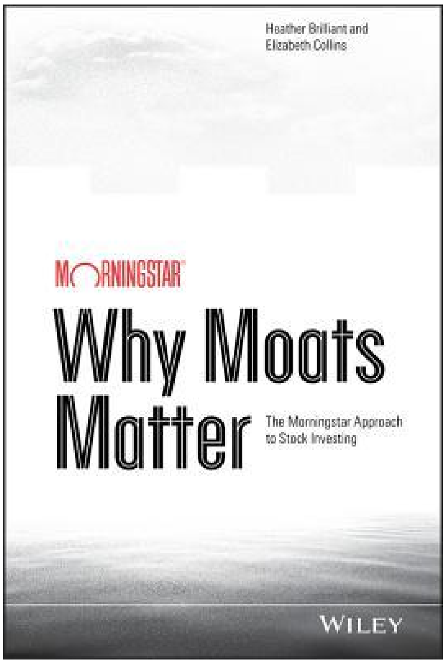

Why Moats Matter: The Morningstar Approach to Stock Investing

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Why Moats Matter: The Morningstar Approach to Stock Investing Heather Brilliant , Elizabeth Collins **Incorporate economic moat analysis for profitable investing** *Why Moats Matter* is a comprehensive guide to finding great companies with economic moats, or competitive advantages. This book explains the investment approach used by Morningstar, Inc., and includes a free trial to Morningstar's Research.

Economic moats--or sustainable competitive advantages--protect companies from competitors. Legendary investor Warren Buffett devised the economic moat concept. Morningstar has made it the foundation of a successful stock-investing philosophy.

Morningstar views investing in the most fundamental sense: For Morningstar, investing is about holding shares in great businesses for long periods of time. How can investors tell a great business from a poor one? A great business can fend off competition and earn high returns on capital for many years to come. The key to finding these great companies is identifying economic moats that stem from at least one of five sources of competitive advantage--cost advantage, intangible assets, switching costs, efficient scale, and network effect. Each source is explored in depth throughout this book.

Even better than finding a great business is finding one at a great price. The stock market affords virtually unlimited opportunities to track prices and buy or sell securities at any hour of the day or night. But looking past that noise and understanding the value of a business's underlying cash flows is the key to successful long-term investing. When investors focus on a company's fundamental value relative to its stock price, and not where the stock price sits today versus a month ago, a day ago, or five minutes ago, investors start to think like owners, not traders. And thinking like an owner will makes readers better investors.

The book provides a fundamental framework for successful long-term investing. The book helps investors answer two key questions: How can investors identify a great business, and when should investors buy that business to maximize return?

Using fundamental moat and valuation analysis has led to superior risk-adjusted returns and made Morningstar analysts some of the industry's top stock-pickers. In this book, Morningstar shares the ins and outs of its moat-driven investment philosophy, which readers can use to identify great stock picks for their own portfolios.

Why Moats Matter: The Morningstar Approach to Stock Investing Details

Date	: Published July 21st 2014 by Wiley (first published January 1st 2014)
ISBN	: 9781118760239
Author	: Heather Brilliant , Elizabeth Collins
Format	: Hardcover 228 pages
Genre	: Economics, Finance, Business

From Reader Review Why Moats Matter: The Morningstar Approach to Stock Investing for online ebook

Ankit Agrawal says

Lays out the Morningstar framework for choosing and recommending stocks based on identifying moats. Details the factors which generate moats for a company and has a number of chapters on sector-wise identification of moats. The material is not new or ground-breaking, rather a summary of those already explained to death by proponents of value investing. That said, pretty much captures the basics of value investing framework. Needless to day, it is also an advertisement for the Morningstar group and its funds.

Jay Waghray says

Much of this applies to the venture class as well!

Asif says

Despite the fact that some of the material is coverer by other books, I think this book is a valuable resource. in particular the focus on selected sectors will be a good reference material.

Charles says

A book on competitive moats, even if mediocre, would get a high rating from me. This one's pretty good. Sure, there are some obvious pitches for Morningstar (like how one of their moat indices outperformed the S&P for about a decade), but the industry-by-industry approach makes this book a guide and not a brochure.

Favorite new moat type: "efficient scale," where a market is best served by only a handful of firms. I.e. orphan drugs, where the market is tiny and new entrants would destroy profits for everyone. I remember this concept from my theoretical industrial economics class in undergrad (the instructor called it something else), but this is the first time I've seen it used in practice.

Terry Koressel says

The book is actually well written from a practical sense. However, for me it was a struggle to finish for two reasons. First, it is so "clinical"....a manual on value investing without any passion to hold my interest. Second, I am well read on value investing....Ben Graham, Warren Buffet and many others. Why Moats Matter is simply a restatement of the Warren Buffet value investing philosophy. In fact, the books cites Warren Buffet dozens of times. The book is light on innovative, new, novel ideas....just a simple primer on traditional Buffet value investing. In summary, if you are new to value investing....this is a good book to introduce you to the subject. If you are an experienced value investor, especially if you are well read on the subject, skip this book. There are better sources.

Nashvilledore says

Very basic summary of components of competitive advantages.

Jonathan Perez says

I came across this book by chance earlier last year while searching for material on the topic of competitive advantages. Obviously, this subject is of great importance to any investor. When buying businesses, the gurus of value investing always try to understand the source of the competitive advantage. Because in the long run, it’s the trend in earnings that dictate the value of a business. When you are a business owner, what you don’t want is that someone starts offering your product or service just as well as you do. That would launch a price war. These things never end well.

First, the basics are as follows: remember that moats can come from many places. For instance, you can find them in: a brand, a patent, or a regulation. But the large size of a business can also act as a moat (think economies of scale). Then the complexity of the product or service that a business offers can deter competitors (think switching cost), or the fact that it benefits from network effects (i.e.: Facebook, Uber, Airbnb, the more people use them, the more relevant they become). Finally, the economics of a sector itself can give a business a structural advantage. I.e.: if you service really well a niche market whose size isn’t about to grow, then by definition there isn’t much room for an extra competitor. In the old cowboy movies, someone would translate that as “There can only be one sheriff in town”.

Second, once you think there might be a moat, never forget to test its strength: does the brand command higher margins vs. peers and what has been the trend in the last ten years? What do customers say about it? TripAdvisor, Facebook, Twitter, can offer a good amount of data to proxy that vs. peers over time. Are patents about to expire? Is the patent portfolio well diversified?. Are the regulatory barriers of entry permanent or fragile? Also, do they come with price controls (e.g.: Airports, Tv networks, Casinos). Are the cost advantages related to process, location, transport, scale, access to a unique asset, or bargaining power with the suppliers? How long will it take for competitors to replicate them?

In a nutshell, the simple question I need to ask myself before buying a business is as follows: is the price/product/service mix that the business offers replicable? And if so, how quickly?

The tricky part is that there is no such a thing as a permanent moat. No fortress can resist the assaults of the enemies forever. Unless the opponents lose interest and go away? That can only happen if either i) the moat is so high that it is discouraging (I guess that it rarely is so, ok except maybe for Coca-Cola or Google?) ii) the castle behind the moat (understand the business) is not attractive enough for all the enemies of this world. In my opinion, such situations are the sweet spot. Probably in an era where technology disrupts everything and where eventually robots and machines are going to replace us all, then the ideal business is a niche business so that it does not attract too many competitors. I think this is what Bruce Greenwald (the professor or Value Investing at Columbia University) meant when he said “the best moats are in services consumed and produced locally.” And I think this is also what Warren Buffett signaled when, a few years ago, he bought a series of regional newspapers.

Anyway no matter how much I already read about this, there is always something new to learn. In this book, it was the series of business cases and examples. This MorningStar team seems to think these are worth a closer look: Rockwell Automation, IBM, Southern, Novo-Nordisk, Intuitive Surgical, Labcore, Quest, Ormat, Monsanto. I have already added one of them to my watch list.

Liam Polkinghorne says

Not a bad overview of elements of competitive advantage.

InvestingByTheBooks.com says

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 parlor – 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 quantative 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 Sachses 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.

Brian Zheng says

The book presents a well researched investment process by Morningstar that focus on moat of the business, ie. the stability of achieving above average return in the long run. In the second part of the book, a few industries are analyzed to demonstrate how to evaluate the strength of the moat for a business.
