Morningstar StockInvestor: Evaluating Economic Moats while Building Portfolios

Paul Larson, Equities Strategist, Editor, Morningstar StockInvestor
Morningstar

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Our global database includes more than 325,000 investments.
Morningstar Equity Research

- One of the largest independent equity research groups in the world.

- 90+ analysts covering ~1800 companies across the globe.

- We now cover entire capital structure; entered credit research space in 2009 with corporate credit ratings.

- Consistent, disciplined research approach focused on intrinsic values and economic moats.

- *StockInvestor* newsletter Morningstar’s initial foray into equity research in mid-90’s.
StockInvestor Companion Site: msi.morningstar.com

Featured Commentary

Notification, 02/08/11 -- New Issue Available
The latest issue of Morningstar StockInvestor is now available. Please go to the following website to download your PDF copy of this issue:

http://msi.morningstar.com/Newsletter.aspx

If you have any problems logging in to the site, please send us an e-mail at newslettersupport@morningstar.com.

In the February issue, you will find:

--In the cover story, I step out on a limb and make ten more...

Notification, 02/08/11 -- New Issue Available

Roundup, 02/04/11 -- Another Blizzard

Trade Alert, 02/04/11 -- Tortoise Portfolio Trades

Roundup, 01/28/11 -- Blizzard of Earnings

Roundup, 01/21/11 -- Three Strong Earnings Reports, One Weak One

Trade Alert, 01/21/11 -- Hare Portfolio Transactions

Roundup, 01/14/11 -- A Yo-Yo Week for Apollo and St.

Portfolio Performance

Cumul Ret % 6/18/01 - 9/30/10

-20
-10
0
20
40
60
80
100

81.7%
73.8%

Our Picks
S&P 500

Click to view our Tortoise and Hare Portfolios

Featured Video

Wide-Moat IPO in the...Larson: High Quality Is...
Agenda

► Morningstar’s Approach to Competitive Analysis
  ► What is an Economic Moat?
  ► What’s Not?

► Where Morningstar Finds Moats

► Why Moats Matter

► Current Favorite Stocks
What’s A Moat?

- Capital seeks the areas of highest potential return, so all firms face competition that seeks to force down high returns on capital.
  - But some firms generate high returns for a very long time.
  - How? By creating economic moats around their businesses.

- An economic moat is a structural business characteristic that allows a firm to generate excess economic returns for an extended period.
  - Note that “structural” means “inherent to the business.”
  - Smart managers and great execution are important, but they’re not structural attributes.
What’s a Moat?

- The key to having an economic moat is the sustainability of excess returns, rather than the absolute level of return on capital.
  - A company with 40% returns on invested capital (ROIC) due to a hot product has no moat. The returns cannot be forecasted with any level of confidence.
    - Fashion stocks (Crocs, Heelys), Motorola Razr
  - A company with 12% ROIC – and a low cost of capital – that is structurally protected from the competition may have a wide economic moat, because we can forecast those returns with a high degree of confidence.
    - Pipelines, Railroads
Sources of Economic Moats

- Intangible Assets
  - Brands
  - Patents
  - Approvals & Licenses
- Customer Switching Costs
- The Network Effect
- Cost Advantages
  - Process
  - Scale
  - Low-cost resources
Sources of Economic Moats

▶ Switching Costs: Do to the costs – in time or money – of switching to a competing product/service outweigh the benefits?

▶ Monetary/Labor Costs
  - Oracle
  - Autodesk
  - Intuit
  - Data processors

▶ Low or uncertain benefits from switching
  - Amazon
  - Asset managers
Sources of Economic Moats

- Intangible assets
  - Brands: Does it increase the consumer’s willingness to pay, or reduce search costs?
    - Sony vs. Tiffany
    - A-B InBev, Nestle, P&G, Coca-Cola
  - Patents: Valuable, but subject to expiration & challenge.
    - Big pharma
  - Licenses & Government Approvals.
    - Waste haulers, aggregate companies
Sources of Economic Moats

- **The Network Effect** – One of the most powerful types of competitive advantage, which occurs when the value of a good or service increases with the number of users.

- **Examples of the Network Effect**
  - MasterCard, American Express, Visa
  - eBay
  - Microsoft
  - iPhone Apps
  - Financial Exchanges
Sources of Economic Moats

- **Cost Advantages** – Not necessarily tied to size
  - **Process** – Invent a cheaper way of delivering a good or service that rivals cannot (or will not) replicate. Nucor, Steel Dynamics.
  - **Scale**
    - Distribution – Stericycle, Sysco, UPS
    - Manufacturing – Intel
    - Niche Markets/Single-Scale Efficiency – Graco, Blackbaud
  - **Low-cost resource base** – Ultra Petroleum, Compass Minerals.
What’s Not An Economic Moat

- Size / Dominant Market Share: High market share does not give a firm a moat. (Ask Compaq – or GM.) In fact, market share may be irrelevant – bigger is not necessarily better.
- Technology: What one smart engineer can invent, another can improve upon. (Exception: Creating a standard that’s widely adopted.)
- Easily-replicable cost advantages (lean manufacturing, outsourcing).
- Hot Products: Can generate high returns on capital for a short period of time, but sustainable returns are what make a moat.
What’s **Not** An Economic Moat

- **Management**: Smart managers may *create* (or destroy) a moat over time, but great management is not a moat *by itself*.

  - "Go for a business that any idiot can run – because sooner or later, any idiot probably is going to run it." – Peter Lynch

  - “When management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that remains intact.” – Buffett

  - **Management matters, but moats often matter more.**
Buffett’s Message to Managers

From WB letter to BRK managers, 9/26/01: “What should you be doing in running your business? Just what you always do: Widen the moat, build enduring competitive advantage, delight your customers, and relentlessly fight costs.”

From 2010 BRK shareholder meeting: “The thing I want to pay managers for is widening the moat that separates their business from other businesses.”
Managers Shoveling Dirt in the Moat

- De-worsification is the number-one cause of self-inflicted wounds to the moat – and to shareholders’ brokerage accounts.
  - Cintas’s move into fire safety and document management.
  - H&R Block’s purchase of Olde.
  - Pitney Bowes’ move into mail-room outsourcing.
  - Cisco’s move into consumer markets
  - Ticketmaster buying Live Nation
  - Ebay buying Skype
Where Morningstar Finds Economic Moats

- Three groups: Wide, Narrow, and None.
- Wide moats are tough to find. Less than 10% of the companies that we follow have wide economic moats.
- Moats vary by sector & industry.
  - Fewer moats in highly commoditized or competitive sectors like computer hardware, consumer services (retail/restaurants), or industrial materials. Only 1/3 of the companies in these three sectors are wide/narrow moat.
  - More moats in areas with high switching costs (data processors) and durable brands (consumer products),
Why Moats Matter

- Moats add intrinsic value!
- A company that is likely to compound cash flow internally for many years is worth more today than a company which isn’t.
Why Moats Matter

- Companies with moats have greater resilience.
  - If a firm can fall back on a structural competitive advantage, it’s more likely to recover from temporary troubles.
  - Companies with moats hold the high ground; in tough times (rising water) they can maintain profitability while weaker competitors succumb.
  - This is a great psychological backstop for the investor who’s trying to buy when everyone else is screaming “sell!”
  - The key question to ask when negative news hits is simple: Does the information affect the company’s economic moat?
So, I Should Only Buy Wide Moat Stocks?

- **Short answer:** Well, that depends.
- **Long answer:**
  - There’s nothing “wrong” with no-moat stocks – if purchased at a sufficiently cheap price, they can be great investments.
  - Wide moat companies are neither better nor worse than no moat companies – they’re just different.
  - Understanding which companies in your portfolio have competitive advantages and which don’t can improve your investing by helping you make better decisions.
    - **Wide Moat = Innocent until proven guilty**
    - **No Moat = Guilty until proven innocent**
Isn’t the Moat Already Priced In?

► Short answer: Sometimes, but less frequently than you might think.
► Long answer:
  ► Most market participants own securities for short time periods, and moats matter much more in the long run than over the short term. (Time-horizon arbitrage.)
  ► Recency bias causes most investors to assume that the current state of the world (good or bad) persists for longer than it usually does.
  ► Empirical evidence suggests that waiting for wide moats to become cheap is a compelling strategy.
    ► Buffett, Sequoia, Mairs & Power, Jensen
Putting Moat Concept Into Action: Morningstar StockInvestor

- Edited by Paul Larson
- Included in subscription: Monthly print/pdf newsletter, email trade alerts, weekly market commentary, subscriber website
- Focus of service: Companies with wide economic moats
- Newsletter contains Wide-Moat Watchlist. Has all 152 U.S.-listed stocks of wide-moat companies
- Centerpiece of service: Tortoise and Hare model portfolios
- Tortoise and Hare are real-money portfolios that are handily beating the market since 2001 inception.
- Low turnover (∼15%), and approximately 50 stocks between two portfolios.
## Moat Concept Works: Performance of Tortoise and Hare Portfolios

<table>
<thead>
<tr>
<th>Cumulative Total Returns</th>
<th>Tortoise</th>
<th>Hare</th>
<th>T&amp;H Combined**</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>(As of 2/28/11)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-Year</td>
<td>12.8%</td>
<td>26.9%</td>
<td>19.4%</td>
<td>22.6%</td>
</tr>
<tr>
<td>2-Year</td>
<td>64.6%</td>
<td>109.2%</td>
<td>84.1%</td>
<td>88.3%</td>
</tr>
<tr>
<td>3-Year</td>
<td>10.0%</td>
<td>29.9%</td>
<td>19.1%</td>
<td>6.7%</td>
</tr>
<tr>
<td>4-Year</td>
<td>8.4%</td>
<td>29.5%</td>
<td>17.9%</td>
<td>2.9%</td>
</tr>
<tr>
<td>5-Year</td>
<td>21.3%</td>
<td>53.7%</td>
<td>35.5%</td>
<td>15.2%</td>
</tr>
<tr>
<td>6-Year</td>
<td>33.9%</td>
<td>75.5%</td>
<td>51.7%</td>
<td>24.9%</td>
</tr>
<tr>
<td>7-Year</td>
<td>41.6%</td>
<td>91.6%</td>
<td>62.7%</td>
<td>33.6%</td>
</tr>
<tr>
<td>8-Year</td>
<td>96.4%</td>
<td>155.0%</td>
<td>121.7%</td>
<td>85.0%</td>
</tr>
<tr>
<td>9-Year</td>
<td>81.7%</td>
<td>119.4%</td>
<td>98.6%</td>
<td>43.1%</td>
</tr>
<tr>
<td>Since Inception*</td>
<td>102.9%</td>
<td>99.6%</td>
<td>101.3%</td>
<td>31.6%</td>
</tr>
</tbody>
</table>

*Inception: 06/18/01  **Time-weighted, assuming equal investments at inception
Putting Moat Concept Into Action: Wide-Moat Focus Index

- Index comprised of the 20 wide-moat stocks with the lowest price/fair value ratios, using Morningstar’s fair value estimates.

- It is equal-weighted, and rebalanced quarterly.

- Compared to Tortoise and Hare, much higher turnover (~125%).

- Index was created in 2007, but we have performance data going back to 2002.
## Moat Concept Works: Performance of Wide-Moat Focus Index

<table>
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<tr>
<th>Annualized Total Returns</th>
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<th>S&amp;P 500</th>
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<tr>
<td>(As of 2/28/11)</td>
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</tr>
<tr>
<td>1-Year</td>
<td>20.3%</td>
<td>22.6%</td>
</tr>
<tr>
<td>2-Year</td>
<td>48.1%</td>
<td>37.2%</td>
</tr>
<tr>
<td>3-Year</td>
<td>12.7%</td>
<td>2.2%</td>
</tr>
<tr>
<td>4-Year</td>
<td>7.5%</td>
<td>0.7%</td>
</tr>
<tr>
<td>5-Year</td>
<td>9.6%</td>
<td>2.9%</td>
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<tr>
<td>Since Inception*</td>
<td>15.6%</td>
<td>7.9%</td>
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Index comprised of the 20 wide-moat stocks with the lowest price/fair value ratios. It is equal-weighted, and rebalanced quarterly.
Favorites Worth Discussing

► Abbott Laboratories ABT
  ► Wide-moat, diversified healthcare company. Only about 10x forward earnings despite growth rates near 10%. Humira fears vastly overblown. $68 fair value est. vs ~$47 stock.

► Cloud Peak Energy CLD
  ► PRB coal-miner. Only narrow moat, but very cheap at only 10x forward earnings, 5x EBITDA. $31 fair value estimate vs ~$21 stock. Asian demand could be game-changer.
More Favorites

- Lowe’s LOW
  - At current stock price (~$26), market pricing in nominal SSS increases and no margin improvement from cyclical trough. This is too conservative; our fair value estimate is $36.

- St. Joe JOE
  - Largest private landholder in Florida. Battleground stock lately with mutual fund giant Bruce Berkowitz taking on both short-sellers and company management. At a recent $26 per share, implied value of land is just $4,000 per acre. Our fair value estimate is $40 per share.
More on Moats


- *Competition Demystified*, Bruce Greenwald (Penguin, 2005)

- Annual Reports – The more, the better. Build that mental database!

- *The Halo Effect*, Phil Rosenzweig (Free Press, 2007)
The chef is eating the cooking!

Disclosure: I personally own nearly all the stocks in the Tortoise and Hare, including these in this slide deck…
ABT, ADSK, AXP, BRK.B, CLD, CMP, CSCO, CTAS, EBAY, JOE, LOW, MA, MSFT, PG, SYY, UPL
Questions? Feedback?

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