Back to Basics: All About Moats

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to do one of our back to the Basics episodes. Today we're going to talk about moats. If you are new to the show, this is something that we've been doing for a little while. And every Thursday we do a back to the Basics episode to talk about foundational ideas to help you become a better investor. So today's conversation will center around moats. And so Andrew, I'm going to turn it over to you and we can start talking about moats. What are they?

Andrew [00:00:27]:

Well, a moat is what we can think of as what makes a company strong. So capitalism doesn't need to be said. It's a very competitive endeavor and there's always competition trying to steal your lunch that goes from the smallest businesses all the way to the biggest. So the way that if we're going to be buying these stocks as investments and wanting to partner with these businesses, good businesses that can last a long time, most of the time have really strong moats. And it's basically just another word for competitive advantage. What separates you from your competition? What makes it so that they can't just come in and steal all your customers? What is special about a business? And that's basically what all the conversation around moats is about. I guess there's a metaphor for it too. That can be helpful, right?

Dave [00:01:24]:

I always envision a moat as that water around or ditch around a castle. And it helps me visualize that's what a moat is. And I think Warren Buffett, I'm going to paraphrase, I don't remember the exact quote, but he basically said he liked crocodiles and sharks and all kinds of defensive creatures in the moat to help protect the company from competition. And so I think that paints a real good picture of what a moat is. He's correct me if I'm wrong, but he's kind of the originator of this idea or the term motes, is that correct?

Andrew [00:01:58]:

I think so. I mean, I haven't really seen anybody talk about it before he did.

Dave [00:02:03]:

If he wasn't the first one, he's certainly the one that has made it popular, put it in investors lexicon of terms that everybody should know and understand. So I guess what's important, why is this idea of a motor competitive advantage important? Important?

Andrew [00:02:21]:

Well, its going to depend on what youre trying to do with your investments. So lots of stock pickers might buy a lot of stocks and try to buy low, sell high and do it a lot in a short amount of time. And if thats the case, then the moats probably not that important to you. But for somebody whos trying to buy something and hopefully hold it for 10, 15, 20 years, the moat is critical. Thats whats going to protect things like the companys profits, because if you have lots of different competitors coming, one of the classic sayings, I guess, or industry jargon or however you want to word it, is the race to the bottom. So when you have just too many businesses competing for a limited set of customers, whats the easiest way to steal customers? To charge less than the guy next to you and it can quickly become a race to the bottom. That does happen a lot with a lot of industries eventually. So if you have a moat, then whether that's the industry has the moat or the business has the moat, that should be able to protect against that race to the bottom.

Andrew [00:03:32]:

So if I buy an Apple iPhone, competitors might have a cheaper option, but Apple's not going to be in a race to the bottom because their moat is the fact that me, the customer is willing to pay more. And so there's something different about the Apple product and that's one example of a moat. But there's lots of ways that a company can have a moat which protects it from a race to the bottom or a race to bankruptcy.

Dave [00:03:59]:

Right? Yeah. So maybe we can talk a little bit about going through maybe some of the more common moats and then we can talk about like how do you define or how do you find companies that have moat? That's always the fun one.

Andrew [00:04:13]:

Yeah, that is the fun one. Let's start with some easy things. So one moat that I feel like is easier to understand, the scale economies. Basically, economies of scale, as a business gets bigger and bigger, they become more efficient. And so a business that is bigger can be more profitable than the business that is smaller when there are scale economies present. Thats because for things like if a big business can buy

things in bulk, then maybe they can get more of a discount on that versus its very small competitor. Its not buying as much because its just smaller, smaller volumes. And so thats just one example.

Andrew [00:04:55]:

And theres lots of ways that economies of scale or scale economies can work its way to help a business become a lot more profitable by keeping its costs lower than competitors. And so if you have relative costs that are lower than competitors, you can do things like you can play the race to the bottom price wars game and actually come out on top and kind of survive that period because you are more efficient than your competitors. You can have more opportunities to invest in growth when you have more profits. And that can kind of compound the advantage of scale. Ive heard it talked about as like a flywheel. I think ive used that phrase before, like a scale advantage flywheel. The bigger you get, the more efficient you get, which allows you to invest more and become bigger and then more efficient. And so it can really build on itself.

Andrew [00:05:50]:

And that can be very powerful. But it depends on the industry, depends on the company. And not all, especially, I think, in technology, like intangible technology, software, the economies of scale are not always as obvious as something that's brick and mortar. For example. Walmart is like a great example of scale economies.

Dave [00:06:16]:

Yes.

Andrew [00:06:16]:

When you're a product and you're able to sell into Walmart, you basically hit the jackpot. And Walmart wants to have a special discount. It's, it's a lot more reasonable than asking the guy down the street.

Dave [00:06:28]:

Yeah, yeah, for sure.

Andrew [00:06:29]:

What do you think about with scale economies?

Dave [00:06:31]:

I really like that idea, the flywheel, and kind of gives me an vision of a snowball. Right. You know, as it gets bigger, it can reinvest, which makes it bigger. And as it kind of rolls down the hill, so to speak, it, it becomes a bigger and bigger beast of its own. Walmart obviously is a fantastic example. I think Amazon's a great example of this as well. I would say Costco is probably a good example of this as well. Maybe we could just kind of talk a little bit about Nick Sleep and his idea of the shared economy scale, because I think that kind of goes hand in hand with scale economies.

Dave [00:07:00]:

And hes also talked about Costco and Amazon in respect to that. Do you want to explain what were talking about, Trey?

Andrew [00:07:07]:

If I had to say, Im taking this mental model to the prom and I can only pick one, a scale economy share would be the one. Its just, its such a powerful moat because its like you said, its like a snowball where it builds on itself and it's very hard to replicate. And so the idea, I love talking about Costco other than being like an avid customer there, but the way that they share the savings with customers, it makes customers more loyal. So where somebody like a Walmart or target might have that scale advantage and they might use that to keep profits for themselves, Costco takes what would have been profit to them and gives it to their customers. And so because Costco is not trying to make profit on their items, customers keep coming back. And that's why they're willing to pay for membership. So when you buy a stock like Costco, actually, most of their profits are coming from membership fees and not from profit margin on items. And so like you said, the flywheel of that is they get bigger and then they can have more stores and then get bigger and that's more and more savings for customers and that's very hard to disrupt because I think you see a lot of businesses just in general kind of get too fat and happy and that complacency and that kind of neglect of the customer is what can start to cause their downfall.

Andrew [00:08:47]:

But when you have a business that's basically partnering with their customers saying like, hey, we're going to win and you're going to win, that's very hard to, that's very hard to be, it's very hard to replicate and it's a very powerful long term strategy. And it's worked for Costco for decades. And as long as they can continue it, it can probably continue for decades more.

Dave [00:09:11]:

Yeah, it's definitely one of the more powerful moats out there. And I really have only seen it in Costco and Amazon. Are there any other companies that really do you think have been able to take advantage of that?

Andrew [00:09:23]:

I'll go out on the limb and I've written that I think Microsoft Azure is a scale economy shared and simply because again, if we're like a small mom and pop shop, we don't have the money to buy our own servers and get that all installed ourselves. So we'll go to a Microsoft Azure or AWs. And so that saves us money. And so in effect, Microsofts kind of using that scale to save its customers money that they would have had to outlay. So I mean its probably not as clean of an example as like Costco or Amazon, but I like to think of the cloud companies like that.

Dave [00:10:03]:

I think one thing we should probably mention as we talk about some of these different modes, some companies youre going to find may have several or two or three different types of motes as part of their competitive advantage and others may only have one. And sometimes the different kinds of moats that we talk about, they may be rarer, so they may be harder to find. But if you do find them, then that's really when you want to really, I guess consider investing a lot into those companies because they're going to have, as Andrew said, very hard to disrupt something like a Costco or an Amazon. The next mode I think I want to talk about is switching costs and this one is a very, they're all very powerful but they have, some have more, I guess, power, if you will, and maybe are harder to disrupt than others. And to me, switching costs entails the idea that they either have a product or a method, that they've created a particular company that is so amazing and difficult to replicate that the customer, once they're in the web of the company, if you will, it's really hard for them to leave. When I think of switching costs, I think of banks, and I think of the payments companies, both of those very, very, very hard to, once you get entwined in their ecosystem, it's really hard to get out of. And I'll give you an anecdote. When I worked at Wells Fargo years ago, we used to say that people have longer relationships with their banks than they do with their significant others.

Dave [00:11:37]:

In part, that was because it's such a pain in the butt to leave the bank, and because you have to change your, if you have direct deposit, you have to change that. You have to change all of your payments and where everything goes. And if you have lots of different intricate financial, either met payments, transfers, deposits, investments, all those different things, it's really, really hard to change all that to go to another bank. And let's say you have your mortgage at the bank, you also have your car loan at the same bank, and you have two credit cards at the bank. To switch all that to a new bank, it's really, really hard. And if you're already paying your mortgage from your checking account, it's very convenient. It's super easy to do, super

easy to set up. And if you go to another bank, let's say you leave Wells Fargo and you go to bank of America, then that becomes a harder process.

Dave [00:12:23]:

It's not impossible, but it's harder. And most people just don't want to deal with that. And so that is why something like a switching cost for a bank, for example, can be so powerful. But then I also think of a company like Intuit that has the tax software that everybody uses either to pay their taxes or to do their taxes. And it's once you get in that system, it's really, really hard to get out. Because if you're using Quickbooks, for example, to do your bookkeeping, and you're a small mom and pop business, it's going to be very, very hard to replace that, because that is even more of a pain in the butt to weave to try to go do that. That to me, just makes it very, very strong moat. And anytime you come across a company like that, ADP, paychecks, the payroll companies, another company that would be really strong in that area.

Dave [00:13:12]:

Kind of on the other side of the equation is a company like Jack Henry, because they do the plumbing for banks. So when you think about your online banking or your statements or checking your, your deposits at your ATM, that's all done through Jack Henry's programs. And for a bank to take all that out and put it in a new one is really, really complicated. It's very expensive, takes lots of time to do and lots of training, and most banks just don't want to deal with it. And so it can be very, a company like Jack Henry can have a lot of legacy accounts because of that and others in that industry as well. So that's why something like that has huge switching costs. And it just makes it very painful for a customer to leave and go to another provider of those items. And that's why I like switching costs.

Andrew [00:14:00]:

It's amazing how the switching costs can come in and all shapes and sizes. I think of a Danaher, which I have shares of Danaher. I have shares in a lot of these companies, actually. So if I'm talking about company today, you can maybe assume a good chance I own it. But Danaher is a company that serves the life sciences, and so they're helping biotechs and companies like that to, you know, they're helping them in the labs. And so when a company is trying to get a drug to market, they're using Danaher's supplies. And then if they get FDA approval, well, then they're going to continue to use Danaher supplies because it's very hard. Once you have that FDA approval, if you want to change an aspect of the process, you probably have to go back and get more FDA approval, obviously, depending on the context.

Andrew [00:14:51]:

But in general, that's kind of how to think about it. And so those switching costs are quite difficult. And for a company like Danaher or other kind of recurring revenue businesses with high switching costs, that can be a great source of compounding growth because switching costs can create pricing power, which creates very easy growth for the business. And they didnt even have to get new customers. They just kept doing what they do with the same customers. So you can get extra levels of growth because of the recurring revenues and the pricing power, which are enabled by the switching costs. So it can be quite beautiful when it works together in certain ways.

Dave [00:15:36]:

Yeah, exactly. Yeah. Danaher is a beautiful example of that. Thats awesome. So I guess what would be another moat that investors should look out for.

Andrew [00:15:46]:

Intangible assets is a good one. I mentioned the brand power around Apple, Starbucks can maybe qualify for that. A premium brand that has customer loyalty. And so, you know, if I take Starbucks versus, do I want to throw Dunkin under the bus? Just a typical coffee chain, you know, maybe they do some iced coffees and, you know, maybe some morning coffees. If people really like Starbucks brand versus vanilla coffee bean or something, those two businesses could have two separate. They could have the same number of stores, but Starbucks would get more profit from that stores than a vanilla brand. And that's the power of branding. And in a lot of the same ways that switching costs creates pricing power, branding can also create pricing power.

Andrew [00:16:34]:

Because if you think about a brand for a lot of brands, you can't always put your finger on why you like a brand. But you just know that I choose this brand and I pay more for it because I like the brand. The best brands do that really well. Another one I think of is like Coca Cola. They do that really, really well to the point where I found myself many times. You guys have Diet Coke? No, would be a Diet Pepsi. I'm good, right, so I'll have water. Yeah, exactly.

Andrew [00:17:04]:

So, you know, certain brands just carry weight and that creates pricing power and it can create more profitable and easier compounding over the long term.

Dave [00:17:17]:

Yeah, yeah. Brands is something that I think a lot of companies aspire to get to, and I think that's one of the probably stronger moats. Coca Cola, I think, is probably, to me, is probably the greatest example of that, I think. What did Charlie say a long time ago about the pricing power of Coca Cola? That they can basically raise the price one penny and they can still make quite a bit of profit just by raising it a very small amount. He also said something along the lines, if you have to have a seance to. To decide whether you can have, you know, raise your prices, you don't have pricing power. So to me, I think Coca Cola is a perfect example. I also, when I think of brand power, I also think of maybe of companies like Nike.

Dave [00:17:56]:

The swoosh is certainly a brand that people recognize. McDonald's is very much a brand that people recognize. Google, that's a verb now. So I would. I would argue that they've definitely achieved brand power. I would say a company like Visa has brand power as well. The logo is very recognizable. And all those things, I think, indicate power beyond just the.

Dave [00:18:20]:

The company itself. I think it indicates to people, you know, a level of quality that they're going to expect whenever they use the product, whatever it may be, whether you like McDonald's hamburgers or not, or their french fries or not, you still, there's a certain level of expectation you get whenever you go there. And same with Nike shoes. What's that?

Andrew [00:18:39]:

It's predictable whether I go to McDonald's here or across the country or even in the UK, which I've done. Yeah, kind of dumb, but I did sacrilege. I'll pass on the, on your great local delicacies. Let me have a McDonald's burger.

Dave [00:18:56]:

McDonald's, yeah.

Andrew [00:18:59]:

But I think it goes to like you. You expect that, right?

Dave [00:19:02]:

Yes. So I think when you find companies that have that kind of brand power, that can really be a strong competitive advantage. And the hard part about brands is that a lot of it doesn't show up necessarily on the

financial statements. And so it can be a hard thing to quantify with numbers. A lot of times all you have to do is just ask yourself, do you think this is a brand? And if it's obvious to you, then I think that's pretty easy. Newer companies that maybe are starting to develop that would be Airbnb and Lululemon, they certainly have achieved a level of fame and a recognition, and over time they probably will develop a consistency of output that they can probably be labeled as brands for sure.

Andrew [00:19:49]:

Yeah, 100%. So what would be another big moat that you think is important to know?

Dave [00:19:56]:

I think network effects, I think is probably one of the biggest ones and it's probably the most, I would argue maybe one of the more common ones defined. And basically what it means is the more people use the network, the more the network becomes valuable. And the easiest way to describe it is you look at a company like meta or Facebook, you think about the more users that are on the network, the more other users want to be on the network. And it just keeps laddering up and it just makes that network more and more valuable. That's really what a network effect is. You think about a company like Visa. Visa is a network effect and it has a two sided network effect that the consumers, us, when we go to pay for things, we expect our cards to be taken. And since most of the banks here in the United States offer debit cards in particular, is either a Visa card or a Mastercard, when we go to pay for things, we expect those to be used.

Dave [00:20:56]:

So the network or the merchants, the people we buy stuff from, the 711 or the Kroger or the Walmart or wherever online, Amazon, we expect them to accept a Visa or a Mastercard. And so that becomes a two sided network. Where each side of the network has to relies on each other to be available for us to use, and that becomes a very, very powerful mode. And that is one of the ones, when I think of Visa and Mastercard, for example, to me that is a perfect illustration of a network effect. And that's in part why those companies are so powerful. And the same with meta. It's not a company I own, but it certainly is a powerful network effect, and it's a very powerful competitive advantage. And you look at all the other social media platforms other than TikTok, they have all struggled to reach the same level of importance that meta has.

Dave [00:21:53]:

Instagram is probably, but that's really part of meta, so it's not really separate. But think about Twitter or X, you think about Snapchat, they have all struggled to reach the same level of network effect that meta has, or even TikTok now.

Andrew [00:22:07]:

Yeah, meta is, I think, the perfect example for network effects. The way I kind of understand it is if I think about like my Instagram journey to be all dramatic, the more kind of like quality content creators got on that on the platform and started using Instagram, the more engaging and entertaining and satisfying the experiences I had on Instagram were, because the more content creators are where the better content came to the surface, the more people like me who are users that are on there, the more money the content creators can make. And so it's like not quite self reinforcing, but it is like as the network expands, it does become a better place for everybody in the network.

Dave [00:22:54]:

Yep, exactly. Insurance companies can be, have network effects as well, because the more people that are in their network, the more services they can offer around the country, to different hospitals and things like that. And so that can help build some of the network as well. There's lots and lots of examples of network effects out there. So what's the last moat, if you will, that we should discuss?

Andrew [00:23:17]:

Well, we kind of touched on that with scale economies, but cost advantages, if you are a low cost producer, you can have a pretty strong moat, kind of for a lot of the same reasons that having scale economies would give you a really strong moat. And so when you are the low cost producer, you know, sometimes this can come maybe not from scale advantages, but it can come from like a technical competency. Maybe you have, I think, of some of the semiconductors, maybe in this way, where if you have a better way of doing things, or a cheaper way or more efficient way of doing things, then you're simply able to have lower costs than your competitors that can be a huge advantage for all of the reasons that scale economies can also be a huge advantage.

Dave [00:24:08]:

Would you say Texas Instruments is an example of that in the semiconductor world?

Andrew [00:24:12]:

Yeah, perfect reach on about that, because we both own that one, too.

Dave [00:24:17]:

Right. The advantage that Texas instruments has is because of the scale that they operate. They also can create a lot of the products that their customers need for a very, very low cost, and they can hold onto them for a very long time. So they can have a lot of inventory for, the chips that theyre making are analog. And so these are, theyre much simpler, if you will. Well, certainly simpler than the cutting edge stuff. But even just the average everyday semiconductor that are made through TSMC, AMD, intel, some of those companies are more complicated, and the ones that Texas instruments are making are simpler, but they have a billion and one different use cases, and then they don't really go out of style. And so Texas instruments can make lots of them, which means that they can drive down the cost because they have so many of them, and they can offer those deals to the people that are buying them.

Dave [00:25:13]:

And they offer, and because they have such a good large scale, they can offer them online, and they have different distributors that they can work through as well, which helps reduce the cost of their chips as well. And as they continue to expand their capacity, which is what they're doing right now, they'll be able to drive down the cost more because they'll be able to make them, they'll be able to make more of the parts that people want for a lower cost, which means that they can pass that cost on to the customer as well, which is what they do. And so that is another advantage that they have in that respect. So big, big, big advantages. Now, we understand the different kinds of moats. If you're looking to determine whether a company has a moat, are there any numerical ways that you can do that? It's not easy, but are there any indicators that they could have a moat?

Andrew [00:26:02]:

Yeah, well, I mean, if the business performance is good, whether you're looking at revenue growth or return on invested capital or pick your favorite business success performance metric, any of those things could potentially indicate a moat. But its not always a guarantee.

Dave [00:26:20]:

No.

Andrew [00:26:20]:

So you have to be careful, Robert.

Dave [00:26:22]:

Yeah, you do. One of the things I like to look at is gross margins of a company that can give you an indication of a potential moat, especially if the margins are expanding. That means that the company probably has a pricing power over competitors. And so if they can, if they can leverage the cost advantage that they have being able to buy the materials or the products that they need to make the stuff they sell at a lower cost. And they can charge more because they have either a superior product or just the better efficiencies of distribution or myriad of different things. But if you see the gross margin continually going up, I'm not talking one year to one year, but if you see them improve over a five or ten year period, that could indicate that the company has some sort of pricing power and that could be an indication of a potential moat. So that's one thing I like to look at along with the ROIC. Obviously we've talked about that a couple times in the past.

Andrew [00:27:23]:

Yeah, I would probably keep it in context. Moats are very important, but other things in investing are important too. Pricey pay matters and industries do change. So no moat is forever. I don't remember who was talking about this. That's probably a podcaster I listened to, but they were talking about less about like does the company have a moat? But more like is its moat strengthening or weakening? And I really like that mindset because these things are really fluid and the stuff does change over time and a company needs to continually maintain or strengthen its moat. Otherwise eventually its moat can erode. And we've seen countless examples over history of when that happens.

Andrew [00:28:06]:

And so as investors we need to stay alert. And like you like to say a lot, Dave, stay curious because things can change. And if youre not curious, youre not gathering information, you might get blindsided by it. So thats what I would say right.

Dave [00:28:21]:

I think that point that you made about the price you pay is important too. I think even if you identify a company that has a moat, it doesnt mean that you should pay any price to own that company. And as Andrew said, they're fluid and the power that it has may wane over time. And even though a company like McDonald's for example, has this huge branding power, I don't know if over a ten year period, if that is going to be the best investment, depending on where you are in your journey and what you're looking for, if you're looking for more growth in your investments, that may not be the best method because it's not a fast grower at this point. And does it pay a great dividend? Absolutely. Does it buy back shares? Yep, check two. But it may not grow as fast as the economy forever and its probably closer to the end of that than it is to the beginning of that. And so you have to be careful when youre thinking about moats, it is important to

find companies that have competitive advantages because that can give them a longer durability and a longer ability to be good investments for a longer period of time.

Dave [00:29:28]:

But as Andrew said very astutely, theyre fluid and it will change and nothing is forever. If you need any more evidence of that, the top ten stocks 20 or 30 years ago, and youre not going to see the same things that are in there today. And I would argue if we do that, if we fast forward in time, we go in our little time machine and look 2030 years from now, probably a lot of the companies were looking at today that are dominant arent going to be dominant in that timeframe. Thats what history can tell us. Doesnt mean its absolutely, but chances are high that that will happen.

Andrew [00:30:01]:

Yeah, for sure.

Dave [00:30:02]:

All right. Well, with that, we will go ahead and wrap up our show for today. I hope you enjoyed our conversation on moats and how to find them, what to look for and the importance of them and what to watch out for. And with that, we'll go ahead and sign off. You guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week and we'll talk to you all next week.

We hope you enjoyed this content. Seven steps to understanding the stock market shows you precisely how to break down the numbers in an engaging and readable way with real-life examples. Get access today@stockmarketpdf.com until next time have a prosperous day. The information contained just for general information and educational purposes. Only it is not intended as a substitute for legal, commercial, and or financial advice from a licensed professional review, our full disclaimer@einvestingforbeginners.com.