IFB362: Why Some Stocks Always Seem Expensive

Alright folks, welcome to Investing for Beginners podcast. Today we have episode 362. Today Andrew and I are going to discuss something related to valuation. It's called cap or competitive advantage period and this is a term I'm not sure if Michael Mauboussin originated it, but I associated with him in his writings.

00:00:53 Dave

So with that, we're going to go ahead and just kind of dive into the topic and then we'll just see where it takes us. So, Andrew, do you want to maybe kind of give everybody maybe a 30,000 foot view of what a cap is or competitive advantage period might be?

00:01:08 Andrew

Yeah, I'm happy to. So you have businesses, you have the economy, you have a bunch of average businesses and then you have the select few businesses that are.

00:01:21 Andrew

So good at what they do, so able to make profits so able to grow that they create what's called excess returns or basically just.

00:01:31 Andrew

Returns and growth that's higher than the average.

00:01:36 Andrew

In order to do that.

00:01:38 Andrew

For a long time, sustainably, you usually need some sort of competitive advantage to do that, and the competitive advantage or the Moat helps you to sustain that.

00:01:49 Andrew

And so for every business and in every industry that's going to look different and maybe a lot of businesses in certain industries don't even have 1, you could argue, but for.

00:01:52

Right.

00:02:00 Andrew

If you really outstanding businesses, they have this competitive advantage period, which is a period of time where they are able to.

00:02:09 Andrew

We will put on the market.

00:02:11 Andrew

Because they have a Moat and that's what competitive advantage period is as far as I understand it. I'm no expert, but I have read at least one of Robinson's writings about the cap.

00:02:26 Andrew

And so that's my understanding of it. And with that kind of as a backdrop, why is it? Why is it important or how does it explain certain market?

00:02:37 Andrew

Behaviors if you.

00:02:38 Dave

Will. Yeah. The interesting thing about it is I think it helps to me, it helps explain.

00:02:46 Dave

Why those certain businesses that you're referring to?

00:02:50 Dave

Tend to have higher valuations for longer periods of time and you can think about throw out some usual suspects that kind of fit into this.

00:03:01 Dave

This realm, if you will, companies like Visa, MasterCard, Costco, Hermes, Porsche are just some of the ones that just kind of come to to mind. Naturally, you never, ever, ever not, never, ever. You rarely see them trade for low multiples, low PE's.

00:03:20 Dave

E of 15 for any of those companies we just mentioned, it's unheard of. And so when you think about a competitive advantage period.

00:03:30 Dave

It makes sense because the way we normally air quote value companies is using something like a DCF or a discounted cash flow model and generally with those you project 5 or 10 years of cash flows and then discount them back to the present day and value the company based on.

00:03:52 Dave

All those machinations.

00:03:53 Dave

The problem is, is that when you're looking at a company like MasterCard who has developed this very strong Moat, a very strong brand, a not unbeatable company, no company is unbeatable, but just a very strong competitive business.

00:04:09 Dave

Using a 10 year period is too short and so the competitive advantage period is a way of extending that valuation model to give you an idea of what really the company is worth because you're not.

00:04:26 Dave

It can't just be limited on a 10 year period. Now none of us can see 10 years into the future and trying to look 17 years into the future just for example, seems even more particularly daunting. And it's not easy. But it's to me, it's more about a thought exercise.

00:04:43 Dave

About how you you.

00:04:44 Dave

Use the valuation model and how you think about looking at a value of a company like a MasterCard compared to competitors, PayPal or something along those lines, the mote is way bigger for MasterCard than it is for other companies in their industry. Discover for example, it's way bigger than discovers and.

00:05:05 Dave

And so you have to value them differently, even though they're in the same industry, you can't value Amazon the same way you value Walmart. And so it's or Costco and Walmart. They're they're not the same businesses, even though they are, you know, big box grocery, you know, stores.

00:05:22 Dave

Different and we all know that intuitively, but when you value them, I think you have to look at.

00:05:29 Dave

You have to look at the value of them of of them longer so.

00:05:33 Dave

I guess when you're thinking about this kind of thing, I like to think about.

00:05:39 Dave

Not only the mode, but also how wide that mode is and is the mode growing and does. What are your thoughts on that?

00:05:49 Andrew

Do you have a long term mindset searching for safe compounders? So am I and I'm investing my entire life savings with the picks from valuespotlight.com.

00:06:02 Andrew

I think it's always important to consider Moat and consider whether it's growing or decaying. Some again, very select few types of businesses.

00:06:14 Andrew

Have modes that.

00:06:17 Andrew

As part of the secret of the mole is the automatic strengthening of it.

00:06:23 Andrew

It's a virtuous cycle. So Nick, sleep talked about this when he.

00:06:30 Andrew

I don't know if he was the.

00:06:31 Andrew

First person to.

00:06:32 Andrew

Explain this idea, but he definitely popularized it. Probably one of the first people to this idea of scale economy shared so scale economy shared is a type of Moat that it gets stronger the longer it lasts really.

00:06:47 Andrew

And.

00:06:49 Andrew

To give you like a Long story short, it's basically if the mole is from scale, which means as a company gets bigger, gets a stronger mole like a Costco you mentioned.

00:06:59 Andrew

Then.

00:07:01 Andrew

In Costco's case, they share the benefits of their scale with their customers, and so the bigger Costco gets, the more valuable they become to the customers.

00:07:11 Andrew

And the more money the customers give to them, and then the more valuable they become the customers. So you see how it's a self reinforcing loop.

00:07:18 Andrew

Now you can say scale advantages.

00:07:22 Andrew

And you could say lots of businesses have scale damages. That's not the same thing because it's not self reinforcing, there's not a.

00:07:31 Andrew

A loop that builds on itself and so that that would be the difference. But when I think of.

00:07:37 Andrew

How do you find modes that are widening?

00:07:40 Andrew

That's that's such a hard thing to do because, like you said, who can who has a crystal ball who can see the future 10 years alone when you're out. But there are a few businesses and we can debate.

00:07:54 Andrew

Any business going down the list, whether that's the case for them or not, but there are a few that actually do get stronger and so it becomes a it becomes more of a question of.

00:08:06 Andrew

Is something terrible going to happen to this business, but you can for any, which is why you diversify your your investments.

00:08:12 Andrew

But if that's the question versus.

00:08:16 Andrew

You know a million other questions that you have to ask yourself whether remote is going to strengthen or not the the easier one, the easier decision.

00:08:24 Andrew

And one that's more likely to be long lasting is 1 where.

00:08:28 Andrew

It's already ingrained in it, and it has that virtuous cycle. Those are kind of my thoughts on winding modes. Do you have other things that you think of when you hear the winding note idea?

00:08:38 Dave

Yeah, I think.

00:08:40 Dave

I think of how do you measure that and I don't know that you can and like, is there any quantitative way that you can measure?

00:08:50 Dave

This, this, you know, mastercards mode is widening and I don't know that there's a way. There's some subtle ways that maybe you could see if the companies margins are expanding or if the revenue growth is maybe accelerating, maybe some of those things might give you an indication that they're they're.

00:09:12 Dave

They're widening their mode, or they're capturing more market share from their.

00:09:16 Dave

Matters. And so those things could give you some clues, but I think you know, to your point of what Nick Sweep was talking about, when I think about Visa and MasterCard, maybe through the lens of what he was talking about, it's not exactly the same. But the idea that the businesses are getting better.

00:09:37 Dave

Just helps strengthen the moats for those businesses.

00:09:40 Dave

And if I think about MasterCard and Visa, for example, those companies are working towards, not necessarily pivoting but adding additional revenue streams to what is already the core part of their business in the anticipation that those other parts of the business become a bigger, bigger part.

00:10:01 Dave

Share of how those companies continue to grow, and to me that indicates that aid the core business is also is already really strong.

00:10:11 Dave

But it also they also have opportunities or options optionality I guess to not pivot but to move into other things that can be maybe ancillary, but also complementary to what they're doing and it also indicates to me that because of their openness and willingness to work with competitors.

00:10:31 Dave

Directly, IE Ojin, Bitcoin, PayPal, all these other companies.

00:10:38 Dave

Being willing and able to work with them also helps to me strengthen their Moat, because those are the people that in theory could try to compete away some of what MasterCard and or visa are trying to do and take some market share with them. But because MasterCard and Visa are.

00:10:56 Dave

Aggressively open about working with other companies or other systems like Bitcoin, then that to me helps reduce the threat of disruption or somebody coming in and and undermining what it is that they do. And until there is some sort of new payment rail.

00:11:16 Dave

That.

00:11:17 Dave

Kind of encompasses everything. I don't know that there's something that's on the horizon that could disrupt those companies and to me that that just gives them more strength.

00:11:29 Dave

For their Moat, and it also means that their competitive advantage period is going to be longer than somebody else in the payment space because.

00:11:39 Dave

Those other companies you know, throw out a couple that have been kind of the rage on on Fenwick recently. Wise and remitly, these are companies that do a lot of cross-border payments and moving money around different parts of the world and whatnot. And I don't know either one of them as intimately as I do visa.

00:11:59 Dave

But I also know that that's something that Visa competes in.

00:12:02 Dave

And if you're going to value what visa is doing or is attempting to do, you know kind of comparatively to those other two companies, I would put a longer growth period or a longer period on that being a valuable resource for visa than I would the other two companies. I don't know that they'll be.

00:12:19 Dave

As successful over.

00:12:20 Dave

As long a period as visa could be.

00:12:23 Dave

And so when you're thinking about valuing the company, I would give a lot more value to the for a longer period of time to visa because of that and all the other things that they do than I would for something like wise, wise remitly. I'm not saying those are bad investments. I'm just saying that when you value them, I would look at them completely.

00:12:41 Dave

Different differently.

00:12:43 Dave

Does that make sense?

00:12:45 Andrew

Yeah, for sure. Do you think this is a loaded question, I guess because every situation is different, obviously, but do you think the market generally behaves that way too or do you think?

00:12:57 Andrew

Other things.

00:13:00 Andrew

Get beat up.

00:13:02 Andrew

Does it just?

00:13:03 Andrew

Depend on what industry we're talking about.

00:13:06 Dave

Yeah, it could depend. I mean, there's I think there's certainly things.

00:13:13 Dave

If you look at wise and remitly, I think people are undervaluing the value of their cash flows. Whereas I think with Visa and MasterCard they're assigning a higher.

00:13:26 Dave

A higher price to their value because it's a longer period of value and it's going to be.

00:13:33 Dave

More valuable, longer as wise and remitly are.

00:13:38 Dave

They've both been around for 5-10 years, but they're also still early in the in the journey in what they're doing and there's no, there's no guarantee that that visa at some point may.

00:13:52 Dave

Outdo both of.

00:13:52 Dave

Them and that could be a very big thing for them and MasterCard and.

00:13:59 Dave

What wise and remitly are doing?

00:14:02 Dave

Could be.

00:14:04 Dave

Repeated away and very easily. And so I think that the market is actually probably thinking that that's what's going on because if you look at the the financials, if you look at the revenue growth, the wise for example, it's.

00:14:17 Dave

It's for documents.

00:14:19 Dave

You know 6070% crazy numbers, but the market is not valuing.

00:14:24 Dave

Very much. It's not valuing it very highly, it's it's a lower rated company if you will. And I think a lot of it is because there's a lot of uncertainty that and they really.

00:14:35 Dave

Continue to compete in the space when Visa and MasterCard, the juggernauts are there and are capable of doing what they're doing as easily. If they choose to do it.

00:14:48 Andrew

A lot of times that's kind of what it comes down to, right when you have these differences in valuation.

00:14:56 Andrew

People are going to say different things, but a lot of it can come down to if you're talking to, let's be clear. If you're talking a long term investors who are looking to buy and hold something and compound it and just sit there and do nothing.

00:15:12 Andrew

The differences in valuation or maybe more differences on how long?

00:15:17 Andrew

Do people expect?

00:15:20 Andrew

A competitive advantage to last for a certain company.

00:15:24 Dave

Yeah, I mean, you know, we were talking earlier on our evaluation hackathon about O'Reilly and I think if you think about how the market is treating that company or the way a lot of investors think about that company, is that the EV revolution is going to be ultimately is going to be.

00:15:43 Dave

The the death knell for a company like O'Reilly or AutoZone.

00:15:48 Dave

And.

00:15:49 Dave

I think because of that, investors look at their potential competitive advantage. Period is a lot shorter than they would a company like Tesla, for example. Tesla is, I think we all agree is is a unique case because you know of who drives the bus at that company and so he engenders a lot of.

00:16:09 Dave

Well, good and bad tension. And there is definitely some enthusiasm baked into.

00:16:18 Dave

The value of that company, but it's unquestionably that they've done a fantastic job doing what they do, but are they really going to come eat the lunch, you know, of some at some point of an AutoZone? I I.

00:16:30 Dave

Don't know we could.

00:16:31 Dave

Probably argue about that from now until the end of end of time, but I think the market, when they look at AutoZone and O'Reilly, I think they.

00:16:38 Dave

I think they look at them as like, not that they're bad companies, but they're like dead men walking because disruption is coming for them. It's just a matter of.

00:16:46 Andrew

Based on low multiple.

00:16:50 Speaker 5

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00:17:08 Speaker 5

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00:17:22 Andrew

Alright. Do you think there are ways that the CAP?

00:17:28 Andrew

Ideas taken too far, where people kind of run with it.

00:17:33 Andrew

And or do you? Have you seen examples of that where people kind of run with?

00:17:36 Andrew

The cap idea. Yeah. Yeah, for sure.

00:17:39 Dave

I think the way you can look at it.

00:17:41 Dave

Is there's a?

00:17:42 Dave

Couple ways you do.

00:17:42 Dave

Look at it so #1 when you're normally doing evaluation of a company, you want to estimate the terminal growth rate at roughly the GDP or somewhere.

00:17:54 Dave

In that range.

00:17:55 Dave

You know anything, anything above?

00:17:57 Dave

The growth rate of the GDP, if you do it to Infinity, then that's not.

00:18:03 Dave

That's not logical. It's not reasonable. It can't.

00:18:05 Dave

Happen because of.

00:18:06 Dave

Just the nature of compounding and I remember a story that Professor Damodaran talked.

00:18:11 Dave

About or he?

00:18:12 Dave

Had students turn in valuations and student turned in evaluation with Tesla and their terminal rate, which is normally 2 to 5%, give or take.

00:18:23 Dave

He had put an 8%.

00:18:25 Dave

And so the value of the company he was, you know, he was projecting basically that in a 20 year period that Tesla would be larger than the GDP of the United States. And if you win another 10 years, it would be larger than the GDP of the world. And so everything that everybody did.

00:18:45 Dave

It would have.

00:18:45 Dave

To be bought from Tesla and nothing else. And obviously that's not reasonable and no matter how much you drink the kool-aid, that's that's not reasonable for any.

00:18:56 Dave

Company and you and Costco, I guess the point is, is that when you think about those?

00:19:01 Dave

Things you have.

00:19:02 Dave

To think about it has to be you have to be logical and and try to be reasonable about that. And so when you're thinking about the competitive advantage period, the enthusiasm you have about a business has to be built into some sort of realities.

00:19:17 Dave

Of.

00:19:18 Dave

History of business how long companies have been in business, how long they can stay on top. You would be surprised how, how short that really can be. I don't have the numbers in front of me and I'm I'm not recalling them. And maybe Andrew can can fill in if he remembers, but the amount of time a company spends in the S&P 500.

00:19:38 Dave

As a member is not very long, it's I think it's less than 10 years.

00:19:42 Dave

And if you look back on the last 20 or 30 years of like the top ten companies I know Buffett showed this.

00:19:49 Dave

At A at.

00:19:50 Dave

A shareholder meeting recently, if you look at the last 20 or 30 years, the amount of companies that have stayed in that top ten of the S&P is 2 and Apple and Microsoft, the rest of them have all fluctuated.

00:20:03 Dave

In and out, you know there's been, there's been the ciscos, and then there's been the the exons and the, you know, companies like that. And then, you know, now we have Apple and Microsoft and NVIDIA, but.

00:20:15 Dave

Those you know, a lot of these companies are new new to S&P 500, new to the top. You know meta is new, NVIDIA is new, Tesla is New Berkshire Hathaway is new. You know, they've been around for 60 years, but this is a new thing for them. And so my point with all that is that when you're trying to value a company and you're looking at this.

00:20:35 Dave

The idea of of extending your valuation because you think their competitive advantage is going to be a lot longer than a 10 year period, it may very well be, but it can't be 40 years just because that's just not it's not logical, it's not sustainable and if it is, it's going to be 1 Unicorn Company 1 and not.

00:20:53 Dave

One of them, and one Unicorn company that could possibly do that. And there's always outliers when you're thinking about.

00:21:01 Dave

Valuing companies and you just have to be. You have to try to be as reasonable as you possibly can and.

00:21:08 Dave

The thing that I like about the competitive advantage period is it helps explain maybe why a company like a Costco or a MasterCard seems like it's always expensive.

00:21:19 Dave

And.

00:21:20 Dave

It's because it is because the the value that the company is creating is a longer period than it's normal brethren in the 10 year range. And so that makes sense logically, but the hard part about it is, is that there is no rule or hard fast number that you can apply to it. It takes some.

00:21:40 Dave

Intuition and it also takes some knowledge of the business and the history of the company and the interest of their work in to kind of extend those numbers to give you.

00:21:50 Dave

A range of what you think the value could be, and it's not easy and it's not. It's not hard and you can't apply it to every single company because the simple fact of the matter is, is that companies rise, a companies fall and they go out of business and it happens to all of them. You know, if you looked at 30 years ago and you asked our grandparents.

00:22:11 Dave

For our parents, do you think GE would be not the dominant business that it is today? Nobody would have said yes.

00:22:16

Yes.

00:22:17 Dave

I mean, and look at it now. It's a shell of itself, and it used to be one of the most dominant business in in the United States. And now it's, you know, it's a shell. And we look at Microsoft and Apple and think that's never going to happen to them, but.

00:22:30 Dave

It could it? Probably.

00:22:32 Dave

Will at some point we don't want it to, but that's just the reality of.

00:22:36 Dave

Of investing as nothing stays the same forever.

00:22:41 Andrew

You know Vitali Katznelson did a e-mail that he did recently. It was a article he wrote, I think he said was one of the first ones he ever wrote. It was like 1994 or something.

00:22:53 Andrew

And he was talking about the danger of what he I don't know if he called it or somebody else called it, like religion stocks.

00:23:00 Dave

Yeah. Religion stocks, yeah.

00:23:02 Andrew

Have you read this?

00:23:03

Yeah.

00:23:04 Andrew

It was. It was fascinating that you brought up Coca-Cola.

00:23:05 Dave

MHM.

00:23:08 Andrew

And and really with with the presence of any of these religion stocks, they become religion stocks because they make people a bunch of money. And then so because the stocks been so good for so long, it gets this cult type following.

00:23:14

MHM.

00:23:22 Andrew

Use Coca-Cola as an example.

00:23:24 Andrew

Oh no, I guess he wrote this in 2004. So it was 20 years ago, not 30. My bad, looking at Coca-Cola and at the time in 1999.

00:23:32 Andrew

Thing the PE got to something like a 45.

00:23:37 Andrew

And the 10 year growth rate of earnings at the time was 14.2%. So you look at that and you would say.

00:23:45 Andrew

Why wouldn't they continue? They have. They've had, like, amazing, amazing CEO.

00:23:52 Andrew

Earnings growth at 14% a year for 10 years like.

00:23:54 Andrew

What's not to love?

00:23:56 Andrew

And.

00:23:58 Andrew

You Fast forward just a few five years later, and then even looking back in hindsight today it hasn't been.

00:24:07 Andrew

I mean, yeah, the relative strength between Coca-Cola and Pepsi and say Doctor Pepper, it's still there, but the I guess the thing that that.

00:24:17 Andrew

Brained and think of is maybe people becoming more health conscious or something.

00:24:24 Andrew

So a disruption if you will, that came out of left.

00:24:27 Andrew

Field.

00:24:28 Andrew

That maybe Cokes moo didn't get weaker against its competitors, but something else came customers preferences changed and it just goes to show that.

00:24:40 Andrew

That idea of a CAP and the limitedness of it is a very uncomfortable thing.

00:24:49 Andrew

To have to deal with as an investor.

00:24:52 Dave

It is.

00:24:52 Andrew

But if we were to respect history.

00:24:55 Andrew

Then we'll know that.

00:24:56 Andrew

It's something to watch out for, yes.

00:24:59 Dave

Yeah, exactly. I mean you you really have to.

00:25:02 Dave

You have to understand the history of the markets and understand the history of the businesses.

00:25:09 Dave

And to your point about Coca-Cola.

00:25:12 Dave

It doesn't last forever and you just have to as much as it sucks to take some of those things into account. You have to and you have to realize that when you're trying to figure out why does the market think this is so you know worth so much and it really comes down to.

00:25:32 Dave

I think that.

00:25:34 Dave

The markets looks at Walmart and they look at Costco and they think the dollar of earnings that Costco generates is more valuable than the earnings that Walmart generates. It doesn't mean that one's a better investment or another necessarily, but it just means that the market thinks that those those earnings are more expensive and it's like going to buy a car.

00:25:54 Dave

We use this example.

00:25:56 Dave

You go buy a car, you you buy a Tesla and you buy a BMW. Both luxury vehicles. If you pay 70.70 K for a Tesla and you pay 50K for a BMW, that means you think that the the value of the car or Tesla is worth more to you.

00:26:15 Dave

Than it is buying the BMW.

00:26:18 Dave

And they're both luxury vehicles. They're both great cars. They both could be electric for, for that matter. But you just you pay more for the other one because you think that's more valuable to you. And that's why when I, when I look at these companies that are higher priced, that's the way I interpret it is that the market looks at them and thinks that that, that dollar of value.

00:26:38 Dave

They generate is more valuable and it's going to be more valuable for a longer period of time than a competitor. And that's that's kind of how I try.

00:26:46 Andrew

To look at it.

00:26:47 Andrew

So how does an investor deal with the uncomfortableness of?

00:26:53 Andrew

The CAP and the agility of the.

00:26:55 Andrew

Cap.

00:26:56 Dave

That's a good question. That's one of the hard parts of investing, right is is dealing with.

00:27:01 Dave

The uncomfortableness I think.

00:27:04 Dave

The way I try to do it is by.

00:27:09 Dave

Spending a lot of time thinking about the Moat and competitors of the business.

00:27:17 Dave

And trying to.

00:27:20 Dave

Maybe not necessarily invert per se, but certainly think of worst case scenarios like stress test.

00:27:27 Dave

What? What? What could?

00:27:29 Dave

How could this go wrong? You know, you were talking about Coca-Cola earlier. You know what's not the love 14%, you know, earnings growth, you know that's that's awesome. Especially for a business like Coke, you know, that's.

00:27:41 Dave

That's not a.

00:27:41 Dave

High tech business. So you think about companies today that that you know, we're talking about some of these special businesses.

00:27:50 Dave

That's what I think about is I think about, OK, what what could unseat Pasco? What could unseat Visa? What could go wrong with this investment and how likely do I think that is? And I think the more that I get to know the businesses and the business models and understand them better and the competitors and then I think that really helps me.

00:28:09 Dave

Understand why the market is valuing visas dollar more than somebody else.

00:28:14 Dave

'S.

00:28:15 Dave

And why I think that will be a longer period of valuation than others.

00:28:21 Dave

What are your thoughts on that?

00:28:23 Andrew

I think it's a.

00:28:23 Andrew

Good answer, OK.

00:28:26 Dave

All right, folks. Well, with that, we'll wrap up our conversation on CAP or competitive advantage period. I hope you enjoyed our conversation today. If you are unfamiliar with this term, go check out Michael Mollison's paper he wrote about this extensively. You can just type in competitive advantage period and Michael Mobisson and you will discover.

00:28:45 Dave

It on the.

00:28:46 Dave

Miracle that Google is also he also writes about it in his book expectations investing.

00:28:51 Dave

As well. So those are two good resources beyond and there's a nice conversation today. It could be really helpful when you're valuing companies and trying to just think more deeply about the businesses that you own or want to own. And so with that, we'll go ahead and sign us off. You guys go out there and invest with the margin of safety. If that's on the safety, have a great week and we'll talk to you next week.

00:29:10 Speaker 2

We hope you enjoyed this contest.

00:29:13 Speaker 2

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00:29:24 Speaker 2

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00:29:36 Speaker 6

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00:00:02

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00:00:05 Speaker 1

Quick, they actually got me into reading stats for anything.

00:00:08 Speaker 1

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00:00:10 Speaker 2

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00:00:15 Speaker 1

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00:00:22 Speaker 1

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00:00:32 Dave

Alright folks, welcome to investing for beginners podcast. Today we have episode 362. Today Andrew and I are going to discuss something related to valuation. It's called cap or competitive advantage period and this is a term I'm not sure if Michael Mobisson originated it, but I associated with him in his writings.

00:00:53 Dave

So with that, we're going to go ahead and just kind of dive into the topic and then we'll just see where it takes us. So, Andrew, do you want to maybe kind of give everybody maybe a 30,000 foot view of what a cap is or competitive advantage period might be?

00:01:08 Andrew

Yeah, I'm happy to. So you have businesses, you have the economy, you have a bunch of average businesses and then you have the select few businesses that are.

00:01:21 Andrew

So good at what they do, so able to make profits so able to grow that they create what's called excess returns or basically just.

00:01:31 Andrew

Returns and growth that's higher than the average.

00:01:36 Andrew

In order to do that.

00:01:38 Andrew

For a long time, sustainably, you usually need some sort of competitive advantage to do that, and the competitive advantage or the Moat helps you to sustain that.

00:01:49 Andrew

And so for every business and in every industry that's going to look different and maybe a lot of businesses in certain industries don't even have 1, you could argue, but for.

00:01:52

Right.

00:02:00 Andrew

If you really outstanding businesses, they have this competitive advantage period, which is a period of time where they are able to.

00:02:09 Andrew

We will put on the market.

00:02:11 Andrew

Because they have a Moat and that's what competitive advantage period is as far as I understand it. I'm no expert, but I have read at least one of Robinson's writings about the cap.

00:02:26 Andrew

And so that's my understanding of it. And with that kind of as a backdrop, why is it? Why is it important or how does it explain certain market?

00:02:37 Andrew

Behaviors if you.

00:02:38 Dave

Will. Yeah. The interesting thing about it is I think it helps to me, it helps explain.

00:02:46 Dave

Why those certain businesses that you're referring to?

00:02:50 Dave

Tend to have higher valuations for longer periods of time and you can think about throw out some usual suspects that kind of fit into this.

00:03:01 Dave

This realm, if you will, companies like Visa, MasterCard, Costco, Hermes, Porsche are just some of the ones that just kind of come to to mind. Naturally, you never, ever, ever not, never, ever. You rarely see them trade for low multiples, low PE's.

00:03:20 Dave

E of 15 for any of those companies we just mentioned, it's unheard of. And so when you think about a competitive advantage period.

00:03:30 Dave

It makes sense because the way we normally air quote value companies is using something like a DCF or a discounted cash flow model and generally with those you project 5 or 10 years of cash flows and then discount them back to the present day and value the company based on.

00:03:52 Dave

All those machinations.

00:03:53 Dave

The problem is, is that when you're looking at a company like MasterCard who has developed this very strong Moat, a very strong brand, a not unbeatable company, no company is unbeatable, but just a very strong competitive business.

00:04:09 Dave

Using a 10 year period is too short and so the competitive advantage period is a way of extending that valuation model to give you an idea of what really the company is worth because you're not.

00:04:26 Dave

It can't just be limited on a 10 year period. Now none of us can see 10 years into the future and trying to look 17 years into the future just for example, seems even more particularly daunting. And it's not easy. But it's to me, it's more about a thought exercise.

00:04:43 Dave

About how you you.

00:04:44 Dave

Use the valuation model and how you think about looking at a value of a company like a MasterCard compared to competitors, PayPal or something along those lines, the mote is way bigger for MasterCard than it is for other companies in their industry. Discover for example, it's way bigger than discovers and.

00:05:05 Dave

And so you have to value them differently, even though they're in the same industry, you can't value Amazon the same way you value Walmart. And so it's or Costco and Walmart. They're they're not the same businesses, even though they are, you know, big box grocery, you know, stores.

00:05:22 Dave

Different and we all know that intuitively, but when you value them, I think you have to look at.

00:05:29 Dave

You have to look at the value of them of of them longer so.

00:05:33 Dave

I guess when you're thinking about this kind of thing, I like to think about.

00:05:39 Dave

Not only the mode, but also how wide that mode is and is the mode growing and does. What are your thoughts on that?

00:05:49 Andrew

Do you have a long term mindset searching for safe compounders? So am I and I'm investing my entire life savings with the picks from valuespotlight.com.

00:06:02 Andrew

I think it's always important to consider Moat and consider whether it's growing or decaying. Some again, very select few types of businesses.

00:06:14 Andrew

Have modes that.

00:06:17 Andrew

As part of the secret of the mole is the automatic strengthening of it.

00:06:23 Andrew

It's a virtuous cycle. So Nick, sleep talked about this when he.

00:06:30 Andrew

I don't know if he was the.

00:06:31 Andrew

First person to.

00:06:32 Andrew

Explain this idea, but he definitely popularized it. Probably one of the first people to this idea of scale economy shared so scale economy shared is a type of Moat that it gets stronger the longer it lasts really.

00:06:47 Andrew

And.

00:06:49 Andrew

To give you like a Long story short, it's basically if the mole is from scale, which means as a company gets bigger, gets a stronger mole like a Costco you mentioned.

00:06:59 Andrew

Then.

00:07:01 Andrew

In Costco's case, they share the benefits of their scale with their customers, and so the bigger Costco gets, the more valuable they become to the customers.

00:07:11 Andrew

And the more money the customers give to them, and then the more valuable they become the customers. So you see how it's a self reinforcing loop.

00:07:18 Andrew

Now you can say scale advantages.

00:07:22 Andrew

And you could say lots of businesses have scale damages. That's not the same thing because it's not self reinforcing, there's not a.

00:07:31 Andrew

A loop that builds on itself and so that that would be the difference. But when I think of.

00:07:37 Andrew

How do you find modes that are widening?

00:07:40 Andrew

That's that's such a hard thing to do because, like you said, who can who has a crystal ball who can see the future 10 years alone when you're out. But there are a few businesses and we can debate.

00:07:54 Andrew

Any business going down the list, whether that's the case for them or not, but there are a few that actually do get stronger and so it becomes a it becomes more of a question of.

00:08:06 Andrew

Is something terrible going to happen to this business, but you can for any, which is why you diversify your your investments.

00:08:12 Andrew

But if that's the question versus.

00:08:16 Andrew

You know a million other questions that you have to ask yourself whether remote is going to strengthen or not the the easier one, the easier decision.

00:08:24 Andrew

And one that's more likely to be long lasting is 1 where.

00:08:28 Andrew

It's already ingrained in it, and it has that virtuous cycle. Those are kind of my thoughts on winding modes. Do you have other things that you think of when you hear the winding note idea?

00:08:38 Dave

Yeah, I think.

00:08:40 Dave

I think of how do you measure that and I don't know that you can and like, is there any quantitative way that you can measure?

00:08:50 Dave

This, this, you know, mastercards mode is widening and I don't know that there's a way. There's some subtle ways that maybe you could see if the companies margins are expanding or if the revenue growth is maybe accelerating, maybe some of those things might give you an indication that they're they're.

00:09:12 Dave

They're widening their mode, or they're capturing more market share from their.

00:09:16 Dave

Matters. And so those things could give you some clues, but I think you know, to your point of what Nick Sweep was talking about, when I think about Visa and MasterCard, maybe through the lens of what he was talking about, it's not exactly the same. But the idea that the businesses are getting better.

00:09:37 Dave

Just helps strengthen the moats for those businesses.

00:09:40 Dave

And if I think about MasterCard and Visa, for example, those companies are working towards, not necessarily pivoting but adding additional revenue streams to what is already the core part of their business in the anticipation that those other parts of the business become a bigger, bigger part.

00:10:01 Dave

Share of how those companies continue to grow, and to me that indicates that aid the core business is also is already really strong.

00:10:11 Dave

But it also they also have opportunities or options optionality I guess to not pivot but to move into other things that can be maybe ancillary, but also complementary to what they're doing and it also indicates to me that because of their openness and willingness to work with competitors.

00:10:31 Dave

Directly, IE Ojin, Bitcoin, PayPal, all these other companies.

00:10:38 Dave

Being willing and able to work with them also helps to me strengthen their Moat, because those are the people that in theory could try to compete away some of what MasterCard and or visa are trying to do and take some market share with them. But because MasterCard and Visa are.

00:10:56 Dave

Aggressively open about working with other companies or other systems like Bitcoin, then that to me helps reduce the threat of disruption or somebody coming in and and undermining what it is that they do. And until there is some sort of new payment rail.

00:11:16 Dave

That.

00:11:17 Dave

Kind of encompasses everything. I don't know that there's something that's on the horizon that could disrupt those companies and to me that that just gives them more strength.

00:11:29 Dave

For their Moat, and it also means that their competitive advantage period is going to be longer than somebody else in the payment space because.

00:11:39 Dave

Those other companies you know, throw out a couple that have been kind of the rage on on Fenwick recently. Wise and remitly, these are companies that do a lot of cross-border payments and moving money around different parts of the world and whatnot. And I don't know either one of them as intimately as I do visa.

00:11:59 Dave

But I also know that that's something that Visa competes in.

00:12:02 Dave

And if you're going to value what visa is doing or is attempting to do, you know kind of comparatively to those other two companies, I would put a longer growth period or a longer period on that being a valuable resource for visa than I would the other two companies. I don't know that they'll be.

00:12:19 Dave

As successful over.

00:12:20 Dave

As long a period as visa could be.

00:12:23 Dave

And so when you're thinking about valuing the company, I would give a lot more value to the for a longer period of time to visa because of that and all the other things that they do than I would for something like wise, wise remitly. I'm not saying those are bad investments. I'm just saying that when you value them, I would look at them completely.

00:12:41 Dave

Different differently.

00:12:43 Dave

Does that make sense?

00:12:45 Andrew

Yeah, for sure. Do you think this is a loaded question, I guess because every situation is different, obviously, but do you think the market generally behaves that way too or do you think?

00:12:57 Andrew

Other things.

00:13:00 Andrew

Get beat up.

00:13:02 Andrew

Does it just?

00:13:03 Andrew

Depend on what industry we're talking about.

00:13:06 Dave

Yeah, it could depend. I mean, there's I think there's certainly things.

00:13:13 Dave

If you look at wise and remitly, I think people are undervaluing the value of their cash flows. Whereas I think with Visa and MasterCard they're assigning a higher.

00:13:26 Dave

A higher price to their value because it's a longer period of value and it's going to be.

00:13:33 Dave

More valuable, longer as wise and remitly are.

00:13:38 Dave

They've both been around for 5-10 years, but they're also still early in the in the journey in what they're doing and there's no, there's no guarantee that that visa at some point may.

00:13:52 Dave

Outdo both of.

00:13:52 Dave

Them and that could be a very big thing for them and MasterCard and.

00:13:59 Dave

What wise and remitly are doing?

00:14:02 Dave

Could be.

00:14:04 Dave

Repeated away and very easily. And so I think that the market is actually probably thinking that that's what's going on because if you look at the the financials, if you look at the revenue growth, the wise for example, it's.

00:14:17 Dave

It's for documents.

00:14:19 Dave

You know 6070% crazy numbers, but the market is not valuing.

00:14:24 Dave

Very much. It's not valuing it very highly, it's it's a lower rated company if you will. And I think a lot of it is because there's a lot of uncertainty that and they really.

00:14:35 Dave

Continue to compete in the space when Visa and MasterCard, the juggernauts are there and are capable of doing what they're doing as easily. If they choose to do it.

00:14:48 Andrew

A lot of times that's kind of what it comes down to, right when you have these differences in valuation.

00:14:56 Andrew

People are going to say different things, but a lot of it can come down to if you're talking to, let's be clear. If you're talking a long term investors who are looking to buy and hold something and compound it and just sit there and do nothing.

00:15:12 Andrew

The differences in valuation or maybe more differences on how long?

00:15:17 Andrew

Do people expect?

00:15:20 Andrew

A competitive advantage to last for a certain company.

00:15:24 Dave

Yeah, I mean, you know, we were talking earlier on our evaluation hackathon about O'Reilly and I think if you think about how the market is treating that company or the way a lot of investors think about that company, is that the EV revolution is going to be ultimately is going to be.

00:15:43 Dave

The the death knell for a company like O'Reilly or AutoZone.

00:15:48 Dave

And.

00:15:49 Dave

I think because of that, investors look at their potential competitive advantage. Period is a lot shorter than they would a company like Tesla, for example. Tesla is, I think we all agree is is a unique case because you know of who drives the bus at that company and so he engenders a lot of.

00:16:09 Dave

Well, good and bad tension. And there is definitely some enthusiasm baked into.

00:16:18 Dave

The value of that company, but it's unquestionably that they've done a fantastic job doing what they do, but are they really going to come eat the lunch, you know, of some at some point of an AutoZone? I I.

00:16:30 Dave

Don't know we could.

00:16:31 Dave

Probably argue about that from now until the end of end of time, but I think the market, when they look at AutoZone and O'Reilly, I think they.

00:16:38 Dave

I think they look at them as like, not that they're bad companies, but they're like dead men walking because disruption is coming for them. It's just a matter of.

00:16:46 Andrew

Based on low multiple.

00:16:50 Speaker 5

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00:17:08 Speaker 5

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00:17:22 Andrew

Alright. Do you think there are ways that the CAP?

00:17:28 Andrew

Ideas taken too far, where people kind of run with it.

00:17:33 Andrew

And or do you? Have you seen examples of that where people kind of run with?

00:17:36 Andrew

The cap idea. Yeah. Yeah, for sure.

00:17:39 Dave

I think the way you can look at it.

00:17:41 Dave

Is there's a?

00:17:42 Dave

Couple ways you do.

00:17:42 Dave

Look at it so #1 when you're normally doing evaluation of a company, you want to estimate the terminal growth rate at roughly the GDP or somewhere.

00:17:54 Dave

In that range.

00:17:55 Dave

You know anything, anything above?

00:17:57 Dave

The growth rate of the GDP, if you do it to Infinity, then that's not.

00:18:03 Dave

That's not logical. It's not reasonable. It can't.

00:18:05 Dave

Happen because of.

00:18:06 Dave

Just the nature of compounding and I remember a story that Professor Damodaran talked.

00:18:11 Dave

About or he?

00:18:12 Dave

Had students turn in valuations and student turned in evaluation with Tesla and their terminal rate, which is normally 2 to 5%, give or take.

00:18:23 Dave

He had put an 8%.

00:18:25 Dave

And so the value of the company he was, you know, he was projecting basically that in a 20 year period that Tesla would be larger than the GDP of the United States. And if you win another 10 years, it would be larger than the GDP of the world. And so everything that everybody did.

00:18:45 Dave

It would have.

00:18:45 Dave

To be bought from Tesla and nothing else. And obviously that's not reasonable and no matter how much you drink the kool-aid, that's that's not reasonable for any.

00:18:56 Dave

Company and you and Costco, I guess the point is, is that when you think about those?

00:19:01 Dave

Things you have.

00:19:02 Dave

To think about it has to be you have to be logical and and try to be reasonable about that. And so when you're thinking about the competitive advantage period, the enthusiasm you have about a business has to be built into some sort of realities.

00:19:17 Dave

Of.

00:19:18 Dave

History of business how long companies have been in business, how long they can stay on top. You would be surprised how, how short that really can be. I don't have the numbers in front of me and I'm I'm not recalling them. And maybe Andrew can can fill in if he remembers, but the amount of time a company spends in the S&P 500.

00:19:38 Dave

As a member is not very long, it's I think it's less than 10 years.

00:19:42 Dave

And if you look back on the last 20 or 30 years of like the top ten companies I know Buffett showed this.

00:19:49 Dave

At A at.

00:19:50 Dave

A shareholder meeting recently, if you look at the last 20 or 30 years, the amount of companies that have stayed in that top ten of the S&P is 2 and Apple and Microsoft, the rest of them have all fluctuated.

00:20:03 Dave

In and out, you know there's been, there's been the ciscos, and then there's been the the exons and the, you know, companies like that. And then, you know, now we have Apple and Microsoft and NVIDIA, but.

00:20:15 Dave

Those you know, a lot of these companies are new new to S&P 500, new to the top. You know meta is new, NVIDIA is new, Tesla is New Berkshire Hathaway is new. You know, they've been around for 60 years, but this is a new thing for them. And so my point with all that is that when you're trying to value a company and you're looking at this.

00:20:35 Dave

The idea of of extending your valuation because you think their competitive advantage is going to be a lot longer than a 10 year period, it may very well be, but it can't be 40 years just because that's just not it's not logical, it's not sustainable and if it is, it's going to be 1 Unicorn Company 1 and not.

00:20:53 Dave

One of them, and one Unicorn company that could possibly do that. And there's always outliers when you're thinking about.

00:21:01 Dave

Valuing companies and you just have to be. You have to try to be as reasonable as you possibly can and.

00:21:08 Dave

The thing that I like about the competitive advantage period is it helps explain maybe why a company like a Costco or a MasterCard seems like it's always expensive.

00:21:19 Dave

And.

00:21:20 Dave

It's because it is because the the value that the company is creating is a longer period than it's normal brethren in the 10 year range. And so that makes sense logically, but the hard part about it is, is that there is no rule or hard fast number that you can apply to it. It takes some.

00:21:40 Dave

Intuition and it also takes some knowledge of the business and the history of the company and the interest of their work in to kind of extend those numbers to give you.

00:21:50 Dave

A range of what you think the value could be, and it's not easy and it's not. It's not hard and you can't apply it to every single company because the simple fact of the matter is, is that companies rise, a companies fall and they go out of business and it happens to all of them. You know, if you looked at 30 years ago and you asked our grandparents.

00:22:11 Dave

For our parents, do you think GE would be not the dominant business that it is today? Nobody would have said yes.

00:22:16

Yes.

00:22:17 Dave

I mean, and look at it now. It's a shell of itself, and it used to be one of the most dominant business in in the United States. And now it's, you know, it's a shell. And we look at Microsoft and Apple and think that's never going to happen to them, but.

00:22:30 Dave

It could it? Probably.

00:22:32 Dave

Will at some point we don't want it to, but that's just the reality of.

00:22:36 Dave

Of investing as nothing stays the same forever.

00:22:41 Andrew

You know Vitali Katznelson did a e-mail that he did recently. It was a article he wrote, I think he said was one of the first ones he ever wrote. It was like 1994 or something.

00:22:53 Andrew

And he was talking about the danger of what he I don't know if he called it or somebody else called it, like religion stocks.

00:23:00 Dave

Yeah. Religion stocks, yeah.

00:23:02 Andrew

Have you read this?

00:23:03

Yeah.

00:23:04 Andrew

It was. It was fascinating that you brought up Coca-Cola.

00:23:05 Dave

MHM.

00:23:08 Andrew

And and really with with the presence of any of these religion stocks, they become religion stocks because they make people a bunch of money. And then so because the stocks been so good for so long, it gets this cult type following.

00:23:14

MHM.

00:23:22 Andrew

Use Coca-Cola as an example.

00:23:24 Andrew

Oh no, I guess he wrote this in 2004. So it was 20 years ago, not 30. My bad, looking at Coca-Cola and at the time in 1999.

00:23:32 Andrew

Thing the PE got to something like a 45.

00:23:37 Andrew

And the 10 year growth rate of earnings at the time was 14.2%. So you look at that and you would say.

00:23:45 Andrew

Why wouldn't they continue? They have. They've had, like, amazing, amazing CEO.

00:23:52 Andrew

Earnings growth at 14% a year for 10 years like.

00:23:54 Andrew

What's not to love?

00:23:56 Andrew

And.

00:23:58 Andrew

You Fast forward just a few five years later, and then even looking back in hindsight today it hasn't been.

00:24:07 Andrew

I mean, yeah, the relative strength between Coca-Cola and Pepsi and say Doctor Pepper, it's still there, but the I guess the thing that that.

00:24:17 Andrew

Brained and think of is maybe people becoming more health conscious or something.

00:24:24 Andrew

So a disruption if you will, that came out of left.

00:24:27 Andrew

Field.

00:24:28 Andrew

That maybe Cokes moo didn't get weaker against its competitors, but something else came customers preferences changed and it just goes to show that.

00:24:40 Andrew

That idea of a CAP and the limitedness of it is a very uncomfortable thing.

00:24:49 Andrew

To have to deal with as an investor.

00:24:52 Dave

It is.

00:24:52 Andrew

But if we were to respect history.

00:24:55 Andrew

Then we'll know that.

00:24:56 Andrew

It's something to watch out for, yes.

00:24:59 Dave

Yeah, exactly. I mean you you really have to.

00:25:02 Dave

You have to understand the history of the markets and understand the history of the businesses.

00:25:09 Dave

And to your point about Coca-Cola.

00:25:12 Dave

It doesn't last forever and you just have to as much as it sucks to take some of those things into account. You have to and you have to realize that when you're trying to figure out why does the market think this is so you know worth so much and it really comes down to.

00:25:32 Dave

I think that.

00:25:34 Dave

The markets looks at Walmart and they look at Costco and they think the dollar of earnings that Costco generates is more valuable than the earnings that Walmart generates. It doesn't mean that one's a better investment or another necessarily, but it just means that the market thinks that those those earnings are more expensive and it's like going to buy a car.

00:25:54 Dave

We use this example.

00:25:56 Dave

You go buy a car, you you buy a Tesla and you buy a BMW. Both luxury vehicles. If you pay 70.70 K for a Tesla and you pay 50K for a BMW, that means you think that the the value of the car or Tesla is worth more to you.

00:26:15 Dave

Than it is buying the BMW.

00:26:18 Dave

And they're both luxury vehicles. They're both great cars. They both could be electric for, for that matter. But you just you pay more for the other one because you think that's more valuable to you. And that's why when I, when I look at these companies that are higher priced, that's the way I interpret it is that the market looks at them and thinks that that, that dollar of value.

00:26:38 Dave

They generate is more valuable and it's going to be more valuable for a longer period of time than a competitor. And that's that's kind of how I try.

00:26:46 Andrew

To look at it.

00:26:47 Andrew

So how does an investor deal with the uncomfortableness of?

00:26:53 Andrew

The CAP and the agility of the.

00:26:55 Andrew

Cap.

00:26:56 Dave

That's a good question. That's one of the hard parts of investing, right is is dealing with.

00:27:01 Dave

The uncomfortableness I think.

00:27:04 Dave

The way I try to do it is by.

00:27:09 Dave

Spending a lot of time thinking about the Moat and competitors of the business.

00:27:17 Dave

And trying to.

00:27:20 Dave

Maybe not necessarily invert per se, but certainly think of worst case scenarios like stress test.

00:27:27 Dave

What? What? What could?

00:27:29 Dave

How could this go wrong? You know, you were talking about Coca-Cola earlier. You know what's not the love 14%, you know, earnings growth, you know that's that's awesome. Especially for a business like Coke, you know, that's.

00:27:41 Dave

That's not a.

00:27:41 Dave

High tech business. So you think about companies today that that you know, we're talking about some of these special businesses.

00:27:50 Dave

That's what I think about is I think about, OK, what what could unseat Pasco? What could unseat Visa? What could go wrong with this investment and how likely do I think that is? And I think the more that I get to know the businesses and the business models and understand them better and the competitors and then I think that really helps me.

00:28:09 Dave

Understand why the market is valuing visas dollar more than somebody else.

00:28:14 Dave

'S.

00:28:15 Dave

And why I think that will be a longer period of valuation than others.

00:28:21 Dave

What are your thoughts on that?

00:28:23 Andrew

I think it's a.

00:28:23 Andrew

Good answer, OK.

00:28:26 Dave

All right, folks. Well, with that, we'll wrap up our conversation on CAP or competitive advantage period. I hope you enjoyed our conversation today. If you are unfamiliar with this term, go check out Michael Mollison's paper he wrote about this extensively. You can just type in competitive advantage period and Michael Mobisson and you will discover.

00:28:45 Dave

It on the.

00:28:46 Dave

Miracle that Google is also he also writes about it in his book expectations investing.

00:28:51 Dave

As well. So those are two good resources beyond and there's a nice conversation today. It could be really helpful when you're valuing companies and trying to just think more deeply about the businesses that you own or want to own. And so with that, we'll go ahead and sign us off. You guys go out there and invest with the margin of safety. If that's on the safety, have a great week and we'll talk to you next week.