

# Owning A Moat Can Help Your Portfolio

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## Agenda

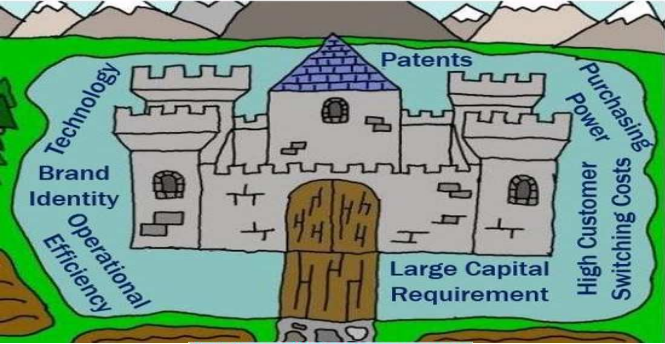
- ▶ Economic moats and their performance
- ▶ Moats, Warren Buffett and Quality
- ▶ Quality or evaluating management is important
- ▶ Strong Moats = Sustainable Competitive Advantage = "Quality" = Strong Business Model
- ▶ Morningstar is the expert in moats
- ▶ Summary




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## What is a Wide Economic Moat?



▶ An Economic Moat protects a company's profits from being attacked by business forces  
 Traditional management theory terms: "Sustainable Competitive Advantage" or "Entry Barriers"



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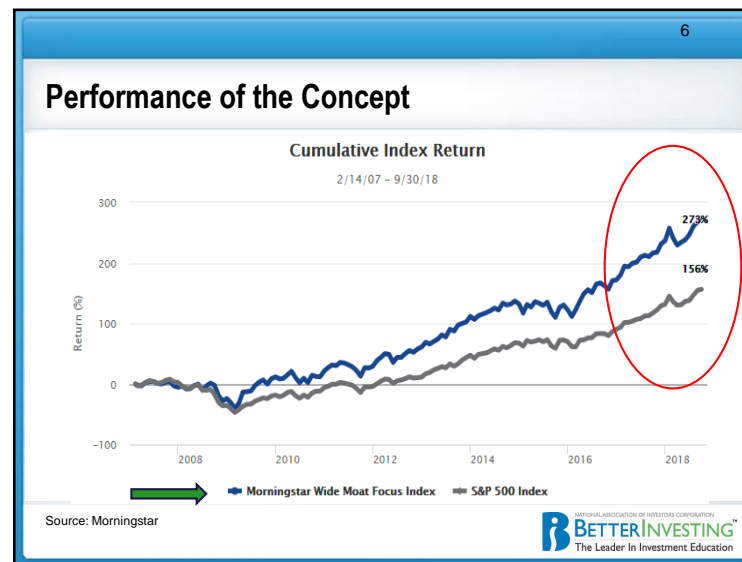
### The Stock is in the Buy Range – are You Done?

In business, I look for economic castles protected by unbreachable moats. - Warren Buffet

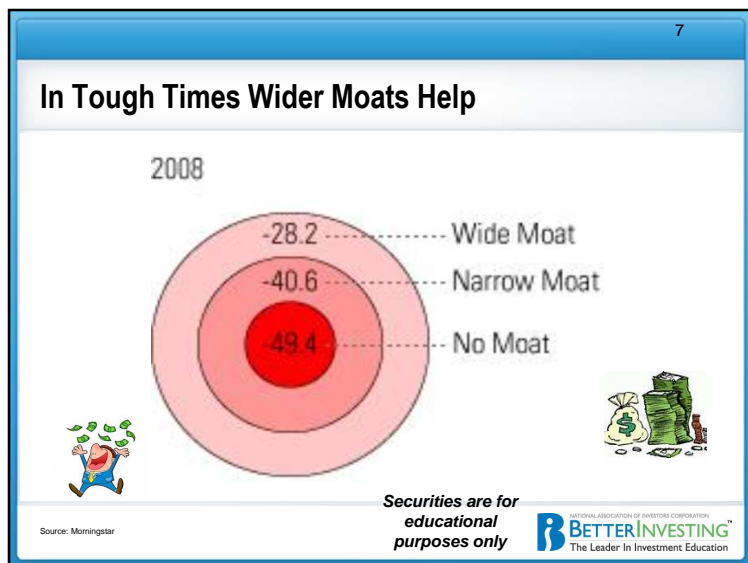
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### Moat Performance – Wide Moats Win

Market Performance by Moat Rating and Moat Source

	Number of Companies	Median Annul 5 Yr TR (%)	Mean Annul 5 Yr TR (%)	Median Annul 10 Yr TR (%)	Mean Annul 10 Yr TR (%)
Morningstar Coverage Universe	1,503	13.7	13.2	7.3	6.8
<b>Wide-Moat Companies</b>	209	<b>15.7</b>	15.6	<b>10.6</b>	<b>11.0</b>
Narrow-Moat Companies	643	15.5	16.0	8.6	9.0
No-Moat Companies	651	10.5	9.6	3.3	2.9

Source: Morningstar Magazine, August / September 2017.

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### Basic Moat Thought Process

- ▶ Margins should be higher and last longer for wide moat stocks. Though “no moat” stocks can do well, I suspect growth will become the key metric to watch.

Wide Economic Moat

ROIC

Time Horizon

Narrow Economic Moat

ROIC

Time Horizon

No Economic Moat

ROIC

Time Horizon

Source: Pat Dorsey, Morningstar.

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### Warren Buffett on Quality and Moats

- “When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever.” Source: Letter to shareholders, 1988.
- “It’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price.” Source: Letter to shareholders, 1989.
- “Long ago, Ben Graham taught me that ”Price is what you pay; value is what you get.” Whether we are buying socks or stocks, I like buying quality merchandise when it is marked down.” Source: Letter to shareholders, 2008.

Source: Berkshire Hathaway Annual Report

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### Wide Moats = Sustainable Competitive Advantage = Quality Stocks

- ▶ An economic moat (competitive advantage) allows a company to fend off competitors and earn sustainable excess economic profits. (Wide or Narrow)
- ▶ My belief: wide or narrow moats = higher margins, those leading to good quality stocks, but they must be purchased at a reasonable price.
- ▶ Section 2 of the Stock Selection Guide (SSG) is our **Quality Section**. Spend some time here to:
  - Improve your returns.
  - Retain good stocks over time.
  - Determine when a company is past its prime.

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### Use the SSG to Find Excellent Management or Quality

- Use Section 2 of the SSG to determine quality.
- Two profitability measures –
  - Pre-tax profit margins
  - Return on Equity (ROE)
- One balance sheet analysis - Debt-to-Capit:

Evaluate Management												
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	39.4%	38.3%	37.8%	40.5%	40.4%	41.0%	38.4%	25.8%	31.8%	38.3%	34.7%	UP
% Return on Equity	16.7%	15.8%	14.8%	18.1%	20.4%	17.9%	19.8%	13.2%	14.1%	13.1%	15.8%	DOWN
% Debt To Capital	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	DOWN

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### A Wide Moat Is Similar to a Solid SSG

- Moats help identify sustainable competitive advantages.
- By doing this work it can help:
  - Support holding stocks longer of good, quality companies.
  - You to understand the SSG numbers.
  - Provides items to think about in regards to whether your long term holdings are losing their advantage.
- **Sections 1 & 2 of the SSG are how we analyze a company's business model or moat.**




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### Moat Analysis

▶ Moat stocks are more profitable than no moat stocks. Wide moats stocks are more profitable than narrow moats.

Moat Rating	Number of Companies	ROIC TTM (%)	ROIC Trailing 3 Yr (%)	ROIC Trailing 10 Yr (%)	Operating Margin Trailing 10 Yr (%)	Net Margin Trailing 10 Yr (%)
Wide	209	12.5	13.5	19.0	21.1	14.1
Narrow	643	9.0	9.7	14.8	14.7	9.0
None	651	5.1	4.8	8.6	7.6	4.4

Source: Morningstar Magazine, August / September 2017.

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### The Financial Reality of Moats


**Company with an Economic Moat**



Return on Invested Capital

Time Horizon


**Company without an Economic Moat**



Return on Invested Capital

Time Horizon

- A weakening moat, margins or "Quality" can show in the stock price over time.
- Wide moat stock valuations can be too high and thus this should be the concern of the quality stock investor.



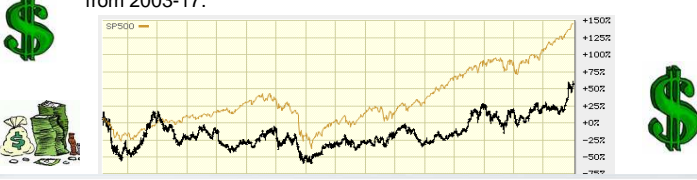

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### Example of Losing an Advantage

Evaluate Management	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	20.0%	23.9%	20.4%	16.2%	36.8%	32.9%	27.9%	23.9%	28.3%	25.7%	27.7%	DOWN
% Earned on Equity	14.2%	16.0%	13.1%	10.2%	22.4%	25.9%	20.6%	16.9%	19.6%	19.3%	20.5%	DOWN
% Debt To Capital	5.2%	4.7%	4.8%	5.1%	4.1%	13.8%	20.8%	18.8%	19.7%	27.1%	20.0%	UP

Intel is a leader in their industry, but the industry changed. The chart is from 2003-17.

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### Solid Moat - What Do You Think?

Evaluate Management												
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	32.2%	39.5%	38.3%	37.6%	40.5%	40.4%	41.0%	38.4%	25.8%	31.8%	35.5%	DOWN

- The last 5 years are down. Interesting?
- The last year has recovery.
- High pre-tax margin business model.
- *Knowing your company by understanding their business by doing additional analysis can help with winning stocks like ISRG and long term issues.*

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### Wall Street Worries over Margins and Earnings Growth = Opportunity

Evaluate Management												
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	32.2%	39.5%	38.3%	37.6%	40.5%	40.4%	41.0%	38.4%	25.8%	31.8%	35.5%	DOWN

Opportunity - Know your company. Stock dropped from \$198 to \$115 over two years.

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### Why This Moat Information is Useful?

- Moats look at the world in a similar fashion:  
 – **Wide – Narrow - None.**
- It forces you to think about a company's business model - positives and negatives.
- If a stock has a high margin or wide moat, the key is whether it is sustainable. Important for your stock.
- Competitive advantages identified by this research can protect high profit margins.

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### Question time

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### Morningstar Moat Categories

- ▶ The three moat system should help you think about as they classify long term business models.
- ▶ Morningstar identifies wide moat stocks.
- ▶ There are 5 sub - categories.

*By learning more I can understand the stock's long term business model and if it has a sustainable competitive advantage.*






*I like the potential advantage of wide moat stocks.*

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### Morningstar's Sources of Sustainable Competitive Advantage

-  **Switching Costs**
-  **Intangible Assets**
-  **Network Effect**
-  **Cost Advantage**
-  **Efficient Scale**

Source: Van Eck


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### Definitions of Competitive Forces

- Economic moat is a sustainable competitive barrier against competition.
- **Network Effect** – With each additional customer who uses the product or service, it increases the value for each individual user. A network effect can help a company to increase its advantages over competitors. *It is perhaps the strongest type of economic moat.*
- **Switching Costs** – Is where you can't obtain the good/service elsewhere, thus they have a high customer switching cost. Payroll processing has been an example of this competitive advantage.





Source: Investopedia, Morningstar. **Securities are for educational purposes only**

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### Definitions of Competitive Forces

- The idea of an economic moat refers to how likely a company will keep competitors at bay.
- **Intangible Assets** - A broad category that includes brands, patents, and regulatory licenses.
- **Low Cost Advantage** – Ability to offer lower prices than your competitors for the same product or services.
- **Economies of Scale** – Lower cost advantage typically comes from size or scale or "The Largest Player". Spread the costs over your size.







Source: Investopedia, Morningstar. **Securities are for educational purposes only**

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### Moat Analysis – Network Effects Has Strong Performance

Market Performance by Moat Rating and Moat Source

	Number of Companies	Median Annlzd 5 Yr TR (%)	Mean Annlzd 5 Yr TR (%)	Median Annlzd 10 Yr TR (%)	Mean Annlzd 10 Yr TR (%)
Morningstar Coverage Universe	1,503	13.7	13.2	7.3	6.8
<b>Moat Source</b>					
Switching Cost	314	16.4	16.5	9.3	8.9
Network Effect	112	17.1	18.0	10.0	11.7
Intangible Assets	491	15.9	15.7	8.9	8.9
Cost Advantage	358	15.9	15.7	8.9	8.9
Efficient Scale	200	13.2	13.3	9.0	8.5

Source: Morningstar Magazine, August / September 2017.

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### Finding Wide Moat Information

- Used to go to Morningstar.com, but not available for free - it is now part of their premium service. 😞 😞
- Check with your discount broker – Schwab does have it.
- Check with your Library have online access. SF Library does have it. You can use your library card to access Morningstar electronically from home.

- If you don't have a card, go to that library and ask.

Source: Morningstar

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Source: Morningstar

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### Morningstar's "Free" Online Moat Analysis

Morningstar's Analysis

Valuation: Dec 03, 2019 | Currency in USD

Starbucks' Experience, Innovation, and Digital Efforts Give Reasons to Look Past Coronavirus Fears

Fair Value: 92.00 | Uncertainty: Medium

Last Close: 85.84

1-Star Price > 124.20 | 5-Star Price < 84.40

Economic Moat: Wide

Trend: Positive

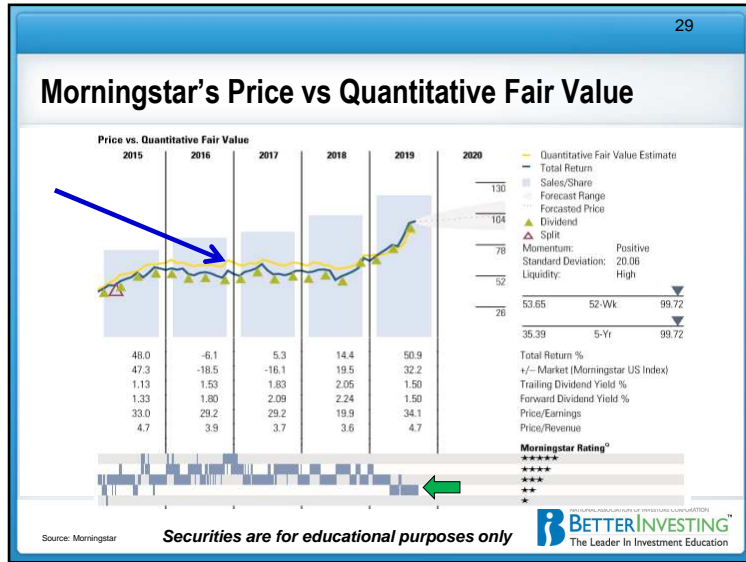
Stewardship: Exemplary

You get more stars when the current price is close or below Morningstar's Fair Value. Also if a stock price is way above Fair Value, you get fewer stars.

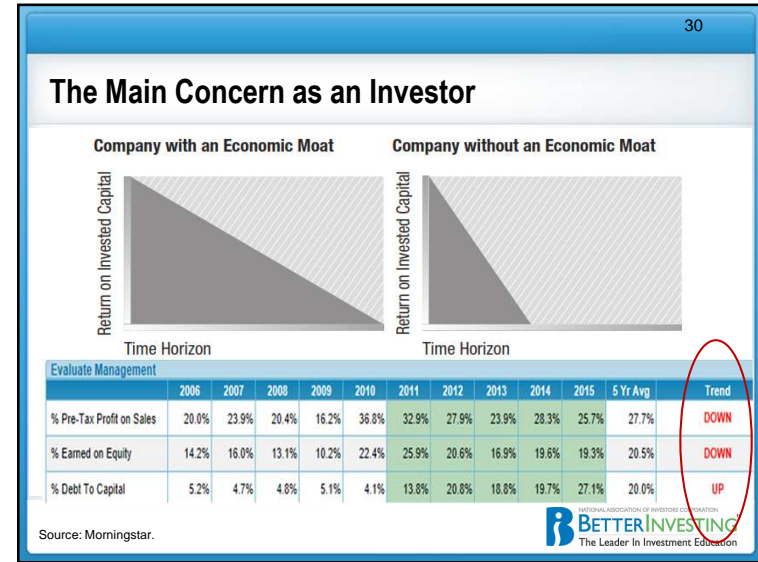
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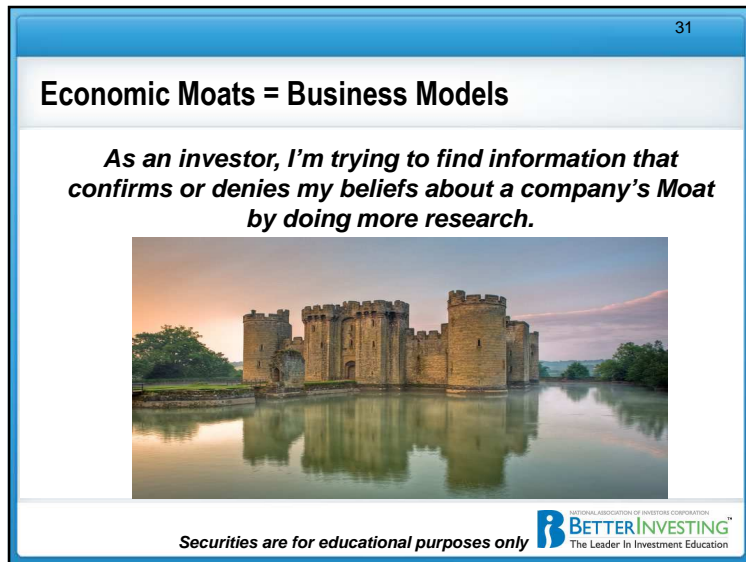
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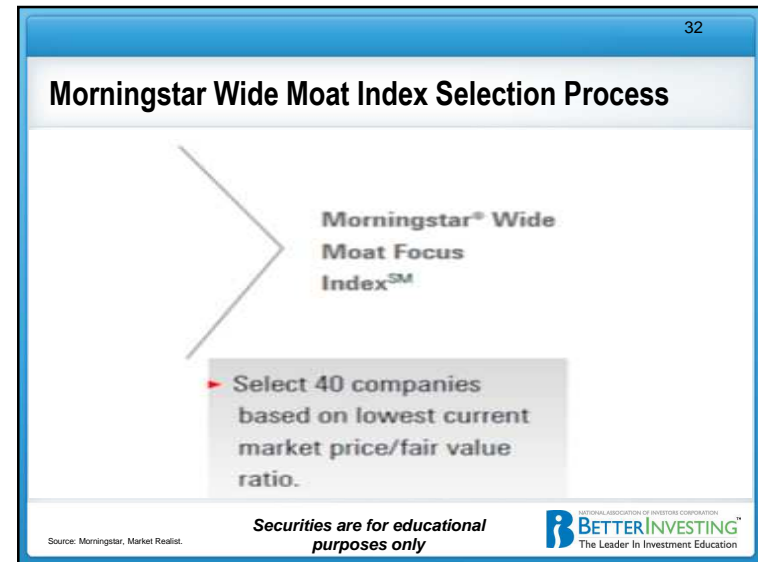
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### MOAT – Van Eck Vectors Morningstar Wide Moat Index

Holdings	% Portfolio Weight	First Bought	Previous 4 Periods	as of Feb 07, 2020	1-Year Return	P/E	Equity Star Rating	Economic M.
Biogen Inc	3.02	Dec 21, 2015		103,104,006	9.71	10.58	★★★★	Wide
ServiceNow Inc	2.94	Sep 23, 2019		100,461,951	50.27	80.65	★★★★	Wide
Intel Corp	2.84	Sep 24, 2018		97,171,471	36.70	13.26	★★★	Wide
Salesforce.com Inc	2.78	Jun 20, 2016		94,790,559	19.87	59.88	★★★	Wide
BlackRock Inc	2.76	Sep 24, 2018		94,326,862	37.09	17.48	★★★	Wide
Bristol-Myers Squibb Company	2.75	Sep 19, 2016		93,762,101	35.72	10.89	★★★	Wide
Amazon.com Inc	2.73	Jun 20, 2016		93,168,378	28.80	70.42	★★★★	Wide
Philip Morris International Inc	2.61	Jun 18, 2018		89,035,556	19.99	15.72	★★★★	Wide
Microchip Technology Inc	2.60	Dec 18, 2017		88,671,012	22.26	16.23	★★★	Wide
United Technologies Corp	2.57	Jun 20, 2016		87,674,086	32.35	19.12	★★★	Wide
Guidewire Software Inc	2.53	Dec 19, 2016		86,386,732	28.26	90.09	★★★	Wide
Nike Inc B	2.52	Jun 24, 2019		86,088,202	21.79	28.57	★★★	Wide
Facebook Inc A	2.51	Sep 24, 2018		85,821,663	27.62	23.26	★★★	Wide
Zimmer Biomet Holdings Inc	2.51	Dec 19, 2016		85,575,357	33.02	18.83	★★★★	Wide
Medtronic PLC	2.48	Dec 19, 2016		84,653,690	36.19	19.72	★★★	Wide
Berkshire Hathaway Inc B	2.45	Sep 23, 2019		83,533,955	12.72	19.16	★★★★	Wide
Emerson Electric Co	2.43	Dec 24, 2018		83,027,324	14.17	20.12	★★★	Wide
Dominion Energy Inc	2.43	Mar 19, 2018		83,010,077	21.76	19.42	★★★	Wide

Source: Morningstar

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### If You Want to Learn More?

*This is simply the best investment book I have read in my thirty-plus years in and around 'Wall Street.'*  
—Dr. Ash Frazier, Director Asset Management

The Morningstar Approach to Stock Investing

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### Summary

- ▶ I feel there is more to do than just doing an SSG.
- ▶ Strong Moats = Sustainable Competitive Advantage = “Quality” stocks = Strong business models to protect your stock.
- ▶ Moat analysis is a good way to help support owning a stock and wide/narrow moat stocks can fend off competitors to earn excess profits.
- ▶ Morningstar has found that cheap wide moat stocks is a good ownership process.

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## Upcoming Events and Library Analysis

**San Francisco Education Event**  
**Smart Money Week**  
 April 4, 2020  
 10:15 am to 3:15 pm  
*Classes to be presented:*  
**Retirement: What is your magic number?**  
**Finding Quality Stocks Using Fundamental Methodology**  
 Using Value Line  
**Guide to Reading a Value Line Research Report**  
 Investing Basics  
**Finding the Best Mutual Funds**  
 Investing with ETFs

**Look for more details soon from BetterInvesting**

**The event will be located at:**  
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