IFB310: Decoding the Numbers: How to Analyze Moats and Competitive Advantages in Business

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Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 310. Today we have three great listener questions we're going to answer. So without any further ado, let's go ahead and dive right on in. So here we go. Number one, what tips can you give if I want to start investing? So this is kind of a broad range question and I think we can have a lot of fun with this. So, Andrew, I'm going to give you a first swing at it.

Andrew [00:00:22]:

All right, let's take a swing. I would say just get started before we even dive into all different things you can do. Just get started, try and put some money in something. It's going to be a lifelong journey. You're going to make mistakes. We all make mistakes. But the most important thing is that you are investing. That's step number one.

Andrew [00:00:45]:

Get in the game. Make sure you start investing and let the rest fall into play.

Dave [00:00:51]:

What would you tell them to buy?

Andrew [00:00:52]:

I would say buy something you're comfortable with. You can open a brokerage account. I like to use fidelity. It's an easy one. That's one of the brokerage accounts I use. Go to fidelity.com. You can open a brokerage account just like you would a checking account. You give them your information online, they should get you improved relatively soon.

Andrew [00:01:10]:

And then from there you could buy Apple stock or you could buy Petco. Like my daughter decided to know that habit. And I'll tell you, the money she'd lost so far on Petco doesn't matter compared to how she is thinking about the market and starting to put more money into it. And that's really the bigger picture.

Dave [00:01:30]:

Yep, exactly. My daughter started investing and she has three companies that she owns, shopify, Roblox and Disney. And she hasn't done well with any of them, but it keeps her interested in the market. She keeps asking me questions, how did they do? How's it doing, how did it do today? Those kinds of things. So it keeps her interested and gets her curious and hopefully at some point she'll start asking me more pertinent questions and you can kind of go from there. But, yeah, start today, there's zero reason why you can't. You don't have to have a lot of money. You can literally go and open an account, a Fidelity account you can open in a day and you can have money transferred there and be ready to go tomorrow.

Dave [00:02:11]:

And you can buy Apple if you want, or Petco or Roblox for that matter. It doesn't really matter. You don't have to hit a home run with your first one. Not everybody will. Most people won't and I got lucky in my first swing, but the next few swings, not so good. So it's part of the game. But you can't get where you want to go if you don't start. You got to put 1ft in front of the other.

Dave [00:02:28]:

So that would be my 1st first, I guess. Hip so let's say we've gotten them to they're like, all right, you guys, I hear what you're saying. I'm going to start where do they go next?

Andrew [00:02:38]:

I would try to learn some of the history of the stock market. And I think you start with the stock market because you can branch into the vast sea of options that you have with investments. But I would start with the stock market because to me it's quite simple and we're all exposed to businesses. We probably work at a business and some of those are traded on the stock market. And we can all understand that when a business gets profits and then they grow, then that the business becomes more valuable and that's really what stocks do. Yes, it moves up and down a lot. Yes, there's a lot more complexity to it and it can get kind of wild. But when you really kind of zoom out and look at history over the very long term, the economy has grown, businesses have grown and the stock market has grown and that's all tied in together.

Andrew [00:03:28]:

It's the same kind of concept. And then from there you can learn, hey, maybe even after I've looked at the history and I kind of understand how stocks work, maybe it is still too risky for me, then you can kind of work down the ladder of less risky options. But I think until you know what the stock market is and if you have a 401K, by the way, you have stocks in the stock market. So it only makes logical sense that you understand what's behind the hood of your 401K. But that basic concept. It's the economy, it's businesses, it's stocks. I hope it becomes more and I'm biased saying this because I get excited to talk about it, but I just hope that it becomes more like the everyday kind of lexicon that like, hey, these are businesses, these are stocks, these are real things. It's not some abstract place with casino type behavior.

Andrew [00:04:19]:

There is a lot of common sense to it. It's just it can become endlessly complex, I guess. How would you look at all of that?

Dave [00:04:28]:

I love the idea of looking at the history of the stock market and there are some fascinating stories in there. You could read about the Great Depression. You can read about Black Monday and Black Friday and all these days that specific things happen. You can look@the.com bust and you can just look throughout the history of the stock market and see kind of all these ebbs and flows of how the markets work. You can go back to the beginnings of the stock market and look at what happened in Holland with the Tulip mania and some of those things and the Dutch East Indies Company and just all that stuff. It's endlessly fascinating, but it can also give you perspective on how much maybe technology has changed, but maybe how much human behavior really hasn't. And you can kind of compare that. And that's one of the most important things about investing is you don't have to be the smartest person.

Dave [00:05:20]:

I read something earlier today where Warren Buffett said the smartest people in the world are often the worst investors. And you don't have to have above average intellect. You have to have above average emotional IQ and being able to weather the ups and downs. It's encouraging to me because you don't have to be the next Einstein to invest. You can just be you and do really well as long as you have kind of the right context and the right stomach for it and understand what you're walking into, understanding that when you do invest, you're buying a business. You're not buying a ticker or a piece of paper or something that flashes across the top of your computer screen when you're not working at work. It is a business. When you buy a piece of Apple, you own Apple just like Tim Cook does.

Dave [00:06:06]:

Granted, not the same level, but you own the business and that's what you're buying. And it's the one that's going to do all the heavy lifting and the hard work for you over the years as you own it. And so I think when you start to understand that and then the history and the context of what you're buying, I'm going to butcher the statistics, but just kind of understand the flavor of what I'm trying to say. When you think about buying investments and you think about the history kind of zoomed out, a lot of people focus so much on what happens today. But if you back away from the history, you can see that your chances of getting a good return exponentially explode. And so I think if you look at a stock price from day to day, you have a 50% chance of winning or losing. And as you go farther away from that day focus, your returns gradually improve to where you get to. If you look at your portfolio once every 100 months or something, you're going to be far much greater chance of getting a good return than a bad return.

Dave [00:07:05]:

And that's over the overall portfolio. I'm not talking about individual companies. You have to look at your whole portfolio of that and that's many, many companies that you own. And so that can help give you perspective. And I think one of the things that a lot of people get into when they start investing is they think it's all about numbers and it's all about being smart. And some of that does help, but it's really more about your emotional IQ and understanding your own feelings and not getting jittery in, selling when things are going bad and buying when things are going great, because that's the exact opposite thing you want to do. So if you can learn to control your emotions and understanding history and what's happened in the past because it will happen again. And this time is not different.

Dave [00:07:46]:

It will happen again. And a lot of times, if you understand that, that can help you withstand some of the future volatility that you will experience. Nothing you buy will go up and to the right every single day, every single month, every single year, you're going to see drops. And it's just part of the game of investing. And the sooner you can accept that and understand that you can handle that, the much better you're going to do over a longer term. And I guess those are kind of some of my thoughts on that.

Andrew [00:08:12]:

I don't know if I'm beating the dead horse here. You mentioned the idea of a company like Apple doing all the work. Once you buy a share of that company, I think it's really powerful to have that kind of a mindset. One of my old longtime friends, Miranda Marquette, she has this metaphor for the way she thinks about investing, planting money, seeds. And really that's what we're doing when we're buying stocks. You are doing the work, you're earning the money, you're saving it. You're with faith, putting it down into the soil. And if you look at the way things grow, some stuff does get taken over by other stuff and doesn't receive the sunlight and it withers and it dies.

Andrew [00:08:54]:

But you get massive forests too, that come. And if you look at stocks, a big stock portfolio, the returns can be kind of similar too. So I think it is important to have the patience, like you said, to not just rip the seed out from the ground before it's even done any work, but at the same time also being diversified and making sure you don't have your whole life savings writing on one company. You have enough companies where you're going to see some success, you're going to see some failure, but overall, your entire wealth is going to grow because you have a diversified portfolio of investments instead of just one.

Dave [00:09:32]:

Yeah, that's awesome. I love that analogy. That's a great analogy. It's very visual and it really helps kind of, for lack of a better word, plant the seed. That give you an idea of how this could actually work. That's one of the things I know Buffett has talked a lot about, is really understanding what you're doing and you're looking for. And all these things we're talking about don't just apply to buying individual companies. The same rules, the same ideas.

Dave [00:09:56]:

You can apply to investing in index funds or ETFs or mutual funds or bonds. You can also use the same idea when you're thinking about investing in your 401K. So all these rules and tips that we're passing along right now are really more overall investing tips. They don't have to just be specifically, I have to buy Amazon. This is the only way I can do it. If you buy any ETF. You can follow the same kinds of rules and ideas. It'll help you in the long run.

Dave [00:10:24]:

Understanding the history, understanding the volatility, and understanding that you're planting seeds for the long term will go a long, long ways towards making you a successful investor.

Andrew [00:10:35]:

100%.

Dave [00:10:36]:

All right, so now we've beaten that horse to death. Let's move on to the next question. So we got hey, I've been enjoying your podcast. Listen to the majority of them through these two months. I got one question. What is the best brokerage out there, not only in the US. But also in the EU. So there's a couple that I know kind of off the top of my head.

Dave [00:10:54]:

One for sure. I know is global. The other one is focused more on EU, but you can buy US. Stocks through it. So the US one or the global one is Interactive Brokers, and they allow you to buy companies all over the world wherever you are. And so I know that's very useful. I don't personally use it, but I've had lots of my foreign friends say that it's pretty awesome and it allows them to buy companies in the US. Pretty easily.

Dave [00:11:17]:

The other one that I just came across recently through the Twitter machine is a company called Trade Republic. And I know that speaking to some of my EU friends on the Twitter machine or the X machine, they have all spoken highly of Trade Republic, and it's one of the ones that they use to help them buy companies in the U as well as the US. And they just announced a few days ago that they're going to be offering a pass through on interest rates. So any cash that you don't invest in your Trade Republic will earn 4%. So that's kind of a nice bonus. If you're not if you're looking for things or you want to store money at a certain place, that might be an option for you as well. So those are a couple that I'm familiar with. Do you have any input on this, Sir Andrew?

Andrew [00:11:57]:

No, I'm a US guy through and through.

Dave [00:12:00]:

Okay, all right, I hope that helps. Those are a couple that I've come across. If anybody out here is listening and they know some other options, please pass them along to us and we will go ahead and pass them on as well. We tend to be a little bit US focused, but I'm trying to branch out, so if you can help us out or help our listeners out, please let us know.

Andrew [00:12:17]:

So can a us. Citizen open an account with one of.

Dave [00:12:21]:

These and then trade with Interactive Brokers? Yes, I know they can. The prime nation one. That one. I'll be honest with you, I'm not 100% sure on that. Or trade republic. I'm sorry, I'm not 100% sure on that one.

Andrew [00:12:33]:

Okay, cool.

Dave [00:12:35]:

Perfect. All right, so the last question that we have here today is what metrics can we use to identify a competitive advantage? And this is from Paul from Twitter. So, Andrew, do you want to take the first swing at this?

Andrew [00:12:47]:

Where do you even start? Right? It's tough. I mean, you want to use metrics to find good businesses, and you want to find metrics to find competitive advantage. And it's kind of similar. I don't know if I would say that it has to be one or two. One that I'll say I used yesterday doesn't confirm 100% that there's a competitive advantage. But it's a good signal to see is one of the companies that I own over the last 15 months or not 15 months? Over the last 15 quarters, however many months it is, I guess be 45 months, they have had higher growth on their revenue than their competitors. So it tells you something's going on here that's helping this company grow faster than these other companies, and they're selling similar products or services. So that could be a good indicator.

Andrew [00:13:43]:

Not to say, yeah, they have a competitive advantage, but if I thought my business has a competitive advantage and then I see those numbers, maybe that helps me to feel like, okay, management says that what they're going to do is going to be successful, and they are achieving that success. So I feel like there's really a ton of metrics you could use. I do kind of like keeping it simple and looking at things like revenue growth over time and how that compares with the industry. I guess that could be one.

Dave [00:14:12]:

Yeah, that's one. I came across this post on Twitter a few days ago that was kind of talking about this and the two that they mentioned in the post, which I thought were kind of interesting. Number one was gross margins, and the other one was return on invested capital, which we've talked about many times before. The gross margin, one I thought was kind of interesting because it could indicate that the company has a form of pricing power, especially if those margins improve over a period of time. And they were talking about anything over greater than 40%. And you can probably come up with different arbitrary numbers to, I'm going to only invest in companies that have 55% gross margins and growing. Yeah, don't do that. But there are different many different ways you can go with that.

Dave [00:14:59]:

I think the thing that I kind of like to do is use some of those metrics to help me screen for companies and then start looking at the individual companies themselves and looking at their business model. Because I don't think you can necessarily identify for sure that this company has a competitive advantage just based on ROIC, for example. It can certainly be a leading indicator, for sure, but it's not always a guarantee. There's plenty of companies out there that have very high ROICs intel. That do not have a moat. Intel, I think you have to be careful with how you use them. Numbers for numbers sake can tell you a lot, but I think you have to be careful with how you use them. It could be a weapon that can be used in the wrong hands in the wrong way.

Dave [00:15:49]:

So I guess that's one of the ways I think about it. What are your thoughts on trying to, I guess, identify what a mode is and kind of how somebody can maybe start to identify something like that?

Andrew [00:16:02]:

I don't know if there's an easy answer other than just trying to think deeply about it as much as you can. I mean, how many times do we have moat conversations? We just have one before hitting record, right? It's a constantly evolving thing and that's what makes stock picking really fun. You have companies now like Airbnb or Uber, these platforms with moats that wasn't even a thing 1020 years ago. And so moats change the way that customers and employees and on and on and on, all these people that interact with a business, all of that changes. I guess we talked about some of the downsides of the metrics, that's the good side of the metrics is that you can use a metric like gross margin. And that's not going to change all that much to help you understand certain types of businesses. I know gross margin can kind of sound maybe a little abstract if you're not an accounting person. I don't know if it's worth digging into, but if you were to compare Apple to Samsung, for example, and if it cost them $100 to make the same phone, but Apple charges 400 and Samsung charges 200, that gross margin is what it costs to make something and what they sell it for.

Andrew [00:17:23]:

So Apple would have a higher percentage because their costs are the same, but they're selling it for higher. That's, I think, a good example of a moat in Apple's case because they have that pricing power and that's where gross margin would be a good leading indicator, like you're saying. But if there's another business that maybe has a high gross margin, but that gross margin is going down over time, that's maybe a moat that's getting eroded. It's a competitive advantage that's becoming less and less of an advantage. And so that's the type of things where I don't know how to prescribe that other than saying you just start to absorb those ideas over time with experience as you start to think about them, talk about them, learn about them. A lot of good resources out there to learn about this stuff. You don't have to reinvent the wheel.

Dave [00:18:12]:

No you don't. And I think understanding the business model, understanding how the company makes money and then thinking, just sitting back and thinking for a few minutes of why is Apple's moat so strong? And why are people willing to pay $1,000 or more for a phone even though it may not necessarily cost them more to make it this year than it did last year, but what's driving people to pay more for that particular mode and it could be a myriad of reasons. And the thing that you have to understand when you talk about those ideas is trying to think through the upsides as well as the downsides. Trying to determine moats or competitive advantages is a bit of a soft skill. And you can use numbers to help you narrow down potential moats, but it doesn't always indicate that that company has a moat versus another one. And I'll give you a few examples. If you look at kind of the broad spectrum of companies that are operating in the air, quote, cloud space, whether it's internet security, whether it's platforms, whether it's distribution or networking, any of those kinds of things. All of those companies across, not all of them, but the vast majority of those companies are sitting in the 60% to 80% gross margin realm which are really high.

Dave [00:19:29]:

And if you just looked at that broadly you could say, okay, all these companies have moats. Well that's not realistic. It's not realistic to say that Datadog has a moat as well as MongoDB has a moat, as well as CrowdStrike has a moat, as well as Cloudflare has a moat. They may all well have moats. I'm not saying they do or don't, but I'm just saying you can't just assign blanket numbers and look at that. Another reverse example of that is a company Andrew and I were talking about earlier is costco. Their gross margin is 14, 15%, really low, but they have a moat. But it's not based on their gross margin, it's based on their business model and what they do to generate the moat.

Dave [00:20:10]:

And the low gross margin is a result of why they do what they do to help grow the business. And so numbers can help you find the story and sometimes they can tell you the story, but they can't always tell you the whole story. You can't just be careful of broadly just assigning something saying that if you look at the gross margin of perfect example is Microsoft, Google and Amazon. All three of them are competing in the hyperscaler cloud space. But Amazon is a different beast than the other two in the fact that they have this huge part of their business. The e commerce business is what they're famous for. First is very low margin, but then AWS, which is their cloud portion of the business, is hugely profitable. But because of the way they report their financials, if you look at Microsoft's gross margin in Amazon's, you're going to be like wow, Amazon sucks.

Dave [00:21:06]:

They don't, it's just, it's a different business model. And so you have to really understand that business model or you have to learn a way to separate AWS from that to compare it to Microsoft or Google. And even comparing all three of those can be a little tricky sometimes. So I guess all that to say when you're thinking about trying to determine competitive advantages. One of the things that I like to do, and one of the things I have done is Michael Porter has written this fantastic book about competitive advantages. It can be a little dense that's I e hard to read. There's a great summary that was written by and I'm going to blank on the woman's name right now. Of course, remember it at 02:00 this morning, but I'll try to put it in the show notes.

Dave [00:21:49]:

But she wrote a great summary of the book, which is not as near as dense as Michael Porter's work is. It's a fantastic book. I'm not saying you shouldn't read his work, but if you're more in the beginner stage, it might be a lot to bite off. But you can easily Google competitive advantages and moats. You can go to our website, investingforbeganners.com. You can find information about those. But all that stuff can kind of help to formulate what moats are and then just pick five companies and go, okay, what is this company's moat? What is this company's moat and what is this company's just, you know, that's your homework for today, if you will, is go out and try to figure out those ideas and that'll help you start the process of learning. Why does Coke have a know? It's just a mean why does that have a know? Why does Tesla have a moat? Why does do they have a know? Those are all things you can it's easy to throw out the word and say they do have a moat, but you need to think about the implications as well as what is driving the moat and what could unseat the moat.

Dave [00:22:49]:

So those three ideas can really go a long ways towards you really understanding a business. I guess.

Andrew [00:22:54]:

I wonder if there's a company that we haven't talked about on the show before that we could in real time, which I'm sure will make for great content, try to out loud think about if a company has a mode or not.

Dave [00:23:09]:

Yeah, I think that would be great.

Andrew [00:23:10]:

All right.

Dave [00:23:10]:

So after a few minutes of picking, we have found a company that we have never talked about before that might be an interesting conversation about if it has a moat or not. So the company that we chose was John Deere, and the ticker symbol is De. So those of you out there following along andrew, what are your thoughts on John Deere? Do they have a moat? And if they do, what would it be?

Andrew [00:23:32]:

Well, I guess it's a good example because I know nothing about tractors. I don't own a John Deere. I haven't done much research on the company other than hasn't hit my screens. So what do you think?

Dave [00:23:48]:

I would say that it does have a moat for several reasons. Well, I guess there's kind of three reasons. The first reason is they've developed a brand name around their products. And you say John Deere, and just about everybody in the world knows what you're talking about. They've developed the quality of products and the breadth of products in the farming industry that everybody really knows what a John Deere is. And I know there's other brands out there, but John Deere is really the one. If you say that to somebody that knows nothing about farming, they instantly think of a tractor or a combine. And so that's really what's associated with so they have a brand recognition which helps them generate more sales and it also helps them generate higher profits and higher prices because they have that branding that they can kind of push back on.

Dave [00:24:36]:

They also have the quality of the equipment that they produce as well as the quality of the replacement parts that they produce. Now they just recently announced that they're going to allow other people to repair their equipment. Prior, everything had to be done through the kind of the John Deere ecosystem. But now they're going to start allowing people to buy outside of John Deere products to replace their products, which is kind of an indication that the company is trying to adapt to kind of current economic realities and also understanding what it is that they do. The other thing that they have is they have a technology moat which may surprise people.

Andrew [00:25:13]:

Yeah, I'd be curious to hear about that when I run it through my little spreadsheet that's kind of automated. I see a couple of things that stand out. I see they have revenues that have grown year after year after year. There is some volatility there which makes me think, okay, this is probably a cyclical company, which means they do really well when the economy is strong and not so well when the economy is weak. Not every company is like that, but cyclicals are. And I see return on invested capital, which was one of the metrics you mentioned a little bit earlier, has been improving over the last five years. So that's a good signal. So when you start talking about the kool aid of John Deere and I look at the numbers, you start to say, okay, there's probably something that checks out about some of the things you're saying.

Andrew [00:26:01]:

Because I think when you find companies that may or may not have a strong moat, I think it's really easy to hear really strong arguments about it. And you can use the metrics to kind of double check that because I could love on IBM until the cows come home, but until they fix the revenue situation, it might not be the best.

Dave [00:26:26]:

Exactly, exactly. I mean if you think about some of the, I guess the big name moats that are thrown out, know a company like John Deere has a network effect because the more that you use their equipment, the. More you're going to continue to use the equipment. And because of the replacement value of the equipment and as well as the parts that need to be used to fix their equipment, it has this kind of network effect that the more farmers that use their equipment, the more they're going to continue to use it. And they also have a bit of a switching moat as well, because you're not just plunking down $10 to buy these things, a lot of that equipment is hundreds of thousands of dollars. And so to switch to another brand is a lot of money. So it behooves farmers to buy a tractor or combine and sit and use that thing for a lot of seasons before they switch out to another brand. And because the quality and they have connections in the communities as well.

Dave [00:27:24]:

So these stores are in the communities and they know the people that they're working with. And so all that kind of helps develop a moat. And I guess the last thing I was going to throw out there was the whole technology thing. They've been really forefront in helping with developing data that farmers can gather to help learn to be better at their job, for yield that they take in the miles and the usage of their machines when the machines need to be repaired, as well as developing different ways that they can enhance their crop yields as well. So all those things can go a long ways towards helping the farmers maximize what they're working with, because Mother Nature is always the easy beast to work with. And so it can really help them drive a lot of revenue for the farmers, which in turn is going to help build some loyalty and some switching costs for John Deere as well.

Andrew [00:28:18]:

So I guess my question for you was I didn't realize you cheat on this little mental exercise, joking, of course, when you had first thought about this company, how did you learn all of these things? And how can people replicate that kind of a process when they have a company that they might be interested in?

Dave [00:28:35]:

Yeah, that's a good question. So the first thing that I did was I obviously read the Ten K, and I read through The Ten K, I read through some of their quarterly reports and I read through some of the investor presentations that they presented. And then I started branching out and asking other people in the ecosphere that I operate in, I e. Twitter, get some feedback from them, and then I wrote about them. So I put my thoughts out there in public and then people can comment on those and correct me if I'm wrong or confirm if maybe I'm thinking the right way. So that helped as well. I also used the Google machine to just type, I literally typed in what is John Deere's moat? And then you find articles that will tell you what other people think is their moat. And then you can compare that to what you've researched in your knowledge and that can be very helpful as well.

Dave [00:29:28]:

I also went to the public library when I was in Chicago, and I have a subscription through their online portal for Morningstar. And Morningstar has these great reports that they put out on individual companies. And one of the things that they focus on is moats. And so they have a section in those write ups that talk about what they think is a moat for particular companies. And John Deere was one of them. And so I was able to kind of gather information from that. And then the last thing that I did was I used Michael Porter's framework of what our competitive advantages and then tried to work through each section of that to try to help confirm or deny what I thought about the company. That was kind of my process for it.

Andrew [00:30:09]:

That's awesome. I think that's perfect. Do that next time you're somebody who wants to figure out paul, you asked the question, how can I identify a competitive advantage or moat? Do that. Do that.

Dave [00:30:22]:

Yeah. All right, folks. Well, with that, we will go ahead and wrap up our show for this week. Don't forget to subscribe to the show in your preferred podcast app. If you enjoyed our little show, if you would kindly consider giving us a five star review, it greatly helps our show. And don't forget to browse the incredible materials we created for you@einvestingforbeganners.com. Lastly, consider continue growing your knowledge as an investing for Beginners insider with insights and educational dips delivered right to your inbox for free. Sign up today.

Dave [00:30:50]:

And with that, we will go ahead and sign us off. You guys go out there and invest with a margin of safety, emphasis on safety. Have a great week and we'll talk to you all next week. Bye.