

Investing into Economic Moats

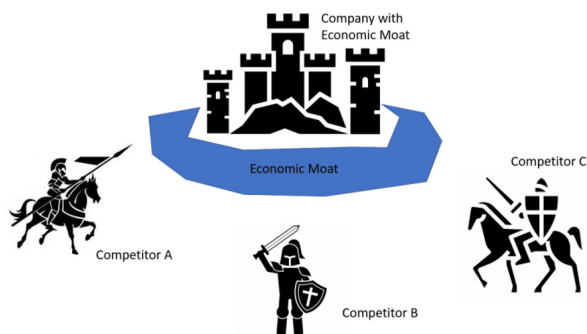


The notion of sustainable competitive advantage, put forward by Warren Buffet, is at the heart of fundamental analysis. Here is an overview.

Charles-Henry Monchau *Chief Investment Officer*

What is an “Economic Moat”?

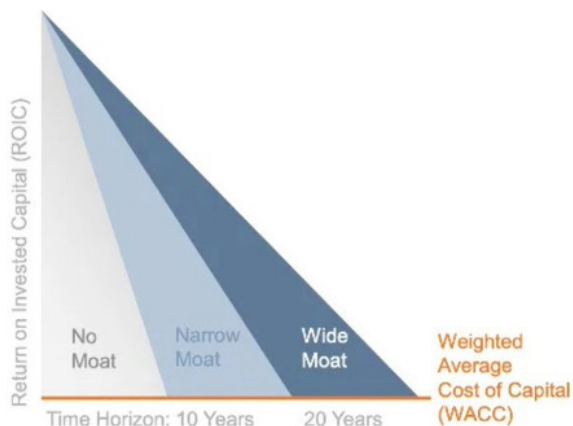
Initially used by Warren Buffet, a moat is the sustainability of a company’s competitive advantage. In a market-based economy, competition is attracted to areas of activity in which companies have high profitability. With the arrival of new competitors, the profitability of companies tends to erode. Only companies with a significant competitive advantage are able to fend off competitive forces in a sustainable way.



Source: Capuccino Finance

For Morningstar, the "economic moat" allows a company to generate excess economic returns over an extended period of time. Economic moat is the return on capital employed (or "ROCE") compared to the weighted average cost of capital (or "WACC").

The higher the economic moat, the higher the ROIC will be compared to the WACC over a longer period of time.



Two criteria must be met to have a moat: 1) the prospect of a return on capital that exceeds its cost; 2) sources of competitive advantage that will prevent this return from being rapidly eroded.

The concept of "economic moat" (sustainable competitive advantage) is often used as a central element in the fundamental analysis of companies. It also plays a key role in assessing the long-term investment potential of a stock and in estimating its intrinsic value.

Indeed, companies with structural competitive advantages tend to generate high returns on invested capital, which allows them to generate earnings growth and free cash flows above the market. As a result, stock market performance is often better than that of the indices.

The 5 types of “Economic Moat”



1. Switching costs

This type of competitive advantage exists when a consumer faces significant costs in switching from one service provider to another.

These costs give providers negotiating power over prices which allows them to maintain relatively high margins.

Intuitive Surgical, ADP, Oracle, Stryker and Salesforce are good examples.

2. Intangible assets

This category includes trademarks, patents and regulatory licenses. New entrants do not have this type of competitive advantage and therefore are not able to duplicate the product or service of the first entrants.

Companies such as Coca Cola, Sanofi, Johnson & Johnson and Unilever should be included in this category.

3. Network effects

Network effects are one of the most privileged sources of an "economic moat". The more people use a certain product or service, the more valuable the network becomes. Visa/ Mastercard, Ebay, Meta (Facebook) and Alphabet (Google) are good examples.

4. Cost advantages

When a company can operate at sustainably lower costs than its competitors, it has a competitive advantage that is difficult to replicate.

Ikea, Shell, Amazon.com, ABInBev and Walmart are among the companies that enjoy this type of competitive advantage.

5. Economies of scale

Oligopolistic markets are served by only a few firms. These firms generate economic benefits, but new entrants would reduce the returns to capital of the established players to a level at or below the cost of capital. The oligopoly situation protects them from new entrants.

UPS, utilities and some transport companies are in oligopolistic (or monopolistic) situations and thus benefit from economies of scale.

Buffett's Monopoly Companies

Industry	Buffett's Investments	Market Share	Industry Leaders
Credit & debit cards	Visa, Mastercard, Amex	99	Visa, Mastercard, American Express
Credit rating agency	Moody's	95	S&P, Moody's, Fitch
Kidney dialysis	Davita	92	Fresenius, Davita
Rail transportation	BNSF Railway	87	BNSF, Union Pacific, CSX, Norfolk Southern
Paint	Benjamin Moore	84	Sherwin-Williams, Benjamin Moore, Behr
Courier	UPS	82	UPS, FedEx
Domain names	Verisign	80	Verisign
Domestic airlines	DAL, AAL, UAL, LUV	80	Delta, American, United, Southwest
Batteries	Duracell	75	Duracell, Energizer
Mobile homes	Clayton Homes	71	Clayton Homes, Champion, Cavco
Gold & silver mining	Barrick Gold	66	Newmont, Gold, AngloGold, Kinross
Soda	Coca-Cola	57	Coca-Cola, PepsiCo, Keurig Dr Pepper
Commercial Banking	JPM, BAC, WFC, USB, BK	44	JPM, BAC, WFC, C, USB

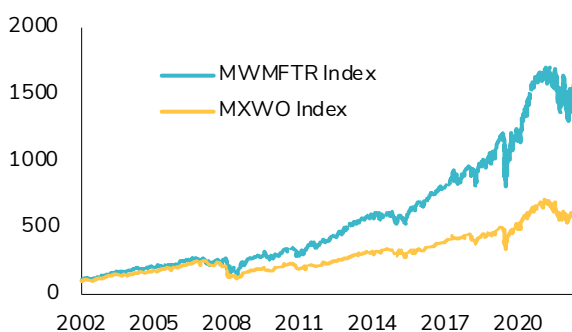
Source: Compounding Quality

What is the historical performance of this investment approach?

U.S.-based Morningstar has created indices that reflect the performance of a basket of stocks selected using the "Economic Moat" investment approach.

Since 2002, the Morningstar Wide Moat Focus Total Return Index has outperformed the MSCI World Index by more than 5% per year (see chart below).

Total Return performance of the Morningstar Wide Moat Focus Total Return Index vs. the MSCI World Index from 9/30/2022 to 1/31/2023



Source: Bloomberg

US asset manager VanEck has launched ETFs (Exchange Traded Funds) that replicate this type of index. Among them the VanEck Morningstar Global Wide Moat UCITS ETF (NB: this is NOT an investment recommendation).

The 10 largest holdings of this ETF are included in the table below (source: Van Eck).

TOP 10 Holdings (%) as of 31 Dec 2022

Total Holdings: 68				
Holding Name	Ticker	Shares	Market Value (USD)	% of Net Assets
AIRBUS SE	AIR FP	14,657	1,736,650	2.29
BLACKBAUD INC	BLKB US	29,235	1,720,772	2.27
SAFRAN SA	SAF FP	13,521	1,687,188	2.23
EMERSON ELECTRIC CO	EMR US	17,179	1,650,215	2.18
ANHEUSER-BUSCH INBEV SA/NV	ABI BB	27,432	1,647,405	2.17
ROPER TECHNOLOGIES INC	ROP US	3,655	1,579,289	2.08
ZIMMER BIOMET HOLDINGS INC	ZBH US	12,360	1,575,900	2.08
BLACKROCK INC	BLK US	2,221	1,573,867	2.08
SANOFI	SAN FP	16,320	1,564,789	2.06
IMPERIAL BRANDS PLC	IMB LN	62,700	1,561,987	2.06
Top 10 Total (%)				21.50

Source: VanEck

Final words

Just as physical moats protect castles from enemies, economic moats—or sustainable competitive advantages—protect companies from competitors. Legendary investor Warren Buffett devised the economic moat concept. It can be seen as the foundation of a successful stock-investing philosophy for most fundamental, long-term oriented investors.

Source: Compounding Quality, Morningstar

For further information

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