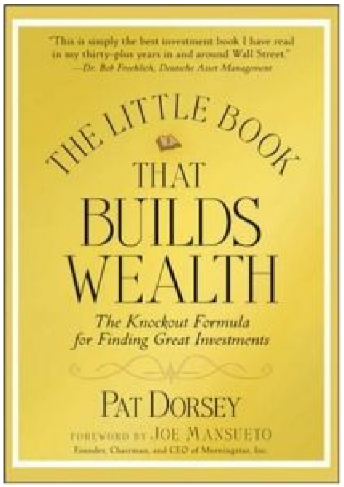

Book The Little Book That Builds Wealth

The Knockout Formula for Finding Great Investments (Little Book Big Profits)

Pat Dorsey
Wiley, 2008
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Recommendation

How do you pick stocks? Do you pay attention to earnings? Chart patterns? Growth potential? Your Uncle Morty? Instead of all that, use the same basic system that investment guru Warren Buffett perfected: Look for solid profitable companies that own a piece of the market, buy their stock and hold it a long time. Morningstar, the investment research company, uses the same approach to analyze and rate stock values. Its director of equity research, Pat Dorsey, explains its stock analysis system in this small volume. The stock selection system calls for seeking companies with protected unique advantages, called "economic moats." What sounds straightforward in theory may not be as easy in practice: Finding a structurally protected stock today is not necessarily a simple stroll across the drawbridge. Still, *BooksInShort* finds Dorsey's presentation succinct and readable, and recommends it to investors who are not yet familiar with value investing and similar approaches.

Take-Aways

- Your optimal stock investment strategy: When the price is right, buy a sound company with good profits that it can sustain.
- Look for companies with a strong return on capital.
- Seek a company with an "economic moat," that is a notable structural marketplace advantage.
- This moat will protect the company against aggressive competitors.
- When you buy stock in such an undervalued company, hold it for the long term.
- This investment strategy made Warren Buffett a multibillionaire.
- Moats have nothing to do with the quality of management, superior strategy or market dominance. Those factors all can change quickly.
- • Moats are company assets that create market advantage, like patents, licenses and brands.
- Good networks, high customer switchover costs and low operating costs also confer a market advantage.
- Even the strongest moats eventually can fail to protect their companies.

Summary

The Best Investment Strategy

Investors can choose among multiple stock market strategies, but many of them are flawed. The best tactic is straightforward: Buy great companies at good prices and hold their equities over the long term. This approach works well for investment guru Warren Buffett. To make it work for you, follow a "game plan" with four sensible steps:

1. **“Identify”** – Find firms that are most likely to be profitable year after year. These companies offer the greatest long-term potential.
2. **“Wait”** – Don’t buy these stocks until their prices fall below their intrinsic value.
3. **“Hold”** – Do not get rid of these stocks unless: 1) The company “deteriorates”; 2) The stocks begin to sell for more than they are worth; or 3) Better investments present themselves. Otherwise, plan to sit on them patiently for years.
4. **“Repeat”** – Follow these same steps for all of your investments.

Look for High and Sustainable Profits

In your investment planning, focus on the most profitable businesses, the ones that offer the greatest return on capital. Such companies are money machines that compound wealth. Of course, capital always flows to businesses that offer the best returns. Thus, competitors are sure to spring up to emulate highly profitable businesses. Many profitable firms, once challenged, find it difficult to maintain their high rates of return on capital for extended periods. However, some businesses withstand constant, intense competitive pressures and keep earning profits, including such companies as Johnson & Johnson, Oracle and Anheuser-Busch.

“Economic Moats”

What prevents competitors from trying to take over a profitable company’s business? The answer is clear: the firm’s competitive advantages, the factors that Buffett calls “economic moats.” As moats protected medieval castles, economic moats protect profitable companies from aggressive competitive challenges. They make companies more viable and valuable. Your goal is to find them, so you can invest in good, undervalued companies protected by great moats.

> “How can you accurately identify companies that are great today and likely to remain great for many years to come?”

Economic moats are invaluable assets for companies and investors. When you buy stock in a company, its moat protects your funds. Companies without moats have no protection against strong competitors. They may be on top one day and out of the business the next, replaced by a more competitive product or service. Think of how many technology and Internet companies were blisteringly hot just a few years ago, but have now disappeared due to competitive pressure. Moats make companies more resilient. Companies with moats can weather market setbacks far more readily than firms without them. Consider Coca-Cola’s ill-advised New Coke product launch. Despite this major, costly flop, Coca-Cola’s overall business remained viable due to its core brand, which is a primary competitive moat. Your task as an investor is to learn to spot good, undervalued companies with strong moats and jump on them quickly.

“Moot Moats”

Do not be fooled by factors that only seem to be moats. For example, strong management, while definitely an asset, is not a moat. Bad management can replace good management at any time. A moat is not replaceable. It is a valuable, structural characteristic. An intelligent business strategy is not a moat either. Certainly, a smart business strategy can move a company ahead of its competitors. Just think of Southwest Airlines and Dell Computer. In general, though, great strategy, superior products and large market share are not bona fide moats. Indeed, they may turn out to be investment “money traps.” That is, they may influence the market only in the short-term until something better comes along. As such, they can be illusory.

> “Buy wonderful companies at reasonable prices and let those companies compound cash over long periods of time.”

Chrysler was printing money during the 1980s when it introduced the minivan. However, its competitors quickly jumped into the minivan business. Chrysler did not have a structural competitive advantage. Without a moat, it could not protect its minivan franchise. On the other hand, consider Chrysler supplier Gentex, which manufactures rearview mirrors that dim automatically. The company introduced its high-tech mirrors around the same time that Chrysler introduced its minivans. Gentex owned important patents on its new mirrors. That kept other firms from getting into this highly specialized market segment with their own competitive products, like Chrysler’s competitors. Gentex’s patents were an economic moat, a structural advantage no other firm could match.

> “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.”

Look for stocks with one or more of these four “structural competitive advantages”:

1. “Intangible Assets”

Patents, regulatory licenses and brands are intangible but important assets. They act as economic moats by providing singular, irreplaceable marketplace positions, essentially mini-monopolies.

- **Brands** – A great brand enables a company to charge its customers a premium price. Tiffany’s has a great brand. It can charge its customers higher prices for its diamonds than other jewelers charge, though the diamonds are virtually indistinguishable. This gives Tiffany’s an economic moat that its competitors cannot match.
- **Patents** – A patent is not irrevocable, so it may supply only a temporary competitive advantage. A company that owns numerous patents, such as 3M, is in a stronger position. Because of its history, investors can assume that 3M will continue to produce and market popular, patentable, competitive products.
- **Regulatory Licenses** – Companies that can charge what they want for their licensed products, such as pharmaceutical manufacturers, are generally more attractive investments than, say, utility companies that have licenses to sell electric power at set rates. “Regulatory moats” based on numerous small rules are better than one giant rule the government can change quickly.

> “In the United States, the rise of big-box retailers like Target, Wal-Mart and others has permanently changed the economics of many consumer-products companies for the worse.”

While valuable, these assets do not necessarily bestow permanent marketplace advantages. Customers may abandon a brand. Governments can revoke licenses. Other manufacturers may challenge patent holders. Proceed with caution.

2. "Customer Switching Costs"

Within certain industries, customers find it extremely easy to switch from one company to another. A customer who normally buys Shell gasoline can start buying Mobil gas immediately if a new, more convenient station opens. The customer has no switching cost. This is not true for banking customers. Switching from one bank to another means ordering new checks, filling out numerous forms and doing all sorts of paperwork. Due to relatively high switching costs, most people stay with the same bank for six or seven years. Firms with high switching costs can charge more for their products and services than those with low switching costs.

3. "The Network Effect"

Companies with vast networks possess a strong competitive advantage. Take American Express: The more retailers accept its card, the more valuable it becomes. Amex and its primary competitors, MasterCard, Visa and Discover, own 85% of the credit card market. This gives these companies a tremendous competitive edge over any new credit card suppliers. In technology, Microsoft has created a similar monopoly for its software products. Most businesses rely almost exclusively on its software, so the entire corporate world is Microsoft's network. No wonder it is immensely profitable. Other manufacturers with competing software find it almost impossible to crack this gargantuan network. On the Internet, eBay occupies a similar position in online auctions. All of these companies own economic moats others cannot easily bridge. Thus, they can charge higher prices. Most firms that benefit from network effects share data or connect users to each other, but they usually do not manufacture physical goods.

4. "Cost Advantages"

A company that can lower its costs has a distinct advantage over its competitors, but this advantage may not be sustainable. For example, in recent years many companies moved their call centers to countries with relatively low labor costs, including India, China and the Philippines. But these companies' rivals can do the same thing. In some industries, the competitive advantage rests almost entirely on price. Companies can control their costs and, thus, their prices, with "cheaper processes, better locations, unique assets and greater scale." In your investment search, seek firms that offer available, cheaper substitutes for relatively expensive products or services.

> "Moats depend less on managerial brilliance – how a company plays the hand it is dealt – than they do on what cards the company holds in the first place."

A company's size also can be an unbridgeable economic moat. Yet "being a big fish in a small pond is much better than being a bigger fish in a bigger pond." Look for a firm's size advantage in its scale of manufacturing and the breadth of its distribution networks.

Moats Can Dry Up

Companies with strong economic moats usually can remain winners over the long term, although some moats dry up. For example, some decades ago Polaroid's instant-developing film radically changed photography. But now digital imaging has made most film photography out-of-date. Long-distance telephony once was highly profitable, but the Internet has virtually killed the business. Indeed, technology can cause market changes that rapidly cripple entire industries. Once unassailable structural advantages can vanish overnight due to new developments. Newspapers used to be cash cows, but many now lose money, in part due to the Web's devastating effect on "news, advertising and classifieds." Sometimes, the impact of change isn't immediately apparent. For example, the rise of Home Depot and Lowe's, giant home improvement centers, wiped out small mom-and-pop hardware stores. This, in turn, has put new pricing pressure on many suppliers, including such well-known brands as Stanley Works, and Black & Decker. Savvy investors must pay close attention to such changing market dynamics.

Moat Construction Can Be Difficult

Target your future investments toward industries where moats are easier to construct. For example, software companies and telecommunication firms can develop moats more readily than firms in other business areas. Media companies, particularly those like Time Warner and Disney with highly singular content, benefit from strong moats. They can amortize their initial high production costs readily because of their extremely low redistribution costs. On the other hand, companies that deal directly with consumers, like retailers and restaurants, find it extremely difficult to develop notable competitive advantages. The culprit: low switching costs.

Return on Capital

When you find a company with a nicely dug moat, make sure it is meaningfully profitable in relation to its return on capital or total invested funds. Also learn its "return on assets (ROA), return on equity (ROE) and return on invested capital (ROIC)." Make sure its return on capital continues to be strong over the long term. Will it be able to maintain solid returns year after year?

> "Bet on the horse, not the jockey. Management matters, but far less than moats."

In effect, reverse-engineer the current stock price, which could be based more on "market emotion" than on the stock's intrinsic value. Wise investors want their returns tied to actual corporate performance, not to fickle market whims. Consider risk (future cash flow), growth (the extent of the cash flow), return on capital and the economic moat's ability to protect future profits. Is the stock price "lower than the most likely value of the business?" If the market estimate is for a certain amount of growth and you believe the company is most probably going to do better, and definitely not worse, that looks like a good choice. Companies with relatively low market valuations are your best investment opportunities. Compare your valuation estimate with that of the stock market. You don't have to know "exactly what the future" holds; you only have to judge that it is "very likely going to be brighter than the share price" indicates.

About the Author

Pat Dorsey, CFA, is Director of Equity Research at Morningstar. He helped develop the company’s stock rating system.