Dorsey, Pat – The Little Book that Creates Wealth

Wiley, 2008, [Equity Investing] Grade ★★★★

Warren Buffett has four main principles for investing in businesses. They need to be within his circle of competence, run by good management, have good long-term prospects and be available at a fair price. *The little book that creates wealth* gives the investor some well needed filters for how to think about good long-term prospects. In order to achieve high returns over the long term the business needs to have some type of competitive advantage or in Buffet terms, moat. A book that is most often recommended for readers who want to understand the concept of a moat is Michael Porter's book *Competitive Advantage*. However, this is a book for corporate managers. Dorsey wanted to write a book for investors and it doesn't disappoint.

Pat Dorsey has had a long career at Morningstar where he was Director of Equity Research and where he was one of the main contributors to the firm's economic moat ratings. Morningstar follows businesses and rank them in terms of the strength of the moat and an ETF has even been created to track these businesses. For a long-term investor that wants to create wealth without having to continuously find new investment opportunities the business then needs to have some kind of moat. Munger refers to this as "sit on your ass investing" in his usual witty way.

Businesses that are undervalued for the short term may give the investor gains but the challenge is that these gains need to be re-invested, causing the need for continuously making good stock picks. It takes time to find good investments, meaning that it's important to benefit from the opportunities that come up. Having a large analyst team makes it possible to analyze a broad set of companies leading to a higher chance of finding continuously good opportunities. This might be harder for the individual investor.

Dorsey divides moats into four categories: intangibles (brand, patents, licenses), switching costs, network effects and economies of scale. The moat can either be strong, *wide moat*, or weak, *narrow moat*. It's rather self-explanatory that a business can't be prosperous over the long term without having some kind of advantage against the competitors. A business may have a patent that shuts out the competition for a set period of time or it may have a brand that enables the business to set a price that is above the cost of production. Some businesses have historically had a high degree of customer retention meaning that the switching costs are high. A typical example of a business with high switching costs are banks. An example of a business with high network effects is Facebook where existing users benefit from having more users on the platform. Interestingly, Dorsey explained during a presentation that it's not always a benefit for a company to have all or many types of moats; a really wide moat in any of the categories may well be better.

The book is focused on the US in terms of the majority of businesses examples that is brought up and especially in terms of how to think about taxation which disturbs the flow a bit for a non-US investor. A topic in the book where value investors often have different opinions is about moat versus management. Dorsey is of the view that moat is more important and uses the quote from Buffett: *"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact"*.

I tend to agree with this as there are so many examples of great managers working in tough industries without being able to create sustainable high returns on capital. However, I would also like to emphasize that an excellent manager may well create a corporate culture that could work as a moat in certain instances and through this achieve extraordinary results in highly competitive industries.

For investors who want to understand the concept of moats this book is a great start. It's short but packed with insights and I have already started to benefit from the book in terms of how I think about barriers to enter an industry. I didn't pick that up the first time I read Porter's *Competitive Advantages* which is why I have to give a lot of credit to Pat Dorsey for helping me to grasp this important concept better. If the concept of moats isn't part of your set of mental models yet, then begin with reading this book.

Niklas Sävås, December 30, 2017