Chapter One

Economic Moats

What's an Economic Moat, and How Will It Help You Pick Great Stocks?

FOR MOST PEOPLE, it's common sense to pay more for something that is more durable. From kitchen appliances to cars to houses, items that will last longer are typically able to command higher prices, because the higher up-front cost will be offset by a few more years of use. Hondas cost more than Kias, contractor-quality tools cost more than those from a corner hardware store, and so forth.

The same concept applies to the stock market. Durable companies—that is, companies that have strong competitive advantages—are more valuable than companies that are at risk of going from hero to zero in a matter of months because they never had much of an advantage over their competition. This is the biggest reason that economic moats should matter to you as an investor: Companies with moats are more valuable than companies without moats. So, if you can identify which companies have economic moats, you'll pay up for only the companies that are really worth it.

To understand why moats increase the value of companies, let's think about what determines the value of a stock. Each share of a company gives the investor a (very) small ownership interest in that firm. Just as an apartment building is worth the present value of the rent that will be paid by its tenants, less maintenance expenses, a company is worth the present value* of the cash we expect it to generate over its lifetime, less whatever the company needs to spend on maintaining and expanding its business.

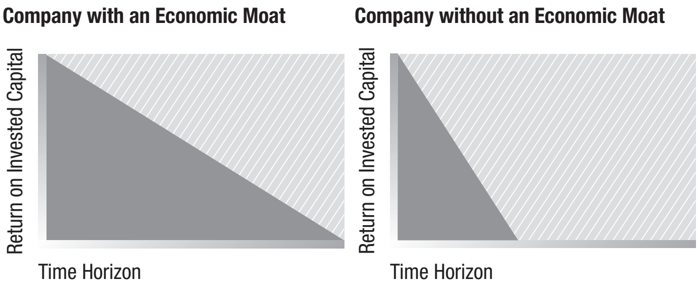
*To calculate present value, we adjust the sum of those future cash flows for their timing and certainty. A dollar in the hand is more valuable than one in the bush, so to speak, and cash we're confident of receiving in the future is worth more than cash flows we're less certain about receiving. I'll go over some basic valuation principles in Chapters 12 and 13, so don't worry if this isn't clear just yet.

So, let's compare two companies, both growing at about the same clip, and both employing about the same amount of capital to generate the same amount of cash. One company has an economic moat, so it should be able to reinvest those cash flows at a high rate of return for a decade or more. The other company does not have a moat, which means that returns on capital will likely plummet as soon as competitors move in.

The company with the moat is worth more today because it will generate economic profits for a longer stretch of time. When you buy shares of the company with the moat, you're buying a stream of cash flows that is protected from competition for many years. It's like paying more for a car that you can drive for a decade versus a clunker that's likely to conk out in a few years.

In Exhibit 1.1, time is on the horizontal axis, and returns on invested capital are on the vertical axis. You can see that returns on capital for the company on the left side—the one with the economic moat—take a long time to slowly slide downward, because the firm is able to keep competitors at bay for a longer time. The no-moat company on the right is subject to much more intense competition, so its returns on capital decline much faster. The dark area is the aggregate economic value generated by each company, and you can see how much larger it is for the company that has a moat.

EXHIBIT 1.1 Company with an Economic Moat versus a Company without a Moat



So, a big reason that moats should matter to you as an investor is that they increase the value of companies. Identifying moats will give you a big leg up on picking which companies to buy, and also on deciding what price to pay for them.

Moats Matter for Lots of Reasons

Why else should moats be a core part of your stock-picking process?

Thinking about moats can protect your investment capital in a number of ways. For one thing, it enforces investment discipline, making it less likely that you will overpay for a hot company with a shaky competitive advantage. High returns on capital will *always* be competed away eventually, and for most companies—and their investors—the regression is fast and painful.

Think of all the once-hot teen retailers whose brands are now deader than a hoop skirt, or the fast-growing technology firms whose competitive advantage disappeared overnight when another firm launched a better widget into the market. It's easy to get caught up in fat profit margins and fast growth, but the *duration* of those fat profits is what really matters. Moats give us a framework for separating the here-today-and-gone-tomorrow stocks from the companies with real sticking power.

Also, if you are right about the moat, your odds of permanent capital impairment—that is, irrevocably losing a ton of money on your investment—decline considerably. Companies with moats are more likely to reliably increase their intrinsic value over time, so if you wind up buying their shares at a valuation that (in hindsight) is somewhat high, the growth in intrinsic value will protect your investment returns. Companies without moats are more likely to suffer sharp, sudden decreases in their intrinsic value when they hit competitive speed bumps, and that means you'll want to pay less for their shares.

Companies with moats also have greater resilience, because firms that can fall back on a structural competitive advantage are more likely to recover from temporary troubles. Think about Coca-Cola's disastrous launches of New Coke years ago, and C2 more recently—they were both complete flops that cost the company a lot of money, but because Coca-Cola could fall back on its core brand, neither mistake killed the company.

Coke also was very slow to recognize the shift in consumer preferences toward noncarbonated beverages such as water and juice, and this was a big reason behind the firm's anemic growth over the past several years. But because Coke controls its distribution channel, it managed to recover somewhat by launching Dasani water and pushing other newly acquired noncarbonated brands through that channel.

Or look back to McDonald's troubles in the early part of this decade. Quick-service restaurants are an incredibly competitive business, so you'd think that a firm that let customer service degrade and failed to stay in touch with changing consumer tastes would have been complete toast. And in fact, that's the way the business press largely portrayed Mickey D's in 2002 and 2003. Yet McDonald's iconic brand and massive scale enabled it to retool and bounce back in a way that a no-moat restaurant chain could not have done.

This resiliency of companies with moats is a huge psychological backstop for an investor who is looking to buy wonderful companies at reasonable prices, because high-quality firms become good values only when something goes awry. But if you analyze a company's moat prior to it becoming cheap—that is, before the headlines change from glowing to groaning—you'll have more insight into whether the firm's troubles are temporary or terminal.

Finally, moats can help you define what is called a "circle of competence." Most investors do better if they limit their investing to an area they know well—financial-services firms, for example, or tech stocks—rather than trying to cast too broad a net. Instead of becoming an expert in a set of industries, why not become an expert in firms with competitive advantages, regardless of what business they are in? You'll limit a vast and unworkable investment universe to a smaller one composed of high-quality firms that you can understand well.

You're in luck, because that's exactly what I want to do for you with this book: make you an expert at recognizing economic moats. If you can see moats where others don't, you'll pay bargain prices for the great companies of tomorrow. Of equal importance, if you can recognize no-moat businesses that are being priced in the market as if they have durable competitive advantages, you'll avoid stocks with the potential to damage your portfolio.

The Bottom Line

1. Buying a share of stock means that you own a tiny—okay, *really* tiny—piece of the business.
2. The value of a business is equal to all the cash it will generate in the future.

(continued)

3. A business that can profitably generate cash for a long time is worth more today than a business that may be profitable only for a short time.
4. Return on capital is the best way to judge a company's profitability. It measures how good a company is at taking investors' money and generating a return on it.
5. Economic moats can protect companies from competition, helping them earn more money for a long time, and therefore making them more valuable to an investor.