can't grow well because they are trapped there – but they can be enormously profitable.

Management

- "Good jockeys will do well on good horses, but not on broken-down nags." – Warren Buffett
- Best jockey riding a goat won't win a race against a newbie on a Triple Crown horse.
- Look for good horses first.
- Jockey is not irrelevant, but if he is riding a goat, he won't win no matter what.
- Managers matter in the context of a moat.
- Required level of managerial skill is inversely related to the quality of the business.
- The worse the business, the better the manager.
- The better the business, decent manager will do. Think MSFT and Ballmer.

Moats, Management and Mistakes

- Moats can buffer management mistakes.
  - Microsoft minted money despite Steve Ballmer.
  - New Coke did not kill Coca Cola
  - Moodys put profits before integrity, and still cranked out a 40% operating margin
  - But even a genius like David Neeleman couldn't change the fact that JetBlue is an airline — the worst industry known to mankind

The Good and the Bad

- Good managers are constantly looking for ways to widen a company's moat.
- Amazon's focus on customer experience. Amazon has become a search engine for finding products. People buy on Amazon without comparing prices. Only takes a few mouse clicks, but people don't do it.
- Amazon figured out that trust matters more online than offline. In a retail scene, I give you money, you give me a good and we are finished. No trust.
- Online, a lot of trust is needed to create an account, trust that my credit card won't be stolen, trust that the goods will arrive on time to the correct address.
- This trust enabled them to build a moat.
- Costco – uses scale to lower costs. Costco gets bigger. Cost savings go back to customer. Brings more customers which allows more cost savings.
- Diworsification – Cisco moved into consumer markets to try and capture a different market. Strayed from sticky and profitable enterprise business to highly demanding and price sensitive consumer market.
- Expanding should be done out of strength. Subtle difference. Strong businesses that try to expand into new markets do it when their core product is strong, profitable and still growing. Weak businesses start to expand when they see their core business declining to try and compensate for slowing growth.
- Bad decisions come more frequently by businesses run by hired hands with little incentive.

Country and Cultural Differences

- Local differences can create moats. Foreign companies cannot own banks in Canada. Thus, Canadian banks will always be very profitable than banks in any other country.
- In Germany, most municipalities don't allow you to wash your car in your driveway or street. Car washing business is good in Germany. Germans like cars, but you can't wash your car.
- Retail is a tough business in the US. Huge market. Any competitor can easily come in.
- South Africa have high margins for retail due to small market. Not enough for all companies. New entrants won't survive.
- Cultural preferences can create advantages. Beer travels well. Can be exported to many countries. Spirits travel well. Candy and snacks do not.

Why Moats Matter

- Moats add intrinsic value
- A company that can compound cash flow for many years is worth more than a firm that cannot.
- The value of an economic moat is largely dependent on reinvestment opportunities.
- The ability to reinvest tons of cash at high incremental ROIC = a very valuable moat.
- If a firm has a limited ability to reinvest, the moat adds little to intrinsic value.

Isn't the Moat Already Priced in?

- Short answer: Less often than you think.
- Long answer:
  - Most investors own securities for short time periods, and moats matter in the long run.

    - Most investors assume the current state of the world persists longer than it usually does.
    - Most investors focus on short-term changes in price, not long-term changes in moats.

- Quantitative data in the market tends to be efficiently priced.
- Qualitative insight and understanding the structural characteristic of the business, switching costs, why customers behave the way they do, why can this company raise prices – these are less efficiently priced.
- “All the information is in the past, but all the value is in the future” – Bill Miller

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