

Brilliant, Heather & Collins, Elizabeth – Why Moats Matter

John Wiley & Sons, 2014, [Equity Investing] Grade ★★★★★

In a capitalistic economy with free market entry new competition will ensure that any existing company's surplus financial returns will evaporate over time. That is, unless there is something that interferes and protects the incumbents from new competition. Few have spent more time thinking of sustainable incumbent competitive advantages – or moats in Warren Buffett's parlour – than the independent investment research firm Morningstar. In fact the firm has built its entire research process around the two building blocks moats and margin of safety. The credited authors are co-CEO of Morningstar Australasia and Director of Equity Research in North America respectively, but a large number of Morningstar staff have contributed to the book.

Why Moats Matter implicitly has two parts. The first is a detailed run through of Morningstar's equity research methodology – complete with an ending quantitative back test showing that their undervalued stocks in companies with wide moats generate excess returns. The second is a one-by-one description of the moat in a number of industries. The authors' stated goal is to provide the reader with the means to determine a company's moat and margin of safety, to use in his own investment decision-making. Perhaps the less clearly stated goal is to advertise the merits of Morningstar's research? Sell side equity research is a tough business and it's not easy to compete with the Goldman Sachs of this world. The structure of the book certainly opens up for the risk that it becomes a (lengthy) promotional leaflet.

As I like Morningstar's approach I might be biased, but I don't think that the book crosses the "ad-brochure-line". Also, even if it doesn't exactly sparkle it's not as dry as you might expect of a book on research methodology. I appreciate that Morningstar looks at the right things such as "moat trends" or the level of uncertainty of their intrinsic stock valuations (demanding a larger margin of safety to rate it a buy if they feel less sure) and that

they systematize intangible factors into actionable grading systems in a way that differentiates them from the bulge bucket research. Five sources of economic moats are identified: 1) Intangible Assets such as brands or patents, 2) Cost Advantages due to for example economies of scale, 3) Switching Costs where the customers finds it expensive or inconvenient to change supplier, 4) Network Effects created by positive loops from growing number of users and 5) Efficient Scale where rational new entrants are kept out of an industry as their entry would destroy the market – also for themselves.

Why Moats Matter is in a way a sequel. In 2004 Pat Dorsey, then Morningstar's Director of Research wrote *The Five Rules For Successful Stock Investing* with a parallel two-part structure. I prefer the current book as it is more to the point - focused on moats - and the industry descriptions are less general and better ties in with the preceding discussion on competitive advantages. Also, there are a larger number of illuminating corporate case studies in *Why Moats Matter*. Where the target audience for the first book felt like the retail investor, even seasoned value investors can appreciate this one.

No objections? With regards to the book there is one chapter on applying moats to dividend investing that felt a bit out of place and redundant. To some extent I would have appreciated a more thorough discussion on how several moats can enforce each other. Columbia's Bruce Greenwald has pointed to the combination of scale economies and some source of customer captivity as the most enduring competitive advantage. Concerning the methodology I would argue that Morningstar's practice of emphasizing duration over size when judging moats is a bit narrow. The size of the excess return and the ability to invest plenty of capital without diminishing the return also matters.

However, we are talking fine print here. I definitely think the book delivers on its (stated) aim.

Mats Larsson, August 25, 2014